“The Changing Capital Market Infrastructure”

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Good afternoon

It is always a pleasure to be amongst friends and colleagues. It has been a little over 6 years ago when I last spoke to your association at this very venue when I was then the Secretary of Finance for the Philippines. Interestingly, I opened my speech then with the following comments:

“This conference is being held at a time when Asian economies are showing signs of recovery from the weaknesses we saw in 2001 and the economic and political fears we experienced earlier this year. A palpable sense of optimism is returning to investors and consumers alike in the region. The economic outlook appears to be improving with each new set of data from the industrialized countries and more strongly from our own Asian region.”

We were then coming out of the damaging impact of the September 11 terrorist attack, the Iraq war, and the SARS epidemic. The global financial and economic crisis we are going through is certainly of far greater proportion and extent, but I can easily give the same opening statement today and I will not be off the mark.

Let me spend a minute or two to just highlight what I believe got us on the verge of a global depression. In my mind, the prolonged period of excessive liquidity and low interest rates created an intoxicating but explosive cocktail of the following ingredients:

1. Low cost of capital that inflated asset values across most markets;
2. The same low cost of capital led to a break-down in credit and investment disciplines;

3. Excessive liquidity encouraged layers upon layers of leverage for the same underlying assets;
4. Low interest rates pushed investors both individuals and institutions to seek higher yields by taking more risks which were, at times, inappropriate or misunderstood;
5. The combination of excessive liquidity, investor appetite for yields and risks, and the demand from issuers and user of funds coupled with the rock scientists and bankers driven by short term profits created a environment for unhindered financial engineering and the most complex financial instruments;
6. The emergence of largely unregulated and opaque fund managers using substantial leverage to enhance their yields and, as a consequence, their incentive fees; and
7. In most jurisdictions, the legal and regulatory framework and the regulatory agencies have not been able to keep up with the new environment, new financial instruments, and new types of institutions.

With these contributing factors to the global financial crisis, it is inevitable that we will see significant changes in the capital market landscape particularly in the West where the crisis started. While Asian financial institutions have managed relatively well, changes in the US and European policy and regulatory contour will also impact Asia. Whether directly such as the calls to implement OECD standards on information exchange, or indirectly as in the proposed Alternative Investment Fund Manager Directive in Europe, Asia will have to manage through these pressures for universal application of financial reforms without undermining its own regional and domestic capital market development.

We in the financial industry will have to adapt to these new realities.

First, without doubt it will be back to basics for the industry as a whole. Basic services and strategies where the central focus is on client needs and a retreat from products with complex financial structures will be the way forward for most institutions. Complex financial products that demand excessive leverage will face obstacles in terms of reduced client and market appetite in absorbing such products.

Second, there will be greater regulatory scrutiny, especially in matters pertaining to leverage and risk. Regulators will be more sensitive towards, and diligent about, risk control systems and how risks are being managed. Regulators will seek a more granular understanding of risks which will mean more reporting requirements.

Third, calls for stronger capital buffers as well as liquidity and leverage ratios will be a likely outcome in one form or another. The challenge is how to gain a global consensus on the definition of such prudential limits considering the different business models in different markets. For instance, should Asian banks that generally rely more on core customer deposits to fund loans be subjected to the same leverage and liquidity ratios as the investment banks in the US that rely on borrowed money?

These new standards will require financial institutions to be more capital efficient. Coupled with the scarcity of capital and a rise in the cost of such capital, this will mean that banks will have to reduce or eliminate businesses that are heavy users of capital including unsecured lending, proprietary trading, and illiquid assets. Client-driven flow business will become the primary focus.

Fourth, there will be strident calls for greater transparency and disclosure. Regulators will want more information on a whole range of matters. From opaque financial structures to how a company is incorporated, from the type of governance structures in place to how bank executives are compensated, all these issues are being re-examined.

Additionally, in light of the Lehman mini-bond debacle that hit some of our Asian centers to the Madoff and Stanford Ponzi scandals in the West, there will be greater focus on how financial products are being sold to the public, especially to the retail market. We are already seeing such regulatory developments emerge in two of Asia’s regional financial centers, Singapore and Hong Kong.

