FINANCIAL INSTABILITY, REGULATORY REFORMS AND BANK GOVERNANCE
– LESSONS FROM THE EAST-ASIAN FINANCIAL CRISIS

A thesis submitted to the University of Manchester for the degree of Doctor of Business Administration (DBA) in the Faculty of Humanities

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<table>
<thead>
<tr>
<th>Ch. No.</th>
<th>Chapter/Section Name</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction</td>
<td>11</td>
</tr>
<tr>
<td>2</td>
<td>Literature Review</td>
<td></td>
</tr>
<tr>
<td>2.1</td>
<td>Introduction</td>
<td>15</td>
</tr>
<tr>
<td>2.2</td>
<td>Economic and Historical Context of Financial Crises</td>
<td>16</td>
</tr>
<tr>
<td>2.3</td>
<td>Minsky’s Financial Instability Hypothesis</td>
<td>22</td>
</tr>
<tr>
<td>2.4</td>
<td>Regulatory Reforms and Bank Governance</td>
<td>36</td>
</tr>
<tr>
<td>2.5</td>
<td>The East Asian Experience</td>
<td>44</td>
</tr>
<tr>
<td>2.6</td>
<td>The Research Question and its Ramifications</td>
<td>50</td>
</tr>
<tr>
<td>3</td>
<td>Research Methodology</td>
<td>53</td>
</tr>
<tr>
<td>3.1</td>
<td>Overview of Existing Research Methodologies</td>
<td>53</td>
</tr>
<tr>
<td>3.2</td>
<td>Research Methodology Adopted for this Project</td>
<td>70</td>
</tr>
<tr>
<td>3.3</td>
<td>Research Methodology – Implementation Aspects</td>
<td>74</td>
</tr>
<tr>
<td>3.4</td>
<td>Limitations of the Research Methodology</td>
<td>87</td>
</tr>
<tr>
<td>3.5</td>
<td>Ethical Considerations</td>
<td>88</td>
</tr>
<tr>
<td>3.6</td>
<td>Summing Up</td>
<td>89</td>
</tr>
<tr>
<td>4</td>
<td>Macro-economic and Policy Environment Prior to 1997 Crisis</td>
<td>91</td>
</tr>
<tr>
<td>4.1</td>
<td>Favourable Macro-Economic Environment</td>
<td>92</td>
</tr>
<tr>
<td>4.2</td>
<td>Policy and Institutional Environment</td>
<td>96</td>
</tr>
<tr>
<td>4.3</td>
<td>Factors Influencing Bank Governance</td>
<td>102</td>
</tr>
<tr>
<td>4.4</td>
<td>Risk Management Failures</td>
<td>109</td>
</tr>
<tr>
<td>4.5</td>
<td>Panic Dimension in the East-Asian Crisis</td>
<td>117</td>
</tr>
<tr>
<td>4.6</td>
<td>Summing Up</td>
<td>124</td>
</tr>
<tr>
<td>5</td>
<td>Regulatory Reforms Post 1997 Crisis</td>
<td>126</td>
</tr>
<tr>
<td>5.1</td>
<td>A New Regulatory Philosophy</td>
<td>127</td>
</tr>
<tr>
<td>5.2</td>
<td>Changes in Ownership Structures</td>
<td>136</td>
</tr>
<tr>
<td>5.3</td>
<td>Enhancing Market Discipline</td>
<td>144</td>
</tr>
<tr>
<td>5.4</td>
<td>Financial Innovation and New Financial Products</td>
<td>152</td>
</tr>
<tr>
<td>5.5</td>
<td>Summing Up</td>
<td>158</td>
</tr>
<tr>
<td>6</td>
<td>Bank Governance and Risk Management Post 1997 Crisis</td>
<td>160</td>
</tr>
<tr>
<td>6.1</td>
<td>Professionalising the Board</td>
<td>161</td>
</tr>
<tr>
<td>6.2</td>
<td>Regulatory Reforms in the area of Risk Management</td>
<td>172</td>
</tr>
<tr>
<td>6.3</td>
<td>Promoting the Right Compliance Culture</td>
<td>189</td>
</tr>
<tr>
<td>Ch. No.</td>
<td>Chapter/Section Name</td>
<td>Page No.</td>
</tr>
<tr>
<td>--------</td>
<td>----------------------</td>
<td>----------</td>
</tr>
<tr>
<td>6.4</td>
<td>Summing Up</td>
<td>192</td>
</tr>
<tr>
<td>7</td>
<td>A Minskian Analysis of 1997 Crisis and Regulatory Reforms</td>
<td>194</td>
</tr>
<tr>
<td>7.1</td>
<td>Introduction</td>
<td>194</td>
</tr>
<tr>
<td>7.2</td>
<td>Destabilising Effects of a Stable Macro-Economic Environment</td>
<td>196</td>
</tr>
<tr>
<td>7.3</td>
<td>Role of Regulation in Stabilising an Unstable Economy</td>
<td>200</td>
</tr>
<tr>
<td>7.4</td>
<td>Evolution of a New Banking Business Model</td>
<td>205</td>
</tr>
<tr>
<td>7.5</td>
<td>Business Strategy, Risk Management and Bank Governance</td>
<td>213</td>
</tr>
<tr>
<td>7.6</td>
<td>Limitations to the Analysis</td>
<td>217</td>
</tr>
<tr>
<td>8</td>
<td>Conclusion</td>
<td>219</td>
</tr>
<tr>
<td>8.1</td>
<td>Academic Contribution and Policy Implications</td>
<td>219</td>
</tr>
<tr>
<td>8.2</td>
<td>Pointers for Further Research</td>
<td>222</td>
</tr>
<tr>
<td>8.3</td>
<td>Summing Up</td>
<td>223</td>
</tr>
<tr>
<td></td>
<td><strong>Annexes</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Annexure 1 - List of External Interviewees</td>
<td>224</td>
</tr>
<tr>
<td></td>
<td>Annexure 2 - Questionnaire for External Interviewees</td>
<td>226</td>
</tr>
<tr>
<td></td>
<td>Annexure 3 - List of Case Study Bank Officials</td>
<td>227</td>
</tr>
<tr>
<td></td>
<td>Annexure 4 - Interview Questionnaire for Case Study Bank Officials</td>
<td>228</td>
</tr>
<tr>
<td></td>
<td><strong>Bibliography</strong></td>
<td>230</td>
</tr>
</tbody>
</table>

**Total Word Count:** 87223
List of Tables

<table>
<thead>
<tr>
<th>T. No.</th>
<th>Table</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>Exchange Rate Regimes of East Asian Nations (1996)</td>
<td>93</td>
</tr>
<tr>
<td>4.2</td>
<td>Structure of Banking Systems before the Crisis</td>
<td>103</td>
</tr>
<tr>
<td>4.3</td>
<td>Prior Crises in East Asian Nations</td>
<td>106</td>
</tr>
<tr>
<td>4.4</td>
<td>Related Party Lending and Governance Failures</td>
<td>109</td>
</tr>
<tr>
<td>4.5</td>
<td>Domestic Bank Credit and Property Exposures</td>
<td>111</td>
</tr>
<tr>
<td>4.6</td>
<td>Rate of Currency Depreciation 1997-98</td>
<td>120</td>
</tr>
<tr>
<td>4.7</td>
<td>Broad Indicators of Economic Impact of Crisis</td>
<td>124</td>
</tr>
<tr>
<td>7.1</td>
<td>Increased Stature of Central Bank Oversight in East Asia</td>
<td>201</td>
</tr>
<tr>
<td>7.2</td>
<td>Extracts from Annual Reports of Case Study Banks</td>
<td>207</td>
</tr>
<tr>
<td>7.3</td>
<td>Positive Impact of New Business Models on Profitability &amp; Growth</td>
<td>214</td>
</tr>
</tbody>
</table>

List of Figures

<table>
<thead>
<tr>
<th>F. No.</th>
<th>Figure</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>Annual GDP Growth Rate of East Asian Nations</td>
<td>92</td>
</tr>
<tr>
<td>4.2</td>
<td>Year-on-Year percentage Change in Nominal Exchange Rates</td>
<td>93</td>
</tr>
<tr>
<td>4.3</td>
<td>External Debt and Net Portfolio Equity Liabilities during 1991-96</td>
<td>94</td>
</tr>
<tr>
<td>4.4</td>
<td>Domestic Credit by Banking Sector (as a percentage of GDP)</td>
<td>96</td>
</tr>
<tr>
<td>4.5</td>
<td>Market Capitalisation of Listed Companies (as a percentage of GDP)</td>
<td>113</td>
</tr>
<tr>
<td>4.6</td>
<td>Foreign Bank Borrowings during 1991-96</td>
<td>115</td>
</tr>
<tr>
<td>4.7</td>
<td>External Liabilities to Foreign Exchange Reserves (1996)</td>
<td>116</td>
</tr>
<tr>
<td>4.8</td>
<td>Currency Composition of Long-Term Debt (1996)</td>
<td>116</td>
</tr>
</tbody>
</table>
ABBREVIATIONS

ASEAN – Association of South-East Asian Nations
BI (Indonesia) – Central Bank of Indonesia (Bank Indonesia)
BIS – Bank for International Settlements
BNM (Malaysia) – Central Bank of Malaysia (Bank Negara Malaysia)
BOT (Thailand) – Central Bank of Thailand (Bank of Thailand)
BSP (Philippines) – Central Bank of Philippines (Bangko Sentral Ng Pilipinas)
BTO – Bank Taken Over
CAR – Capital Adequacy Ratio
FSMP – Financial Sector Master Plan
GDP – Gross Domestic Product
HPAE – High Performing Asian Economies
IBRA – Indonesian Bank Restructuring Agency
IEO – Independent Evaluation Office
IMF – International Monetary Fund
Purpose – The purpose of this research project is to explore the research question – how does the pursuit of agenda of regulatory reforms, post the crisis, influence governance arrangements at banks and assist them in maintaining resilience during subsequent episodes of crises?

Research methodology – The project adopts a comparative case study approach involving a mix of review of secondary resources and fieldwork interviews across East Asian nations.

Findings – The project applied the Minskian Financial Instability Hypothesis to the 1997 East Asian crisis. It explored the macro-economic and policy environment during 1990s for highlighting institutional failures at the heart of the crisis. The interview findings offered contextual setting and diverse perspectives for regulatory reforms aimed at improving bank governance, post the crisis. The experience of case study banks outlined the impact of regulatory reforms on banking business models, post the crisis. The role of post-1997-crisis regulatory reforms in bringing about East Asian resilience, during the 2007 crisis, is thus analysed in the research project.

Practical implications – The research project provides emerging economy perspective to regulatory reforms and offers policy-level recommendations for banks, regulatory authorities, corporate borrowers, and statutory auditors in maintaining governance standards conducive to financial stability in the long run.

Originality – The project claims originality of application, interpretation and evaluation (which are considered as building blocks for “academic contribution”) of an important academic theory in the context of financial crises – Minsky’s Financial Instability Hypothesis. It integrates the aspects of financial instability, regulatory reforms and bank governance in the context of East Asian financial crisis by introducing the concept of “economic responsibilities” of market participants from emerging economies.
DECLARATION

No portion of the work referred to in the thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institute of learning.

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1) Introduction

As a qualified accountant, literature on corporate governance captured my academic interest even after I stepped into a professional career. My interest further enhanced when I joined ICICI Bank, India, in 2003 in a role that demanded functioning closely with the board of directors and its committees. At that time, Indian banking sector in general and ICICI Bank in particular made foray into various global locations. As a part of the license granting process, internal governance and risk management policy frameworks were closely reviewed by regulatory authorities at each of the international locations. Working with internal and external teams on these policy aspects, therefore, offered a truly global experience for understanding regulatory expectations on bank governance.

Over a period of time, my roles and responsibilities included review of international best practices to design policy-level governance frameworks at our bank. Internationally, such best practice guidance (in terms of functioning of board and audit committees, independent directors and external auditors) was available from various policy-making bodies and academic studies, notably from the West. My work exposure led me to understand that the international guidance available on the subject was more suited to banks that are advanced in terms of product, process, technology and human resources. I found that the available literature lacked step-by-step guidance for bank governance framework from scratch, especially for a bank in an emerging economy. For instance, from an Indian context, a significant amount of management and board focus is spent on areas like policy-directed lending to priority sectors, effective use of credit information in risk management, impact assessment of global macro-economic forces on domestic bank credit, and improvements required for internal technology systems. My objective of enrolling into the Doctor of Business Administration (DBA) programme from the University of Manchester in 2007 was therefore to begin an intellectual journey that would help me in applying international best practices of bank governance to banks in an emerging economy like India.

The year of my enrollment into the DBA programme, 2007, however, marked the beginning of an historical phase in the global banking landscape. The sub-prime crisis that began in that year turned out to be “an historic turning point in our economy and culture” (Shiller (2008, p.1). The crisis resulted in a phase of financial instability internationally and exposed the weaknesses in regulatory oversight on aspects relating to bank governance (notably in the US). The global
banking landscape witnessed, during 2008 and 2009, various regulatory reform proposals (relating to improved bank governance, enhanced credit and liquidity risk management, controls on financial innovation), which were subjected to rigorous academic research. The scope of the research was to evaluate their impact on bank governance regimes that could withstand future episodes of financial instability in a more resilient manner. The research studies indicated that best practices in bank governance were still a subject matter of academic debate internationally. I realised that a review of this academic debate is not only an intellectually enriching experience, but also provides policy-level inputs for regulators and banks in emerging economies.

The DBA research project therefore attempts to contribute to this academic debate by evaluating emerging economy perspectives for regulatory reform proposals aimed at improving bank governance. With this objective, the research project reviews, through secondary sources and fieldwork interviews, the experience of banks in Thailand, Indonesia, Malaysia and Philippines (countries that were affected by the 1997 East-Asian financial crisis). The experience (spanning 15 years from 1993 to 2008) represents the emergence of these East-Asian nations\(^1\) (which were criticised for weak bank governance standards during the 1997 crisis) as resilient nations that relatively withstood the effects of 2007 crisis with improved bank governance regimes. The DBA project accordingly highlights the learnings from the East-Asian crisis for gaining practical insights I was contemplating through academic research.

