The rapid spread and far-reaching impact of the global financial crisis have highlighted the need to strengthen financial systems in advanced economies and emerging markets. Emerging markets face particular challenges in developing their nascent financial systems and making them resilient to domestic and external shocks.

In this timely volume Masahiro Kawai, Eswar Prasad, and their contributors offer a systematic overview of regulatory frameworks in both advanced countries and emerging markets. Their analyses and observations clearly point out the challenges to improving regulation, efficiency of markets, and access to the financial system. Policymakers and financial managers in emerging markets will need to grapple with some key questions as they restructure and reform their financial markets:

◆ What lessons does the global financial crisis of 2007–09 offer for the establishment of efficient and flexible regulatory structures?
◆ How can policymakers develop broader financial markets while managing the associated risks?
◆ How—or should—they make the formal financial system more accessible to more people?

This booklet summarizes the analysis presented in the new ADBI and Brookings Institution Press title: Financial Market Regulation and Reforms in Emerging Markets

Masahiro Kawai is dean of the Asian Development Bank Institute. From 1998 to 2001, he was chief economist for the World Bank’s East Asia and the Pacific Region, and he later was a professor at the University of Tokyo.

Eswar S. Prasad holds the New Century Chair in International Economics at the Brookings Institution. He is the Tolani senior professor of trade policy at Cornell University and a research associate at the National Bureau of Economic Research. He was previously head of the Financial Studies Division and the China Division at the International Monetary Fund.
Financial Market Regulation and Reforms in Emerging Markets

Highlights

Masahiro Kawai and Eswar S. Prasad
Editors

About this volume

This booklet condenses the papers in *Financial Market Regulation and Reforms in Emerging Markets* down to a quick introduction for anyone interested in the issues dealt with in this book.

Readers interested in purchasing the full length book can order it from the Brookings Institution Press, details of which are at the back of this booklet.
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Financial Market Regulation and Reforms in Emerging Markets

The global financial crisis has generated momentum for policymakers to craft substantive regulatory reforms geared toward ensuring the integrity and resilience of financial systems in the advanced economies. The macroeconomic consequences of the crisis have also affected many emerging markets and low-income developing economies, even though this group has rebounded more quickly and sharply from the crisis than did advanced economies. While the financial systems of many emerging economies, particularly those in Asia, proved more resilient than advanced economies to the financial crisis, the shared ramifications of the crisis have brought into even sharper relief the importance of sound financial systems for emerging markets as well as developing economies. An efficient and stable financial system is essential for any economy to achieve sustained growth and to absorb various types of shocks.

The financial crisis forced the reconsideration of even basic principles of financial regulation. Meanwhile, the imperative of financial development remains as strong as ever in emerging markets, although the focus is more on basic elements—such as strengthening of banking systems and widening the scope of the formal financial system—rather than on expanding the use of sophisticated financial instruments and innovations. Remarkably, emerging economy financial systems have in general proved to be more robust and less affected by the global turmoil compared to their advanced economy counterparts—it will be important to carefully identify the right lessons from this outcome.

The crisis has highlighted the need for strengthening financial systems to make them more resilient to shocks. Emerging markets face challenges in stabilizing their still-immature financial systems in the face of shocks, both domestic and external, and financial reforms are critical to these economies as they attempt to pursue sustainable high-growth paths. New paradigms for financial development and regulation will have to be suitably reframed for emerging markets, which have a number of varying institutional and capacity constraints. Low-income developing countries, where the breadth of formal financial systems is severely limited, pose an even greater set of conceptual and practical challenges.
Policymakers in emerging markets are grappling with a number of issues, including what lessons the crisis can offer for the establishment of efficient and flexible regulatory structures, the avenues that should be pursued to enable effective regulation of financial firms with large cross-border operations, and the reforms that should be implemented to raise financial inclusion. A broad reconsideration of the optimal, appropriate regulatory and supervisory frameworks of financial firms, products and markets is needed for these economies.

Policymakers in emerging markets face a number of complex conceptual and practical challenges as they attempt to improve their frameworks for financial regulation. They need to balance the quest for financial stability with the imperatives of financial development and broader financial inclusion. These objectives can in fact reinforce one another. There are also various aspects of macroeconomic policies and cross-border regulation that have implications for financial stability and the resilience of the financial sector in emerging markets.

This book ties together the various themes of the overall research agenda that covers financial market development, regulation, access and other related issues. The book attempts to assess the implications of the financial crisis for the design of regulatory frameworks and models, taking into account the specific constraints in emerging markets.

The chapters in this volume focus on identifying and evaluating the lessons from the crisis and on designing effective strategies for maintaining the momentum of financial development and inclusion in emerging markets, with a particular focus on those in emerging Asia. The main areas covered in this book are as follows:

—Basic principles of financial regulation: synthesizing evolving paradigms of the key characteristics of optimal regulatory structures to promote financial stability.

