

THE BASEL PROCESS AND REGIONAL HARMONISATION IN ASIA

This paper examines the move toward greater harmonisation in banking supervision in Asia. Central banks in the Asia Pacific region have strengthened their cooperation through various channels. Equally important, international institutions including the Bank for International Settlements have responded to such trends by becoming more involved in regional forums and better accommodating the needs of regional economies. It discusses globalisation and regionalisation and concludes that they are not mutually exclusive concepts; instead they are complementary, as society can exploit the opportunities brought by the free economy while at the same time instilling prudence in the economy and the financial system. The so-called Basel Process is a key element of the global financial system. The influence of market participants has rendered the Basel Process more transparent and market oriented. On the other hand, rapid financial innovation has necessitated the cooperation of various Basel-based committees under the umbrella of the Financial Stability Forum. The paper points out that regional harmonisation can be achieved through the Basel Process and concludes that cooperation should be pursued in both crisis management and crisis prevention, emphasising role of central banks in the latter.

Introduction

The globalisation of domestic financial markets has produced seemingly conflicting results. On the one hand, central banks and regulatory authorities have cooperated to come up with a set of global standards, with the so-called Basel Process serving as one of the central vehicles. On the other hand, market volatility and repeated financial crises have led to greater regional cooperation between such institutions. Several questions arise. How can global standards be reconciled with regional interests? Is it possible to incorporate regional elements in the Basel Process? Or are independent regional bodies needed?

The age of regionalism?

Even before the tragic events of 11 September 2001 in the United States, many economists and policymakers had for some time been talking about the end of globalism. The Asian crisis in

1997, and the Russian crisis and the collapse of hedge fund LTCM (Long-Term Capital Management) in 1998 had been considered testimony to the failure of globalism. The introduction of capital controls in some countries and their apparent success, as well as the decision by the US Federal Reserve to organise the rescue of LTCM, were seen as further proof of the need for public intervention in the global financial system.

In parallel with the sentiment of anti-globalism, regional cooperation has been increasing. European economic and monetary union (EMU) is now in its final stage, and regulatory frameworks are being harmonised; for instance, in the context of uniform licensing. In the Asia Pacific region, there has been a proliferation of economic forums: in addition to existing forums such as ASEAN (Association of South East Asian Nations) and APEC (Asia Pacific Economic Cooperation), the East Asian financial crisis led to the establishment of the Manila Framework and ASEAN-plus-3 (Japan, China and Korea) grouping.

In the same vein, central banks in the Asia Pacific region have strengthened their cooperation through various channels, setting up the SEANZA (South East Asia, New Zealand, Australia), SEACEN (South East Asian Central Banks) and EMEAP (Executive Meeting of East Asia-Pacific Central Banks) groupings. EMEAP, which was established in 1991 and enlarged in 1996,¹ gives regional central banks an opportunity to discuss financial issues in an informal and candid manner. The Reserve Bank of Australia has played an important role in strengthening central bank cooperation. Governor Bernie Fraser's call for an Asian BIS was an essential factor behind the move toward greater regional cooperation. His successor, Ian Macfarlane, also contributed to this process by actively participating in regional forums and giving a number of speeches on central banking cooperation.

International financial institutions have responded to the growing regionalism by becoming more involved in regional forums. Following the Japanese Ministry of Finance's proposal to establish an Asian Monetary Fund, the International Monetary Fund became deeply involved in the Manila Framework and the ASEAN-plus-3 grouping. The IMF has tried to modify its conditionality so as to better accommodate the needs of regional economies, as evidenced by its recent change of attitude toward capital controls.

The Bank for International Settlements (BIS) has also strengthened its cooperation with regional central banking forums. Since the BIS provides the secretariat for various Basel-based forums, including, in particular, the Basel Committee on Banking Supervision (BCBS), it has assisted these forums in their aims of harmonising standards and improving global financial stability. Although the BIS started life as a European institution,² in the 1990s it started to

expand its scope, inviting many non-European central banks to become shareholders. In addition, Basel-based forums have given greater emphasis to regional characteristics in their initiatives to improve the stability of the global financial system. The BIS opened a representative office for Asia and the Pacific in Hong Kong in 1998, and a Hong Kong trading room in 2000. The Hong Kong Office has hosted various meetings tailored to the needs of regional central banks. Furthermore, the BIS will open an office for the Americas in Mexico City later this year.

Are globalism and regionalism mutually exclusive?