The findings from fieldwork interviews, however, underscored the need for a comprehensive theoretical explanation that could steer the analysis of interview findings in a more focused manner. At this juncture, the research project encountered the writings of Hyman P. Minsky, whose contributions to economic thinking in the form of Financial Instability Hypothesis are now widely quoted in various books dealing with 2007 financial crisis. The research project therefore critically evaluated Minskian perspectives by integrating aspects - relating to financial instability, regulatory reforms and bank governance - in the context of East-Asian crisis. Subsequent chapters are organised in the following sequence for taking readers through this whole intellectual journey in a systematic manner.

The research project begins with Chapter 2 - “Literature Review”, which deals with the limitations of mainstream academic literature in explaining the origins of 2007 financial crisis.

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\(^1\) The term East Asian Nations generally comprise - the Four Dragon nations (South Korea, Taiwan, Hong Kong and Singapore), the Four Tiger nations (Thailand, Indonesia, Malaysia and Philippines). However, the scope of this research project is restricted to the East Asian Tiger Nations only. The underlying rationale for selection of these countries for the research project is comprehensively covered in Chapter 3 dealing with Research Methodology.
comprehensively. The chapter therefore introduces Minsky’s Financial Instability Hypothesis, which deals with aspects of bank finance and bank regulation, for understanding the unstable nature of markets. In addition, the chapter covers the agenda of regulatory reforms proposed by Minsky for stabilising an unstable economy and subsequent challenges in implementing these reforms. The chapter further focuses on academic debates concerning the origins of 1997 crisis and the regulatory reforms pursued thereafter. The chapter thus provides theoretical and historical insights required for formulating the research question that will be examined in the research project.

Chapter 3 – **Research Methodology** outlines the methodological considerations and explains that earlier studies that dealt with the origin of the East-Asian crisis used quantitative analysis, while those that focused on post-crisis reforms used a qualitative approach. The merits and limitations of each of these approaches are therefore comprehensively dealt with in this chapter. The chapter further provides academic justification for the comparative case-study methodology adopted for the project. The chapter thereafter decomposes the research question into various sub-questions to explain the operational aspects of the research project. In particular, the chapter provides justification for the countries selected and case-study banks identified for the research project. The chapter further presents profile of interviewees who contributed to this project as well as the nature of interview questions used during the fieldwork.

Chapter 4 **“Macro-economic and Policy Environment prior to 1997 Crisis”** provides a contextual setting to the research project through review of secondary sources of information - such as World Bank reports and data on macro-economic indicators. This chapter presents the macro-economic environment prevalent in East-Asian nations prior to the crisis and the policy and institutional aspects that led to bank governance failures during the crisis. The role of each of the players in the economy - political forces, central banks, banks, international institutions, external auditors, corporate borrowers – has been examined to evaluate the origins of the 1997 crisis in a comprehensive manner. The chapter further reviews the impact of financial contagion on the East-Asian nations in the context of volatile capital flows that surged in these economies in the years prior to the crisis.

Chapter 5 deals with **“Regulatory Reforms Post 1997 Crisis”** drawing inferences from fieldwork interviews. The themes covered in this chapter include aspects such as - shift in the regulatory philosophy, changes initiated in bank ownership structures, role of monitoring agents (such as depositors, investors and external auditors) and the aspects of financial innovation - all arising from the pursuit of post-crisis regulatory reforms. The chapter further outlines issues
encountered by regulators in implementing regulatory reforms. In doing so, the chapter brings out unique experiences of East-Asian nations in certain areas and common regional initiatives in certain other areas associated with regulatory reforms. The sources of such commonality and the relevance of contrasting experiences are emphasised with the narratives offered by interviewees.

Chapter 6 deals with “Bank Governance and Risk Management post 1997 Crisis”. After reviewing the foundations of regulatory reforms in the preceding chapter, the institution-level dynamics at each of the case-study banks are presented in this chapter. The challenges faced by banks in implementing regulatory reforms for improved governance is also comprehensively covered in this chapter. The chapter touches upon the key aspects of bank governance focusing especially on: professionalisation of board of directors; the enhanced role of independent directors and external auditors; improved risk culture and the role of risk appetite in the governance framework. These aspects are elaborated using the experiences narrated by officials of case study banks and industry experts.

Chapter 7 deals with “A Minskian Analysis of East-Asian crisis and Regulatory Reforms”. It critically evaluates the alternative arguments found in mainstream academic literature dealing with East-Asian resilience during 2007 crisis. The chapter demonstrates that these alternative arguments could be synthesised by using Minsky’s financial instability hypothesis. Accordingly, the chapter reviews Minskian perspectives underlying in the material presented in chapters 4-6. In doing so, it draws out useful insights - about origins of East-Asian crisis, scope of regulatory reforms and structural changes subsequent to 1997 crisis - to understand the East-Asian resilience in a more focused manner. The chapter also indicates certain areas that require further work by East-Asian nations in future years, for sustaining the resilience exhibited during the 2007 crisis.

Chapter 8 – “Conclusion” summarises the fieldwork findings for possible policy implications concerning regulators, banks, and corporate borrowers. The chapter concludes the overall research project by outlining its academic contribution in areas of financial instability, regulatory reforms and bank governance.
2) Literature Review

2.1 Introduction

This chapter reviews the existing literature on financial crisis and examines the role of bank governance and regulation against historical arguments on the origin of financial crisis. It begins with the premise that the review of literature offers insights and provides historical perspectives for any research work. As Samuelson (2009) mentions, having a very healthy respect for the study of economic history is important, "because that’s the raw material out of which any of your conjectures or testings will come” (quoted by Roubini 2010, p. 59). Review of academic literature in the context of historical episodes of financial crises, for identifying the patterns and trends therefrom and for developing regulatory policy prescriptions, at the time of a new crisis, is one of the intellectual fetes in the study of, what Roubini (2010) aptly coined as, “Crisis Economics“. Reddy (2011) observes that historical events such as financial crises influence ideas, interests and integrity of the individuals and institutions engaged in formulation of public policies. Accordingly, as long as there have been episodes of crises, there have been academic attempts to put them into context.

Roubini (2010) demonstrated that financial crises come in many shapes and guises such as the Tulip Mania of 1630s to the sub-prime mortgage crisis of 2007. Financial crises have occurred under various monetary and regulatory regimes impacting advanced as well as emerging economies to varying degrees. Kindleberger & Aliber (2005) notes that financial crises often involve the failure of large number of banks, the lack of confidence in the ability of a country to maintain the parity for its currency and the implosion of a bubble in stock markets and in real estate markets. Reddy (2011) observed that discussion of financial crises spans several aspects of policy such as institutional dynamics, ethical dimensions, behavioural aspects, and the network nature of economic activities due to technological developments. Accordingly, various studies on financial crises in the past have covered a wide variety of areas such as - channels through which the financial crisis spread (Blanchard & Fischer 1989), success of crisis resolution measures (Dziobek and Pazarbasioglu 1997), cross-crisis comparisons based on the duration and depth of the crises (Borio and White 2004, Bordo et al., 2001) and efficacy of regulatory regimes in preventing the financial crises (Barth, Caprio and Levine 2006).
According to a database compiled by Reinhart and Rogoff (2008), there were 239 episodes of financial crises in the form of sovereign defaults during 1800-2006, of which 126 were in Latin America, 73 in Europe, 26 in Africa and 14 in Asia. The database, however, further reveals that while many now-advanced economies have graduated from a history of serial default on sovereign debt, graduation from banking crises has proven, so far, virtually impossible. Further, it was also observed that, pursuant to recent developments in financial markets, the incidences of banking crises in even smaller, poorer economies has increased over time. The conclusions can also be further corroborated by another database compiled by Caprio and Klingebiel (1997) which identified 112 systemic banking crises in 93 countries since the late 1970s. Rochet (2008) reported that on average, the fiscal cost of each of these recent banking crises was of the order of 12% of the country's GDP but exceeded 40% in some of the most recent episodes (notably in South Korea and Indonesia). Incidences of banking crises therefore renewed academic interest in various areas: historical analysis of banking crises (Kindleberger & Aliber 2005), global governance of financial systems (Alexander et al 2006), remedial measures to fix global finance (Wolf 2008), politics and policy of bank regulation (Rochet 2008), macro-prudential policy aspects (Claessens et al 2010).

Reviewing such a vast academic literature on financial and banking sector crises is, therefore, admittedly a complex task given the variety of dimensions the subject has thrown up for researchers. Therefore, in order to provide an orderly context to the research project, this literature review chapter has been organised in the following sequence. The chapter begins with economic and historical context of financial crises by categorising the existing literature into two different schools of thought for the purpose of this literature review. It thereafter reviews the literature on financial instability by demonstrating the role of bank finance in exacerbating the financial crises. It critically examines the literature that deals with the impact of regulation on governance frameworks at banks. A brief overview of the East-Asian experience against the theoretical insights is also provided in the subsequent section. It finally concludes by formulating a pertinent research question concerning the broader aspects of financial instability, regulatory reforms and bank governance.

2.2 Economic and Historical Context of Financial Crises

Referring to the financial crisis of the US in 2007 and the global recession that followed, it is often quoted in the literature (Bezemer 2009, Keen 2011) that the Queen of England had asked the academic community – “Why did no one see this coming?” The question subtly
hinted that the general level of competence of real-world economists and regulators is relatively less than what the society requires. The British Academy forum of economists which thereafter convened to answer the Queen’s question wrote to her concluding as under (quoted in Black 2010, p. 3):

“The failure to foresee the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole.”

In order to understand the conventional wisdom that was prevalent prior to the crisis, it is appropriate to review the existing academic literature on financial crises by classifying it into two schools of thought. While the nomenclature varies across academic studies depending upon the context, the classification adopted solely for the purpose of this literature review is based upon the assumptions of the respective school about markets. In one school of thought that was considered the dominant mainstream economics orthodoxy prior to the crisis, ‘stability’ of markets is an essentially given premise. Markets, according to this school, are viewed as self-correcting efficient entities that always attain equilibrium by adjusting themselves to information availability. On the other hand, there are various other studies that question the stable nature of markets and their ability to self correct. These studies indeed focused on the inherent “instable” nature of markets as the contributory factor for financial crises (Roubini 2010, Bezemer 2011, Motianey 2011). There is abundant literature arguing that the current global financial crisis has exposed the weaknesses in the stability school of thought citing that it was primarily responsible for the failure of collective imagination of academicians and policy makers (see Alexander et al 2006, Dymski 2009 & 2010a, Reddy 2011). The crisis had also simultaneously opened doors for greater examination of instability school principles as an alternative school of thought for providing prescriptive tools to deal with financial crises (see Kregel 2007, Papadimitriou and Wray 2008, Keen 2011, Cooper 2010).

Each of the schools is further explained below:

a) “Stability” School of Thought

As Roubini (2010) points out, much of mainstream economics is obsessed with showing how and why markets work - and work well. He states that this obsession dates back to the origins of the profession of economics, beginning with the Scottish thinker Adam Smith. In
his magnum opus, "Wealth of Nations" published in 1776, Smith points out to the concept of an "invisible hand" in the capitalist free market economy, which asserts that self-centered behavior by individuals necessarily leads to highest possible level of welfare for the society as a whole (Keen 2011, p.38). The “invisible hand” governs the diverse interests of individual economic actors in the market and converts the market into a stable, self-regulating economic system. Accordingly, Smith proposes that market functioning does not require external intervention as it can be restrictive. In the words of Smith (2010 [1776], p. 261):

“to prohibit a great people, however, from making all that they can of every part of their own produce, or from employing their stock and industry in the way they judge most advantageous to themselves, is a manifest violation of the most sacred rights of mankind”.

Roubini (2010) explained that this non-interventionist free market theory was subsequently accepted and further developed by various other economists, who went on to build mathematical models for supporting free market theory. Keen (2011) similarly provided an exhaustive list of economics concepts - such as Say’s Principle, Walrasian Law, Hicks Classical Theory - which further echoed the belief of economists in the fundamental stability of market functioning. Cooper (2010) dealt with an important development in the later era - the efficient market hypothesis - in greater depth to outline the fundamental philosophy of the stability market proponents. Review of the works of Roubini, Keen and Cooper summarises that the stability school proponents base their arguments on two basic assumptions: first, collectively, market players have an ability to correctly price the assets (and, therefore, their collective wisdom need not be questioned by an external central authority); and, second, markets are, therefore, equilibrium-seeking, self-correcting, efficient, and stable systems.

The overall thrust of this school - that markets could incorporate all known information into prices - remained an acceptable theory in business schools and economics departments for a long time (Keen 2011). Asset price fluctuations are generally considered as a mere reflection of the change in the underlying fundamentals based on availability of new information into the market. In order to predict the asset prices accurately, stability school proponents often resorted to probability distributions, which are constructed using observed historical asset values. Cooper (2010) stated that the usage of probability distribution led the believers in market stability view the variations - between the predicted price movement using the probability distribution and the actual price movement observed within real financial markets - as "fat tail" risks. The risks are called as such, because such departure occurs only in the tail of the probability distribution i.e., very rarely when there are "system-wide adverse
events” that trigger them by questioning the collective wisdom of the market (Rajan 2010, p. 137).