—Financial regulatory reforms in emerging markets, with a focus on emerging Asia: dealing with the challenges of limited institutional development and regulatory capacity.
—The financial development agenda: improving financial intermediation and fostering an environment conducive to the development of broader financial markets, including basic derivatives products.

—Financial inclusion: investigating how to increase the access to the formal financial system for households and entrepreneurs in emerging markets and assessing whether greater inclusion is consistent with promoting sound regulation.

—Cross-border financial regulation and, more broadly, regulation of financial firms that have a substantial presence in emerging markets.

**Basic Principles of Financial Regulation**

What is the right way to approach financial sector regulation and supervision? A reconsideration of basic principles is needed to design an effective and flexible regulatory mechanism that is capable of dealing with financial innovations and systemic risks.

Before the financial crisis, the debate about optimal regulatory structures was focused narrowly on a few issues. One aspect of the debate was whether the United Kingdom’s single regulator model, as embodied in the Financial Services Authority (FSA), was better than the multiple regulator framework of the United States, where the presence of different agencies with varying jurisdictions allowed large and complex financial firms to engage in regulatory arbitrage. The crisis exposed gaping weaknesses and flaws in both models. The FSA was responsible for overall financial stability but appears to have regulated with a “light touch,” allowing large levels of systemic risk to build up in the system. In the United States, regulatory failures, including a similar “light touch” approach, were compounded by gaps in the overall framework for supervision and regulation that left some products and markets relatively unregulated and created large opportunities for regulatory arbitrage.

A different facet of this issue is the contrast between rules-based and principles-based regulation. Rules-based regulation, which emphasizes following the letter of the regulation, typically involves more direct control by the regulatory authority and has been the preferred mode in emerging
markets. It had been argued that principles-based regulation, which emphasizes adhering to the spirit of the regulation, is more appropriate for advanced economy financial markets. But this approach also may be relevant for emerging economies looking to develop their financial markets by opening them up to more innovation and risk taking. The crisis has shown that both approaches, which tend to be based on microprudential regulation of individual financial firms, may be insufficient for dealing with systemic risk.

Some observers have identified four major market failures that precipitated the global financial crisis—excessive risk-taking by financial firms under implicit government guarantees; regulatory focus on individual firms rather than systemic risk; lack of transparency of financial firms, products and markets; and proliferation of the shadow banking system. Policymakers need to identify the source of market failures first and then design regulations to specifically address those market failures. Furthermore, striking the right balance among goals, such as reducing systemic risk, protecting innovation, and maintaining political feasibility, is an important priority for the design of these policies.

One clear impact of the crisis is the consensus that has developed on the need to increase the levels of capital held by financial firms. The Basel Committee on Banking Supervision has proposed tighter capital requirements for banks, including higher levels of Tier 1 capital, a higher ratio of core Tier 1 capital, a capital conservation buffer and a countercyclical capital buffer. These regulatory requirements are to be phased in over a number of years although it is likely that markets will begin to use Basel III requirements as benchmarks even before their official implementation. Higher capital ratios and higher-quality forms of capital that better enable banking firms to absorb losses and continue as going concerns in the face of adverse financial and macroeconomic shocks should provide for a more effective first line of defense for those banks and limit systemic spillovers.

Stricter capital and liquidity requirements for the banking system should help to prevent the reemergence of an under-regulated nonbank financial sector that poses a threat to financial stability as a result of shifts of financial activity to outside the regulatory perimeter. Determining appropriate capital adequacy standards for the shadow banking system will
indeed be a key challenge in an effective redesign of the regulatory system. A related challenge is to ensure that tighter capital standards for banks and other highly regulated entities do not result in these firms simply shifting their activity to less regulated areas, including off-balance-sheet activities such as structured investment vehicles. Such a shift would simply encourage more risk taking and raise systemic risk as well, since many off-balance-sheet activities could effectively end up on-balance sheet in times of crises.

In addition, the nature of capital requirements will have to be reevaluated to ensure that they do not tend to amplify systemic financial distress. Existing risk-weighted capital requirements can sometimes reinforce credit booms by allowing financial firms to expand credit in good times, as well as exacerbate financial panics in times of crisis by requiring financial firms to raise capital by selling assets into falling markets. The alternative of a countercyclical capital requirement, however, creates complications in terms of defining and measuring the business cycle. Even in relatively calm periods, it is not easy in real time to distinguish between trend and cyclical movements in output, and this becomes even more difficult as a practical matter in emerging economies where business cycles tend to be more persistent.

