

The Global Financial Crisis and Regulatory Response

***- Challenges for the future of
financial services liberalization -***

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****Any views expressed in this presentation
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Today's Presentation

- I. Update on the global financial crisis and the measures taken**
- II. Lessons from Japan's experience in financial crisis management**
- III. Recent discussions in international forums**
- IV. Challenges for financial services liberalization**

I. Update on the global financial crisis and the measures taken

Origin of the Current Financial Crisis

- It started out as financial market turmoil caused mainly by losses from US sub-prime loans and related securitized products such as residential mortgage backed securities (RMBS).
- Now, it has grown into a full-scale financial crisis with **huge and cumulating losses incurred by financial institutions across a broad spectrum of securitized products and loan portfolios.**

Declaration of the G20 Summit on Financial Markets and the World Economy

November 15, 2008

Root Causes of the Current Crisis

- ***Market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence.***
- ***Weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system.***

(G20 Summit) Root Causes of the Current Crisis (cont.)

- ***Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.***
- ***Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes.***

Extent of Losses at Global Financial Institutions

- IMF estimates total losses for the global financial system amounted to 2.2 trillion US dollars (January 2009).
- Major global financial groups have *each* posted cumulative losses of tens of billions of dollars.
- Japanese financial institutions have collectively lost around 3.2 trillion yen (over 30 billion dollars).

Current Status

- **Severe stress and loss of confidence in the global financial markets have created market paralysis and caused a global credit crunch.**
- **Such a situation in the financial markets has led entire economies into a rapidly deepening recession. No country is immune anymore.**
- **Urgent need has arisen for a quick policy response.**

Current Status (cont.)

- **In the past months, governments and central banks have been working in close coordination to implement measures for restoring market confidence and stabilizing the financial system (e.g. public capital injection, nationalization, full protection of bank deposits, credit guarantees, purchase of toxic assets etc.).**
- **However, conditions in the credit markets remain extremely tight. Such tight credit conditions will probably continue for some time.**

Current assessment for Japan

- **Japan's financial system itself is still in a less severe condition compared to US and Europe.**
- **In terms of losses incurred and exposures to securitized products, the direct impact of the global financial market turmoil has been relatively small.**
- **Early implementation of Basel II for all deposit-taking institutions, as of end-March 2007, may have helped Japanese financial institutions in improving risk management and control.**

Current assessment for Japan (cont.)

- **However, as the global financial market turmoil intensified since the collapse of Lehman Brothers last September, credit conditions in Japan have also deteriorated sharply.**
- **The real economy has now fallen into negative growth, and share prices have declined, strongly affecting the balance sheets and profitability of Japanese financial institutions.**
- **De-coupling is no longer possible.**

Examples of Measures Taken

- The Japanese government and the Bank of Japan, in coordination with other relevant bodies, have been taking **various measures to improve credit conditions for businesses** with a strong sense of urgency.
- Such measures include those aimed at enhancing credit to SMEs, strengthening the capital of deposit-taking institutions using public funds, and providing for more clarity in accounting standards for financial products.

Examples of Measures Taken (cont.)

- **Measures to strengthen the regulatory framework from a medium to long-term perspective have also been implemented.**
- **Examples are revisions to supervisory guidelines for improving the transparency of securitized products, and enhancing risk management and disclosure by financial institutions based on global best practice.**
- **The regulatory framework for credit-rating agencies is to be strengthened.**

Permanent measures to ensure financial stability and to prevent financial crises

- **Early warning system and prompt corrective action (PCA) scheme based on capital adequacy and other indicators of risk**
- **Public administration in case of insolvency or liquidity shortage (including the use of a bridge bank scheme)**
- **Deposit insurance system and other safety net provisions to protect depositors**
- **Possibility to use public funds in recapitalizing banks, or to nationalize a bank**

II. Lessons from Japan's experience in financial crisis management

Lessons from Japan's experience in financial crisis management

- 1. Prompt and accurate recognition of losses is essential***
- 2. Toxic assets need to be taken off the balance sheet.***
- 3. Undercapitalization of financial firms needs to be addressed, if necessary, by injecting public funds as capital.***
- 4. Exceptional measures, such as full guarantee of all bank deposits and temporary nationalization of troubled banks, can be useful in times of serious crises.***

Lessons from Japan's experience in financial crisis management (cont.)

