

## Discussant on the ADB July 09 Report, “Beyond the Crisis: Regulatory Reform”

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## Comments on Regulatory Reform

- I concur that **leverage** makes matters worse!
  - It has been an age old problem in *how to regulate human greed* !?!
  - **Capital market failures** can exacerbate the problem posed by coordination failure and broader macro-economic failure.
  - What if the regulation and market belief based on *false assumptions* are the main causes?
  - It is interesting to see
    - Single vs Multiple regulators on p. 81 & 82
    - “No one-size-fits-all” **regulatory** (p. 80)
- IF WE ALL use the Western model of “ideal free” market, Asia would be in equally big mess.

## Disclaimer / Safe Harbor

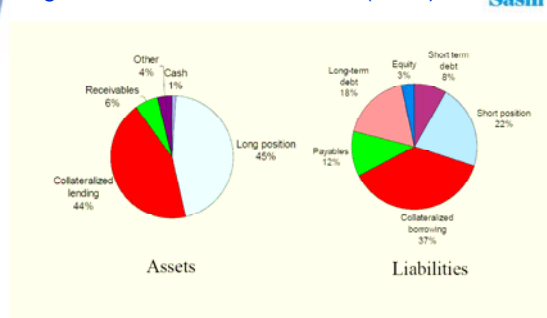
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Fig 1: Lehman Balance Sheet (2007)



- Why did Lehman brother allow to leverage excessively ?
- The inter-lock financial contracts with others were over USD1 Trillion.

## ADB July 09: Beyond the Crisis & Regulatory Reform

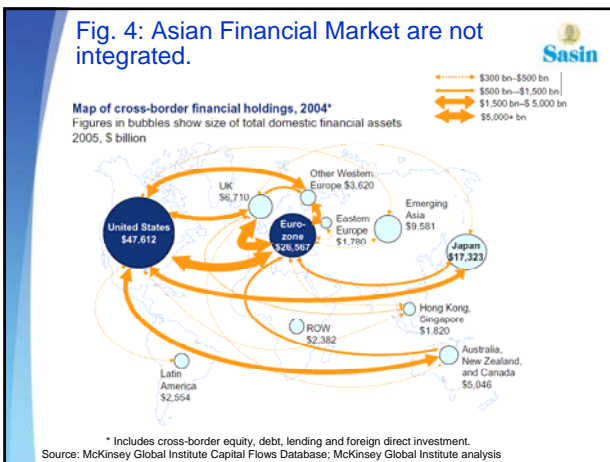
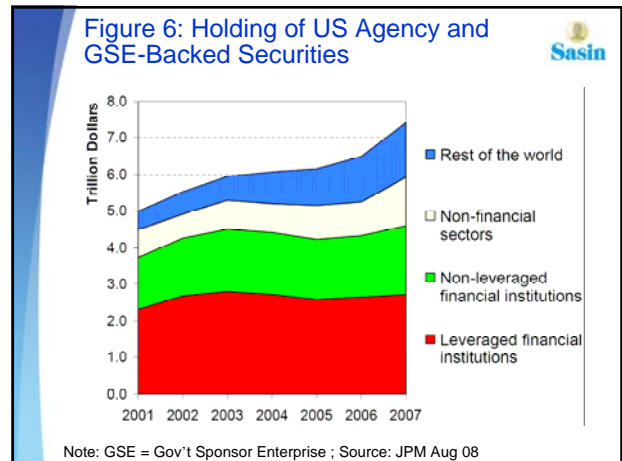
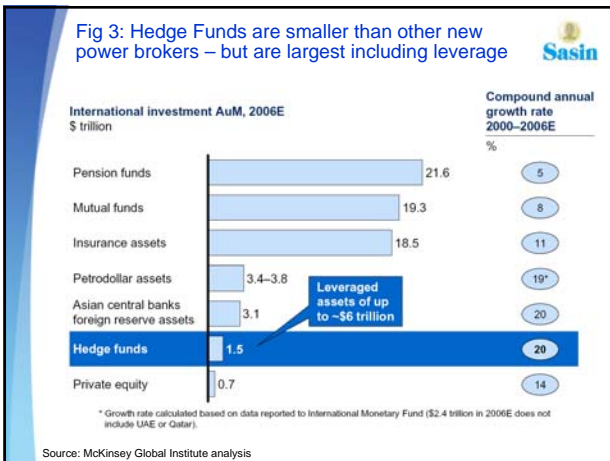
Rational for Regulatory Reform:

1. Supervisors failed to stop excessive risk-taking & **leveraging** by banks.
  - > Market failures lead to **systemic crisis**.
2. Crisis mgt in helping resolve impaired financial institutions – local & int'l
  - > Need a better coordination.
    - between agencies & across nations
  - > Need for **unified regulatory framework**
    - At home and oversea.