The dynamic provisioning approach adopted in Spain appears to have had some success as it facilitates earlier detection and coverage of credit losses in loan portfolios. This requires banks to build up buffers against cyclical downturns, thereby increasing the resilience of individual banks as well as the banking system as a whole, a consideration that is particularly relevant for emerging market economies with bank-dominated financial systems. The Basel Committee’s proposal of a countercyclical buffer based on “excess credit growth” that could reflect the buildup of system-wide risks appears reasonable and should alleviate some of these concerns. But it may be difficult to define excess credit growth in the case of emerging economies whose financial systems are still developing, and this approach may still be subject to the problems of identifying unsustainable booms in economic activity and credit aggregates.

In assessing capital requirements on the basis of risk, it will be important to consider the broader relationship among credit, liquidity, and market risks. At times of crises, these risks can interact with and amplify
each other. For instance, during the global financial crisis, credit and market risks surged when liquidity dried up in financial markets. To deal with the impact of such feedback effects, capital requirements could be structured to take a broader view of risk and the relationships (and potential feedback mechanisms) among different sources of risk in the financial system. This implies that different aspects of risk must first be carefully considered at the level of the individual financial firm and then also analyzed at a broader systemic level.

The crisis has created a clear recognition of the need to evaluate and manage financial risks at the systemic level rather than solely at the level of individual firms. In complex financial systems, where there is a high level of interconnectedness among financial firms, firm-specific risk can quickly transform into aggregate-level risk. The solution is, in principle, to monitor firm-specific as well as aggregate risk. But a lot of work needs to be done on how to properly evaluate aggregate risk, especially in determining what sort of reporting requirements are needed to make proper assessments of the level of interconnectedness among different financial firms within a system. The ultimate goal is to implement a systemwide approach for regulating systemically important institutions—identified as such based on their size, extent of leverage, interconnectedness with other firms, and degree to which they provide financial services critical to the operation of key markets.

There is an increasing impetus in different economies to establish an institutional framework to coordinate the work of different regulatory agencies and to provide oversight of the agencies themselves. For instance, the U.S. Treasury has recently set up a Financial Services Oversight Council while the Rajan Committee made a similar recommendation to set up a Financial Sector Oversight Agency in India, a proposal that has recently been accepted by the government. There are some challenges in determining the authority of such an agency, particularly if it is subsumed under an existing regulatory agency.

As discussed in the context of capital requirements, it is important to ensure that tighter regulation in one area does not tend to lead to regulatory arbitrage in the form of financial firms shifting the regulated activity to less tightly regulated jurisdictions. The financial crisis has shown that operations of unregulated entities have the potential to contaminate
markets and infect even highly regulated sectors in times of crisis. Thus the systemic consequences of the operations of lightly regulated and unregulated entities will have to be taken into account as part of the process of overall regulatory coordination.

An equally important priority is to increase transparency in financial markets. This is a broad concept that includes substantive issues such as bringing more derivatives products onto exchanges where they can be traded in a more transparent setting and, thereby, can be monitored and regulated more effectively. There are risks inherent in large over-the-counter (OTC) derivatives contracts that raise counterparty exposure and elevate the level of systemic risk. One approach to tackling this problem would be to standardize derivatives products to the extent possible and improve the technical trading infrastructure in order to increase the incentives for financial firms and other corporations to hedge various kinds of exposures on exchanges rather than via OTC instruments. There is still a legitimate role for certain types of OTC products and the challenge here is to ensure that the regulatory net covers these products and that financial firms involved in these products are subject to high capital requirements for these activities. Transparency is about much more than reporting requirements, however. It entails a careful reconsideration of accounting principles, the responsibilities of accountants, and concepts to match the increasing sophistication of financial products and the risks embedded in them.

There are also basic conceptual and practical questions that need to be addressed in the context of setting up the broad regulatory framework, including, for instance, whether it is appropriate for the central bank to have responsibility for overall financial stability in addition to price stability. In the United Kingdom, a decision was made to shift the responsibility for overall financial stability, including the power to regulate and supervise individual financial firms, from the FSA to the Bank of England (BoE). As a result, the BoE has acquired the dual mandates of achieving both financial stability and price stability. In the United States, which ostensibly had an efficient regulatory system but was plagued by flaws in the multiple regulator model, a decision was made to give the Federal Reserve Board (Fed) expanded regulatory authority over large, systemically important (“too big to fail”) institutions. When this change was proposed, enormous resistance arose because of fears of concentration
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of power with the Fed and also concerns about diluting its primary objective of pursuing price stability. Some observers pointed out the presence of regulatory capture as regulators were considered subject to intense political pressure that led them to put the interests of financial firms ahead of the general public interest. Although the Fed has no official mandate to promote financial stability, it now has a considerable power to do so in addition to its official mandate of achieving price stability and full employment.

