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Emerging Markets Tranquil Oases in a Sea of Turbulence?
Financial Regulation and Lessons learned for the EME from Subprime and other Crises
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A comparison between the Asian crises of the 1990s and the recent sub-prime crises confirms that the emerging market economies (EME) were better able to withstand the repercussions and fallout from the crisis situation this time round.[1] Learning from the Asian crises, most EME undertook policy reforms aiming at ensuring financial soundness, built up strong macroeconomic fundamentals and also maintained an extremely healthy external position through increased export competitiveness, reducing external debt and increasing foreign exchange reserves. Additionally, the development of local currency debt and bond markets, as well as improvements in banking regulation and supervision – through stronger bank capitalization, reduction in non-performing loans (NPLs) (resulting from policy reforms, the implementation of Basel I and lessons from the Asian crisis), improved soundness and lower vulnerability indicators – helped mitigate the risk of exposure by the EME. Most credit institutions in EME also had limited exposure to: structured products, collateralized debt obligations (CDO), asset backed securities (ABS), credit derivatives; international credit and bank market; and off balance sheets items.

Subsequent to the turmoil, policy makers have been more keenly aware of the importance of addressing the underlying causes of the problems, rather than the symptoms. The focus is no longer on how the turmoil should be managed, but on policy reforms to strengthen the financial system on a longer-term basis, regardless of the specific sources of disturbances.

The turmoil in global financial markets is still evolving, however, and the risks to global financial stability are serious. Among the pressing problems to be addressed by regulators are the poor risk management practices by firms, the weaknesses in disclosure and in the originate to distribute model, regulatory frameworks, poor performance by the credit rating agencies in rating models (especially in the case of structured credit products). Private agents who were expected to enforce transparency and governance standards, disclosure and accuracy in information have misled investors to pursue immediate benefits, hence leading to the current crisis in that most important of financial markets, the mortgage market.

Planks for Policy Action and Reform

Central banks have played a pivotal role when the credit crisis risked generating a major financial meltdown, in order to restore financial and macroeconomic stability and improve

[1] Refer to Khor Hoe Ee and Kee Rui Xiong, "Asia: A Perspective on the Subprime Crisis", Finance and Development, June 2008 for more discussion on this topic.

supervision. However the persisting crisis has revealed weaknesses in central bank and regulatory monitoring, supervision and available tools for intervention in the event of liquidity 'evaporation'. Central banks and regulators need to enhance their macro-prudential toolkit to understand and address the recurring problems of liquidity, leverage, and contagion in today's globalized financial system. Creation of a right balance between progress and prudence, innovation, and caution becomes necessary. This will ensure that any move away from traditional banking practices toward more innovative techniques will be accompanied by enhanced management of liquidity risk and by enhanced prudential supervision. Specifically these principles translate into 5 main planks for policy action and reform, applicable to both developed and emerging market countries:

- Credit standards must be maintained at all times and bank supervisors need to ensure compliance
- Central banks will need to extend their mandate and regulatory/supervisory net to include investment banking
- The balance sheets of banks as well as the corporate sector need to be monitored constantly, including subsidiaries in foreign countries and off-balance sheet items
- Good corporate governance in financial institutions should be instilled through increased transparency, timely disclosure to markets, shareholders and regulators
- Financial linkages must be understood: policymakers and regulators should ensure that sufficient resources are devoted to financial surveillance, supervision, and risk management to mitigate the risks engendered by financial innovations
- Economic fundamentals are essential: sustainable current account balances and a foreign reserves cushion help ensure that the consequences of an exogenous shock can be mitigated.

Central Banks and Basel Frameworks

The credit crisis and problems of illiquidity over the past year has also made clear that central banks need to develop a liquidity management framework. The fundamental lesson is that disruptions and contractions in financial institutions balance sheets can lead to a reduction in real economic growth. Central banks need to impose liquidity risk management standards on the extended banking system (i.e. including investment banks), while the role of the Central Bank as lender of last resort and the nature of acceptable collateral needs to be developed. Financial firms have used ad hoc approaches to control market liquidity risk so far, making their responses to crises difficult to anticipate, generating systemic risk. Potential sources of risk need to be tackled, through improvements to the risk management systems and correcting the pitfalls of the originate-to-distribute model to reduce Principal-Agent problems. In essence, banks were encouraged to neglect credit risks of clients because they knew or assumed that they could offload these risks through securitization. Investors that acquired the securitized loans were not aware of the deterioration in the quality of the collateral because they were basing their decisions on past records of mortgages defaults. These practices and the distorted incentives which encouraged reckless lending on a monumental scale will need to be reformed to restore financial soundness and the confidence of investors.