- 5. ① Short-term measures to contain the adverse effects of the ongoing crisis, and, ② Re-designing of the regulatory framework in the medium to longer-term need to be implemented simultaneously and in a balanced manner.**
- Important to strike an appropriate balance between these two strands of policies.**
- (Japan in the 1990s may not have been a success story in this respect.)**

Balancing the act

- **Policies to strengthen prudential regulation and supervision need to be balanced with the principles of a free market economy.**
- **Care should be taken not to over-regulate, and suppress market activity and competition.**
- **Measures taken need to be consistent with liberalization commitments under the GATS and EPAs/FTAs.**

III. Recent discussions in international forums

Main recommendations of the FSF WG (April 2008)

- **Further enhancement of risk management practices at financial institutions**
- **Revisions to Basel II capital rules**
- **Improving transparency and valuation of complex financial products**
- **Improving the supervisory monitoring system and stress-testing**
- **Further international supervisory cooperation, particularly in information exchange and cross-border supervisory oversight**
- **Establishing rules for the proper role and conduct of rating agencies, and encourage proper use of the ratings by investors.**

Statement by G-7 Finance Ministers and Central Bank Governors on Global Financial Market Turmoil September 22, 2008

- **We reaffirm our strong and shared commitment to protect the integrity of the international financial system and facilitate liquid, smooth functioning markets, which are essential for supporting the health of the world economy.**
- **We strongly welcome the extraordinary actions taken by the United States to enhance the stability of financial markets and address credit concerns, especially through its plan to implement a program to remove illiquid assets that are destabilizing financial institutions. We also strongly welcome the measures taken by other G-7 countries. Major central banks have been coordinating to address liquidity pressures in funding markets, which has been critical in addressing disruptions in global financial markets. Several regulators have taken decisive actions to combat market manipulation and stabilize financial markets, including a temporary ban on short selling of financial stocks.**

Statement by G-7 Finance Ministers and Central Bank Governors on Global Financial Market Turmoil (cont.)

- We recognize the importance of making regulation more effective and bringing investors back into a liquid and stable marketplace. **We remain committed to full and rapid implementation of the Financial Stability Forum (FSF) recommendations to enhance the resilience of the global financial system for the longer term.** We look forward to the FSF report this fall on progress made in strengthening prudential supervision and regulation, improving firms' risk management practices, enhancing disclosure and transparency, and strengthening accounting frameworks.
- We pledge to enhance international cooperation to address the ongoing challenges in the global economy and world markets and maintain heightened close cooperation between Finance Ministries, Central Banks and regulators. **We are ready to take whatever actions may be necessary, individually and collectively, to ensure the stability of the international financial system.**

Declaration of the G20 Summit on Financial Markets and the World Economy

November 15, 2008

Actions Taken and to Be Taken

- ***Continue our vigorous efforts and take whatever further actions are necessary to stabilize the financial system.***
- ***Recognize the importance of monetary policy support, as deemed appropriate to domestic conditions.***
- ***Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.***

(G20 Summit) Actions Taken and to Be Taken (cont.)

- ***Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support.***
- ***We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.***

(G20 Summit) Common Principles for Reform of Financial Markets

- ***Strengthening Transparency and Accountability***
 - ***Enhancing Sound Regulation***
 - ***Promoting Integrity in Financial Markets***
 - ***Reinforcing International Cooperation***
 - ***Reforming International Financial Institutions***
- **G20 Action Plan to Implement Principles for Reform** (to be followed up and updated at London G20 Summit, 2 April 2009)

G20 Finance Ministers' and Central Bank Governors' Communiqué

14 March 2009

- **Made recommendations to the London Summit to ensure:**
 - **all systemically important financial institutions, markets and instruments are subject to an appropriate degree of regulation and oversight, and that hedge funds or their managers are registered and disclose appropriate information;**
 - **stronger regulation is reinforced by strengthened macro-prudential oversight;**

G20 Finance Ministers' and Central Bank Governors' Communiqué (cont.)