Regulatory Frameworks for Emerging Markets

Along with a reconsideration of basic principles, it will be important to think about how to adapt these principles to the particular circumstances of emerging market economies where there are significant institutional and capacity constraints. Although country-specific conditions cannot be ignored, it will still be useful to develop a framework for making progress on this issue.

Many of the basic principles that are being formulated, including higher capital requirements and a focus on liquidity risk management, are as relevant for emerging markets as they are for advanced economies. For emerging markets, it is also a priority to deal with institutional and capacity constraints that limit effective regulation and hinder financial stability. Indeed, even basic microprudential regulation—the effective oversight of individual financial firms—can be a challenge for many emerging economies. From the perspectives of both individual bank efficiency and regulatory stability, a key priority for financial firms in these economies is to implement good risk-evaluation and risk-management practices on their loan portfolios.

Policymakers in emerging markets recognize that a core priority is to strengthen their institutional frameworks in order to promote financial stability. This includes instituting comprehensive insolvency procedures to wind down financial firms and other corporations, and developing a more robust legal framework to enforce property rights consistently and fairly.

It has been argued that the global financial crisis originated from the interplay among lax financial regulations that allowed financial firms to
take excessive risks, excessively loose monetary policy in major advanced economies, and global imbalances. Existing regulations were not adequate for dealing with the rapid growth in derivatives and securitized credits in the past decade. The growing shadow banking system contributed to the increasing divide between the financial and real sectors. This yields a number of policy priorities, including macroprudential regulations that mitigate systemic risk, broader regulatory scope, greater capital and liquidity buffers, more effective risk management on the part of financial firms, and stronger international coordination.

It is interesting to compare China’s banking regulation and standards with that of the Basel Core Principles for Effective Banking Supervision (BCPs). China’s practices could be characterized as rules-based while the BCPs are seen as principles-based. One could make the argument that China’s regulatory standards, while significantly influenced by the BCPs, are more prescriptive and specific and that this approach is more suitable for emerging markets. A sound supervisory framework should be dynamic and reflect the realities of the financial sector for which it is created. While best practices in advanced economies should be considered as a starting point for enhancing current supervisory frameworks, one should bear in mind that a single framework does not fit all types of financial firms or systems.

Another important issue is whether financial crises can be prevented, even if their precise timing cannot be predicted, by identifying and dealing with sources of instability. Policymakers need to complement top-down macroprudential supervision with microprudential supervision. This necessitates adequate provision of liquidity by the central bank during crises and a clearly defined cross-border insolvency resolution mechanism for failed global financial firms. At the national level, systemic crises are best managed by a strong and comprehensive regulatory body.

Latin American and Asian experiences show not only how valuable lessons can be extracted from crises but also how these lessons are sometimes forgotten over time. In the debt crises of the 1980s and 1990s, a number of Latin American countries suffered from problems caused by currency mismatches between their external assets and liabilities, particularly by borrowing large amounts of short-term debt denominated in
foreign currency. Asian economies faced similar problems during the

Major Latin American and Asian economies have withstood the global
financial crisis reasonably well as a consequence of having substantially
reduced their foreign currency borrowing. By contrast, the debt-financed
growth of many Eastern European economies, especially that using foreign
currency debt, left them highly vulnerable to the latest crisis. Maintaining a
cautious approach to foreign currency-denominated borrowing improves
safety, but this approach has to be balanced against the benefits to financial
firms and their corporations from borrowing abroad. A sensible regulatory
approach can be used to balance the benefits of foreign currency
denominated debt against the attendant currency risk, with one aspect of
this being careful monitoring of the level of currency risk to which the
financial system as a whole is exposed.

Another key constraint in emerging economies is inadequate
regulatory capacity that is unable to keep up with fast-evolving markets
and products. This constraint is exacerbated by the challenge that
competent and knowledgeable staff in regulatory bodies in these
economies tend to be quickly absorbed by the private sector. A revolving
door between regulatory bodies and the private sector can heighten the risk
of regulatory capture. This is one area where multilateral institutions can
play a useful role. They can help build capacity by providing training to
country officials, synthesizing and transferring information about
international best practices, and providing direct guidance in the
formulation of codes and regulations.

The issue of regulatory capacity is of course closely related to the
regulatory structure itself. Although there are benefits in terms of
preventing gaps and regulatory arbitrage, establishing a single regulator
may be a significant challenge for emerging economies. In the presence of
multiple regulatory agencies, a viable approach would be to create an
oversight body that effectively coordinates the work of individual
regulators, conducts macroprudential supervision, limits the degree of
regulatory arbitrage, prevents large gaps of coverage from opening up in
the regulatory framework, and oversees the regulation of large
systemically important institutions with cross-border operations. This
framework will have to be regularly recalibrated as financial markets develop and become more complex.