The stability school proponents derived their further strength from the subsequent works of economists drawing on the efficient market hypothesis. Cooper (2010) summarised the efficient market hypothesis which stated that while external adverse shocks can push markets away from their natural optimal state, markets that are by definition equilibrium-seeking systems will attain normal course on their own without external influence. Thus, according to the stability school hypothesis, there cannot be any internal destabilising force in the market nor is any external intervention required to restore them to equilibrium in case of exceptional situations (Bezemer 2009). Central banks that believed in the stability school therefore developed their policy actions with the overarching philosophy that they really should not be in the business of figuring out when asset prices are too high: after all, they do not really know much more than market participants (Allen and Gale 2007, Abreu and Brunnermeier 2003, Borio 2003, Rajan 2010, Roubini 2010). Further, as markets naturally achieve an optimal equilibrium, central banks supporting the efficient market hypothesis also believed that any interference with market forces can at best achieve nothing, but more likely will push the system away from equilibrium towards a sub-optimal state (Rajan 2010). As Roubini (2010, p. 4) points out, academic community and regulators that believed in stability school principles therefore considered that financial crises are “freak events: highly improbable, extremely unusual, largely unpredictable and fleeting in their consequences.”

How then will the stability school explain the events such as the great economic depression of 1929? To answer this question, Overtveldt (2010) and Keen (2011) point to monetary theories (representing a strand of stability school which dealt with quantitative aspects of monetary policy) developed by mainstream economists (and in particular by Friedman and Schwartz (1963)). Monetary theorists argued that the great economic depression of 1929 was a classic case of central banks failing to take quick and decisive action and it was not fundamental failure of stability of markets. The monetary theorists claim that the failure of central banks of not resorting to timely monetary policy easing during 1929, when they anticipated recession, resulted in falling levels of aggregate demand in the economy. A free market economy without excessive regulatory intervention was therefore still considered a valid premise if the central bank could swiftly handle the recessionary situations by keeping the financial system from imploding, and restoring the market, through effective monetary policy action (Moore 1979, Kydland and Prescott 1990, Krugman and Eggertsson 2012). Rajan (2010, p.101) argues that, based on these theories, central bankers have become
“triumphant” in even making public statements that the policy levers for managing a modern economy were well understood by them. Policy makers have therefore even showcased periods of milder recessions in the pre-crisis period as a testimony of their achievements (See Greenspan 1997, Bernanke 2004).

Thus stability school proponents hailed the efficiency of equilibrium-seeking markets, which in their view, had the ability to self-correct any asset price adjustments and hence need not be subjected to any regulatory oversight. Central banks, as per this school, are required to step into the breach only when there is a system-wide adverse event that would threaten the market equilibrium. Monetary policy as a tool of central bank intervention was considered more effective and was attributed as the major reason for periods of relatively less instability, prior to the 2007 crisis.

b) Instability School of Thought

In the aftermath of financial crisis in 2007, the proponents of stability school of thought have been subject to criticism (Kregel 2007, Krugman 2009, Bezemer 2011). For example, Keen (2011) argued that the theory based on equilibrium economic models tend in general to ignore processes which take time to occur, and instead assume that everything occurs in equilibrium. For theories based on such models to be allowable, the inherent processes of a market economy must be stable, which is a problematic assumption. Thus the critics of the stability school dismiss the equilibrium-seeking nature of the market and question its self-correcting ability. This leads to the proposition that crises in the economy are not rare events, but are inherent events that will periodically destabilise the economy. Keen (2011) referred to significant contributions from economists (like Fisher 1933, Schumpeter 1934, and Keynes 1936) to support his argument.

Through his major publication in 1936, "The General Theory of Employment, Interest and Money", Keynes provided both an intellectual and a policy-prescriptive alternative to the mainstream economic theory, based on his analysis of events of 1929. Keynes’ General Theory used novel tools of analysis, such as consumption and liquidity preference, and employed concepts unfamiliar to mainstream economics till then - such as uncertainty. Through these tools, Keynes argued that the transitional processes which are inherent in a decentralised, unplanned, capitalist economy - one in which economic policy does not intervene in an appropriate manner - was not a self-correcting system that tended towards a stable equilibrium. According to him, the financial system necessary for capitalist vitality and
vigour - which translates entrepreneurial “animal spirits” into effective demand for investment - contains the potential for runaway expansion, powered by an investment boom (Roubini 2010, p. 48). Even if the policy remedies succeed in eliminating the adverse effects of business cycles in the short run, the fundamental attributes of capitalism mean that periodic difficulties in constraining and sustaining demand will ensue. Fisher (1933) introduced the concept of ‘debt deflation’ to outline the nature of instability in financial markets. Debt deflation theory states that, if the asset prices fall faster than the debts, the real value of the debt used in acquiring such assets will rise over time. As the debt burden in the scenario of falling asset prices mounts, the probability of debt defaults and bankruptcies soar, fueling a crisis and recession (Keen 2011, p. 273). Joseph Schumpeter (1934) further viewed cycles in markets as waves of innovation in prosperous times, followed by a brutal winnowing in times of depression. He argued that this winnowing can neither be avoided nor can be minimised. While it may be a painful exercise in the short term, it ultimately results in a “creative destruction” or adjustment effect, with creation of a new economic order for the market participants who survived through such adjustment phase (Roubini 2010, p. 55).

Instability school proponents, therefore, argue that in order to have meaningful explanations of financial crises, one must deal with an alternative economic theory that:

“locates the source of credit cycles and financial instability in the financial nature of capitalism: in its use of money rooted in debt, and the interaction between asset markets and the real sector that gives rise to balance-sheet effects” (Bezemer 2011, p.3).

The proponents of this school had therefore envisaged additional roles for central banks in the economy (Borio & White 2004, Alexander et al 2006, Rochet 2008, Overtveldt 2010, Roubini 2010, Cooper 2010). For instance, Overtveldt (2010) states that, once banks and financial institutions, which are capable of developing powerful liquidity multipliers themselves, through increased leverage, are brought into the discussion, the traditional roles of credit and liquidity creation performed by central banks tend to be difficult. In such circumstances, Overtveldt (2010) argues, central banks should not solely act as monetary authorities merely relying on refinements of monetary policy but should also acknowledge their role as regulators of the financial system. In absence of such an acknowledgement, Overtveldt argues, central banks are prone to what he termed as “disaster myopia” (2010, p. xiv) which results in complacency and carelessness in spotting the risk build-ups and potential losses in the system.
A review of the arguments put forward by critics of the stability school indicates that the inherent instability of markets arises from the finance provided by institutions such as banks. Understanding the role of bank finance in exacerbating the financial crises therefore promises a useful starting point for evaluating the remedial measures that can be developed to prevent the recurrence of financial crises. An attempt has therefore been made in the subsequent section to review the work undertaken by Hyman P Minsky, professor of Washington University, who formulated the financial instability hypothesis with a special focus on the role of bank finance in a capitalist economy.

2.3 Minsky’s Financial Instability Hypothesis

Minsky demonstrated, using his Financial Instability Hypothesis, how banks and other financial institutions could, as they became increasingly complex and interdependent, bring the entire economic system crashing down. Minsky explained that capitalism is prone to endogenous destabilising forces and is by its very nature unstable and prone to collapse. Writings on Minsky (Wray 2007, Roubini 2010, Keen 2011) indicate that Minskian analysis is in turn built on insights of great non-neoclassical thinkers like Schumpeter, Fisher and Keynes. However, Minsky’s strength, as Keen (2011, p.326) points out, was to weave these “individually powerful and cohesive but incomplete analysis into one coherent tapestry that explained the occasional depressions the capitalist economy is inherently exposed to.”

This section presents an overview of the Financial Instability Hypothesis, including the role of bank finance in exacerbating financial instability and the agenda of reforms suggested by Minsky for stabilising the unstable economy. A review of the post-Minskian literature to evaluate the applications of financial instability hypothesis to the 2007 financial crisis is also presented in this section.

a) Financial Instability Hypothesis – An Overview

If markets are believed to be fundamentally stable, “can IT – a spectacular collapse such as the Great Economic Depression of 1929 – happen again?” This was the question which Minsky focused upon through his various essays on instability and finance. To answer this question, Minsky believed that it is necessary to call for an economic theory that makes great depressions as one of the possible states within which the real world capitalist economy can find itself. Minsky (1984, p. 16) argued that “if a theory is to explain an event, the event must be possible within the theory. Furthermore, if a theory is to guide policy that aims at
controlling or preventing an event, the event must be possible within the theory.” According to Minsky, when judged against this standard, extant economic theory based on the efficient market hypothesis suffers from serious limitations. In particular, the extant theory concludes that crises are extremely rare events, which can occur only because of policy errors or from non-essential institutional flaws.

Minsky viewed the capitalist economy at best as “conditionally coherent” characterised by a robust financial system and few innovations (Minsky 2008 [1986], p.197). Papadimitriou and Wray (2008 p. xii) explain the manner in which Minsky rejected the equilibrium methodology of mainstream economics as irrelevant in analysing a real-world capitalist economy and instead argued that “stability is destabilising”. Minsky, according to them, believed that relative tranquility gradually encourages more risk-taking and innovative behavior that increases income even as it disrupts the conditions that generate coherence and tranquility. That is, the market forces that operate when a system is stable will push it toward instability, so that even if anything like equilibrium could be achieved, it would be offset by behavioral responses that would quickly move the economy away from equilibrium. This difference in Minsky’s treatment of capitalist economy had two different academic implications. First, unlike other critical analysis of capitalist processes, which emphasise the crash, Minsky was more concerned with the behavior of corporate agents and financial institutions during the euphoric periods. Second, unlike other analyses that blame “shocks”, “irrational exuberance”, or “foolish” policy, Minsky argued that the processes that generate financial fragility are “natural” or endogenous to the system (Papadimitriou and Wray 2008, p. xii).

How did Minsky arrive at the conclusion that bank finance promotes financial instability? Charles Kindleberger used the Minsky’s model to explain an answer to this by demonstrating how speculative bubbles lead to “Manias, Panics, and Crashes” (1978, 2005). While Minsky’s financial instability hypothesis laid out a general framework, Kindleberger supplied numerous historical examples to support this general framework by analysing hundreds of financial crises dating back centuries and arguing that they share a common sequence of events, one that followed Minsky’s financial instability hypothesis. In his book, Kindleberger provided a qualitative description of the Minsky Model (referred to as the Kindleberger-Minsky model by Saqib 2001, Sheng 2009), comprising five stages of the financial crisis - displacement, monetary expansion, overtrading, revulsion, and discredit (Kindleberger & Aliber 2005, Minsky 1982). In Stage one (displacement), the economic outlook is always opportunistic and profit making becomes easier target to achieve consequent to favourable macro-economic conditions. Stage two (monetary expansion) results from the spread of this optimism into the
banking system and a lending boom gets built up gradually with the expansion of bank credit in the economy. Stage three (overtrading) begins when, backed by the availability of bank finance and opportunities to make profits easily, borrowers begin to speculate and ‘euphoria’ begins. Stages four and five (revulsion and discredit) occur when there is an uneasiness that spreads in the system, prices tend to decline after reaching the top, signs of illiquidity creep in, firm failures become common and eventually panic creeps into the banking system leading to a full-scale crisis situation in the economy (Sheng 2009). An in-depth explanation of this phenomenon is provided in subsequent paragraphs.

b) Financial Instability and Bank Finance

Minsky stated that, the “overall fragility-robustness of the financial structure, upon which the cyclical stability of the economy depends, emerges out of loans made by bankers” (Minsky 2008 [1986] p. 261). Minsky explained the endogenous processes by stating that operating units in an economy are primarily dependent upon the immediate credit extended by banks to finance the investment in capital assets that can generate cash-flows in future. He provided insights into the borrowing behavior of these operating units, by distinguishing them into three types of borrowers – hedge borrowers (whose source of repayment of debt in its entirety is operating income), speculative borrowers (who use operating income for repayment of interest but rely on new loans for repayment of the principal) and Ponzi borrowers (whose operating income is not sufficient to even repay the interest obligation). Minsky stated that the borrowing units create increased demand for bank finance over a period of time, which creates disequilibrating pressures in the economy. More the demand for investment finance by operating units, more the profit-seeking bankers will find ways of accommodating their customers and as a result, the “supply of financing from banks grows so fast that prices of capital assets, prices of investment output, and finally, prices of consumption output all rise” (Minsky 2008 [1986], p. 264). Bank finance thus sets the stage for financing an inflationary expansion by unleashing the “animal spirits” of the operating units. The way to deal with the inflationary growth through expansion of credit by banks is to curtail the supply of bank finance through tools available at the disposal of central banks.

Minsky (1984) therefore examined the efficacy of two traditional central banking tools - manipulation of reserve requirements or increasing the interest rates - for curtailing the supply of money in the system. Minsky explains that reserve-ratio manipulation as a central bank tool assumes the operation of money-multiplier theory, which postulates a decrease in money supply by banks through increase in deposit reserve requirements by a central bank.
However, as Holmes (1969) argues, the money multiplier model theoretically assumes that the banking system expands only after the central bank puts reserves in the banking system, but in the real world, banks extend credit, creating deposits in the process, and look for reserves later. Overtveldt (2010) also argues that the money-multiplier model is practically difficult to operate, as profit-seeking bankers tend to always look out for alternative funding sources not subject to reserve requirements. In the process, banks endeavour to give ever greater promises of safety to alternative fund providers either by shortening the term of liabilities or by providing special assurances. This results in the creation of new funding sources by banks through innovative financial instruments. Minsky, therefore, argued that normal profit seeking by financial institutions through innovation continually subverts the attempts by authorities to constrain money-supply growth through deposit reserve requirements (Minsky 1984).

Minsky therefore examined the other central banking tool - increase in interest rates - for controlling the money supply, which forces banks to tighten the financing terms (by increasing the rate of interest or demanding better collateral). The supply price of investment finance therefore exceeds the demand price and a period of credit contraction sets in. During this phase, some of the firms involved in ‘hedge finance’ get shunted to the ‘speculative finance’ group and those involved in the ‘speculative finance’ group become ‘Ponzi borrowers’. As borrowers get shunted to the next level, panic sets in the market, as borrowers fear of mounting debt burden. This results in sudden contraction of credit and distress sales for repayment of bank finance, leading to falling asset prices, debt deflation and eventually crisis sets in (Kindleberger & Aliber 2005). Thus the central bank could indirectly trigger a crisis if it resorts to increase in interest rate to curtail money supply growth.