The current crisis has also exposed the weaknesses of the Basel I and II frameworks' excessive reliance on credit ratings to signal which securitized assets are the riskiest and highlighted the pro-cyclicality of capital adequacy requirements. Despite these weaknesses, what is required now is not writing off Basel II or delaying its implementation, but a better implementation of Basel II guidelines. Following the Financial Stability Forum recommendations, there is a need for more rigorous stress-testing, particularly in downturn economic conditions for strengthening capital treatment of complex securities; improved governance of supervisors including more pervasive powers to request timely information and investigate dubious practices; stricter guidelines to investment banks (e.g. recommend only investment grade products); and clarity in accounting rules including off balance items

The GCC: tranquil oasis in a sea of financial turbulence

Turning to the GCC and wider MENA region, evidence suggests that exposure to the sub-prime crisis has been limited for a number of reasons:

- The low prevalence of and exposure of the banking and financial systems to securitized or structured products with complex features embedded
- Limited expertise in assessing structured investment products and therefore reluctance to take exposure to these assets
- Regulatory and prudential rules which discouraged exposure to sub-investment grade investments or instruments
- Growing importance of Islamic banking and finance, and compliance with Shari'a tenets in financial instruments that resulted in 'market segmentation' and lower portfolio substitution effects.
- Higher risk-adjusted returns on investments in EME than in traditional markets

With the implementation of Basel II, especially in the Middle East and North Africa/Gulf Cooperation Countries (GCC) region, banks will have to be more transparent and maintain high levels of transparency and disclosure. Banks will be forced to manage risks better with balance sheet and off-balance sheet information being made public.

GCC regulators have so far decided that banks must first implement the simplest approach to capital management under Basel II - "standardized approach". Some have already implemented this new regulation on minimum capital ratios, but setting up a system to measure credit and operational risk can be both a costly and time-consuming process. Over the medium term, the more sophisticated Gulf banks will move to the "Internal Ratings Based" approach especially if they are to compete in international markets. However, the challenge will be to find reliable regional data on the Probability of Default and Loss Given Default. From this viewpoint, recent experience with strong growth, booming conditions and high profitability cannot be a guide to default rates or deteriorating credit conditions. For the

GCC countries that are living exuberant growth rates, setting up early warning systems and monitoring credit market developments should be a high economic and monetary policy priority.

Lessons Learned and Moving Forward

An important lesson from the sub-prime crisis and earlier crises is that private entities have incentives to abuse their positions as referees or de facto regulators leading to an increase in systemic risk and crises. During the dot com bubble it was the financial analysts' role; with the corporate governance crises –the Enron, WorldCom, Parmalat and related episodes-, it was more to do with the role of the auditing firms; the recent sub-prime crisis questioned the credibility of the rating agencies and banking and financial regulators and their role in monitoring credit risk. The damage to investors' trust from these fiascos cannot be remedied by injection of cash at tax payer expense or loose monetary policy – what needs to be done is reform of regulation, oversight and governance. Both the EU and the US are moving towards regulating credit rating agencies and extending the regulatory net to encompass investment and other financial intermediaries[2]. Until September 2006 rating agencies were essentially deregulated and afterwards the only requirement was an obligation to register with the Federal Reserve. Given the oligopolistic structure of the ratings market, the regulatory framework currently in place hinges on self-regulation in the form of the Fundamentals of a Code of Conduct for Credit Rating Agencies issued by the International Organization of Securities Commissions (IOSCO).

In addition to the general lessons for EME central banks, it is imperative to build resilient and sound local capital and bond markets. While it is essential to establish early warning systems, it is also necessary to invest in good corporate governance frameworks and compliance to address issues of transparency, disclosure, risk management and executive compensation. Other than these broad issues, the implementation of Basel II needs to be on track and it should be augmented by an efficient liquidity management framework (lender of last resort and eligible collateral).

[2] The European Internal Market Commissioner, Charlie McCreevy, has delivered a speech titled "Regulating in a Global Market" which underscores the new approach proposed by the EU Commission. On April 22 2008 the U.S. Senate Committee on Banking, Housing, and Urban Affairs heard testimony from the Chairman of the SEC, two experts on the role of credit rating agencies in the credit markets and representatives of the three largest rating agencies. The mood of the Committee was much in favor of new legislation to on credit rating agencies regulation.