The regulatory reform agenda in emerging economies is in fact closely tied to their financial development agenda. Financial instability in some of these economies is caused less by unfettered innovation than by incomplete and underdeveloped financial markets. This dynamic creates its own set of regulatory challenges, but it is worth turning directly to the relationship between two main priorities—financial development and financial inclusion—and see how they tie in with regulatory issues.

**Financial Development in Emerging Markets**

The financial crisis makes it imperative to refine rather than retreat from the objectives and avenues of financial development. Mobilizing savings and effectively channeling them into productive investment remains a key challenge for financial systems in emerging markets. In economies like China and India that have high private saving rates, effective financial intermediation is a key not just for promoting growth but also for improving the welfare impact of that growth.

The financial crisis is likely to shift the emphasis of the financial development agenda toward the basics of strengthening banking systems, developing basic derivatives markets such as currency derivatives, and increasing the depth and liquidity of government and corporate bond markets. The papers in this section attempt to redefine the objectives and avenues of financial development in light of recent events.

In major Asian emerging economies, the financial systems remain largely bank dominated. Moreover, public sector banks (PSBs) still play a dominant role in several key Asian emerging markets including China and, to a lesser extent, India. Improving the efficiency and governance of both public and private banks is a key priority. However, in both of these key Asian emerging markets as well as in many others, PSBs are often seen as instruments of social policy, whose obligations include directing credit toward favored industries.
Interestingly, the financial crisis has cast PSBs in a different light. During periods of extreme financial stress when the rest of the financial system freezes, public banks can serve a useful function by continuing to provide credit as they have direct government backing. But reforms are still necessary to incentivize these banks to turn in an adequate performance in normal times as well. There are large but often hidden efficiency and welfare costs in maintaining an inefficient public banking system. While these banks offer a useful layer of protection during a crisis, this can be a very expensive form of insurance for the economy.

There is no reason, of course, why government ownership *per se* should make a bank inefficient, although this is often the reality as political and social considerations often trump commercial ones. Corporatizing PSBs, which does not necessarily entail a full-scale one-shot privatization but gets them to function more like commercial banks operating without government support, would be one step toward improving their performance. Indeed, some PSBs have increased their efficiency and, despite their social obligations, are able to compete with private sector banks. The State Bank of India is a good example of a publicly owned bank that has become highly profitable and competes effectively with private banks, both domestic and foreign.

The priorities for strengthening banking systems in emerging economies are quite different from those in advanced economies. While banks in many emerging economies, including China and India, meet or exceed even the higher capital requirements proposed under the Basel III Accord, the major priority for these banks is actually to improve their risk management system rather than to strengthen their capital bases. Given the high domestic saving rates in these economies and the likelihood that banks will remain dominant in their financial systems for some time to come, more efficient banking systems that more effectively intermediate domestic savings into productive investment can enhance growth and economic welfare.

Development of corporate bond markets is necessary to broaden the scope of financial markets in order to raise financing for large-scale enterprises and infrastructure projects. In bank-dominated financial systems bond markets create a more competitive environment for financing large firms, thereby inducing entrenched banks to both increase
their efficiency and direct more lending to small-scale enterprises. Bond markets also provide a way of disciplining corporate borrowers and increasing their transparency. In countries like China and India where the needs for financing of large corporates and major infrastructure projects are close to exceeding the capacity of domestic banks, corporate bond markets can serve as an important conduit for channeling both domestic and foreign capital toward these needs.

However, the development of well-functioning corporate bond markets is closely tied to the development of government bond markets since the yield curve on low-risk government bonds serves as a benchmark for pricing corporate risk. In China, India and some other Asian emerging economies, although these markets are growing rapidly in size, the level of market development and depth is still limited partly because of regulatory constraints. The Asian Bond Markets Initiative and Asian Bond Fund projects have attempted to catalyze the development of regional fixed-income securities markets, particularly bond markets, with some tangible results. But more efforts are needed to further strengthen market infrastructure for bond issuance and trading.

Although derivatives products have acquired a negative connotation, there is a range of plain vanilla derivatives and securitized products that have proven to be useful innovations that reduce rather than raise systemic risk when properly regulated. These include commodity derivatives, which can play a key role in many developing economies where a significant fraction of the workforce is still connected to agriculture as well as the extraction and processing of primary commodities. Asian countries have become increasingly open to trade, making it valuable for importers and exporters in these countries to have access to exchange rate derivatives for hedging foreign currency risk.

Indeed, even during the throes of the global financial crisis, the Asian region made progress in setting up some of these markets. In particular, currency derivatives markets have only recently been set up in both China and India; the size of these markets expanded substantially in 2010, indicating the strong demand for these derivative products. Indian authorities have recently permitted the introduction of credit default swaps, albeit in a limited and carefully controlled manner. Nevertheless, this development shows both that there is a demand for a broader range of
derivative products in large emerging economies and that regulators are willing to accommodate this demand as long as there is a reasonable certainty that these products can be effectively regulated and do not elevate the level of systemic risk.

