CAU Asia Focus

COUNTRY ANALYSIS UNIT FEDERAL RESERVE BANK OF SAN FRANCISCO DECEMBER 2011

Risk Management in a Global Environment

Introduction

Since 2007, the Federal Reserve Bank of San Francisco (FRBSF) has held an annual conference or symposium on banking and financial developments in Asia. The inaugural conference was held on the 10th anniversary of the Asian financial crisis and examined the impact of that crisis on Asian economies, and the financial and banking reforms that led to economic recovery and renewed growth throughout the region. Conference participants discussed lessons from the crisis, including lessons relevant to the United States and other Western economies.

In September, 2011, FRBSF hosted its sixth event in this symposium series entitled "Asian Financial Institutions: Risk Management in a Global Environment." Symposium participants considered the current financial crisis with a focus on understanding the policy, regulatory, and industry responses undertaken to mitigate the effects of the crisis and prevent similar events in the future. In addition, panelists considered the efforts undertaken by Asian financial institutions to structure internal systems of governance to better manage risk.

This report is a summary of the discussions that took place over the two day symposium. It does not necessarily represent the views of FRBSF or the Federal Reserve System. Any errors in reporting of the issues discussed are the sole responsibility of the author. For a complete record of the symposium discussions in audio format, please visit http://www.frbsf.org/banking/asiasource/events/2011/1109/agenda.html

Regulatory Perspective

Financial regulators at the symposium included representatives of the United States, England, China, Japan, Hong Kong, Thailand, and the Philippines. Several symposium participants noted that Asia has broadly accepted the principles adopted by or under discussion at the Basel Committee on Banking Supervision and in other arenas. For example, many Asian regulatory agencies have embraced the concepts of macroprudential supervision, living wills for systemically important financial institutions (SIFIs), enhanced capital and liquidity standards, and stronger oversight and regulation of derivatives. Speakers also described the gradual evolution of global regulatory responses to the recent financial crisis, ranging from the initial review of the situation by the Senior Supervisors Group in early 2008 to the Basel III recommendations formulated in 2010.

Speakers suggested that Asian financial institutions and regulators are in a better position to accept these new regulatory regimes partly due to reforms implemented after the 1997-98 Asian financial crisis and partly due to the nature of banking and regulatory approaches traditionally found in Asia. For example, one observer suggested that a macroprudential supervisory approach could be easier to implement in the more bank centric financial systems that exist in several Asian economies. In addition, many regulators in Asia follow a relatively prescriptive approach to monitoring and ensuring compliance with local regulations. Another distinctive element in the financial sectors of Asian economies, as several presenters noted, is the absence of certain products such as complex derivatives, CDOs, and other risk hedging devices. Whether this absence is due to a more conservative approach to banking and finance, or to a lack of demand for these products in Asia, observers at the symposium noted that this situation helped to insulate the Asian financial sector from some of the effects of the latest crisis. It also suggests that the adoption of new global regulations related to these products may be relatively straightforward in Asian economies as local markets for these products are limited or immature.

In terms of capital, Asian regulators implemented enhanced standards following the 1997-98 Asian financial crisis. As a result, financial institutions in Asia appear to be in a position to meet many of the new Basel III standards with minimal, if any, adjustment to their balance sheets. For example, banks in Thailand and

Korea, two countries that were severely impacted by the Asian financial crises, have average Tier 1 capital ratios of over 11%. Speakers noted that China, minimally impacted by the financial crises of the late 1990s, has also directly applied lessons from those events. As a result, Chinese banks have an average total capital ratio of 12.2% and Tier 1 capital ratio of 10.1%.

With respect to liquidity, speakers noted that the high savings rate in Asia is an important factor in helping banks maintain deposit-based funding structures. For example, the average loan-to-deposit ratio among Chinese banks was 68%[1] as of June 2011, while a comparable figure for U.S. banks was 87%[2]. At the same time, observers at the symposium noted that this greater reliance on deposits in Asian banks creates challenges in the implementation of Basel III, particularly with respect to the new Liquidity Coverage Ratio (LCR). Assets that will satisfy the LCR may not be as available in Asian economies as in Europe and the United States. Asian governments running budget surpluses—Hong Kong, Singapore, and Australia, for example—have seen little need to issue sovereign debt, which is one of the principal forms of liquid assets the Basel Committee expects banks to hold. Observers at the symposium expect ongoing discussions with the Basel Committee to resolve some of these questions in advance of the 2015 implementation of the LCR.

Risk Management in Asian Financial Companies

Speakers highlighted the economic, cultural, and political differences in Asia that might have an impact on policy as well as on regulatory action related to the financial industry. Data[3] presented at the symposium also pointed to differences in risk management policies and approaches at the level of the firm.