By examining these alternatives, Minsky argues that it is evident that controlling money supply in order to stabilise the economy, from the inherent destabilising forces leading to inflationary growth, is not sufficient. In his view, this will either be ineffective (if central banks pursue manipulation of reserve ratios) or result in a dismal cycle that brings about debt deflation (if central banks pursue manipulation of interest rates). Minsky therefore concludes that “if we are to bring a halt to the dismal cycle, far-reaching structural reforms are needed” in the capitalist financial system (Minsky 1984, p. 200).
c) Agenda for Reforms

After examining the role of banks in promoting financial instability, Minsky drew out an agenda for reforms covering economic, financial and industrial policies. Considering the relevance of centrality of bank finance to the financial instability, in this section, attempt has been made to outline key elements of agenda for financial sector reforms proposed by Minsky.

Without subjecting his recommendations to mathematical rigour, Minsky proposed an agenda of financial sector reforms, which argues that finance should not be left to free markets. In his words, “a sophisticated, complex, and dynamic financial system endogenously generates serious destabilising forces so that serious depressions are natural consequences of non-interventionist capitalism” (Minsky 2008 [1986], p. 324). Minsky therefore stressed that “periodic reforms of banking system are needed to prevent the development of a financially unstable economy that cannot readily be contained” (Minsky 2008 [1986], p. 355). Minsky, however, criticises the orthodox economics that postulates that central banks should focus on money supply and operate to achieve a constant rate of growth. According to Minsky, this view results in central banks excessively concentrating on monetary policy management by wearing policy blinders that restrict their vision, so that they tend to ignore financing relations by which monetary phenomena affect economic activity. Minsky, however, does not place much faith in monetary fine tuning. He argued that instead of seeking to control the economy through monetary policy route, central banks should focus on their functions as a regulator and supervisor of the financial system and as a lender of last resort. By carefully monitoring and regulating the financial system, Minsky opined that central banks can hinder the endogenous tendency towards financial fragility (De Antoni 2007).

Minsky’s agenda for financial reforms, which he termed as Anti-Laissez-Faire theme, therefore emphasise that “in a world where the internal dynamics imply instability, a semblance of stability can be achieved of sustained by introducing conventions, constraints and interventions into the environment” by central banks (Ferri and Minsky 1991, p. 21). Minsky criticises that the dominant (laissez faire) economic theory leads to the conclusion that regulatory arrangements reflect superstition and ignorance. He states that this conclusion is arrived at because the laissez faire theory assumes that the financial instability phenomena, that central bank regulations and discretionary power are designed to deal with, do not exist in nature. However, according to Minsky, regulatory powers need to be exercised
by central banks in a manner that they should be able to "steer the evolution of financial structure" (Minsky 2008 [1986], p. 359).

Minsky (2008 [1986] p. 261) argued that "a cash flow orientation by bankers is conductive to sustaining a robust financial structure". In order to achieve this orientation, Minsky stated that central banks should use regulatory powers to encourage banks to pursue hedge-financing (in the form of to-the-asset financing), lean against bank strategies that focus on speculative or Ponzi financing approaches and monitor the innovative practices in banking industry. Minsky proposed that cash-flow orientation is best achievable if regulations are conductive to a decentralised relationship-banking model. At a broad level, Minsky’s agenda for reforms therefore call for restricting the asset size of banks relative to their capital, promoting the decentralised relationship-banking model, and facilitating the ease of entry of new players into the industry. At a granular level, Minsky stressed that the emphasis by bankers on the collateral value and the expected values of assets is conducive to the “emergence of a fragile financial structure” (Minsky 2008 [1986], p. 261). He, therefore, underscored the importance of skeptical bankers who should instead adopt a cash-flow orientation rather than place excessive reliance on collateral. In order to achieve this, Minsky’s agenda for reforms called for a relationship banking model where the bankers tend to concentrate on credit-worthiness of borrowers. In order to further achieve this, he warned the bank examiners to be cognizant of the underlying prospective cash flows that operating units must earn if a bank’s anticipated cash receipts are to be realised.

Minsky (2008 [1986], p. 356) further argued that “banks are complex profit-seeking organisations that have a multitude of actual and potential types of liabilities and that innovate in response to profit opportunities.” In their attempt to increase the spread between asset and liability interest rates, banks tend to improve the products and services they provide to borrowers and depositors by creating new types of paper. Thus Minsky observed that new financial innovations result from profit opportunities and underscored that central banks should favor stability-enhancing and discourage instability-augmenting innovative practices. Minsky’s agenda for reforms therefore further called for exercise of regulations by central banks in a manner that they promote financial innovation conductive to successful capitalism (Tymoigne 2009, Vercelli 2009).

The agenda for financial sector reforms thus call for larger role of financial regulation in the central bank functioning. To sum up in the words of Minsky:
“To contain the evils that market systems can inflict, capitalist economies developed sets of institutions and authorities, which can be characterized as the equivalent of circuit breakers. These institutions in effect stop the economic processes that breed incoherence and restart the economy with new initial conditions” (Minsky et al 1994, p. 6).

d) Minsky’ Financial Instability Hypothesis – A Critique

Despite the richness in the theoretical treatment of financial instability, Minsky’s works have not become part of mainstream academic debate until very recently. Barbera (2008) argues that it was because Minsky refused to downplay the world’s unpredictable nature, in order to reduce his vision, to a set of equations. In the preface to the 2008 edition of Minsky’s book “John Maynard Keynes” (p. viii) Barbera stated that Minsky strenuously resisted reducing his thesis to an exclusively mathematical formulation. It can be observed in Minsky’s works that he did not allow his analysis to be constrained by statistical models in an era when econometrics is considered as religion among economists and financial analysts. It had therefore been acknowledged in various academic studies that Minsky provided the twentieth century’s most astute analysis of financial capitalism (Motianey 2011, Rajan 2010, and Roubini 2010). Whalen (2008) maintains that regardless of whether one is a student or a scholar, a policy maker or a private citizen, Minsky’s writings continue to provide meaningful insights about the financial system and economic dynamics as it underscored the value of an evolutionary and institutionally grounded alternative to conventional economics. Vercelli (2009) states that Minsky’s vision is able to cope with financial crisis because it is able to articulate an alternative vision in which disequilibrium, instability, limited rationality, and subjective features play a crucial role. According to Motianey (2011), Minsky’s Financial Instability Hypothesis is a foil for the dominant paradigm as it not only fits the facts better, ex post, but also offers testable and falsifiable predictions at each stage of the analysis, as well as providing concrete and tangible solutions to the paralysis at the heart of the credit creation mechanism.

While supporters hail Minsky’s conceptualisation of financial crises, there is another section of academic literature that is emerging in recent times providing a critique of Minsky’s works. Velupillai (2010) expresses his disbelief that one single model developed by Minsky on the basis of experiences of advanced capitalist economies during the later two thirds of the twentieth century, could be used to make sense of four centuries of episodes of financial turbulence. In his paper, he chose to demystify, what he terms as, much of the present hype around the Minsky moment. He questions whether Minsky ever understood the mathematics
of the nonlinear macro-dynamic models that emerged from what is generally acknowledged to be the pioneering works of Kaldor (1940), Hicks (1950) and Goodwin (1951). Velupillai also argues that there is no evidence that Minsky took the trouble to familiarise himself with the classic framework of an unstable credit economy that was developed by many economists in a manner that is not related to the real equilibrium of orthodox theory. He concludes therefore that Minsky’s understanding of the frontiers of orthodoxy had entered a time-warp at a point when the existing theories around the equilibrium economics had all been “properly buried and their deaths officially proclaimed by the new classical economists” (Velupillai 2010, p. 17).

Dickens (1999) evaluated the 1970 crisis in the US and argued that, contrary to the conclusions of Minsky’s hypothesis, the contributory factors are related to political aspects of the economy. He therefore called for an understanding of the causes of the current period of recurrent financial crises different from that proposed by the proponents of Minsky’s hypothesis. According to Palley (2009), while Minsky’s agenda of regulatory reforms is needed to ensure economic stability, but they alone are not sufficient as they do not address the ultimate causes of the crisis nor will they restore growth with full employment. He even argued that the regulatory reforms have the potential to take away easy access to credit, thereby resulting in even slower growth. Similarly, while Wolf (2008) agreed with the role of leverage as proposed by Minsky as a valid explanation for financial crises, he did not buy into the argument that regulatory intervention could alone prevent them. Wolf argued that the pattern of global imbalances and associated policies also play a large role in setting the explosive charge, resulting in economies becoming highly fragile. The response, according to Wolf, is to call for limiting the scale of macro-economic imbalances, rather than regulatory intervention, since they frequently exacerbate the financial fragility.

**e) Global Financial Crisis and the rise of Post-Minskian literature**

Despite the criticism, the 2007 financial crisis led to emergence of post-Minskian literature that took forward insights from Minsky’s Financial Instability Hypothesis to the next level of academic debate and policy discussion creating a fuller framework for conceptualizing how financial crisis can emerge within the economic process (Dymski 2011). In recent times, many academic researchers have referred to 2007 financial crisis as a “Minsky Moment”, questioning whether US had become a Ponzi nation, in Minskian terms, prior to the crisis (Kregel 2008). However, as Dymski (2011 p. 334) observes, the explanation of financial instability hypothesis without a formal model by Minsky created an ambiguity in usage of key
Minskian terms (such as speculative finance), and “permitted multiple interpretations of even his core concepts: so economists of widely differing methodologies could appreciate his insights and appropriate at least some of his concepts” (Dymski 2011 p. 334).

In light of above observation, this section reviews literature dealing with certain themes focused by post-Minskian economists such as – mathematical modeling of financial instability hypothesis (Keen 1995, 2011; Godley 2001), impact of stages of capitalism on banking business and financial instability (Kregel 2009, 2010; Wray 2008, 2009, 2010), theoretical explanation of monetary policy ineffectiveness in stimulating economic growth (Cooper 2005, 2010), leveraging on Minsky's works for revisiting foundations of financial regulation from a broader socio-economic perspective (Dymski 2009, 2010, 2011). Each of these post-Minskian works is reviewed in this section in order to set the context for using Minskian Financial Instability Hypothesis as the theoretical framework for this research project.

As explained earlier, mainstream economists from the stability school of thought considered the 2007 financial crisis as a fat-tail event, inherently unpredictable due to the scale of unanticipated and unforeseeable exogenous shocks (Roubini 2010). However, studies by Bezemer (2009) and Fullbrook (2010) indicate that there are at least twelve economists who can be legitimately credited for predicting the onset of a massive global financial instability. It is important to note that two out of these twelve economists (Keen and Godley) had indeed modeled Minsky’s Financial Instability Hypothesis for arriving at such prediction. Keen (1995) modeled Minsky during his doctoral research by constructing a model of capitalist economy with finance, via stylized extensions to Goodwin’s growth cycle model. Keen’s model replaces the linear function hitherto used by economists for depicting investment function with a more realistic non-linear relation to capture fundamental Keynesian insights about behavior of agents under uncertainty. The model further used established empirical datum to incorporate the insight that credit money in the economy is created independently of base money. Additional complexities built into the model include the endogenous money creation process to meet finance needs of investment firms and real-world income distribution dynamics. The resultant model used plausible values for real interest rates to demonstrate that the capitalist expectations of profit during booms could lead them to incur more debt than the system is capable of financing. The qualitative behavior of this model reproduced past 30 years of strong cycles in real output followed by “a period when business cycles appear a thing of the past, but then suddenly a crisis breaks out with declining real output” (Keen 2011 p. 13). The model depicted that the crisis would hit as a result of debt-induced depression via a financial breakdown following the paths predicted by Minsky with increasing debt-to-equity ratios and
rising income inequalities. Using the model, Keen (1995 p. 633) concluded that “a long period of apparent stability is illusory and the crisis, when it hits, is sudden – occurring too quickly to be reversible by changes to discretionary policy at the time”. He further professed that subsequent attempt to revive the economy by reducing interest rates and thus stimulating investment amounts to “trying to force the economy back down into the stable section of the vortex, when it has already passed into its catastrophic region” (Keen 1995 p. 633). The endogenous forces therefore result in the perception of any government action as too little and too late, upholding the Minskian insight that crises are to be avoided in the first place, by developing and maintaining institutions and policies that have the ability to constrain bankers and businessmen from engaging in speculative financing practices. Keen (2011) thus distinguishes between the stability school theory and the Minsky’s Financial Instability Hypothesis succinctly by stating that the former is “non-monetary, equilibrium-fixated, uncertainty-free, institutionally-barren, and hyper-rational individual-based reductionist” theory, whereas Minsky’s version was “strictly monetary, inherently cyclical, embedded in time with a fundamentally unknowable future, institution-rich and holistic, and considered the interactions of its four defining social entities: industrial capitalists, bankers, workers and the government” (Keen 2011, p. 327).

While Keen used the cyclical growth models for modeling financial instability, Godley (2001) approached the prediction of financial instability through his stock-flow consistent (SFC) macroeconomic modeling. Unlike Dynamic Stochastic General Equilibrium (DSGE Model - which is deductive in nature), SFC model presents the standard national income equation in terms of accounting for transactions between sectors (private, government and external – to be precise) with the underlying accounting premise that in a monetary economy ‘everything comes from somewhere and goes somewhere’ so that the balances at the aggregate level should be equal to zero (Godley & Wray 1999, Godley & Lavoie 2007). The model is therefore expressed in terms of transactions both at stock and at funds-flow level through a system of tables and equations. It attributes initial values to all stocks and all flows as well as to behavioral parameters and thereafter uses numerical simulation to check the accounting and obtain a steady state for the economy in question. The model then shocks the system with a variety of alternative assumptions (about exogenous variables and parameters) and explores the consequences. The model is post-Minskian in the sense that it brings banking sector stocks and flows (largely excluded from DSGE models) into the centre stage of discussion (by considering them as part of private sector) for demonstrating the impact of endogenous destabilising forces in the economy. Using the SFC model, it was argued that for a long period US economy is maintaining a public sector surplus and trade sector deficit.
along with a private sector deficit. As the economy continues to grow, the unsustainable nature of continued private sector deficit (funded through bank finance) alongside the continued deterioration of the US trade account enabled Godley (2001) conclude that a recession was inevitable for the US economy (Keen 2011).