Fig 2: Leverage can accelerate forced selling with deep discounted price



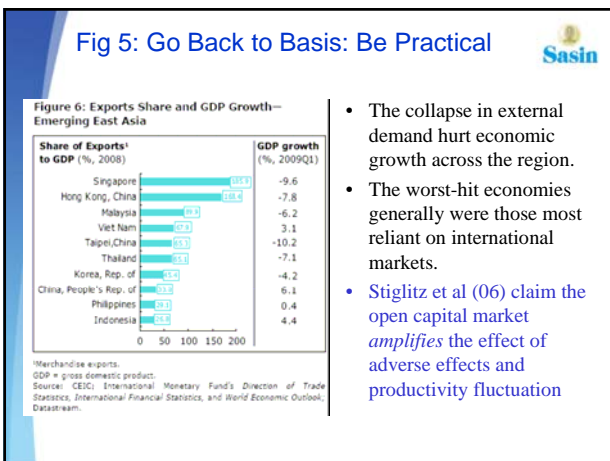
Source: Hedge funds: The credit market's new paradigm, Fitch Ratings, June 5, 2007



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Five lessons to be learned from the crisis:

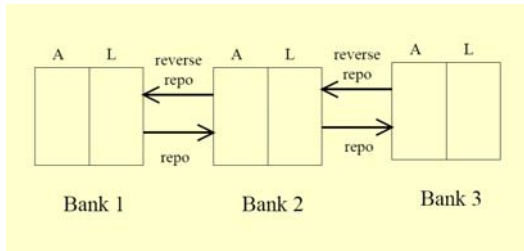
- 2.1 **Regulatory Gap**, Regulatory Arbitrage across products, services & nations
- 2.2 Shadow Banking & **Excessive Leverage**
- 2.3 Contagion & **Financial interdependence**
- 2.4 **Misaligned incentive** in compensation scheme – “Originate-to-distribute” model
- 2.5 **Pro Cyclical regulatory** of financial system



**Latent Risks & Sum of all risks**

- Systemic risk and idiosyncratic risk
  - > Good discussion on Co-Var & VAR (p. 85)
  - > Hoontrakul (08) suggests pricing deposit premium and bank risk for *both* wholesale and retail funding based on Co-Var and VAR.
- Pro vs Counter – Cyclical Measure
  - > Spanish Bank Discussion (p. 88)
  - > Hoontrakul (08) suggests *both* dynamic provision and regulations.

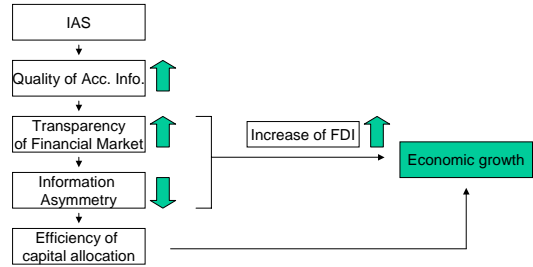
Figure 7 – Interlocked Balance Sheet of Banks create financial interdependence



Why did pre-crisis banks use wholesale funding more than retail funding ? >> Bad Regulations or Imprudent Mgt.

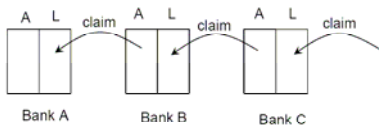
Source: Morris & Shin (2008) and Hoontrakul (2008)

Fig 10: Anglo-American View Decision making for investors



Bad accounting Frameworks pose a danger, claimed Stiglitz et al (2006)

Figure 8 - Domino Hypothesis

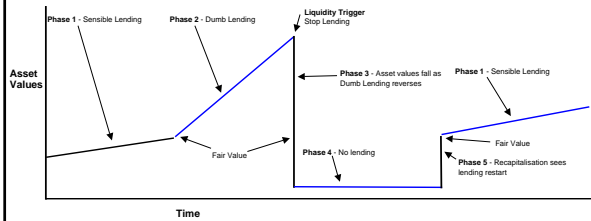


- Channel of financial contagion is chain of defaults.
  - Passive players, who stand by while others fail
  - No role for prices
  - Only implausibly large shocks generate any contagion in simulations

In 2007/8 crisis, direction of contagion has been reversed.