- Like their western counterparts, Asian financial firms continue to be challenged to articulate an acceptable risk appetite, defined by one presenter as "the amount of risk that a company is able and willing to accept in pursuit of its business objectives." Risk appetite should serve as a foundation for the development of risk management tools (or frameworks) that, as noted above, are still being developed in Asian banks.
- Asian financial firms have largely adopted a "three lines of defense" model of risk management, with the business unit, management, and internal audit each having overlapping risk management responsibilities under board oversight. Presenters at the conference made clear, however, that firms themselves acknowledge the challenge of implementing these models. The size of the institution clearly matters; SIFIs will be expected to have more formalized risk management structures in place, while smaller, less complex banks will have risk management functions located more generally across management lines.
- Asian financial firms are less likely than companies in the West to have a separate risk management committee of the board or to integrate risk management frameworks into business decisions. It was suggested that this is likely due to the greater emphasis placed by American and European regulators on the role of boards of directors in establishing a firm's risk appetite.
- Twenty five percent of financial institutions in Asia are investing in analytical and infrastructure enhancements to better address risk in existing processes and in new products (the comparable rate in Western firms is 90%). This is consistent, as noted above, with an Asian banking industry that carefully adopts innovative financial products, and with a regulatory regime that is confident that its more prescriptive approach will enable it to identify any additional analysis needed and require industry compliance.

Conclusion

Participants at the symposium confirmed that Asian institutions and regulators are becoming increasingly focused on advanced risk management systems. That said, in light of the unique orientation of Asian firms and the prescriptive nature of Asian financial regulators, it is likely that the pace of adopting these systems may vary globally in the coming years.

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[1]People's Bank of China report: http://www.pbc.gov.cn/image_public/UserFiles/english/upload/File/Financial%20statistics,%20h1%202011.pdf

[2]"Aggregate Top 50 Bank Holding Company Report," Board of Governors of the Federal Reserve System

[3]Figures used here were presented at the symposium, drawn from a report by Deloitte Touche Tohmatsu Ltd. Entitled "Global risk management survey, seventh edition, **Navigating in a changed world**," February 2011. Additional observations are derived from a report by the Institute of International Finance entitled "Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions," June 2011.

SYMPOSIUM ON ASIAN BANKING AND FINANCE
FEDERAL RESERVE BANK OF SAN FRANCISCO

ASIAN FINANCIAL INSTITUTIONS: RISK MANAGEMENT IN A GLOBAL ENVIRONMENT

September 8 – 9, 2011

SEPTEMBER 8

11:30 am **REGISTRATION**

12:00 pm **WELCOMING REMARKS: Teresa Curran,** Senior Vice President and Director, Banking Supervision and Regulation, Federal Reserve Bank of San Francisco

LUNCH AND KEYNOTE ADDRESS: Mohamed El-Erian, Chief Executive Officer, PIMCO

2:00 pm **PANEL I: Regulatory Environment in Asia: Reform and Changes**
- **Ryozo Himino**, Deputy Commissioner for International Affairs, Financial Services Agency, Japan
- **Liu Chunhang**, Director General, Policy and Research, China Banking Regulatory Commission
- **Nelson Man**, Executive Director, Banking Supervision, Hong Kong Monetary Authority
- **Paul Wright**, Senior Director, Regulatory Affairs Division, Institute of International Finance
- **Jack P. Jennings II (moderator),** Senior Associate Director, Board of Governors of the Federal Reserve System

3:40 pm **AFTERNOON BREAK**

4:00 pm **PANEL II: Asian Financial Institutions: Balancing Regulation and Innovation**
- **Alexander Grawert**, Partner – Head of Greater China, Oliver Wyman Pte
- **Takashi Oyama**, Counselor on Global Strategy, The Norinchukin Bank Group
- **Tom Cunningham (moderator),** Vice President, Banking Supervision and Regulation, Federal Reserve Bank of San Francisco

5:00 pm **DAY 1 CONCLUSION/RECEPTION**

SEPTEMBER 9

8:00 am **REGISTRATION AND CONTINENTAL BREAKFAST**

8:45 am **OPENING REMARKS: John Williams**, President and CEO, Federal Reserve Bank of San Francisco

9:00 am **PANEL III: Risk Management in Asian Financial Institutions**
- **Takuya Fujii,** President and CEO, Promontory Financial Group Global Services, Japan
- **Mark Lawrence**, Managing Director, Mark Lawrence Group
- **Edward Hida II,** Global leader, Risk & Capital Management, Deloitte & Touche
- **Jose Alonso, (moderator),** Director and CPC for MUFG, Federal Reserve Bank of San Francisco

10:30 am **MORNING BREAK**

11:00 am **PANEL IV: Managing Risk: A Conversation with Asian Banking Leaders**
- **Masao Hasegawa**, Chief Risk Officer, Mitsubishi UFJ Financial Group
- **Benjamin Hung,** Executive Director and CEO, Standard Chartered Bank Hong Kong
- **David Wright (moderator),** SVP and Deputy Director, Banking Supervision and Regulation, Federal Reserve Bank of San Francisco

12:00 pm **CONCLUSION**

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