Has globalism succumbed to regionalism? There is no clear definition of what is meant by globalism. It seems, however, that there is a belief that globalism is essentially Anglo-Saxon capitalism, which is seen to be based on the unrelenting pursuit of money and profit that often leads to economic boom and bust, or 'irrational exuberance' in financial markets. There is also a view that capitalism ignores or even destroys the social and cultural fabric of society. The history of modern capitalism shows, however, why such an obsession is not always well grounded. Max Weber's well-known work *The Protestant Ethic and the Spirit of Capitalism* provided an interesting picture of the true spirit of capitalism in the context of Benjamin Franklin's ethic:

It is one of the fundamental characteristics of an individualistic capitalistic economy that it is rationalized on the basis of rigorous calculation, directed with foresight and caution toward the economic success which is sought in sharp contrast to the hand-to-mouth existence of the peasant, and to the privileged traditionalism of the guild craftsman and of the adventurers' capitalism, oriented to the exploitation of political opportunities and irrational speculation. (Weber 1904)

The phrase 'foresight and caution toward the economic success' is exactly what today we call 'prudence', through which central banks and bank supervisors seek to maintain the stability of the global financial system. Although the American economy has often deviated from this spirit of capitalism, giving way to brutal market forces, one of the most important tasks of economic policymakers has always been to instil and maintain prudence or discipline in the economy.

In other words, if globalism is defined as the way to deliver the true spirit of capitalism, it needs to be accompanied by a mechanism to maintain and enhance prudence in the economy and in financial markets. Also, given the complexities of regional economic and financial

systems, such a mechanism needs to take into account each country's social and cultural characteristics.

At the same time, if the purpose of regional cooperation is to enhance regional welfare, countries need to exploit the opportunities that free trade and the free flow of capital bring, although consideration should be given to the sequence of liberalising and globalising the economy. One criticism is that opponents of globalism often ignore the benefits of the free market, concentrating on its costs.

Globalism and regionalism are not mutually exclusive concepts, but are complementary in that globalism should accommodate regional elements and that regionalism should be open enough to avoid ending up as regional egoism.

The main issue therefore is how can regional elements be incorporated into global prudential regulations.

The Basel Process

The so-called Basel Process describes a framework of regulatory harmonisation. The Head of the Monetary and Economic Department at the BIS, William White, defines the Basel Process as 'groups of national officials coming together [in Basel] to discuss international issues of common interest with a view to reaching decisions about recommended forms of behaviour' (White 1999).

One of the most important components of the Basel Process is the 1988 accord on capital adequacy, which is currently being revised. The new Capital Accord is expected to be finalised by the end of 2002 and implemented in 2005. The Capital Accord is often referred to as a symbol of the way national regulatory frameworks can be harmonised.

The Basel Process can be seen as an infrastructure to produce such standards as the Capital Accord. There are four main Basel committees. The Basel Committee on Banking Supervision (BCBS), deals with commercial banks (this is the committee that produced the Capital Accord). The Committee on the Global Financial System (CGFS) covers macro-prudential issues, the Committee on Payment and Settlement Systems (CPSS) covers payment and settlement issues, and the International Association of Insurance Supervisors (IAIS) deals with insurance companies.

The Basel committees have a structure of governance that establishes a clear division of labour between the committees and their secretariats. The secretariats are responsible for

providing open-minded, expert analysis. A large and complex project such as the new Capital Accord depends on highly sophisticated analysis to help committees identify issues for discussion and make decisions. A frequent criticism of meetings organised by other international institutions is that they lack candid and informal discussions, since they are dominated by the beliefs of their staff. Most of the Basel-based meetings have avoided this bureaucratic syndrome, since the secretariats work to enhance open and high-quality discussions rather than trying to guide the debate in a certain direction.³

Committees are organised efficiently to ensure that meetings live up to members' expectations. In the case of banking supervision, the BCBS, now chaired by William McDonough, President of the Federal Reserve Bank of New York, is made up of high-level experts from central banks and bank supervisors. Permanent working groups have been formed to discuss specific issues. For example, the Models Task Force is working out proposals to be discussed by the BCBS for the new internal ratings-based approach to credit risk, which is one of the key issues in the new Capital Accord.

More than 40 working groups, including many ad-hoc and temporary ones, come under the BCBS's umbrella. Although often criticised as placing an increasing burden on central banks and banking supervisors, to some extent this is an inevitable consequence of the Basel Process. Banking has become more complex and sophisticated, and initiatives such as the Capital Accord have to reflect such realities.

In general the Basel Process provides the international financial community with the opportunity to explore good governance in various regulatory and supervisory issues in forums that allow a frank exchange of views with the support of highly sophisticated analysis.