- **financial regulations dampen rather than amplify economic cycles, including by building buffers of resources during the good times...but it is vital that capital requirements remain unchanged until recovery is assured; and,**
- **strengthened international cooperation to prevent and resolve crises, including through supervisory colleges, institutional reinforcement of the FSF, and the launch of an IMF/FSF Early Warning Exercise.**

G20 Finance Ministers' and Central Bank Governors' Communiqué (cont.)

● Also agreed to:

- regulatory oversight, including registration, of all Credit Rating Agencies whose ratings are used for regulatory purposes;**
- full transparency of exposures to off-balance sheet vehicles;**
- the need for improvements in accounting standards;**
- greater standardization and resilience of credit derivatives markets;**
- the FSF's sound practice principles for compensation;**
- identify non-cooperative jurisdictions and develop a tool box of effective counter measures.**

IV. Challenges for financial services liberalization

Actions under way

- **Financial regulators around the world are vigorously working to **urgently** reform the regulatory framework for financial services, as set out in the FSF recommendations and the G20 Summit Action Plan.**
- **Substantial adjustments, including correction of excessive leverage, misaligned incentives favoring short-term profit-taking, and excessive reliance on credit ratings, are required.**

Regulatory Overhaul and Liberalization

- **A complete overhaul of prudential regulation and supervision on a global scale is now indispensable.**
- **The gaps in the regulatory system must be filled, and regulatory arbitrage prevented.**
- **On the other hand, it appears difficult to point to liberalization of financial services trade under the GATS as the *direct* cause of the current crisis, as countries are not in any way prevented from taking measures for prudential reasons under the GATS (Annex on Financial Services).**

The Challenges

- **Simply back-tracking on financial services liberalization will only deepen the crisis, further exacerbating the contraction of credit flows, and undermine the real economy.**
- **This is another type of “protectionism” we all wish to avoid.**
- **Pressures to “ring-fence” domestic financial markets must be resisted.**

Need for prudential regulation and supervision to proceed in tandem with liberalization

- **It has been made clear since during the Uruguay Round negotiations that **the economic gains of trade liberalization must be underpinned by appropriate regulatory and supervisory regimes.****
 - **But it has become clear that international standards and best practices for prudential regulation and supervision have been weak and incomplete.**
- “For all of the benefits derived from good regulation, mistakes were made.” (Jamie Dimon, 11 March 2009)**

The Way Forward

- Action to coordinate prudential regulation and supervision across countries must be pursued **urgently**, through enhanced dialogue and cooperation between regulators of developed and emerging-market countries.
- The FSF has decided to broaden its membership (Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey to join, along with Spain and the EC). So has the Basel Committee.
- **The G20 Summit is expected to develop a roadmap for further action.**

How the WTO can help

- **The WTO can contribute by resisting protectionist pressures in services trade.**
- **It can also help in supporting the ongoing efforts of regulators in overhauling prudential regulation and supervision.**
- **Members should be able to benefit once again from liberalization of financial services trade when global financial markets stabilize, but they need to be reassured that appropriate prudential measures are in place.**
- **Technical support to this end may be crucial.**

Making further progress in financial services negotiations

- **Standardization and convergence of prudential regulation across countries may facilitate future negotiations for liberalization, without unduly endangering the integrity and stability of the financial system.**
- **For example, developing country-by-country inventories of prudential measures could be useful in assisting this process. (*cf. Masamichi Kono and Mamiko Yokoi-Arai, “Dissecting Regional Integration in Financial Services from the Competition Policy and Trade Policy Perspectives”, BIS Papers No.42, October 2008.*)**

Thank You