Bear Stearns and Northern Rock crises were runs on the liabilities side.  
Source: Morris & Shin (2008)

Figure 11: Simplified Asset Value Cycle



Source: J.P. Morgan (Oct 08)

Figure 9: 1 to N Wholesale Bank Creditors Run on Bank 0

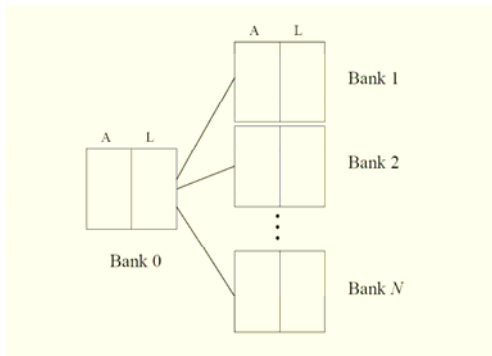


Fig 12: This is not new!! A brief US history: FVA and HCA

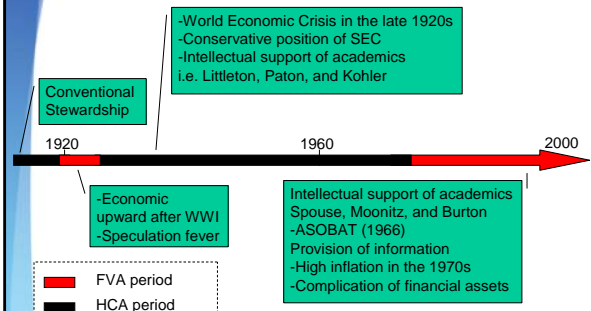


Fig 13: Historical Cost A/C (HCA) and Fair Value A/C (FVA)

	HCA (Historical Cost Accounting)	FVA (Fair Value Accounting)
Key features	<ul style="list-style-type: none"> <li>-Stewardship                             <ul style="list-style-type: none"> <li>•European tradition (esp. Italy and England)</li> </ul> </li> <li>-Income-Statement</li> <li>-Exclusion of unrealized profit                             <ul style="list-style-type: none"> <li>•Distributable profit</li> </ul> </li> <li>-Confirmatory value (transaction based)</li> </ul>	<ul style="list-style-type: none"> <li>-Investment Decisions                             <ul style="list-style-type: none"> <li>•ASOBAT (1966)</li> </ul> </li> <li>-Balance-Sheet</li> <li>-Inclusive of unrealized profit</li> <li>-Predictive value (present values, models, and estimates)</li> </ul>

## Conclusion

- ADB report has a very good & extensive discussion on the great credit crisis.
- Its implied implications are still deeply based on “ideal market” based approach.
- Financial interdependence in globalized world can not be underestimated.
- Pricing for systemic or market risk is equally important to idiosyncratic risk
- What one should learn is how the Asia banking has survived by being practical and conservative.

## Facts-based accounting and Forecasts-based accounting (Ijiri 2005)

- Even for investors, information about the profit and basic accounting information are the most important one. **Historical cost accounting** is the appropriate method for these information.
- Balancing both accounting information: financial record and financial report.
- Taka, Seko & Hoontrakul (08) suggest the 3 steps with the first step to *amend* IAS 39 to build trust.
- **More importantly**, **IASB** this month outlined the first phase of its project to **replace IAS 39**, while **FASB** unveils the **overhaul MTM** based financial accounting.

## Reference

- Fujioka, Taka, Seitaro Seko & Pongsak Hoontrakul (Nov 08\*) “The state of fair value measurement, global financial crisis & implications to Thailand”, Sasin
- Hoontrakul, Pongsak (Nov 08\*) “Global Financial Crisis & Implications to Thailand: An ex-Banker’s View”, Sasin
- Morris, Stephen & Hyun Song Shin (2008) “Financial Regulation in a System Context”, Princeton Univ
- Stiglitz, J. et al (2006) “Stability with Growth”, Oxford Press.
- (July 09) “Beyond the Crisis: Regulatory Reform in Emerging East Asia”, ADB

\* Free downloadable at [www.Pongsak.Hoontrakul.com](http://www.Pongsak.Hoontrakul.com)

## Latent Risks & Sum of all risks

Macro-Prudential Supervision to complement micro-prudential regulations !?!

- > BIS Std have a pro-cyclical bias.
- > BIS on focus on the asset side: default loans
- > IAS 39 or MTM A/C is pro-cyclical

Stiglitz et al discuss on economics as choices

- Latent Risks for full cycle, not current econ
- Macro-econ is intrinsically political process & decision. Ex: Unemployment & Inflation
- Micro-economic is based on individual rational in given framework. Ex: Central Bank & Inflation

# END

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