Evolution of the Basel Process

The influence of market participants

The Basel Process has evolved with the development of the global financial system. The rapid advance in financial products and in the way financial institutions manage risk has necessitated change in all the Basel-based forums. The Capital Accord provides a good example. Even before the current review, the BCBS had already made various changes to the Accord, most importantly by incorporating market risk into the Accord in January 1996.

This approach added a new element to the Basel Process. The decision to allow banks to use their own internal models to assess risk represented a revolution in banking supervision and the regulatory system in general. In contrast to the credit-risk approach where the Accord specified the risk weighting according to a regulatory category of credit, commercial banks are now able to use their internal risk-management models to calculate the risk associated with their trading portfolios, with certain provisos.

It should be noted that the internal-models approach was a response to the strong views expressed by the banking industry during the gathering of public comments on the first proposal in 1993. Public comment is an important characteristic of the Basel Process, and makes the supervisory process more transparent and market-based.

The BCBS's first proposal did not include the internal-models option. The method for measuring market risk was essentially the same as the credit-risk approach; that is, based on risk weights specified by the committee. In fact even at the Bank of Japan, few personnel at that time knew such terms as value-at-risk (VAR) and stress testing.

Commercial banks, particularly US money centre banks that had already introduced a sophisticated risk-management system based on VAR, strongly criticised the first proposal. They stressed that it would force them to maintain regulatory capital that was different from the 'economic capital' used in their more sophisticated risk-management models. Moreover, they would be forced to invest in new information technology to comply with the new regulation.

In response to these concerns, the revised proposal offered two alternatives for measuring market risk – the standardised approach for credit risk and the internal-models approach. The offering of options is another important element of the Basel Process. The revised proposal allowed the standard to be applicable to a wide range of financial institutions by enabling them to use a simple method, while encouraging banks to enhance their risk-management skills through the internal-models approach.

In the ongoing review of the Capital Accord, lessons learned from past experiences such as the first market-risk proposal have been taken into account. The BCBS maintained close contact with major financial institutions with a view to incorporating the most advanced credit-risk models in the proposal. The final proposal offered a number of choices for measuring credit risk and operational risk, including in both cases the use of internal models. This approach enables banks to choose a methodology that fits their particular business and their risk-management practices.

The proposal added important new elements to the Capital Accord. The new Accord focuses on minimum capital requirements (Pillar 1 of the proposal), supervisory reviews of capital adequacy (Pillar 2) and market discipline through effective disclosure (Pillar 3). These provisions are expected to enhance the effectiveness of the Accord through encouraging constant dialogue between supervisors and financial institutions (Pillar 2), and high disclosure standards (Pillar 3). The last two provisions can also accommodate regional elements that are difficult to incorporate in the minimum capital requirements.

Although there have been criticisms of the new proposal, the basic thrust has been supported as being consistent with market practice.⁴

Cooperation among Basel-based committees

The other important development in the Basel Process has been the strengthening of cooperation among the various committees. In addition to the four main Basel committees, the International Organisation of Securities Commissions (IOSCO) can be drawn into the Basel Process. The BCBS, IOSCO and the IAIS deal with supervisory and regulatory issues that concern specific segments of the financial sector – commercial banks, securities houses and insurance companies, respectively – while the CGFS and the CPSS monitor the infrastructure of the international financial system. The deregulation and globalisation of financial markets have necessitated cooperation among these committees on two grounds.

First, deregulation of the scope of business conducted by financial institutions has blurred the dividing line between banks, securities companies and insurance companies. This has required the establishment of independent supervisory agencies that cover all types of financial institutions, and also the need for closer contact between the BCBS, IOSCO and IAIS to maintain a level playing field for financial institutions. In 1996 a Joint Forum of the three committees was established.

Second, the globalisation of financial markets has increased the need for interaction between organisations responsible for the overall stability of the financial system (macro-prudence) and those responsible for the soundness of individual institutions (micro-prudence), particularly with respect to those financial institutions with global networks. Hence, the CGFS and CPSS have strengthened ties with the three other committees in the Basel Process.⁵

The setting of standards in these meetings and their implementation and monitoring has assumed greater importance. For example, in the area of banking supervision, the Core

Principles for Effective Banking Supervision introduced by the BCBS in 1997 have become a global standard, particularly after the East Asian crisis, where a lack of effective supervision was blamed as one of the major causes of the crisis. The IMF and World Bank have played an essential role in monitoring this standard, introducing the Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSCs).

In response to these developments, there was a call for more comprehensive framework to coordinate the efforts of various international financial institutions and committees. This resulted in the establishment of the Financial Stability Forum (FSF), which is chaired by Mr Andrew Crockett, the General Manager of the BIS. The BIS and the Basel Committee jointly established the Financial Stability Institute (FSI) to promote the implementation of the Core Principles and to help supervisors solve problems through sharing experiences in workshops and seminars.