Lastly, there will be greater coordination and harmonization of laws and regulations amongst regulatory agencies. For sure, debates and disagreements will take place amongst policymakers as conflicting national interests come into play. But ultimately, most policymakers and politicians alike will be unwilling to allow an environment that led to this global crisis to rear its ugly head again.

Impact on Asia

What do all these changes mean for our region and how have we faired during these dark months? In many respects, when this crisis griped the West, aside from the volatility due to the market panic and funds being pulled out of Asia to flow back to buttress Western balance sheets, Asia's capital markets, particularly the banking sector, have escaped relatively unscathed. With the dress rehearsal from the 1997 financial crisis, Asia has had the opportunity to restructure its corporate sector by de-leveraging and raising equity resulting in stronger balance sheets and cash-flows. FX reserves have expanded all around and the region now owns about 2/3's of the world's reserves. More significantly, the 1997 crisis led to the strengthening of the financial sector through bank consolidation, reduction in NPL's, and the maintenance of strong liquidity.

As we speak, finance ministers, securities commissioners, and central bankers in Asia supported by the Asian Development Bank continue to work together to promote greater integration of the region's capital markets. In this regard, I have had the privilege of being invited to be a member of the Group of Experts by the ASEAN Capital Markets Forum, an association of all the senior securities regulators in ASEAN. I am please to share with you that much progress has been made in establishing a clear roadmap for regional integration as well as the development of domestic capital markets especially for the younger ASEAN economies. This roadmap has been endorsed and subsequently approved by the ASEAN finance ministers in their gathering earlier this year.

The roadmap, if implemented, will help shape the capital markets in the region. Key objectives include:

- strengthening financial intermediation, capacity, and risk management that supports national and regional growth;
- cooperation between regulators and policymakers within the region to reduce vulnerabilities to external shocks and market volatility; and
- a platform enabling South East Asia to have a stronger voice on financial stability and development issues in the global stage

Some of the crucial elements of the roadmap include

a) harmonization/mutual recognition of market regulations, financial accounting standards, and other market practices. This represents a core strategy of the Plan as it seeks to integrate the region's financial markets. However, acknowledging the differing levels of capital market development and readiness amongst ASEAN countries, the proposal is for mutual recognition initiatives to be implemented bilaterally first and then multilaterally as other countries become ready to join in. Policymakers are hoping that the mutual recognition framework will help facilitate cross border fund raising, product distribution, cross border investments within ASEAN, and freer market access by intermediaries;

b) establishment of regional clearing and settlements systems;

c) regional strategy for ratings comparability that will enhance ASEAN as an asset class; and

d) liberalization of foreign exchange controls and exchange restrictions

While the roadmap is very laudable and key to maintaining the relevance of ASEAN, implementation will be the main challenge. An important step is to establish a well-sequenced program of regional integration initiatives that are incorporated into national capital market development programs. As I experienced as a policymaker, it is one thing to have regional objectives, it is another to translate these into actionable domestic agenda in the respective member countries. Finally, it needs to be reinforced through a well designed ASEAN-level monitoring and coordination mechanism to track progress or lack of it.

Inroads in some of these matters have been made such as taking the first steps towards establishing a regional understanding of credit rating systems. The region has also continued to push ahead on the ASEAN bulletin board for regional equities for which Vietnam reportedly has just signed onto.

In conclusion, it is not surprising that during this tumultuous period, most of our markets have continued to remain open and have stood resilient. In fact, some of our neighbors like Malaysia have taken this opportunity to further liberalize their financial sector. China is trying out novel methods towards partially internationalizing the Yuan.

It is also notable that our regional regulators are not showing signs of swinging to the extreme of over-regulating the financial sector in response to the crisis. Such developments exhibit a certain level of maturity and confidence in the region. Our policymakers have imbued the lessons learnt during the Asian financial crisis and this, in turn, is helping our region's economy to stand strong.

My dear colleagues in the financial industry, the global crisis is too valuable an opportunity to put to waste. Reforms in financial regulations and changes in client behaviour are sure to come. We must make sure to engage policymakers, regulators, and politicians in active dialogue so that the future of the capital markets infrastructure is enriched by our experience and market knowledge. Too much has been said on the "evils" of banking negating decades and centuries of our positive contribution to economic development and prosperity. I am confident that our industry will respond to this challenge.

Thank you.