In the large emerging markets such as China and India, significant progress has been made in improving the technical infrastructure for trading various financial instruments, including equities, bonds, and derivatives. Moving more securities transactions onto open exchanges and creating a viable alternative for OTC transactions would increase transparency and efficiency in these markets. Extensive oversight of the payment, clearing, and settlement mechanisms will be necessary to maintain confidence in these markets, particularly to prevent any single financial firm from playing a dominant role, especially in relatively thin markets.

Many Asian emerging markets have experienced uneven financial development. For instance, in India the stock market has blossomed while other parts of the financial system have progressed more slowly. This varying pace across sectors is attributed to the differences in each market’s regulatory framework and public sector presence. For India, it will be important to reduce overlaps and gaps in the regulatory structure, increase convergence in financial market regulation, broaden financial services provision, create an independent debt management agency, and enhance interagency coordination.

Given these financial development priorities, the question is what the right approach should be to build regulatory capacity relative to fostering financial innovation and development. While it is tempting to put financial stability first and to focus on minimizing risks and potential losses, there could be costs in terms of inefficient credit allocation that results from underdeveloped financial markets.

This points to a difficult tension that emerging economies face between tight regulation that limits the development and/or introduction of new financial markets and products, and effective regulation that provides some space for financial innovation. Financial crises can have particularly painful effects on populations living at or near subsistence levels, so relatively poor and even middle-income countries might choose prudence
over innovation and its attendant risks. At the same time, if holding back financial innovation and development were to distort credit allocation or make growth less inclusive, then the costs would be large, even if they were hidden.

The solution might lie in broadening the perimeter of regulation and adapting the evolving international principles of regulation to suit the needs of newly emerging financial markets and firms. Indeed, since nonbank financial intermediaries in Asian emerging economies are typically smaller than those in advanced economies while also accounting for a relatively smaller share of the financial system, it should be easier for authorities in the region to upgrade their regulatory frameworks to encompass all such financial firms in a more comprehensive manner.

**Improving Financial Access in Emerging Markets**

Financial inclusion is a critical part of the financial development agenda for emerging markets. A significant fraction of the population in these economies lacks access to the formal financial system. This hinders inclusive growth and economic welfare in a variety of ways—by limiting access to credit (for households and entrepreneurs), risk sharing, and diversification of financial savings. Regulators sometimes see broadening financial inclusion as increasing risks to the financial system, but it could in fact be a key component of promoting rather than diminishing financial stability.

Indeed, inadequate access to credit for small and medium-sized enterprises as well as micro entrepreneurs has adverse effects on overall employment growth since these enterprises tend to be much more labor intensive in their operations than large-scale enterprises.

Financial inclusion often has been seen as a social priority that should be subsidized by the government. For instance, the Indian government requires banks to dedicate a certain proportion of their lending to “priority” sectors such as agriculture. Similarly, despite the purported absence of “directed lending,” Chinese banks continue to play an important role in financing investments by large state-owned enterprises. Unfortunately, this
makes the financial inclusion process much less effective and also reduces the overall efficiency of the financial system.

A different perspective is that financial inclusion ought to be viewed not just as a social priority but an area where private financial firms can do better than PSBs if given the right incentives. There is a large demand for even basic financial services in the underserved segments of the population in many Asian economies, particularly in rural areas. The constraint lies in achieving scale efficiencies that make it worthwhile for the private sector to reach these markets.

It is certainly true that broadening inclusion raises a number of conceptual challenges including balancing simplicity and complexity, communicating product characteristics clearly, and increasing the proximity of access. Tailoring financial products to each household rather than just having a generic range of products would be more effective from the perspective of financial inclusion, as the former approach allows for more support from providers and better takes into account behavioral biases and household characteristics.

The available microeconomic and macroeconomic evidence indicates the positive effects of financial inclusion, including microfinance, on individual and aggregate welfare. While innovations in financial inclusion may increase certain idiosyncratic risks, they are unlikely to contribute to systemic risk because of the small size of such entities and could in fact increase systemic stability by channeling financial activities through regulated formal financial firms rather than unregulated informal ones. The global financial crisis should be used as a catalyst to further develop financial inclusion policies that boost the resilience of economies; innovations aimed at countering financial exclusion help strengthen financial systems rather than weaken them.

A lot more work also needs to be done to harness the informal financial system that still plays an important role in developing countries and even in some emerging economies. There is a difficult set of issues that focus on the question whether informal financial systems still have a viable and useful role, and whether they can be brought into the regulatory net in a manner that makes them compatible with overall financial stability. But the role of the informal financial sector, and the potential problems
with instability associated with it, will tend to endogenously diminish in size as the formal financial system takes its place in delivering basic financial services to a broader segment of the population. Thus the financial inclusion agenda is not only compatible with but could also promote overall financial stability.