In sum, the infrastructure for setting standards for the global financial system and the infrastructure for implementing them are now more closely coordinated under the umbrella of the FSF. Given that the BIS also provides the secretariat for the FSF, the Basel Process can truly be described as such.

Regional harmonisation in the context of the Basel Process

In addressing the question of how to reconcile global standards with regional interests, it is important to recognise that there is no real trade-off between global and regional interests. What is needed is a mechanism that strikes a balance between efficiency and prudence, or between dynamism and discipline.

Often associated with efficiency and dynamism, the word globalisation is used interchangeably with such words as liberalisation and deregulation. The aim of these processes is the maximum exploitation of market forces. On the other hand, regionalism is usually considered as providing a counterweight or moderating influence to market forces, and instilling and maintaining prudence and discipline in the economy.

There is, however, a strong caveat to this statement. One example would be the 'long-term nature of decision making' in many East Asian countries, such as relationship lending by Japanese main banks and the close links between the government and chaebol conglomerates in Korea. In the 1980s such close ties were considered to have brought about the 'East Asian miracle' of high economic growth with low inflation. This view was subscribed to by both East

Asian countries and international institutions such as the World Bank (see World Bank 1993; Aoki and Patrick 1994).

The East Asian crisis changed this view – ‘Asian cronyism’ has since been blamed for the crisis (Krugman 1997). Although there are different schools of thought as to the cause of the crisis, it is now evident that some of the characteristics of the Asian economies did accelerate the excessive economic boom. The most important lesson for regional economic cooperation is that regional rules and standards need to be constantly reviewed in light of their original purposes. Regional rules will evolve over time and will have different impacts if other environments change, as will be explained below in the discussion of Japan’s collateralised lending. Accordingly, when the structure of an economy changes as a result of globalisation, artificially maintaining regional rules can be detrimental.

It is therefore essential in any regional economy that policy authorities have a clear understanding of the interaction between global and regional economic systems, and that global standards or rules reflect this. What can be done to incorporate regional elements in the Basel Process?

Is it possible to incorporate regional elements in the Basel Process?

To some extent the Basel Process has already incorporated regional interests in its deliberations. The BIS and the Basel-based committees have modified structures in response to the views of emerging market economies. One such attempt was made by the Basel Committee’s Core Principles Liaison Group, which consists of senior G10 and non-G10 banking supervisors, the IMF and the World Bank. The Committee has also moved to strengthen ties with regional groups. In Asia the Committee and the BIS regularly send experts to meetings organised by EMEAP, SEACEN and SEANZA. The FSI and the BIS Hong Kong office have played particularly active roles.

On the other hand, regional organisations have increased their involvement in the Basel Process. For example, in May 2001 the EMEAP Working Group on Banking Supervision produced comments on the second consultative paper on the new Capital Accord, which represented the collective views of regional central banks. Such cooperative efforts help to resolve any conflicts between global standards and regional interests. It is, however, difficult to come up with standards that are relevant but still take into account the characteristics of regional

economies. In Japan's case, for instance, many economists have pointed out that the Capital Accord acted to accelerate lending by Japanese commercial banks and helped create the financial asset bubble in the second half of the 1980s. This is because the Accord defines 45 per cent of the latent profit in banks' equity portfolios as Tier 2 capital (up to the level of the narrowly defined core capital, Tier 1, which consists of shareholders' equity and reserves). When an economy is booming, the rise in stock prices will increase the capital base and the capacity of banks to lend, resulting in excess lending. In a slump the opposite channel leads to an excessive contraction of banking credit and to deflation. This is still one of the controversial points in the ongoing revision of the Accord.

In Japan the main driving force behind the excess bank lending was the asset price bubble in the real estate sector. After the bubble burst, the decline in stock prices at some points in time did serve as a constraint on bank lending, in particular in 1997 and 1998 when Japan faced the real danger of a credit crunch.

This does not mean that the treatment of equity holdings in the Capital Accord was wrong. In fact it was carefully designed to accommodate the requests of the Japanese banking community, while at the same time preserving discipline. So what went wrong? What should have been addressed was the fact that the Japanese banks had enormous equity portfolios as a result of crossholdings with closely related companies under the main bank system. In the pre-bubble period, the system had worked efficiently to ensure good corporate governance. Meanwhile the unrealised gain cushioned the banks, allowing them to provide financial assistance if companies got into trouble.