While Keen (1995, 2011) and Godley (2001) focused on origins of the financial crisis from a quantitative perspective, Wray (2009, 2010) traced the root-causes of 2007 current financial crisis to Minsky’s qualitative analysis of phases of capitalism. According to Minsky, capitalism initially begun as “commercial capitalism” where investment goods required for commercial production are owned directly by individual entrepreneurs and purchased out of accumulated savings (profits). Bank finance was used to finance working capital and required bankers, through underwriting standards, to monitor the success of their borrowers. In the second phase “finance capitalism”, investment goods became too expensive for individual ownership so that the corporate form separating the production from ownership came into existence. This led to emergence of investment banking in which shares and bonds financed the ownership of capital assets and banks intermediated the process of placing the shares and bonds in the hands of distributed owners (such as households). The consequence of this transformation was that - unlike a commercial banker who is worried about borrower success (for recovery of bank dues) and hence adheres to underwriting standards - investment banker is not worried about commercial success of his borrower but about borrower's financial success in placing shares and bonds in hands of owners. Finance capitalism thus diluted underwriting standards required from bank finance and led to the great depression when prices of shares and bonds rose with no commensurate increase in production of real goods. The end of great depression led to the third phase of capitalism, “managerial-welfare” state capitalism in which the government deficit was expanded in downturn to offset swing of investment. The US New Deal reforms under this phase of capitalism separated investment banks from commercial banks and introduced mechanisms such as deposit insurance for commercial banks.

Kregel (2009) however explained the manner in which the collapse of these New Deal reforms originated the current crisis. He argued that the separation between investment banking and commercial banking (as envisaged under New Deal reforms) led to the situation where unregulated banks were able to provide substitute instruments that were more efficient and unregulated. Such instruments are not available to regulated banks, since they involved securities market activities. This has eventually resulted in securitisation process whereby regulated banks gain access to usage of such instruments in an indirect manner.
Kregel (2009) argues that regulators and courts also contributed to this process by progressively ruling that these activities were related to regulated activities of the commercial banks, allowing them to reclaim securities market activities that had been precluded in the New Deal reform legislation. Wray (2010) explains that this led to the fourth phase “money-manager capitalism” in which the financial wealth grew multiple times placing huge sums of money under professional management. This phase resembled the characteristic features of “finance capitalism” where underwriting standards no longer matter, before extending bank finance as professional money managers assured supply of finance in an uninterrupted manner. The rise of huge hedge funds, their access to Fed’s discount window and FDIC insurance, the simultaneous demise of commercial banking consolidated the power in the financial sector in a handful of huge firms. Wray, therefore, states that the current financial crisis is arising out of the real problem of “erosion of underwriting standards, combined with the government’s endorsement of private obligations”. This has resulted in a situation where traditional “banking had strayed far from the (Minskian) notion that it should promote “capital development” of the economy”. In order to get out of the crisis, Wray (2009, 2010) and Kregel (2009) therefore referred to Minskian agenda of reforms for government policies that attempt to a) restore operations of banks through financial intermediation and relationship banking model, which upholds underwriting standards, b) insulate the payments mechanism from episodes of financial instability, c) support a network of small community development banks (public-private partnerships) that would provide a full range of services, d) discourage finance through managed funds through transaction taxes, and e) formulate policies that do not promote moral hazard arising from central bank interventions during crisis.

While Wray and Kregel focused on Minsky’s agenda of regulatory reforms as an effective tool to deal with the current crisis situation, Cooper (2005, 2010) focused on Minskian insights to explain why monetary policy will be ineffective for stimulating the growth once the economy enters into a recession. Cooper (2005) argued that the period of Great Moderation (where the US economy was able to withstand the intermediate episodes of instability arising from savings and loans crisis, LTCM collapse, dotcom bubble and September 11 attacks) was as a result of ‘indiscriminate-asymmetric stimulus’ provided by the low-interest rate regime pursuant to Federal Reserve’s pre-emptive monetary policy stance (Cooper 2005 p. 6). Such a policy was indiscriminate because it had triggered stimulus in earlier episodes not when growth was weakened but even before when it was “anticipated” to be weakened. It was considered asymmetric because the stimulus was used when economic growth was weak while doing nothing to counter strong growth for a relatively long period of time.
subsequently. Cooper (2005) argued that such a monetary policy stance encouraged the economy to behave like an unstable positive-feedback system (in which a change to the system produces conditions to increase the magnitude of that change). Positive-feedback systems arise from perverse relationships between expansionary monetary policy stance and the investor confidence about its continuance for a long period, which together lead into deteriorating balance-sheet ratios. Considering these perverse relationships, Cooper (2010) argued that markets are not efficient in which movement in asset-prices could be explained with random-walk theory. Instead, Cooper (2010) suggested that one should look into the work of Mandelbrot who found evidence that market behavior in reality is influenced by its own recent behavior. Cooper (2010) argued that Mandelbrot’s work provides another explanation to Minsky’s Financial Instability Hypothesis by arguing that the market memory results in positive-feedback loop system thereby promoting destabilising tendencies in the economy. In order to prevent the economy from the consequences of these destabilising forces, Cooper (2010) refers to Maxwell’s control system theory. The control system theory proposes that one should not seek to achieve perfect stability while governing inherently unstable systems such as financial systems. Instead, such systems should be permitted, and at times should be encouraged, to greater short-term cyclicity, using smaller, more frequent downturns to purge the system of excesses. In this way financial systems will be able to escape the large-scale crises in long-run. However, to achieve this policy, it is important to recognise the need for curtailing excessive credit creation and excessive credit destruction through regulatory and governor mechanisms (from control system perspective\(^2\)) of central banks, which encourage greater self-discipline on the part of financial market participants. Through these regulatory mechanisms, market participants will be encouraged to believe that central banks will be willing to pre-emptively halt a credit expansion, and will be keen to delay their efforts in reversing a contraction, thereby forcing the market participants to learn to manage their own affairs a little better. Cooper (2010, p. 164) therefore concludes that “between the combined insight of the M3 – Minsky, Maxwell and Mandelbrot – there is every reason to believe we already have the foundations of a more realistic philosophy of financial markets, one which if applied through our existing central bank governor system should be easily able to produce a less crisis-prone macroeconomic climate”.

\(^2\) A Governor is a part of a machine by means of which the velocity of the machine is kept nearly uniform, notwithstanding variations in the driving-power or resistance (Quoted by Cooper 2010 p. 195, for explaining his argument through Maxwell’s (1868) paper titled “On Governors”).
The works of post-Minskian economists presented so far focused on application of Minskian insights to the origins of the 2007 crisis and the reforms required to prevent such recurrence in future. Unlike these economists, writings of Dymski (2009, 2010, 2011) outlined certain missing links in the Minsky’s hypothesis, which if addressed through further research would enhance its application to the current crisis. According to Dymski, on one hand, the profundity and relevance of Minsky’s road insights into capitalist dynamics have never been more apparent, as the capitalist financial system during pre-2007 years exceeded its limits and required governmental intervention. However, he observed that the 2007 crisis has deviated in significant ways from Minsky’s financial-cycle model as its locus—household borrowing linked first to racial exclusion and then an out-of-control housing market—has been very different from the investment cycle that Minsky’s model privileges. Dymski, therefore, considers that Minsky’s financial instability hypothesis needs to consider three important factors while drawing out the analytical framework for explaining 2007 crisis - the impact of growing racial exclusion, the role of US cross-border imbalances on domestic financial dynamics and the changing characteristics of bank and non-bank balance sheets. Using these factors, Dymski (2009) demonstrated that banks no longer bear as well originate credit risk, as they are encouraged by structured investment vehicles that became more powerful and leveraged than banks, and in the process they make exploitative loans to borrowers from socially weaker sections. Dymski further states that this process is accentuated by macro-economic imbalances the US economy was exposed to in recent times. In Dymski’s (2011) view, this calls for revisiting the financial instability hypothesis from an open economy perspective unlike Minskian initial explanation using a closed economy perspective. The collective impact of these elements is that the banks no longer do what they are expected to do given the macro-economic environment in which they operate and hence the framework for regulating them needs to be revisited. For this purpose, Dymski calls for focusing attention on four key aspects hitherto overlooked while discussing the reforms of financial regulation – a) the complexity of banking institutions and structural interaction amongst players in the industry b) power relationships prevalent in banking industry that can create systemic dys-functionalities and distorted incentives c) information problems and d) beliefs, confidence and credibility of agents interacting in financial markets (Dymski 2010 p. 10). Considering these essential elements that need to be factored into Minskian analysis and the need for revisiting financial regulation Dymski (2010 p. 15) called for an energetic debate about how to govern finance as he considers that it is time to recognise “the deep implications of unchecked power in finance, and for restoring the terms and conditions of public governance so as to renew the economic functionality and social efficiency of the system of finance”.

35
e) Summing up

The previous section analysed the limitations of mainstream economic orthodoxy that was considered in recent literature to have resulted in failure of collective imagination of its proponents from foreseeing the coming of the crisis. This section analysed the alternative hypothesis proposed by Minsky, which focused on inherent unstable nature of markets for prescribing remedial measures to prevent future financial crises. Bringing the role of bank finance in the capitalist economy and debating on the appropriate form of its regulation, seems to be a credible way of understanding bank failures for prescribing appropriate remedial measures. Such an analysis further promises useful frontiers upon which the agenda of reforms can be implemented by policy makers. Despite the emerging criticism in recent times, Minsky’s Financial Instability Hypothesis has therefore been considered as a useful starting point for this research project, which embarked on the intellectual journey dealing with financial instability and regulatory reforms.

2.4 Regulatory Reforms and Bank Governance

Minsky proposed an agenda of reforms to reformulate the financial structure involving banks, with the effective use of regulatory arrangements. Minsky’s agenda is aimed at influencing the portfolio preferences of banks (skewed towards hedge-financing borrowers), achieving a cash-flow orientation, focused on relationship banking model and monitoring the financial innovation that can threaten the financial instability. If regulation was to successfully transform the financial structure in the economy, as proposed by Minsky, it has to deal with the forces that influence the bank governance at a ground level. It is therefore considered relevant to review the governance literature starting from the classical perspective for examining the unique elements of bank governance and for understanding the issues relevant for regulatory reforms to strengthen the same.

OECD principles (2004, p. 11) define corporate governance as “the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined”. The principal-agent framework and the stakeholder theory are the two classical theories of corporate governance that are commonly used when dealing with the role of governance in improving economic performance of corporate entities. The importance of good governance in the context of non-financial firms is more or less a
given in the context of the classical principal-agent problem: 'good’ corporate governance should provide proper incentives for the board and management (as agents) to pursue objectives that are in the interests of the company and its shareholders (as principals) and should facilitate effective monitoring (see, for example, Jensen 1993, Kaplan 1997). The principal-agent theory thus essentially takes a stock-holder (principal) perspective and provides understanding on how the principal can monitor the agents in an effective manner for ensuring efficient performance of the corporate in the long run. The focus on the stockholder, however, becomes a limitation for other authors and the stakeholder theory approach to governance explicitly attempts to take a broader perspective. This approach states that business and the executives, who manage them, actually do and should create value for customers, suppliers, employees, communities and financiers (or shareholders). Governance, accordance to stakeholder theorists, should therefore focus on how these stakeholder relationships are managed by a corporate entity and how value gets created for these stakeholders (Freeman, 2008).

It is widely acknowledged in the academic literature that governance even in the context of banking organisations is an important attribute relevant in promoting overall stability of the financial system. Academic literature argues that banks are critically important for industrial expansion and capital allocation through their financial intermediary role in the system (Krugman 1998a, Goodhart 2000, Barth, Caprio and Levine 2006, Alexander et al 2006, Rochet 2008). When banks efficiently mobilise and allocate funds, this boosts capital formation, and stimulates productivity growth. Given this important role of banks in financial intermediation, the Basel Committee Principles (2010, p.1) articulate that corporate governance is of “great relevance both to individual banking organisations and to the financial system as a whole”. The Basel Principles further state that public and market have a high degree of sensitivity to difficulties, which potentially arise from any corporate governance shortcomings at banks.

However, there is a section of existing academic literature which argues that in the particular context of banks, neither of the traditional approaches to governance (principal agent or stakeholder approach) is sufficient, considering that banks are special entities which are heavily regulated. Levine (2004) argues that while conflicting risk preferences between the bank’s shareholders and managers result in a classical principal-agent problem necessitating governance mechanisms at banks, there are, however, several other reasons to believe that banks are special, both in terms of complexity and severity of the problems. Shleifer and Vishny (1997), for instance, explains this further by stating that governance problems arise in
banks because opportunity exists for some bank managers to improve their economic payoffs by engaging in unobserved, socially costly behavior about which outside monitoring agents have only inferior information compared to managers inside the firm. The inherent information asymmetry problem therefore presents intensified principal-agent problems in the context of banking organisations. These intensified problems can only be addressed if they are subject to strict regulatory regime that can facilitate transfer of information between agents for effective monitoring of banks. Alexander et al (2006) suggested that the traditional model of the principal-agent problem fails to take account of the important role that financial regulation can play in representing stakeholder interests in the economy. The interests of stakeholders (such as employees, customers, suppliers, etc) depend on a well-regulated and supervised banking sector. Alexander et al therefore argue that in a healthy banking system, the supervisors and regulators themselves are agents acting on behalf of broader stakeholder interests in the economy at large. Barth, Caprio and Levine (2011) similarly argue that state regulation and supervision could improve bank governance by providing monitoring functions that dispersed counterparts (in particular – depositors, shareholders and bondholders) are unable or unwilling to perform. Dewatripoint and Triole (1994) demonstrated that optimal regulation is achievable when prudential regulation with external intervention is combined with elements of market discipline envisaged in governance literature.

