Banking Supervision and Regulations in East Asia and the Prospect of Regional Cooperative Framework‡

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(Incomplete and preliminary)

1. Introduction

The role of the countries in the East Asian region has always been considered important in the global economy. Japan as one of the biggest economies in the world is situated in this region. Some of the most successful stories of emerging economies have also originated from this region. These include the stories of China, Republic of Korea (Korea), Republic of China (Taiwan), Hong Kong SAR, and most of the ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore, Thailand, Viet Nam). Recently the region has become even more important, especially since the rise of China to become one of the big economies in the world. The majority of the countries in the region have also increased their impacts in the world economy. The ASEAN (Association of South East Asian Nations) region has always been considered as a strong alliance with high potential to emerge as another economic force in the world. Indonesia and the Philippines have been among the countries that managed to weather the global financial crisis with persistent positive growth. China, Indonesia, and Korea also have joined Japan to raise their impact in determining the direction of the global economic reform in the world with their membership in the Group of Twenty (G20).

In terms of economic integration, East Asia is definitely left behind by the European Union. There has not been any significant development that can be used as a sure sign of future economic integration in East Asia. ASEAN countries already have target to reach ASEAN Economic Community in 2015, which is a step further from the rest of the countries in East Asia region. Because of the East Asian financial crisis in 1997-1998, ASEAN + 3 already set up a liquidity risk sharing arrangement through the swap agreements. Although the regional cooperation among countries in East Asia is not as established as it is in Europe, the steps toward economic cooperation among countries in the region have been taken. The region has various fora that provide many opportunities to

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share ideas, establish mutual understanding as well as deliberate high level commitment among governments in the region. Although there is still a long way to go to form an intergovernmental body to represent the region (beyond ASEAN), the countries in the region have already been involved heavily in many cooperative efforts in different economic interests (e.g. ASEAN, ASEAN+3, EMEAP, SEANZA). This means that at least the countries in ASEAN + 3 have strong basis for cooperation within the framework of crisis management triggered by the experience of the East Asian financial crisis in 1997-1998.

In terms of financial market, the plan for economic integration faces an obstacle with the fact that the East Asian countries are not in a level playing field. East Asian governments surely can draw a lot of lessons from EU experiences. If we take a snapshot to the ASEAN countries, there exists a gap – although nowadays it is narrowing – between the economic development in ASEAN 6 (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand) and that in ASEAN 4 or CLMV (Cambodia, Lao PDR, Myanmar and Viet Nam). The gap has to be bridged in order to have a smooth process of economic integration. Despite the strong trade relations in ASEAN + 3, the group has been developed because of the common interest to establish macroeconomic stability in the region in the aftermath of the 1997-1998 financial crisis. However, the same problems exist in this cooperative framework. The three countries (China, Japan and Korea) are in the league of their own. The heterogeneity of the economic levels is also reflected in the development of financial markets. Although Singapore can be considered as an advanced financial market, the other ASEAN economies have a long way to go to catch up with the Three and Singapore.

With the plan to establish ASEAN Economic Community (AEC), ASEAN countries make a stronger case for some level of economic integration. In November 2007, ASEAN leaders agreed on the blueprint that will focused on establishing ASEAN as a single market and production base making ASEAN more dynamic and competitive with new mechanisms and measures to strengthen the implementation of its existing economic initiatives; accelerating regional integration in the priority sectors; facilitating movement of business persons, skilled labors and talents; and strengthening the institutional mechanisms of ASEAN1. In the process towards AEC, the ASEAN countries are committed to reduce the gap existed between the ASEAN 6 (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, Thailand) and CMLV (Cambodia, Myanmar, Lao PDR, Viet Nam) through the Initiative for ASEAN Integration and other regional initiatives. In preparing toward the AEC, the ASEAN financial institutions have geared up to anticipate the economic integration by increasing their competitiveness and degrees of openness for cross border access within the ASEAN countries. Although the financial markets of the ASEAN big 5 (Indonesia, Malaysia, the Philippines, Singapore, Thailand) are relatively up to

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1 ASEAN (2007).
compete in the global market, the rest of ASEAN countries still have to play catch up in order to competitively join the global market.