During the asset-price bubble, the system changed completely. Excessive bank lending, and the rapid and persistent increase in the price of collateral (particularly real estate), discouraged banks from strengthening their risk-management practices.⁶

It should be noted that the treatment of the latent profit on equity portfolios, described above, was requested by the Japanese authorities and Japanese commercial banks, which at that time had enormous latent profit. This episode shows that standards cannot replace good risk management by banks in individual countries. What is ultimately important is the ability and willingness of individual supervisors and financial institutions to enforce discipline in the financial system. Any rules or standards, be they regional or global, should be assessed from the viewpoint of whether they can help to instil such discipline.

Do we need a regional regulatory institution?

The Basel Process has been evolving in a way that has been flexible enough to meet the needs of specific regions or countries, as evidenced by the variety of choices offered by the new Capital Accord proposal. The three-pillar approach of the proposal will further facilitate the efforts of regional supervisors in this connection. Although there have been complaints about the complexity of the revised proposal, it reflects efforts to incorporate as many comments as possible. Recent efforts to include non-G10 supervisors in the decision-making process are important and need to be further enhanced.

It is unlikely that there is a need for a new supervisory body aimed at regional harmonisation in the Asia Pacific region. Even in Europe, where an EU-wide uniform regulatory framework is being put in place, there is no consensus about merging supervisory institutions. Furthermore, EU supervisors have committed to the Basel Process by enacting the Capital Accord and subscribing to the Core Principles.

In terms of financial assistance, regional cooperation in Asia is much greater than at the time of the Asian Crisis, through recent initiatives such as the ASEAN-plus-3 grouping.⁷ It would be valuable to further strengthen cooperation between regional supervisors, for instance by establishing a policy forum for sharing experiences and instilling discipline through monitoring. While helping each other can be viewed as crisis management, monitoring each other can be described as crisis prevention.

The experience of Europe is relevant to the East Asia region. There were two main factors that led to the successful introduction of a single currency in Europe.

The first factor is that EMU stands for economic and monetary union, although it is often misinterpreted as European Monetary Union. Without the convergence of the real economy through the long and unrelenting process starting from the European Coal and Steel Community, the Maastricht Treaty – the essential element of monetary union – could not have been brought to life.

The other is the existence of the Deutsche Bundesbank as the anchor of stability. Not only did the Bundesbank serve as a virtual monetary policy board for Europe even before the establishment of the European Central Bank, it pursued regional stability by consistently advocating prudent banking policies. While the European Monetary System and the Exchange Rate Mechanism provided the crisis-management mechanisms, the discipline-oriented domestic policies of the EU countries served as an effective basis for crisis prevention.

Central banks and supervisory authorities in the Asia Pacific region should therefore enhance cooperation, not only through actively participating in standard setting in the Basel Committee but, more importantly, by maintaining and enhancing good governance in their own financial systems.

Notes

- * The author thanks Robert McCauley, Stefan Hohl and Yoshinori Nakata for their thoughtful comments. The views expressed in this paper are those of the author and do not necessarily reflect the views of the BIS or of the institutions represented.
- 1 EMEAP is a group of 11 central banks in the region, and started as a regular meeting of deputy governors. In 1996 governors' meetings started to be held regularly and three working groups were set up.
- 2 Because the BIS was originally established to deal with Germany's national debt after World War I, European central banks have made up most of its shareholders and board members. Also, before the establishment of the European Monetary Institute (the precursor to the European Central Bank), the BIS was the main forum for cooperation between European central banks.
- 3 Here, an analogy can be made with monetary policymaking, which is similar in the major central banks; that is, an independent monetary policy committee consisting at least partly and often dominantly of outside members. This structure works best if independence from both political pressure and from the central banking bureaucracy is maintained.
- 4 The Basel Committee's web site includes the comments central banks and private institutions have made on the new Capital Accord (see <www.bis.org>).
- 5 One symbol of these strengthened ties was a joint meeting in 1995 of three working group chairs dealing with the issue of financial derivatives, namely Danièle Nouy (representing a BCBS working group), Tim Sheperd-Walwyn (IOSCO) and the author (representing the ECSC [Euro Currency Standing Committee], now known as the CGFS). Financial derivatives have made financial markets more global and interdependent, necessitating greater cooperation between committees.
- 6 In the context of the internal-ratings-based approach in the New Capital Accord proposal, the 'loss given default' (LGD) of Japanese bank lending in the bubble period was always considered to be zero, so banks did not have to worry about the probability of default (PD).
- 7 In addition to the regional financing arrangement, the level of multilateral financial support has also increased through various IMF programs; for example, the New Arrangements to Borrow (NAB), Contingent Credit Line (CCL) and Supplementary Reserve Facility (SRF).

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