**Cross-border Regulation**

The global financial crisis is likely to result in policy measures to moderate cross-border capital flows and other aspects of financial globalization. Nevertheless, the capital accounts of emerging economies have become more open over time and it is unlikely that this trend can be reversed once the incentives for cross-border flows return. Macroeconomic policies and financial regulation in emerging markets will have to deal with this reality. The papers in this section cover how policy and regulatory frameworks can deal with complications associated with open capital accounts.

Indeed, issues related to cross-border supervision will be of increasing interest to Asian emerging economies as foreign financial firms increase their presence in the region and the region’s financial firms increase the scale of their foreign operations. Moreover, rising trade and financial linkages among Asian economies imply that the scale of cross-border financial transactions within the region itself will increase rapidly. For Asia a key aspect of greater financial integration relates to capital flows into and out of the region, both of which have increased sharply in recent years and have bounced back strongly after the crisis.

The following factors are likely to intensify the need for more effective cross-border regulation:

1. *Flows from Advanced Economies:* Capital flows from advanced economies to Asian emerging economies are likely to remain strong. The combination of robust growth prospects and tighter monetary policy of Asian emerging economies compared to those of advanced economies should encourage such capital flows.

2. *Rising International Exposure of Asian Banks:* The size and reach of major Asian banks have continued to expand over time. Many banks in the
region, particularly those based in China and India, are likely to have increasing cross-border exposure and become true international banks.

3. Asian Household Demand for Foreign Investments: As income levels in the region rise, the desire for international investments, especially for portfolio diversification purposes, is likely to increase among Asian households and corporations. This motivation is particularly high for aging individuals—especially those in high income economies of Hong Kong; Korea; Singapore; Taipei, China; as well as in China and Thailand—because of the need to secure post-retirement income from diversified sources.

4. The Role of Institutional Investors: Institutional investors based in the Asian region, including pension funds, could serve as an important channel for private as well as official funds to flow abroad. Sovereign wealth funds that manage a portion of national foreign exchange reserves are also likely to aggressively seek investments abroad when foreign asset values remain relatively inexpensive, and this pattern is likely to be maintained even after global financial markets have stabilized.

All of the factors listed above suggest that cross-border supervision will be of increasing interest to emerging Asia. Regulatory authorities in the region will face multiple challenges during the process of greater financial integration both within the region and with the rest of the global financial markets. These trends have led to the consideration of three types of complementary regulatory responses.

1. Greater Oversight by National Regulators: Cross-border operations naturally involve additional risk factors, especially exchange rate risk. National regulators are grappling with various dimensions of risk that arise from larger cross-border exposures, both from the perspective of individual financial firms and from a systemic perspective. In extending the principle of imposing capital requirements on individual units of financial firms in order to allow for orderly resolutions of firms in financial distress, one approach worth considering is to explicitly impose capital requirements on country-specific operations of each financial firm.

2. Better Coordination with Regulators from Outside the Region: The G-20 Working Group on Financial Regulation has noted that exchanges of
information with other national regulators via international colleges of supervisors can enhance monitoring of their domestic financial firms as well as that of foreign firms that have a substantial presence in the region. Regulatory enforcement would still be under the purview of national regulators but this process would improve information sharing and also serve as an additional channel for dissemination of regulatory best practices.

3. Greater Coordination among Regulators in the Region: This is an avenue for promoting regional financial stability. The idea mooted by the G-20 of having colleges of supervisors that could coordinate, or at least share, information concerning financial firms that have large cross-border operations could in principle be implemented at the regional level. There are a number of practical challenges, however, in terms of coordination among countries with very different levels of financial market development, institutional quality, and regulatory capacity. There is a logical role that regional multilateral institutions like the Asian Development Bank and the Inter-American Development Bank could play in fostering and facilitating this process. For example, an Asian Financial Stability Dialogue could be established so that finance ministry officials, central bankers and financial regulators could coordinate their activities to promote regional financial stability.

The academic literature has identified four sources of contagion during the global financial crisis—toxic asset losses, mismatches between assets and liabilities, tighter linkages among financial markets around the world, and portfolio rebalancing of large financial conglomerates. Future regulatory design should include elements such as a global perspective, broader information exchange across emerging markets, insolvency mechanisms for international financial conglomerates, and clear assessment of sources of vulnerabilities.