Given the strategy of the AEC is to increase the openness of the region to the global market, in addition to the strengthening the prudential regulations of the financial sectors, the governments and financial authorities of the ASEAN nations have to pay extra attention to the regulations that mitigate the risk exposure stemmed from conducting cross-border financial transactions. The risk now has different channels to travel. It used to be only through the foreign exchange markets. Now, it can also travel through the capital market and local-currency-denominated money market. Strong financial regulations and supervision are believed to be one of the keys in preventing financial crisis. The experiences of East Asian crisis in 1997-1998 as well as of the recent global financial crisis have also provided the lessons that strong linkages within the global financial markets are capable of facilitating crises to travel across borders. Given this, regional and international fora have recently put additional emphasis on the importance of cross-border financial supervision. The urgency of financial supervisors being able to access information from a financial institution outside their jurisdiction has been one of the top issues within the G20 forum facilitated by the Basel Committee for Banking Supervision (BCBS) and the Financial Stability Board (FSB). China, Indonesia, Japan, and Korea certainly can contribute ideas in both committee and board, as well as share the knowledge and information in the regional fora.

Nevertheless, each nation, whose economy already becomes dependent on the financial market in allocating resources among economic players, must now pay attention to the issues of financial stability. The history of financial crises in the world, especially since the East Asian crisis in 1997-1998, has proven that the impact of a financial crisis could cause economic regression that sometimes could further cause a change in the political regime. The recent crisis amplified the importance of detecting the potential threat before it takes place. It also makes us realize that financial crisis changes forms. It may materialize through a different type of financial institutions, travel to other countries in different channels, take place in different cycles of economy and different stages of economic development.

Microprudential supervision has been established for a long time, ever since the banking institutions were heavily scrutinized and regulated. However, economic crises in the current century has shown that microprudential approach is not sufficient to prevent financial crisis. Nowadays, for financial stability purposes, it is hard to separate microprudential concerns (financial institution supervision) from macroprudential concerns. The experience of Indonesia in November 1997 in the midst of the East Asian financial crisis, shows that considering only the institutional impact in a crisis resolution caused more problems byway of the decline of confidence in the banking system. At the time Indonesia
decided to close 16 private banks that account for only about 3% of the whole banking system. No deposit insurance scheme was in place in advance of the closure. What transpired next is the case of flight to safety, where depositors withdrew funds from private and smaller banks and transfer it to state-owned or foreign banks or abroad, creating systemic impact to the banking system. Failure to consider the systemic impact of closing down a financial institution also transpired in the case of the bankruptcy of Lehman Brothers. The repercussion of the Lehman Brothers case even reached the financial systems in emerging markets. The recent financial crisis has reminded financial authorities that micro- and macro-prudential approaches have to be combined together to obtain effective financial supervision that will guarantee the financial stability.

Given the challenges of the financial supervision everywhere in the world, there are at least two things that can be incorporated in each national level and regional level of financial supervision arrangement. In national level, they are 1) to incorporate macroprudential surveillance into the financial supervisory framework and combine the concerns with the microprudential setup that may have been more established; and 2) to open a channel of communication among national supervisory bodies (when there are more than one in the country) and improve the surveillance to achieve an effective consolidated supervision in the national level. While in regional level, they are: 1) to develop a common language that can be used in sharing information amongst macroprudential surveillance bodies and microprudential supervisory bodies within the region; and 2) to establish channels of communication to support the early warning system and crisis alert mechanism and develop crisis management arrangement within the region.

This paper is aimed at discussing issues in implementing financial regulations and supervision in the framework of regionalism in East Asia, especially in ASEAN and ASEAN + 3. The rest of the paper will be organized as the following. Chapter 2 will discuss about the East Asian financial structure and regulations, with some comparison to the European financial system. Chapter 3 pays special attention to the systemic risk surveillance with discussions of some concerns in light of the recent financial crisis. Chapter 4 addresses the regional financial safety net, which has become more important in the case of unavoidable crisis in the financial system. Chapter 5 provides discussion in combining the micro- and macro-prudential surveillance for regional and the possibility of inter-regional arrangement. And Chapter 6 closes.

