



Enhancing Risk Management and Governance in the Region's Banking System to Implement Basel II and to Meet Contemporary Risks and Challenges Arising from the Global Banking System

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*Session 2.1/2*

## **Financial Crisis and Regulatory Responses**

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## Financial crisis and regulatory responses

### A perspective from the Chinese banking supervisor

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## A series of unbelievable failures

- We have been all shocked
  - The collapse of Bear Stearns
  - The massive federal rescue of Fannie Mae and Freddie Mac
  - Lehman Brothers filing for bankruptcy.
  - Merrill Lynch sold to Bank of America.
  - The Fed \$85bn takeover of AIG.
- With confidence replaced by an unprecedented level of fear, lending is frozen and worldwide markets are plunging. No decoupling.
- “Simply stated, the bright new financial system – for all its talented participants, for all its rich rewards – has failed the test of the market place.” Paul Volcker
- “Modern history’s greatest regulatory failure” Roger Altman, former deputy US Treasury secretary



## Words from senior supervisors

- “**S**imply stated, the bright new financial system – for all its talented participants, for all its rich rewards – has failed the test of the market place.” Paul Volcker April 2008
- “**T**his will come to be seen as the greatest regulatory failure in modern history.” Roger Altman, former deputy US Treasury secretary September 2008
- “**I**t is poor execution of the basics that are at the root of today’s problems.” Nout Wellink, Basel Committee chairman 2008




## Factors contributing to the financial crisis

### Commonly recognized causes

- Exceptional boom in credit growth and leverage of financial institutions
- Growth of financial innovations outpacing institutions’ capacity to manage associated risks
- Poor underwriting standards
- Shortcomings in firms’ risk management practices
- Poor investor due diligence
- Poor performance of rating agencies for structured products
- Incentive distortion



## Regulatory gaps/failures



**CBRC  
assessment  
April 2008**

- Inaction to stop lax credit underwriting standards
- Lack of regulation/oversight of complicated financial instruments such as securitizations
- Lack of regulation/oversight of shadow banking institutions such as mortgage brokers, SIVs, as well as investment banks, rating agencies
- Lack of regulation/oversight of cross-sector risk

## Laissez faire capitalism/free market economy



**Deregulation  
too far?**



- **Best regulation is least regulation**
- **Government regulators were no better than markets at imposing discipline**
  - ♦ Policy to deal with real estate bubbles by cutting interest rates later rather than preventing bubbles from inflating
  - ♦ fear of new regulation of over-the-counter derivatives risked disrupting the capital markets 2002
- **Belief in self-correcting power of markets**



## Underlying theoretical framework and rethinking



**Truth does  
not  
change?**

- “I do have an ideology. My judgment is that free, competitive markets are by far the unrivaled way to organize economies. We’ve tried regulation. None meaningfully worked.” Greenspan before the crisis
- “I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms. ” Greenspan after the crisis Oct. 2008.



## I’m a free market person



**Gorge  
Bush  
Nov. 2008**

- The crisis is not a failure of the free market-system
- If you seek economic growth, social justice and human dignity, the free market system is the way to go
- Government intervention is not a cure-all
- Whether the American leadership in the global economy will continue?
  - ◆ The world will see the resilience of America once again

## The repeal of Glass-Steagall had fueled the crisis ?

### A debate is going on

- Glass-Steagall has been a thorn in the side of American financial industry which like the proverbial lion has howled about the thorn in its paw.
- The more subtle hazards arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments.

*Glass-Steagall forces separation where conflicts and losses can be Mitigated. The case should be considered again*



## Impact of financial crisis on China

### Direct impact: small

- **B**y Sept , total foreign exchange portfolio investments of major banking institutions \$160 billion. Exposures to seven major financial institutions overseas \$7 billion. Total un-realized losses\$1.5 billion

### Potential indirect impact: significant

- **C**redit risk
  - ◆ Of \$160 portfolio investment , 11.3% government bonds , 14.9% agency or quasi government bonds , bonds by financial institutions 37.7% , corporate bonds 7.8% , securitized assets and others28.2%
- **M**arket risk
  - ◆ In terms of currency composition,75.2% in US dollars,10.5% in HK dollar , 7.5%in Euro

## Case of a quite highly regulated banking industry



### China's regulatory practices: back to basics

- Prudent mortgage lending standards
  - ◆ 30% down payment for first homes and 40% for others, verification of income
  - ◆ Stress tests
- Broader oversight of all banking institutions
  - ◆ Say no to shadow banks, raising fund by conduits impossible
- Conservative approach to innovative products
  - ◆ Supervisory approval needed in many cases
- Continued separation of commercial from investment banking

*Stress on regulation in absence of strong market forces*

## Policy orientation of CBRC: Oct 2008

1

Stress on core deposit, risk management and provision of quality services

2

Provision of cross sector financial services is to proceed cautiously with strong emphasis on bank-wide risk management

3

Innovation is to proceed based on an effective cost and benefit analysis for innovative products, robust risk management system and enhanced disclosure

4

A fine balance between the pursuit of policy objectives and maximization of shareholders' profit

## Looking ahead

- Change of financial landscape is inevitable
- More regulation is inevitable and more specifically a higher capital ratio is inevitable
- A continued fight against financial crisis is inevitable
- Learning from mistakes is inevitable

*We will for sure survive the current crisis hopefully  
with a stronger financial system than before.*



## Government position on financial crisis

**Premier Wen Jiabao 28th Oct 2008**

- **T**o improve the functioning of the international financial organizations so as to be more responsive in maintaining international and regional financial stability and strengthen financial regulation. Emerging markets should be involved more in the decision making and rule making process.
- **T**o reform the international financial regulatory/supervisory system so as to set forth appropriate and effective standards, early warning system and crisis prevention system, particularly the monitoring of major reserves currencies countries.
- **T**o speed up the formulation of a diversified international currency system so as to give more height to a number of currencies in support of the stability of the international monetary system.





**Thanks!**

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