In the context of banks, the traditional theory of corporate governance, with principal-agent and stakeholder perspective at its centre, therefore, is subject to continuous refinement. Given additional nuances of bank governance, regulators are under constant pressure to determine the essential elements of appropriate regulation and in the process encounter what Goodhart et al (2009, p.10) terms as the “boundary problem”. “Boundary problem” refers to the situation faced by regulatory authorities to ensure balance between two alternative regulatory approaches - one which is a fairly light-touch regulatory approach, so as to avoid massive avoidance via disintermediation, and the other which is a restrictive and prescriptive regulatory approach for preventing disintermediation via legal prohibition. In the absence of thorough understanding of forces that could influence modalities of bank governance and an appropriate regulatory framework to deal with them, regulators always face the risk of relaxing their norms and of being “captured” by the industry (Palley 2009 p.7). Based on the review of literature, this section therefore deals with five forces which pose implementation issues to regulatory reforms for improved bank governance – viz., ownership and management structures at banks; competition scenario and transformation of banking business models; information asymmetry, risk management and incentives; and
moral hazard problems. In addition, a brief explanation on the nature of unique challenges in the context of emerging economies is also provided in the subsequent paragraphs.

a) Bank Ownership and Management Structures

There is a wide body of literature which argues that the complexity in bank ownership and the possible opacity in the management undermine the regulatory reforms aimed at improving bank governance. Laeven and Levine (2008) observed that, in terms of the ownership concentration, banks around the world are generally not widely held, despite government restrictions on the concentration of bank ownership. While there was enormous cross-country variation, their findings revealed that about 75% of major banks have single owners that hold more than 10% of the voting rights. The findings further revealed that 20 out of 48 countries do not have a single widely held bank (among their largest banks). Further, it is interesting to note from their study that of the banks included in their sample with a controlling owner, more than half are families. Laeven and Levine argued that regulatory restrictions on the concentration of bank ownership are often ineffective or not well enforced by national governments. They further argued that dominant shareholding families employ various schemes, such as pyramidal structures, to build up control in banks, which undermines the bank governance. Thus the systematic differences between bank ownership structures and that of structures employed by other corporate entities pose additional challenges to regulatory authorities for providing appropriate framework for bank governance. In light of the same, Adams and Mehran (2003), who analysed a sample of thirty-five bank holding companies (BHCs) over 1986-96, called for industry-specific approach to corporate governance for bank-holding companies. Apart from ownership concentration, dispersion of management structure further complicates the bank governance framework. This is because, as the larger a bank grows, the relatively less efficient its management becomes in some respects. The resultant decline in management efficiency is commonly termed as a phenomenon of “too big to manage” or “too-complex to manage”. As the Bank of Japan (2005) study reports, theoretically, as the size of a company increases, greater the number of organisational levels it will have and higher the volume of information it must deal with, which then increases agency costs, or costs of monitoring agents (Jensen and Meckling 1976).
b) Information Asymmetries, Risk Management and Incentive Structures

It is often argued in the academic theory that banks operate in a world of information asymmetries - between themselves and borrowers - which call for a greater role of risk management in the traditional bank governance framework (Arrow 1974, Kim and Santomero 1988). Diamond (1984) explains imperatives of risk management by referring to financial market frictions such as moral hazard and adverse selection problems caused by such information asymmetries. Moral hazard on the part of borrowers can be defined as actions taken to obtain loans from banks in a manner detrimental to interests of banks, sometimes in situations where borrowers do not bear the full costs or consequences of their actions. Such actions might involve not revealing relevant information to banks that extend loans to them. Adverse selection on part of the banks arises when borrower has some information, which is imperfectly observable by banks in the normal course, and which, if known prior, would have resulted in a different decision than sanctioning the loan to the borrower. As Diamond (1984) argues, these problems require banks to invest in review of private information for making their loans, in an attempt to reduce information asymmetries. Because these loans are normally illiquid and thus costly to trade, and because bank failure itself is costly when their loans incorporate private information, he argues that banks have an incentive to avoid failure through a variety of means, including holding a capital buffer of sufficient size, holding enough liquid assets, and engaging in risk management.

Studies that focused on bank failure however provide wide variety of reasons for failure of risk-management systems at banks. In the context of recent financial crisis, some of the risk management failures that were cited in the academic literature include: ill-informed cost-benefit trade-offs between risk-strategies and capital raising activities (Kashyap et al 2008); failure to handle risk information appropriately in the organisation (OECD, 2009); lack of effective risk oversight by boards of directors (Kirkpatrick, 2009); improper incentive system, rationalisation and opportunity that encouraged managers in financial institutions to engage in aggressive risk taking (Acharya et al 2012, Tarraf, 2011). The conclusions from these studies therefore indicate that while theoretically it is prudent for engaging in risk management activities, banks found to have engaged in risk-management only when they have adequate incentives to pursue them practically from a cost-benefit standpoint.

The task for regulators is therefore challenging as they need to devise regulatory frameworks for improved governance by aligning private incentives with public interest, without taxing or subsidizing private risk taking (Barth, Caprio and Levine 2006). In this context, Rajan (2005),
however argued that technological change, market liberalisation and institutional change that facilitated the evolution of financial sector in recent times, had simultaneously provided incentives for banks to produce bad outcomes. Studies such as these serve as a wake-up call to regulators to periodically recognise the existence of perverse incentives that were present in the financial sector. Rajan called for changes to incentives of financial managers by adopting a risk-management approach to financial regulation. In a subsequent work published in 2010 Rajan argued that, in the absence of such regulatory framework, incentive structures thrown up by the environment and the state of competition in the market make front-line managers at banks pursue aggressive risk-taking strategies, which the top management has little reasons to curb practice. Similarly, D'Hulster (2011) called for rigorous analysis and review of information sharing practices among regulators and supervisors for ensuring that right incentives are secured during all stages of supervision.

It can therefore be summarised that while the information asymmetry problem – between the bank and its borrowers - provides a case for improved risk management measures in the traditional bank governance framework, the extent to which the regulation can provide enough additional incentives, or restrict the prevalent perverse incentives in the market, would ultimately result in the successful pursuit of risk management initiatives by banks.

c) Competition Scenario and Transformation of Banking Business Models

Forces of competition in any industry could influence the governance structures of the corporates. In the context of banking industry, there are two distinct types of views regarding the role of competition and its impact on bank governance and risk management. The first view, often termed as competition-fragility view, states that the competitive banking systems enhances banking fragility as they impact profitability of banks. Reduced profits are argued to provoke banks to focus less on risk management for saving information screening costs in a bid to improve profitability (Marcus 1984, Keeley 1990, Allen and Gale 2000). On the other hand, proponents of the competition-stability view demonstrate, using cross-country time-series data, that competitive banking systems are less likely to suffer systemic banking distresses. Studies argue that, in absence of competition, banking systems will face adverse consequences of low levels of foreign ownership, weak investor protection, generous safety nets, and weak regulation and supervision (Beck, Demirgüç-Kunt, Levine 2006; Schaeck and Čihák 2010). In the recent period, therefore there is growing literature that recommends an appropriate regulatory framework necessary for orderly encouragement of competition in the banking industry (Beck 2008, OECD 2010, Barth, Caprio and Levine 2012).
Competitive forces in the industry influence models of banking business and thereby pose additional challenges to regulators. Bikker and Spierdijk (2008) argue that, when banks face competition, they tend to shift from traditional intermediation to more sophisticated and complex products associated with less price competition, increasing overall instability in the system. Dymski (2010b) too emphasised the strategic transformation of banking from an interest income-driven machine of Minsky to a fee income-driven business pursuant to prevalent competitive forces. Kregel (2008) further argues that the new ‘originate and distribute’ model of bank led to the loss of their ability to evaluate credit as they no longer derive profits from credit intermediation or by retaining credit risks in their balancesheet. Regulators therefore need to be mindful of the influence of these competitive factors and the resultant transformation of banking models. The transformation can impact the aspect of financial stability of the system in general and the integrity of the bank governance and risk management frameworks in particular.

d) Moral Hazard

Studies of bank governance and financial regulation further provide an argument that although a regulatory framework is a rational response to market failures in banking, certain regulations could exacerbate the moral hazard problem influencing bank governance regimes. Alexander et al (2006) for instance pointed out to deposit insurance regulation which, by reducing the incentives of debt holders to monitor the bank, may intensify the ability and incentives of stockholders to increase risk. Similarly Rochet (2008) argues that bank regulations have the effect of undermining the market discipline arrangements that are at the heart of governance frameworks relevant for non-financial firms. Regulatory frameworks therefore encourage an implicit assumption that given the costs associated with resolution, both at a private institution and the overall system level, regulators will do all that is necessary to prevent the large financial institutions from collapsing. Such an assumption translates into funding advantage and skews incentives towards higher leveraging and risk taking (Demirgiiic-Kunt and Huizinga 2011). Recent studies demonstrate that large financial institutions enjoyed an implicit market subsidy, prior to the 2007 crisis, as they considered themselves too-big to be allowed to fail by regulators (Goldstein and Véron 2011). Thus, regulatory reforms need to carefully calibrate the moral hazards that may arise from the role of a regulator being a representative stakeholder in the banking industry.
e) Globalisation and Financialisation

The previous paragraphs indicate issues that regulators should take into account, while pursuing regulatory reforms for improving bank governance and promoting financial stability. While these issues are relevant for advanced and emerging economies, there are set of additional issues that are relevant for emerging economies in the context of financial regulation and bank governance. Firstly, emerging economies are subject to vulnerability of capital flows due to macro-economic imbalances which could provoke large-scale bank failure through the phenomenon of contagion. Secondly, emerging economies are guided by reform measures from international best practices, which often fail to take into account local market nuances resulting in unintended outcomes. Each of these issues is explained in the following paragraphs.

Kaminsky and Reinhart (2000) argue that the globalisation phenomenon in recent decades increased the inter-connectedness amongst nations. They argue that banking crises were relatively rare earlier due to capital and financial controls, but have increasingly become common since the 1970s often in tandem with currency crises. As nations and their financial systems are increasingly inter-connected through trade and capital flows, a shock in one part of the financial system spreads through the other parts through a series of global ‘linkages’. The linkages generally include inter-bank claims and flow of information about market fundamentals. If these fundamentals are common to other markets, the expected returns, and hence, prices in those markets will also fall. Considering that it is optimal for banks to hold deposits in banks in other regions or sectors in order to provide liquidity if demand is unusually high, when one region suffers a banking crisis, the other regions suffer a loss because their claims on banks in the troubled region fall in value. If the spillover effect is strong enough, it causes a panic in adjacent regions. The panic gets stronger as it passes from region to region and finally becomes a contagion leading to a full-blown crisis (Allen and Gale, 2007; Kodres and Pritsker, 2002). Barton et al., (2003) argue that when the panic dimension collides with the inherent banking fragility, they set off a chain reaction and a country begins to spiral downward, as panic and loss of confidence increase problems in the banking system as well as the real economy at the macro-economic level.

Froud et al (2002) argue that the standard notion of better governance is a narrow, ineffective response to problems created by pressures of the market and that it is ineffective when confronted with process of financialisation witnessed in recent times. Defining financialisation as a situation where capitalism is affected by a dominance of the financial
sector (financial elites, income, institutions and motivations) relative to the productive sector, they argue that the impact of financialisation on the behaviour of economic agents is not problematised either in mature capitalist economies or in developing economies. Erturk (2003) examines an emerging economy case study (Turkey) and demonstrates that this problematisation can be a source of instability and crisis and has the potential to corrupt the governance reforms. This is because the governance reforms propagated by the Western world have the natural tendency to equate the better governance with the stock-market performances. This results in setting up of un-realisable rate of return targets for banks in emerging economies. As these targets are unattainable, banks in the ordinary course look forward to improving their financial performances by investing funds in short-term coupons rather than employment generating long-term projects, thereby intensifying the risk of financial bubbles and instability. Erturk argues that this kind of company behaviour looks similar to practices adopted by banks in mature economies, which resort to financial-engineering methods to achieve unrealistic returns dictated by capital markets that are driven by shareholder value. Similarly Walter (2008) argues that when the emerging economies could not convince the local market players about the intended value of reforms, nor succumb to international pressures, they resort to strategies of “mock compliance” to international best practices, thereby showing the robustness of their banking sector in form, but may not necessarily in substance.

The previous paragraphs (a through e) accordingly provide the nuances of bank governance that can pose particular challenges to the implementation of regulatory reforms both in advanced and emerging economies. Against the above background, the subsequent section presents a review of studies that focused on an important historical experience from the emerging economy context - the East-Asian crisis of 1997.

2.5 The East Asian Experience

The crisis that impacted the East Asian nations in 1997 is widely regarded in the academic literature as an historical event that shook the foundations of the entire global economy (Sharma 2003, Sheng 2009, Vines 2000, Krugman 1998a). The former Thai Finance Minister Surin Pitsuwan termed the East - Asian crisis as the “'Tom Yum Koong Syndrome', like the famous Thai hot shrimp soup – very spicy and dangerous for those who come unprepared” (quoted by Sheng 2009, p. 133). The crisis has challenged many established views in the academic literature about the measures required for economic growth and questioned the role of international financial institutions in preventing a financial crisis (Radelet and Sachs
Warr (2003) argued that the crisis in the East Asian nations was a manifestation of three different types of crisis. First, there was a currency crisis - a rapid outflow of financial capital in anticipation of possible currency depreciation, including depletion of reserves, and forced a radical change in exchange rate management policies of these nations. Second, there was a financial crisis, a collapse of domestic financial institutions induced by the currency depreciation and high domestic interest rates, which resulted from the currency floats. Third, these two resulted in an economic crisis, a contraction of output causing a loss of government revenue, loss of employment and consequent loss of household incomes producing serious hardship for a large number of people.