2. East Asian Financial Structure and Regulations with Some Comparison to European Financial Systems

Historically, the economic development of the countries within the East Asian region has been focused on opening the region for free trade and free capital mobility. The success stories within the region have been revolving around how opening the region has allowed
capital to flow in, which in turn accelerated the economic growth in the region. China story may be different, and it has been vastly documented by various literatures. Because of the free capital mobility, most emerging economies in the region managed to develop their banking system. The striking difference between East Asia and Europe is the fact that the majority of countries in East Asia are emerging markets, and only one country belongs to the G7 group. Although China nowadays started to emerge as a new power economy, it is still categorized as emerging market according to the IMF definition. Europe comprises many industrialized countries, in which four of them are in the G7. Countries in Western Europe are mostly developed economies, while countries in Central and Eastern Europe are mostly emerging markets. This difference is reflected in the development of the financial markets. IMF GFSR of October 2009 provides the indicators that can be used to represent the size of the financial markets (see Table 1). While the ratio of total equities, bonds and bank assets to GDP in Japan (503.3%) is well over that in European Union (488.3%) or Euro Area (452.7%), the financial markets of the rest of Asia only count for 245.7% of the GDP. However, Emerging Asia ratio is approximately three times the ratio in Emerging Europe (87.4%).

Table 1. Europe and East Asia Financial Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP</th>
<th>Equities (Capitalization)</th>
<th>Bonds (Debt Securities)</th>
<th>Bank Assets</th>
<th>Equities, Bonds, and Bank Assets (in percent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Union</td>
<td>17,037.4</td>
<td>7,262.8</td>
<td>29,137.0</td>
<td>46,802.4</td>
<td>83,202.1</td>
</tr>
<tr>
<td>Euro Area</td>
<td>13,538.4</td>
<td>4,984.7</td>
<td>23,793.3</td>
<td>32,510.8</td>
<td>61,288.8</td>
</tr>
<tr>
<td>Emerging Europe</td>
<td>4,125.5</td>
<td>641.6</td>
<td>898.3</td>
<td>2,065.2</td>
<td>3,605.1</td>
</tr>
<tr>
<td>Japan</td>
<td>4,910.7</td>
<td>3,209.0</td>
<td>11,478.4</td>
<td>10,027.0</td>
<td>24,714.4</td>
</tr>
<tr>
<td>Emerging Asia</td>
<td>8,902.0</td>
<td>5,326.7</td>
<td>4,832.9</td>
<td>11,708.4</td>
<td>21,868.0</td>
</tr>
</tbody>
</table>

All numbers are in billions of U.S. Dollars. Emerging Asia countries are Asian countries that belong to the group Other Emerging market and Developing Countries defined by World Economic Outlook (IMF), together with Hong Kong, Korea, Singapore, and Republic of China (Taiwan). Emerging Europe countries are European countries that belong to the group Other Emerging Markets and Developing Countries defined by World Economic Outlook (IMF), together with Israel

In both regions the bank assets are more dominant than financing with equities or bonds. This makes the banking system important in both regions. Although the banking architecture in each country may determine the risks faced banks in any types of crisis, the financial authorities still have to pay more attentions to the banking system as the financing of the economy is dependent on the health of the banking system. This may also be the
reason when the banking systems of East Asia were hit during the crisis of 1997 and 1998, it
had caused a significant economic downturn in the region. This is also true for Europe

The dominance of the banking system can be explained as the following. The region
has a history of asymmetric information problems. Transparency and disclosure policy are
areas in the financial system that still need improvement in the region. This makes bond
markets in the region underdeveloped. Some countries in East Asia just had a boost in the
bond markets because of the recapitalization program to the banking system after the
financial crisis in 1997-1998. The exposure of corporate bonds is relatively small in the
region, especially compared to the emerging markets in Latin America. This is caused by lack
of confidence in the corporate sector that will lead to high cost of funding from the bond
market. On the other hand, the household sectors of the region also have low exposure to
the financial markets. Their preferred investment instruments are concentrated in bank
deposits. This creates low investment demand from the household sectors, which means
even lower demand for bond instruments. For these reasons, funding is concentrated in the
banking sector. The intermediation function of the banking system is an advantage since
banks are better able to put price on the values of investment through their due diligence
and they can require debtors to provide complete information and collaterals.