The global financial crisis also highlighted the problems associated with currency mismatches on the balance sheets of emerging market borrowers, particularly in emerging Europe. The mispricing of foreign exchange risk, externalities from foreign currency exposure, and weak macroeconomic and institutional credibility all contributed to financial dollarization. The experience of Latin America shows a successful case of de-dollarization. Based on such experiences and emerging Europe’s own
circumstances, emerging European economies need a set of macroeconomic and institutional reforms, further development of domestic currency and debt markets, and common application of regulation across economies.

In the aftermath of the global financial crisis, organizations such as the Bank for International Settlements, the International Monetary Fund, and the Financial Stability Board are refashioning international regulatory norms and standards. Emerging market economies would ultimately benefit from the greater financial stability that will be engendered by the steps taken by these organizations. However, these international agencies are standard-setting bodies that can only provide guidance on codes and international best practices. They are unlikely to enforce international standards or to intrude into individual countries’ implementation of those standards. Aligning their own regulatory frameworks with these new standards will be the responsibility of the individual country authorities, creating a complex set of challenges.
AUTHORS AND CONTRIBUTORS

Viral V. Acharya is professor of finance at the New York University Stern School of Business and a research affiliate of the Center for Economic Policy Research, European Corporate Governance Institute, and National Bureau of Economic Research.

Bindu Ananth works for IFMR Trust.

Thomas Cooley is Richard R. West Dean and the Paganelli-Bull Professor of Economics at the New York University Stern School of Business.

Douglas J. Elliott is with the Brookings Institution.

Alfred Hannig is the executive director of the Alliance for Financial Inclusion.

Stefan Jansen is a financial sector specialist and an associate of the Alliance for Financial Inclusion.

Stephen Jeffrey is at Warwick University.

Masahiro Kawai is dean and CEO at the Asian Development Bank Institute.

K. P. Krishnan serves at present as secretary of the prime minister’s Economic Advisory Council in the Government of India and before this worked for many years in the Ministry of Finance of the Government of India.

Rakesh Mohan is a nonresident senior research fellow at the Stanford Center for International Development, Stanford University.

Nachiket Mor is the president of the ICICI Foundation for Inclusive Growth and the chair of the IFMR Trust Governing Council.

Piroska M. Nagy is with the Office of the Chief Economist, European Bank for Reconstruction and Development (EBRD).
Anwar Nasution is professor of economics at the University of Indonesia and served as the senior deputy governor of Bank Indonesia from 1999 to 2004, and chairman of the Supreme Audit Board of Indonesia from 2004 to 2009.

Luo Ping is the director general of the training department of the China Banking Regulatory Commission.

Michael Pomerleano is an advisor at the World Bank.

Eswar S. Prasad is the Tolani senior professor of trade policy at Cornell University, a senior fellow at the Brookings Institution, and a research associate at the National Bureau of Economic Research.

Suyash Rai works for IFMR Trust.

Richard Reid is director of research at the International Center for Financial Regulation (ICFR).

Matthew Richardson is Charles Simon professor of applied financial economics at the New York University Stern School of Business and Sidney Homer director of the Salomon Center for Research in Financial Institutions and Markets, and a research associate of the National Bureau of Economic Research.

Ingo Walter is vice dean of faculty and Seymour Milstein professor of finance, corporate governance and ethics at the New York University Stern School of Business.

Alejandro Werner is undersecretary of the Ministry of Finance, Mexico.

Guillermo Zamarripa is head of the Banking, Securities and Savings Unit, Ministry of Finance, Mexico.

Jeromin Zettelmeyer is with the office of the Chief Economist, European Bank for Reconstruction and Development (EBRD).
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The rapid spread and far-reaching impact of the global financial crisis have highlighted the need to strengthen financial systems in advanced economies and emerging markets. Emerging markets face particular challenges in developing their nascent financial systems and making them resilient to domestic and external shocks.

In this timely volume Masahiro Kawai, Eswar Prasad, and their contributors offer a systematic overview of regulatory frameworks in both advanced countries and emerging markets. Their analyses and observations clearly point out the challenges to improving regulation, efficiency of markets, and access to the financial system. Policymakers and financial managers in emerging markets will need to grapple with some key questions as they restructure and reform their financial markets:

◆ What lessons does the global financial crisis of 2007–09 offer for the establishment of efficient and flexible regulatory structures?
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This booklet summarizes the analysis presented in the new ADBI and Brookings Institution Press title: Financial Market Regulation and Reforms in Emerging Markets

Masahiro Kawai is dean of the Asian Development Bank Institute. From 1998 to 2001, he was chief economist for the World Bank’s East Asia and the Pacific Region, and he later was a professor at the University of Tokyo.

Eswar S. Prasad holds the New Century Chair in International Economics at the Brookings Institution. He is the Tolani senior professor of trade policy at Cornell University and a research associate at the National Bureau of Economic Research. He was previously head of the Financial Studies Division and the China Division at the International Monetary Fund.