Financial Regulation in Asia

Basel 3 and Asia

There has been a feeling for some time in Asia that Basel bank regulatory standards have been devised primarily by European and North American developed countries for their own purposes and that these standards have not always been appropriate to the Asian context. Asian regulators are generally more wedded to direct control mechanisms rather than the Basel principle of allowing freedom of activity but imposing risk-based capital requirements.

Nevertheless, Basel standards became increasingly important as benchmarks for financial sector reform in the wake of the Asian crises of the late 1990s. It is unclear if increased Asian representation in the G20, FSB and the BCBS since 2009 has increased ownership of Basel standards in the region, at least among the major Asian countries. How this expansion of Basel Committee membership might have changed attitudes and internal dynamics within Asia more broadly is also an open question.

The diversity of Asia also raises a variety of questions about implementation. First, high-income countries such as Japan, Singapore, Hong Kong, Australia, and Korea have banking sectors with asset sizes generally in excess of 100% of GDP. In contrast, for many lower income countries that figure is well below 50% and banks are relatively unsophisticated. The applicability of the Basel internal models approach to the latter cases is doubtful, suggesting that the standardized approach will be most relevant for these countries. The compliance costs may still be substantial, raising questions of resources and capacity in both the public and private sectors. Basel risk weights have also been seen to discriminate against SMEs, which might affect disproportionately those Asian countries in which these firms are relatively dominant.

Second, banking sector structure in the region varies widely. In many of the lower income countries, banking sectors are dominated by government and/or foreign owned banks. The latter creates home-host issues, while the former raises the question of whether and how much government ownership substitutes for capital. In regard to foreign owned banks, the problems of cross-border resolution arrangements made apparent by the GFC seems likely to increase requirements for separately capitalized subsidiaries rather than branch entry. But in many Asian countries, entry is primarily via joint ventures, making the ultimate regulatory responsibility and coordination a more complex issue. Asian economies generally do not have special bank resolution regimes.

Third, there may be a growing trend for required capital ratios to differ between countries in the region, raising the question of whether this provides competitive advantages to banks in countries with lower minimum requirements. This will depend on a number of factors, including tax systems (e.g. the presence of dividend imputation and company tax rates) and the presence/importance of explicit or implicit government guarantees on bank deposits and debts. Basel 3 liquidity requirements create further issues, with many countries having an inadequate supply of high quality liquid assets to meet the Liquidity Coverage Ratio (LCR) requirement. This problem includes some high income countries (Australia, Singapore, and HK) who have low government debt levels.

The trend in some countries (China, India, Hong Kong, Mongolia the Philippines, and Singapore) to adopt higher minimum capital requirements than required by Basel III points more generally to a growing level of unilateralism in financial regulation. This points to the continuing challenge of coordinating regulation in the region. Regulatory unilateralism of this kind has also been an issue in more financially integrated Europe, but the EU's new Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR) limit the scope for regulatory unilateralism as part of an effort to maintain the integrity of the single market for financial services. CRD IV allows for some national discretion in these areas but under Article 133, member states intending to apply more stringent national capital requirements must notify and justify them to the Commission, the European Banking Agency and the European Systemic Risk Board. The Commission may issue a negative opinion on grounds that the measure(s) distort the internal market, though may in turn be overruled by the European Council. The extent of such additional national regulatory stringency is also restricted. Possible justifications for national regulatory divergence in the EU include national real estate market bubbles and perhaps the higher systemic risks borne by countries such as the UK with large international financial centres.

The European experience suggests the need for greater regional regulatory coordination as market integration grows, but Asia so far lacks the formal mechanisms to achieve such coordination.

Questions for further research:

1. How is Basel III being implemented in Asian countries? Which are the areas of greatest divergence? Will specific rules be adopted as domestic legislation, or will substantial discretion be granted to regulatory and supervisory agencies?
2. How, if at all, should Asian financial regulation differ from Basel III?
3. What is the evolving division of supervisory responsibility between home and host regulators?
4. What will be the economic impact of Basel III implementation in Asia?
5. Does the recent expansion of Asian participation in the Basel process reduce or increase incentives to coordinate financial regulation in the region?
6. What are the major private sector forums that contribute to regulatory dialogue in the region?
7. What impact do all these processes have on the perceived accountability and legitimacy of financial regulation in Asia?