The shallowness of the financial markets in some countries in the region also makes
their financial regulations mostly address the banking system and the most simple
transactions in the capital markets. Derivative and structured products are thin in these
countries. If we take the ratio of M2 to GDP, the numbers of Indonesia and the Philippines
from 1997 to 2009 are still around 40% to 60%, while those numbers of Malaysia, Singapore,
and Korea have reached above 140%, and of Thailand around 110% by 2009. The lack of
exposure to complicated financial products in the region also have sealed some countries in
the region from the negative impact of the recent financial crisis. It is not surprising that
Indonesia and the Philippines are two of the countries in the world that still have positive

With regard to the banking regulations, most countries in the region are tune to the
international standards set in the framework of Basel Committee of Banking Supervision,
especially Basel II. In some countries, the soundness indicators still follow CAMELS.
However, the supervisory framework has moved on to adopt the risk-based management. In
2009, the banking systems in the region has capital adequacy ratio (CAR) well over 8% (see
Tabel 2). Some countries, namely Hongkong and Singapore, set the requirement of
minimum CAR above 8%. Although each country has its own timetable in complying to all
the standards, it is in their interests to finally implement all the international standards of

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2 CAMELS: Capital, Asset Quality, Management, Earning, Liquidity and Sensitivity to Risks
banking regulations. With the commitment of the G-20 countries to even further strengthen the banking prudential regulations, China, Korea, Indonesia and Japan can even contribute to determine these standards.

Tabel 2. Bank Regulatory Capital to Risk-Weighted Asset (CAR)

<table>
<thead>
<tr>
<th>Country</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>Latest</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>4.9</td>
<td>8.4</td>
<td>12</td>
<td>n/a</td>
<td>December</td>
</tr>
<tr>
<td>Hong Kong SAR</td>
<td>15.2</td>
<td>13.4</td>
<td>14.2</td>
<td>n/a</td>
<td>June</td>
</tr>
<tr>
<td>Indonesia</td>
<td>21.3</td>
<td>19.3</td>
<td>16.8</td>
<td>17.8</td>
<td>April</td>
</tr>
<tr>
<td>Korea</td>
<td>12.8</td>
<td>12.3</td>
<td>12.3</td>
<td>12.9</td>
<td>March</td>
</tr>
<tr>
<td>Malaysia</td>
<td>13.5</td>
<td>13.2</td>
<td>12.7</td>
<td>14.2</td>
<td>April</td>
</tr>
<tr>
<td>Philippines</td>
<td>18.1</td>
<td>15.7</td>
<td>15.5</td>
<td>n/a</td>
<td>December</td>
</tr>
<tr>
<td>Singapore</td>
<td>15.4</td>
<td>13.5</td>
<td>14.3</td>
<td>n/a</td>
<td>September</td>
</tr>
<tr>
<td>Thailand</td>
<td>13.6</td>
<td>14.8</td>
<td>13.8</td>
<td>n/a</td>
<td>December</td>
</tr>
</tbody>
</table>


In most countries in East Asia region, the central bank (or sometimes the monetary authority) is the sole authority of the banking supervision (integrated approach). The fact that some central banks in the region only have the supervision authority on the banking system and not on the entire financial sector (functional approach or institutional approach) seems irrelevant considering the banking system is dominant in the region. However, with the growing integration of the financial sector by the engineering of the financial products, the coordination among financial authorities of the financial sector becomes important. This is contrast to the banking supervision in European countries. Shared authority of banking supervision or the existence of an independent institution outside the central bank that holds the authority to regulate and supervise the banks are commonly found in the financial systems in Europe. Although in some cases the micro-prudential regulations are still within the authority of the central banks, the fact that there is a possibility of multiple institutions sharing authorities in different parts or conducts of the system (twin peaks approach) makes the consolidated and comprehensive assessment of a financial institution more complicated. Given the strength and weaknesses of each approach, Barth et al (2003) found that the structure of the financial supervisory authorities does not influence bank performance. The empirical research, of course, cannot quantify the value of the intangibles that can be found in each country's setup. These intangibles are independent from the institutional design of the financial supervision authorities. Given this, the next question would be “Does the structure of the financial supervision authority influence the degree of success in crisis prevention and resolution?”
The East Asian financial crisis that had hurt most of the region in 1997-98 has been a blessing in disguise in facing the recent financial crisis. Because of the new breed of crisis during that time, many countries in the region has since embarked on structural reforms of the financial system. Prudential regulations and supervisory frameworks have been strengthened and enforced with the sense of urgency to restore the credibility of the financial markets in the region. Combine with the lack of exposure to structured products, the years of strengthening the banking system has brought sound fundamentals within the banking systems. The East Asian banking systems did not have to suffer severely because of the structured asset price depreciation, although they were not immune to the global shock stemmed from the bankruptcy of Lehman Brothers in September 2008. With various measures to overcome the illiquidity problems especially during the last quarter of 2008, they were able to maintain solvency and profitability.