Review of academic literature dealing with the East-Asian crisis, therefore, promises important insights into financial instability, regulatory reforms, and bank governance, for three important reasons. First, there are arguments in academic literature as to whether the crisis was as a result of the international contagion effect, in view of prevalent trade or financial linkages between the East Asian nations; or because of the vulnerability of local banking systems prior to the crisis, in view of their structural weaknesses. Second, another set of academic arguments focused on whether the guidance provided by international financial institutions during the crisis, was in fact helpful in preventing the crisis situation or had exacerbated the same. Third, the resilience exhibited by the East Asian nations during the 2007 crisis prompted another strand of academic debate on whether it can be ascribed to efficacy of regulatory reforms pursued by these nations post the crisis or to the structural changes in the financial systems that occurred in these nations post the 1997 crisis. The review of these arguments provides a comprehensive first hand account of how the theoretical insights discussed in the previous sections operate in a practical world. Accordingly, an attempt has been made in this section to review the academic literature dealing with the East Asian nations in these three lines.

a) East-Asian Crisis – Contagion or Vulnerability?

Academic literature provided two important rival depictions of the Asian Crisis – the contagion theory and the vulnerability theory. Drawing the analogy of viral infection for the crisis, which spreads through the air unpredictably, Contagion theorists argue that the Asian crisis was a result of financial panic amongst the neighbouring nations and there were inherently no vulnerability indicators in East Asian countries prior to the crisis (Bhagwati 1998, Tobin 1998, Das 2000). They argue that the crisis was as a result of collapse of confidence in the Thai currency and banking system, resultant capital flight that provoked a float of the Thai
currency and a drastic decline in its market value. Considering the fact that countries in the region are inter-connected through trade and financial linkages and in the absence of insulative measures such as capital controls, a fall in currency value in one market (Thailand) was interpreted by international investors (such as hedge funds) as a negative signal about the fundamentals of the region. This led to the result that the otherwise relatively healthy economies, suffered the same loss of confidence that had devastated Thailand, with same results (Radelet and Sachs, 1998). **Vulnerability theorists**, on the other hand, argue that there were structural weaknesses in the East Asian nations prior to the crisis, which were merely exposed during the episodes of currency speculative attacks in mid-1997 (Dornbusch 1997, Krugman 1998a, Warr 2003). ‘Vulnerability’ denotes the state of economy to suggest that if a random event results in something going wrong, suddenly a lot can go wrong. According to the vulnerability theorists, the state of economies in the East Asian region was characterised by issues associated with relationship lending (Gomez and Jomo 1999), risk management failures (Sadli 1998, Lee 2000), and bank governance problems (Bluestein 2001, Batunaggar 2002). Vulnerability theorists therefore argue that the random event - the devaluation of the Thai Baht - had merely triggered the otherwise inevitable fallout expected out of these structural weaknesses in the local banking systems.

Krugman (1998a) provided a more broader explanation of vulnerability theory by stating that the analysis of East-Asian crisis “need to focus on two issues normally neglected in currency crisis analysis: the role of financial intermediaries (and of the moral hazard associated with such intermediaries when they are poorly regulated), and the prices of real assets such as capital and land” (quoted in Sheng 2009, p. 86). Once the role of the financial intermediaries, such as banks, is brought into the discussion, it triggers the Minsky’s Financial Instability Hypothesis, as a conceptual framework for explaining the origins of the East-Asian crisis - an approach adopted by another strand in literature. Saqib (2001) argues that Kindleberger-Minsky model fairly comprehensively unfolds the East Asian crisis, as it reflects two leading interpretations of fundamental weaknesses and financial panic of the crisis in two distinctive stages of overtrading and revulsion. Dymski (1999) applied Minsky’s ideas to the broader context of the Asian financial crisis, but modified the framework to incorporate cross-border financial flows based on Minsky’s earlier work (1984). Using the framework, he argued that the tendency of frequent cross-border imbalances leads to frequent asset bubbles and/or asset-price deflations bringing about Minsky crises even without Minsky cycles. Schroeder (2002) attempted to apply Minsky’s financial fragility thesis to the case of Thailand 1984-1999 and concluded that there was empirical evidence to argue that the Thai economy
evolved through Minskian regimes (hedged through speculative to Ponzi) prior to the onset of the 1997 Asian crisis.

Considering the linkage between both the vulnerability and the contagion dimension, it is therefore now widely settled that at the core of the East Asian crisis were both a) large-scale international capital inflows, which created contagion phenomenon; and b) structurally-fragile domestic banking systems, which became vulnerable to panic.

b) East Asian Recovery

As the countries were dragged into the crisis situation during 1997, they called upon International Monetary Fund (IMF) for providing financial support to recover from its impact. IMF had on its part imposed conditionalities that comprised three essential aspects – tight monetary policies for preventing depreciation-inflation spiral and the contagion impact, structural reforms of the financial sector and the non-financial micro-economic reforms aimed at overall reduction of the role of government in the economy (Sharma 2003). The crisis prompted academic debate as to whether the IMF conditionalities played a role in preventing the crisis situation or had exacerbated the same.

As Sheng (2009) explains, the debate corresponds to the one relating to arguments on origins of the East Asian crisis. Proponents of vulnerability theory (see Krugman 1998b), basically blamed the crisis on the crisis countries themselves and supported the structural reforms called by IMF for revamping the local banking systems. On the other hand, proponents of contagion theory (see Radelet and Sachs 1998) argued that the banking panic of the scale suffered by East Asian economies would have brought even sound economies also to a brink of collapse, and therefore concluded that IMF conditionalities had only aggravated the panic situation further. Sharma (2003 p. 44), therefore, considers that the IMF’s record in dealing with the Asian financial crisis has been “mixed”.

Contagion theorists referred to the manner in which IMF handled the conditionalities for extending the financial support to the crisis-affected nations. Stiglitz (2002) argues that IMF policies before the crisis, and conditionalities during the crisis had indeed exacerbated the crisis situation in the East Asian nations. In his view, these conditionalities were supportive of tendencies of globalisation and did not yield intended benefit to East Asian nations. Corsetti et al (1998) and Wade (2001) argued that the IMF recommendations to the East Asian nations, to maintain higher interest rates to continue attracting foreign inflows, had
worsened the crisis by provoking financial losses arising from wide-spread corporate and banking bankruptcies. Furman and Stiglitz (1998) further argued that structural reforms prescribed by the IMF during the East Asian crisis were a distraction in that they imposed heavy costs on economies that are already under strain. Lipsky (2003) argued that the 1997 crisis was not inevitable and was exacerbated by IMF policy errors that sapped the investor confidence, as they underestimated the critical importance of capital flights from crisis countries in the situation of financial panic. Explaining this point further, Radelet and Sachs (1998 p. 73-5) argued that the structural reforms suggested by the IMF during the East Asian crisis “should have been undertaken more gradually, and only as the economy recovered from the effects of the crisis; not, as the IMF insisted they were, in the midst of the crisis.”

The arguments put forward by vulnerability theorists, IMF included, however stressed upon the fact that IMF indeed attempted to address the underlying structural weaknesses in order to provide a long-term solution to the crisis situation. Fischer (1998), for instance, argued that the fund is often called only in a crisis situation and thus has limited role in containing the crisis, which results from the lack of willingness on part of governments to take structural reforms much earlier. He therefore stated that “to ignore the structural issues would invite a repetition of the crisis” (Fischer 1998, p 103). Similarly Mussa (2000) argued that it would be impossible to fix the global financial system without simultaneously fixing the domestic micro-economic structures of crisis-affected countries. Accordingly, stabilising a country’s financial system required institutional reforms advocated by IMF, as they extended well beyond the traditional monetary fiscal and exchange-rate policies.

The alternative arguments on the role of IMF were settled with the constitution of an Independent Evaluation Office (IEO) by IMF itself to examine its role during 1997 crisis. The IEO submitted its self-assessment report in 2003. In the report, the IEO had supported IMF conditionalities as necessary requirements to discipline the nations that promoted structural weaknesses in their financial systems. However, the IEO had also largely admitted that IMF needs to listen more to its members in order to have ownership, prioritisation, and effective implementation of its recommended measures and reforms (IEO 2003).

c) Resilience Thereafter

Considering the role of financial sector in exacerbating the crisis situation and the need for pursuing the structural reforms in a methodical manner, the 1997 East Asian crisis had, in the years thereafter, prompted the international community to adopt and promote a set of
“Compendium of Standards” for promoting financial governance (Walter 2008). The Compendium comprise twelve “key standards for sound financial systems” focusing on aspects of macro-economic policy and data transparency; institutional and market infrastructure; and financial regulation and supervision. Examining the efficacy of these reforms was the subject-matter of research interest especially in the aftermath of the global financial crisis 2007.

The interest emerged out of the fact that while the crisis of 2007 had severely impacted the most advanced economies, East Asian economies have largely been considered unscathed from such significant impact. It is now widely acknowledged in the policy studies that the East Asian nations had entered the 2007 crisis with a “sound set of economic and financial fundamentals” (BIS 2009, p.22), exhibited “resilience” during the post-2007 years (ADB 2009a, p.2) and had indeed emerged “stronger” from the global crisis (World Bank 2010, p. 3). Accordingly, the studies that examined the post-crisis East Asian experience focused on two alternative arguments - one that attributed the resilience of the East Asian banking systems to the post-1997-crisis regulatory reforms and the other one that attributed it to the long-term structural changes in the national economies.

Adams (2008) argued that the substantial improvement in the health of banking sectors, upgraded supervisor and regulatory systems, significant progress in improving risk management, sizable prudential cushions and improved efficiency have provided significant comfort to East Asian banks during the 2007 crisis. Dixon (2009) argued that these developments had left these banking systems much better placed to face a major crisis, than the West, and perhaps, any other part of the global system. Ito et al (2009) attributed the resilience to the solid domestic institutions, especially in the financial sector, arising from the swift policy responses pursued by the East Asian nations. Briguglio and Piccinino (2012) used a “growth-with-resilience” index (GWR) (for measuring the extent to which a country can absorb or counteract external shocks and at the same time promote economic growth) and argued that the East Asian region fares better than the US region on this index. As the direct impact of the global financial crisis on East Asian nations has been limited, Lee and Park (2009) argued that there was relatively less pressure for further financial restructuring and regulatory reform in East Asia than in developed economies in recent times.

However, studies in the academic literature argue that attributing resilience to efficacy of regulatory reforms is premature. Mohanty and Turner (2010) question the argument that microeconomic reforms after the 1997-98 Asian financial crisis have greatly strengthened
banking systems in Asia, as this conventional view does not take enough account of the macroeconomic background. In their view, recent developments such as a sharp rise in domestic savings, combined with the recent large-scale sterilised intervention and easy monetary policy, led to expansion of easy financing conditions, bank credit and large investment of banks into government bonds. Therefore they warn that a highly liquid position of most banking systems in East Asia in recent times may result in a situation that the significant (but so far only latent) increases in market and credit risk might go undetected. Kang and Ma (2007) point out to the lack of historical data on losses for many business areas in East Asian economies that have expanded so rapidly in recent years. They argued that it might expose banks to credit risks that they may be less equipped to manage well in the long-run. Arner & Schou-Zibell (2010) argue that East Asian economies should not be complacent with the short term situation and should focus on enhancing mechanisms to address economic and financial stabilities, to balance and diversify economies, and to develop more effective domestic, regional, and global financial systems.

Thus academic literature provides various arguments concerning the origins of the 1997 crisis, role of IMF conditionalities in recovery, and the source of the resilience exhibited during 2007 crisis. These arguments therefore reveal that pursuit of questions (such as - how does bank governance failures exacerbate a crisis situation and overall instability of a financial system? how do crisis-affected nations go about in implementing regulatory reforms? how do the post-crisis regulatory reforms bring about resilience in a subsequent crisis situation?) promise valuable academic contribution by shaping up policy-making agenda in emerging economies. The questions have the potential to integrate strands of literature so far examined, concerning the sources of financial instability, nuances of bank governance and imperatives of regulatory reforms.

The next section therefore focuses on formulating a research question that comprehensively articulates these concerns into a possible area of inquiry for the research project.

2.6 The Research Question and Its Ramifications

The previous sections so far demonstrate that bank finance generates endogenous unstable forces that can create crises situations in the economy. It further demonstrates that regulatory reforms aimed at reforming the structural transformation of the banking sector could promote stability by reducing banking sector vulnerabilities. However, it is observed that there have been several theoretical arguments in the existing literature, which call for
significant deliberations before pursuing appropriate course of regulatory reforms. In particular, the arguments focused on additional challenges, posed by nuances of bank governance, to authorities entrusted with the responsibility of implementing regulatory reforms. It has been further observed that emerging economies are confronted with additional challenges considering the inter-play of macro-economic forces globally.

An interesting research question that emerges, therefore, from the above theoretical insights is - **How does the pursuit of agenda of regulatory reforms, post the crisis, influence governance arrangements at banks and assist them in maintaining resilience during subsequent episodes of crises?** The answer to this question promises an important contribution to the academic literature for enhancing its practical utility not just amongst the policy makers but also within the industry participants and in particular the boards and senior managements at financial institutions.