The East Asian crisis was also a lesson for the governments in the region about the importance of setting up a better regional financial cooperation as well as a good early warning system and a regional financial safety net. Some initiatives were taken in the region. The first and probably the most important one is to increase contingent liquidity support in the case of systemic illiquidity problem in a country. The countries of ASEAN + 3 agrees on the arrangement following the meeting in Chiang Mai on May 6, 2000. This agreement is then called Chiang Mai Initiative (CMI). CMI is aimed to provide emergency balance of payment support. It is initiated with series of bilateral currency swap agreements among the nations, with the possibility of establishing a pool fund for the region to fight currency speculation. After a meeting in Bali in May 2009, the CMI is escalated to be multilateral arrangements called CMI Multilateralisation (CMIM). CMIM was signed on December 29, 2009 and will take effect in March 24, 2010 with a pool of fund reaching US$120 billions.

In addition to CMI, ASEAN+3 finance ministers setup routine meetings to discuss about Economic Review and Policy Dialogue. This is the chance for the ministries in the region to share their macroprudential information in order to strengthen the surveillance capacity in East Asia. ASEAN+3 also exchange information on short-term capital flow to facilitate effective policy dialogue. The Asian Bond Market Initiative (ABMI) is aimed at developing efficient and liquid bond markets in Asia as well as providing a benchmark for the development of domestic bond market in each country in the region. This is a financial deepening effort in the region that enables better allocation by facilitating access to the market through various players and types of bonds. The development the domestic bond market is intended to diversify the investment products in the region as well as provide competition to the banking system to increase the efficiency of the intermediation process. This is also another effort to establish a level playing field.
CMIM is a monetary arrangement and it is a strong beginning for further enhancement of the regional initiatives in crisis resolution. However, crisis prevention requires even stronger commitment within the region. Although the finance ministers of ASEAN+3 countries have been sharing macroeconomic information in routine meetings, technical-level cooperation is still needed to speed up the information sharing.

3. Some Issues in Systemic Risk Surveillance (Macroprudential Approach)

With the current development of financial regulations and supervisions, the regulatory framework itself is not enough to safeguard the financial stability. When the regulatory framework addressed the microprudential supervision, the macroprudential surveillance should be done under the systemic regulatory framework. The objective of the macroprudential surveillance is to detect the potential systemic problem in the financial system.

Macroprudential surveillance takes both top down and bottom up approaches by means of doing stress testing. In the top down approach, macroeconomic variables are taken into account in order to determine the stress level of the financial system. This is the easier approach since macroeconomic data is easier to obtain and the transmission channels are well known. Nowadays, many institutions (e.g., the IMF) have provided publicly accessible data. While other institutions (e.g., the World Bank, BIS) provide more rigorous data accessible by the financial regulators (central banks or financial supervision authorities). In the meantime, the domestic market and financial institution data should be made available by the financial authorities by means of microprudential surveillance.

Given the recent experience, the scope of the macroeconomic data to be used in the top down approach should not only cover country-level data (e.g., exchange rate, inflation, balance of payment), but also the global financial indicators, which includes the global financial markets and systemically important global financial institutions. In addition, recent crisis also taught regulators to also pay attention to the unthinkable. They are variables that were overlooked in the systemic risk surveillances in the past, such as risk concentration, trading liquidity risk, geopolitical situation and security, or even an increase of risk premium of one country.

The bottom up approach starts from the case of idiosyncratic shock experienced by the financial institution, working its way through the linkages to determine the systemic impact in the case of financial distress experienced by the institution. The difficult part is determining which institutions to start. The systemically important financial institutions can be easily determined by the asset size. However, the definition of a financial institution with systemic impact is different during crisis, and the determinants are not merely the size of the institution. It is important to keep the definition dynamic according to the crisis
situation. An institution may have systemic impact during a crisis situation by the linkages that connect the institution to the other entities in the financial system. The institution that has systemic impact during a financial crisis situation may not be isolated in the financial system, meaning it could also one of the large non-financial corporations. Therefore, determining which institution to stress test requires the knowledge of the financial system and the sensitivity to recognize the crisis transmission channels. The channels could be found by different approaches: 1) product exposure approach (financial instruments and institutional linkages); 2) business exposure approach (corporate sector); and 3) retail approach (household sector).

There are four different approaches in setting up the financial supervisory authority. They are: 1) integrated; 2) institutional; 3) functional; and 4) twin peaks approaches (Group of 30 (2008)). Stress testing under the integrated approach of financial supervision is easier to do. This means all data will be maintained in one institution. However, there is also the risk of being complacent with own analysis. Having different institutions conducting their own analyses can complement each other’s analysis. For the twin peaks approach of the financial supervision authority, smooth and frequent information sharing has to be established in order to obtain the latest and the most accurate data to conduct the stress test. As for other approaches (institutional and functional), the top down stress testing may risk not having the overall assessment of the financial system, as it will be done partially. The weaknesses of the non-integrated approaches have to be bridged with good communication between authorities and market players under the same mindset of maintaining the financial stability.

However, in practise, without common understanding on the objectives of the other function or institution, there is always a risk of miscommunication. The objectives and concerns of microprudential approach is different from the objectives and concerns of macroprudential approach. The common understanding will guarantee the sharing of the right set of information. What usually happens is that one institution may not put the same emphasis on the same set of information as the other institution. This results in some important information arriving too late at the institution that places high priority in gaining the set of information. This would disrupt the early warning system, risking potential systemic risk be detected too late.

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3 In integrated approach, there is only a single authority for all financial regulations. In institutional approach, there will be one regulator for each type of the institution (e.g. insurance company, bank, brokerage service). In functional approach, there will be one regulator for each type of business transacations. In the twin peaks approach, there will be separate regulators for two different objectives: 1) safety and soundness supervision; and 2) conduct of business.

4 The U.S. Financial Regulatory Act of 2008 established “regulation by objectives”, distinguishing between: 1) market stability regulation (for overall financial stability); 2) prudential regulation (to address limited market discipline); and 3) business conduct and consumer protection regulation (standards for business practices and products). There is a risk for having redundant or inconsistent regulations for this setup. There is also a strength for being able to exhaustively address all issues in the financial system.
The ultimate objectives of doing top down and bottom up stress testing is to detect the potential stress that may emerge in the financial system and to timely prescribe policy to mitigate the risks and prevent the financial stress to materialize (the financial stability objective). This objective should not be completely detached from the microprudential surveillance objective, which is to ensure good corporate governance (GCG) or business conducts and customer protection. The key to preventing the financial instability is to establish a credible financial market. This can be achieved by maintaining GCG and protecting the customers’ interests, having a good macroprudential surveillance system and setting up the financial safety net. We will be discussed the latter in the next chapter.

4. The Regional Financial Safety Net

The financial safety net is a framework that will be used when a financial crisis materializes. In the case of banking institutions, the establishment of the deposit insurance institution is a common practice in many countries. All banking systems in ASEAN+5 countries are supported by deposit insurance schemes. However, the financial safety net is not only about having a deposit insurance arrangement. Staying true to the name, the financial safety net is a set of arrangements that functions as a fallback plan during a financial distress to prevent a systemic risk or the collapse of the financial system. This includes the crisis management protocols and crisis resolution. Given the more integrated financial system with the possibility of the existence of more than one financial authorities as well as cross-border arrangement, a financial safety net can be a very complicated arrangement. The decision making in the arrangement requires cross-institution agreement supported by disaggregated information from different sectors in the financial system.

When it comes to setting up a regional financial safety net, having a stronger inter-governmental commitments is an advantage. In light of the recent crisis, the European Union has certainly established one of the first regional arrangement for crisis management. The Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability serves as the basis for the crisis management in the region. This cross-border arrangement is important for European Union considering the level of integration of the economies in the region. It also provides the common language to ensure the same level of urgency to address the situation and to deliver objective assessment of the potential impact to the financial systems in the region.

In the absence of the inter-governmental setup, during recent financial crisis, especially during the fourth quarter of 2008, East Asian countries responded with different levels of measures. Although the policy responses were proven effective, they are of

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5 Refer to Demirguc-Kunt et al (2005) for information on the timing of the establishment of deposit insurance in each country.
different levels. For examples, to prevent bank runs, almost all ASEAN+3 countries increased their deposit protection, but not in the same levels. For example, Singapore and Malaysia announced full guarantee for the deposits in local and foreign currencies within the national banking system, while Indonesia only increases the limit of the guaranteed deposit from Rp 100 millions to Rp 2 Billion per account. This still poses threat of creating imbalances in the region. In the presence of uncertainties, deposits in the amount higher than Rp 2 Billion can flow out of Indonesia to Singapore and Malaysia. Reducing the probability of flight to safety within the region is as important as reducing the probability of flight to safety within the national banking system. This is also true for other sets of policies, such as the direction of the interest rates movement, the measures aimed at reducing speculative transactions in foreign exchange and stock markets, and other common policies that can become concerted efforts to establish balance in the regional markets. Although each country may have its own set of problems according to the domestic financial structure and have different tools and ways to solve the problems, regional crisis measures have to be designed to create balance effects in the region to avoid one country loses while others win.

As it was mentioned earlier, in the case of cross-border crisis management within the region, ASEAN+3 only has the series of bilateral swap agreement that has developed into multilateral arrangement to back up liquidity problem (CMIM). The main objectives of the initiative are to provide contingent short-term liquidity fund in the region and to complement the existing international financial arrangements. The CMIM framework covers the arrangement of surveillance, reserve eligibility, size of commitment, borrowing quota and activation mechanism. The CMIM is as good as short-term systemic crisis resolution. There is still room for better sharing of information in the interests of maintaining financial stability in the region.

5. Issues in Combining Micro and Macro-prudential Surveillance for Regional Financial Supervision and the possibility of Inter-regional Arrangement

With the involvement of many countries with different levels of economic development and different financial infrastructures, combining micro and macro-prudential concerns in the regional and inter-regional financial stability purposes becomes a daunting effort. First, there is the need to have a mutual understanding of the financial stability objectives and concerns. Even in country level, this is still an issue that invites a lot of debate. The presence of systemically important institutions during normal conditions is an easier thing to communicate. However, justifying a failed institution with a systemic impact is a different issue that sometimes requires a long inquiries and political debates. The scarcity of the methodologies and the complete set of data to justify the systemic impact made the quality of the decision during crisis resolution is highly dependent on the quality of the qualitative judgement. In the process, policy makers often have to be in public scrutiny and
take the heat for trying to make the best decision out of the crisis situation. **Do policy makers need legal protection for making decision based on their expertise?** This is a tricky question, one that may be discussed for years and years to come, since it may involve the professional ethics and moral hazard behavior.

The experiences of recent crisis and the East Asian crisis in 1997-1998 should be enough motivation for national financial authorities to put financial stability as top priority. The lessons from the crises have taught us that crisis can spread quickly especially to neighboring countries or countries with strong financial linkages. When the urgency for maintaining the financial stability is established at the same level all over the region, for cross border arrangement, it is important to have a common language or protocols to assess and address the potential systemic impact in the regional financial system. In this case, it is also important to open all communication channels to share information amongst financial authorities in different countries in the region. The communication has to go both ways.

The threat of crisis spillover that travels from one region to another region should be enough to motivate the information sharing for early warning system for the possibility of a systemic impact is also experienced in countries with similar financial infrastructures or similar risk concentration. In addition, the establishment of the Supervisory College clearly signals the importance of paying special attentions to the systemically important global financial institutions. Most countries in ASEAN allows for close to full ownership of foreign banks whether it is in the form of branch offices or locally incorporated firms. The supervisory college then has the authority to gain access on the financial data of the branch offices or the subsidiaries that are operating in other countries. However, the access seems to be such that information can only flow one way, meaning the financial authority of the host countries cannot gain access to the financial data of the parent banks. This arrangement should be modified into two-way access. The host countries also have the need to gain information regarding the performance of the parent companies in order to determine the reputation risk as well as counterparty risk of the subsidiary or branch banks.

The more important - and probably the most important - aspect in the inter-regional cooperation of financial regulations and supervisions is the chance to share knowledge in conducting the micro- and macro-prudential surveillance as well as crisis resolution. Financial crisis has its way to morph into different forms or use different channels to travel. The prevailing frameworks and setups may not be sufficient to handle the shocks. Therefore, the accumulation of human capital is important to overcome the unthinkables. When supervisors, analysts and researchers are well-equipped with knowledge, complemented with data and resources they can always innovate and engineer the methodologies to support better assessment of the financial system, to detect financial risks and imbalances and to be ahead of the curve from the financial engineers that work for the financial institutions.
Europe and East Asia regions have similar visions in taking advantage of the geographical closeness to raise the competitiveness of the regions in the global economy. This makes up for a common ground for potential forum to learn from one another in order to reach the objectives of the regions. ASEM (Asia-Europe Meeting) has been established since 1996 to foster the cooperative efforts between the two regions. This also includes the area of financial regulations and supervision. Even when there is no formal inter-governmental/regional institution that can become the base for enforcing cooperative efforts, a stronger tie between Europe and East Asia seems imminent, especially with the recent global financial crisis. The G20 commitment has strengthened the tie amongst the member countries mandating to strengthen the financial regulation and supervisory frameworks within the member countries and take advantage of the tie to do cross-border supervision and surveillance.

As it was mentioned earlier, there is a difference between the institutional setup of the financial authorities between the European countries and East Asian countries. There is also the difference of the inter-governmental commitment. European countries have a more inter-governmental political commitment with the European Union. In terms of economic arrangement, European Union established itself as a single market. A common currency (Euro) is also used for some countries in the union. In East Asia, although not to the point of having a parliamentary body as in Europe, only ASEAN has the inter-governmental political commitment, while ASEAN+3 remains as an arrangement for economic cooperation crisis management for regional liquidity problem.

The common problem that exists in both regions is establishing a level of playing field in the respective regions. The heterogeneity of East Asian countries is also similar to the case in Europe. There are a number of countries that are still enroute to catch up with some of the more developed ones. While the European Union set up some pre-requisites to join the European Union, ASEAN sees the geographical closeness and cultural similarity as enough reason to form the association or to become members of the association. ASEAN 4 (CMLV) is not going to be left behind. The countries are encouraged and supported to developing their economic infrastructure to keep up with the pace of the ASEAN 6 (Indonesia, Malaysia, the Philippines, Singapore, Thailand and Brunei Darussalam). This may make the process of economic integration in ASEAN region longer.

Nevertheless, both regions found it important to have a sound prudential regulations for the financial system. What is considered sound nowadays is the regulatory framework that has countercyclical measures, encourage the establishment of market discipline and reduce the chance for moral hazard behavior. The regulatory framework also needs to foster intermediation process that supports economic growth, facilitate financial deepening but discourage excessive risk taking. Therefore, it is crucial to install incentives and disincentives
in the regulatory framework to ensure the financial market players behave with automatic adjustment and therefore support the financial stability objectives. Financial authorities should not be afraid to use financial engineering in its regulatory framework. The dynamic provisioning installed in Spain is one good example for authority using financial engineering to provide countercyclical measures for the banking system.

Given the similarity of the situation, Europe and East Asia have more reasons to work together in overcoming the hurdles for setting up the regional arrangement. The G20 commitments in complying to the standards setup under the initiatives of the Financial Stability Board and Basel Committee on Banking Supervision can lead both regions in establishing sound frameworks of regulations and supervision. Once the regional framework is established, there will be less barriers to establish inter-regional framework for banking regulation and supervision since they will be both up to the international standards.

6. Closing Remark

The relationship between East Asia and Europe has the potential to facilitate the efforts to detect the global imbalances, conduct surveillance for financial stability and to expand opportunities to diversify trading partners for risk sharing. The common interest in establishing credible financial markets in both region can be a strong basis for future inter-regional commitments to achieve the goal. There is an opportunity to learn from each other. East Asian countries had gone through a period of recovery from a severe financial crisis in 1997/1998, and therefore managed to produce the level of resilience that enabled the region to weather the recent global financial crisis. EU can learn from this experience. EU has gone through financial market integration overcoming the heterogeneity of the national financial markets in the region. East Asia, provided that this is the direction where the countries in the region would like to go, can learn from this experience. ASEAN blueprint for AEC in 2015 is certainly aiming for a single market just like what the European Union has established.
References

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