As can be observed from the review of academic literature, a possible answer to this question can be obtained by exploring the East Asian post-crisis experience, for drawing out useful lessons relevant for other emerging economies. An important element that is arising from the existing literature is that the studies have so far focused on these debates only by examining the question from a country-level. However, the utility of the research can be enhanced by examining these insights, at the level of individual institutions such as banks, for drawing out useful lessons to implement regulatory reforms in emerging economies. Considering the centrality of banks in the overall capitalist financial system in the Minsky’s Financial Instability Hypothesis, understanding the institutional characteristics for evaluating the research question has various distinct advantages. Firstly, it will help understand the factors that can influence considerations at individual banks and undermine their governance frameworks. Secondly, it will enable regulatory authorities to design regulatory reforms in a more focused manner drawing out appropriate implementation strategies. Thirdly, it will provide regulatory authorities insights into institutional aspects that could potentially threaten successful implementation of regulatory reforms.

The research question further promises a new area of inquiry as it combines the elements of financial instability, regulatory reforms and bank governance into a coherent analysis at a theoretical level. At a fieldwork level, it evaluates the applicability of these theoretical insights by focusing on motivations of official at individual banks and regulatory authorities. It thus attempts to integrate the theoretical and practical perspectives in bringing about the structural reforms required for promoting financial stability in the system. The research
question further attempts to use Minsky’s conceptual insights at all stages of inquiry – before, during and after the crisis situation – unlike the previous studies, which largely focused analysing Minskian insights only at a particular stage. Considering the fact that emerging economies are bank-dominated economies, such a comprehensive treatment of Minsky, also expected to bring out additional perspectives relevant for emerging economies. The research question thus, on a whole, promises possible theoretical extensions and practical policy perspectives, useful for regulators and banks in emerging economies.

The subsequent chapter therefore focuses upon methodological considerations in the context of research. It presents a review of methodologies adopted in previous research studies and justifies the methodology used in this research project.
Methodology adopted for any research project links the research question with the fieldwork approach adopted for its inquiry. As there are various methodologies for undertaking fieldwork enquiry, choice of methodology should reflect specific motivations for undertaking the research project. Selection of methodology for the research project therefore involves various steps - such as review of methodologies adopted in various earlier research studies, examining their relative merits and demerits, justification of research methodology adopted for the current project, decomposing the research question into various sub-questions and finalising the sources of inputs to be used for undertaking analysis of research question.

The Chapter is therefore organised in the following sequence. It begins with the categorisation of existing research studies based on the nature of the methodology adopted. After examining their relative merits and demerits, it moves to the research methodology adopted for the project and attempts to justify the same using certain insights from existing literature. A key section thereafter decomposes the research question into various sub-questions, which were subsequently used in organising the presentation of field work findings. A brief review of the ethical considerations underpinning the fieldwork and analysis stage of the research project is provided towards the end of this chapter. The chapter finally concludes by summing up key aspects discussed in the course of selecting the research methodology.

3.1 Overview of Existing Research Methodologies

The 1997 East Asian crisis was subject to various research studies, both qualitative and quantitative, in the past. The research studies adopted various tools of data collection such as country-level databases, data-sets maintained by international financial institutions, survey questionnaires and fieldwork interviews. An overview of research methodologies, however, reveals an interesting difference in the analytical framework adopted in previous studies. This distinction in research methodologies adopted in previous studies, identified at the level of analysis of the research problem, is therefore used in this chapter for categorising them into two broad conceptual categories – a) research studies that focused on origins of crisis using quantitative modeling or macro-economic indicators; and b) research studies that focused on post-crisis experience using survey-based design or case-study methodology. The evaluation of each of the research methodologies is presented in the following paragraphs:
a) **Research Studies Involving Quantitative Modeling**

There are certain research studies in the past that analysed the East Asian crisis using quantitative models. The objective of these studies is to evaluate whether the pre-crisis behavior of crisis-affected nations indicates a causal relationship between certain data elements chosen for the study and the crisis experience of nations during 1997. Some of the data elements that were subject to cause-effect analysis include governance problems prevalent at domestic corporate firms (Hanazaki and Lieu 2003), inefficiencies and risk-taking behavior of local banks (Laeven 1999), steps taken by central banks for devaluing the local currencies during the crisis (Kho and Stulz 1999). This section critically analyses the advantages and limitations of quantitative models used in these studies. The research studies are selected for review considering the refined nature of checks and balances applied to quantitative models (used in these studies) for factoring in certain real-world complexities.

Hanazaki and Lieu (2003) analysed whether corporate governance problems at domestic corporate borrowers were responsible for their poor performance during the East Asian crisis. The analysis was undertaken using firm-level data (for the period during 1994 to 2000) in five crisis-affected economies (Indonesia, Korea, Malaysia, the Philippines, and Thailand). Three aspects of corporate governance – ownership structure, debt deployed and the extent of corporate diversification - were reviewed for the purpose of assessing their impact on corporate performance, measured by three parameters - return on assets, return on equity and profit-to-sales ratio. In order to evaluate the impact of corporate governance variables on corporate performance during the crisis, a regression equation using the “**random effects**” model was constructed. In statistics, generally “fixed effects” model of regression is used when the independent variable used for the study is considered to be non-random and is used for inferring the behavior of population directly. On the other hand, when the independent variables are thought to be a sub-set of possible values, which one wishes to generalise, researchers use “random-effects” model. The “random-effects” model therefore results in an inferential-leap as the analysis is first used to draw inferences about the possible independent variables and then use such inferences for estimating the values of dependent variable (Raudenbush 1993). The “random-effects” model is considered appropriate for studies involving abstract concepts such as governance problems at firms, aesthetic value of art portraits. Using a regression model based on “random-effects” method, Hanazaki and Lieu (2003) arrived at conclusions even about the inefficiencies in credit monitoring by banks, while analysing the impact of bank debt (as an independent variable) on corporate performance. Conclusions such as these were used to argue that the East Asian crisis was
not the result of a general negative impact of contagion across all firms, but was a manifestation of governance problems at corporates reflected in cross-firm performance variation prevalent even prior to the crisis.

While Hanazaki and Lieu (2003) analysed the relationship between corporate governance and corporate performance using firm-level datasets, to disprove the contagion argument, Kho and Stulz (1999) analysed the impact of currency devaluation steps taken by East Asian central banks during 1997 on bank performance, for arriving at similar conclusions. For this purpose, different sets of banks from four western countries (US, France, Germany and the UK) and six Asian crisis affected countries (Thailand, Indonesia, Malaysia, Philippines, Korea and Japan) were selected for evaluating the returns of bank indices around crisis events. The indices for the study included both equity market and the bank stock indices and the crisis event is defined as the devaluation date when the respective central bank gave up defending the existing exchange rate regime and let the exchange rate drop substantially. To study the impact of the crisis event on the bank indices, a window of 3-4 days around the event was considered. The approach involved regressions equations (using ten bank indices) for estimating the abnormal returns, if any, during periods corresponding to crisis events during 1997. The regression analysis was interesting as it was supplemented with a seemingly unrelated regression (SUR) model, formulated by Zellner (1962). SUR model is considered as a flexible analytic strategy as it enables the researcher to consider the correlation among errors across several individual regression equations, which normally seem to be unrelated, when analysed separately (Beasley 2008). The overall results of Kho and Stulz (1999) research indicated that changes in exchange rate movements have no additional explanatory power for subsequent poor performance of banks beyond their impact on general market movements in Korea, Thailand and Malaysia. Only in Philippines and Indonesia, the research findings identified a direct impact of currency exposures on bank performance. In case of Western banks, the impact of the exchange rate movements was considered relatively insignificant in view of their small exposures to banks in the selected East Asian nations.

Unlike Hanazaki and Lieu (2003) and Kho and Stulz (1999), who disproved the contagion argument in an indirect manner, Leaven (2003) used quantitative modeling directly for supporting the bank vulnerability as a direct contributory factor for East Asian crisis, by analysing the pre-crisis inefficiencies and risk-taking behavior prevalent at East Asian banks. Laeven (1999) used a linear programming technique called “Data Envelopment Analysis (DEA)” to estimate the inefficiencies of banks in Indonesia, Korea, Malaysia, the Philippines
and Thailand during 1992-96. DEA is most widely used non-parametric technique without implicit assumption of existence of ideal efficiency frontier constructed through mathematical model, unlike commonly used parametric techniques. Instead of efficiency frontier based on idealistic scenarios, DEA constructs a frontier based simply on the distance of the best-practice firms from the rest (Schmidt 1986). Leaven referred to various studies (such as Button et al. 1992, Greene 1993) that have argued that DEA analysis is superior to parametric techniques as it is known to produce measured levels of inefficiency even if the impact of various factors concerning the banks (such as actions taken by regulators and central banks in extreme events) are accounted for. Leaven argued that, for recognising the bank efficiencies, it is not enough to look at only the overall performance of a bank but risk factors should be taken into account as well. It is a relevant consideration given that the best bank is not simply the most efficient producer of loans, but is a bank that combines high efficiency with low risk-taking. The DEA resulted in findings that foreign-owned banks took little risk relative to other banks in the East Asian region, and that family-owned banks were among the most risky banks, together with company-owned banks.

As can be observed from the previous paragraphs, quantitative models assisted the specific researchers in analysing the cause and effect relationships in a focused manner. After selection of relevant data-sets and formulation of hypothesis based on literature review, quantitative models analysed the cause-effect relationship with a particular statistical confidence. The three studies presented above demonstrated the manner in which right quantitative models could to a certain extent minimise the impact of complex real-world factors using appropriate additional checks and balances.

Analysis of cause-effect relationship using quantitative models, however, suffers from three limitations. Firstly, it may not be possible in real-world scenario to point-out cause-effect relationship consistently, as there can be cases where what appears to be a causal influence working in one direction actually might be working in the other way or due to a third factor not considered in the study. Although while such cause-effect relationships may be based on sound reasoning, they can only be inferences and there is a theoretical possibility that the real pattern of causal direction is different from what is anticipated. For instance, Hanazaki and Lieu (2003) acknowledge this limitation primarily by stating that their precise quantitative approach could not permit encompassing of various other country-specific institutional characteristics such as corporate law, bankruptcy codes, corporate accounting standards, and corporate finance, which are important factors in regulating the rights and actions of investors and creditors. In the absence of same, it is difficult to establish as to which factor
triggered what (i.e., whether governance problems triggered variations in corporate performance or whether variations in corporate performance (after accounting for impact of corporate accounting standards, corporate law, bankruptcy codes) had resulted in governance problems). Secondly, the measurement processes deployed in the quantitative studies also may, at times, provide an artificial and spurious sense of precision and accuracy. As Bryman and Bell (2007) note, the reliance on instruments and procedures, based on a static view of social life that is independent of people in real lives, hinders the connection between the research and everyday life. For instance, when Laeven (1999) studied the phenomenon of risk-taking and efficiency levels of banks during 1992-96 it was implicitly assumed that the risks, which were built up in banks, were taken by banks only after 1992. The risk measures deployed, therefore, did not include the risk acquired until 1992, which to a certain extent limits the value of the findings of the research. Thirdly, quantitative analysis fails to comprehensively account for complexities of the real-world in their attempt to reduce complexity to a manageable number of variables relevant for analysis. For instance, Kho and Stulz (1999) may conclude, using quantitative analysis, that currency devaluation steps may not have impacted bank-performance in Malaysia, but in reality Malaysia’s capital controls and currency management policies triggered the most controversial academic debate in the aftermath of 1997 crisis (see Jomo 2003). The motivations behind such controls and policies may or may not be explained by only measuring the performance of banks against stock and bank indices during a small window period.

b) Research Studies that Used Macro-economic Indicators for Analysis

Unlike the studies that focused on micro-analysis using firm-level data, this section reviews three specific studies (Warr 2003; Chang and Velasco 1998; Kaminsky and Reinhart 2000) which approached the East-Asian crisis from a macro-economic perspective. The selection of these studies was motivated by the fact that, considered together, these three studies cover the broad streams of arguments concerning the inter-play of macro-economic factors during the 1997 crisis. The objective of these studies was to present a mathematical model in the form of a built-up indicator for monitoring the macro-economic situation in order to prevent future crisis vulnerabilities. As they focus on macro-factors, instead of idiosyncrasies at firm-level, indicator-based studies could be useful for policy-level decision making.

Warr (2003) focused on construction of indicator that provides a snap-shot of macro-economic condition (of three countries – Thailand, Indonesia and Korea) based on three broad macro-economic parameters - adequacy of foreign exchange reserves, financial sector
fragility and real exchange rates. Adequacy of foreign exchange reserves was assessed based on their size relative to the stock of volatile capital obtained from balance of payment statistics of each country. For measuring the financial sector fragility, two ratios (bank loans to country's GDP, foreign liabilities to total loans) were analysed using data obtained from central bank sources of respective countries. Alignment of real exchange rates (nominal vs. real) was measured through various indices (including the IMF/World Real Exchange Rate Index and the Morgan-Guaranty index). For assessing the macro-economic vulnerability, the data on all these parameters was analysed for the period during 1980 to 1997 (for adequacy of foreign exchange reserves) and during 1988 to 1997 (for other parameters). Using the analysis, it was explained that the crisis in Thailand, Indonesia and Korea can be best explained from a macro-economic vulnerability perspective than from the phenomenon of contagion.

Apart from the broad parameters used by Warr (2003), the key focus of the indicator used by Chang and Velasco (1998) is the timing dimension involving the aspect of short-term liquidity. They had therefore constructed an indicator using the definition of “international illiquidity” defining it as a situation when a country’s foreign currency short-term foreign currency obligations could not be met through the amount of available foreign currency assets. The indicator comprised of parameters such as - GDP growth, public sector and private sector debt to GDP, foreign exchange reserves, and short-term obligations. Using the data obtained for defined parameters from BIS statistics, illiquidity indicator was used to measure the impact of the 1997 crisis on Thailand, Indonesia, Malaysia and Philippines (by using the dataset during 1990 to 1996). It was observed through the analysis that the East Asian experience was similar to the experience of Chile (observed by using dataset during 1979 and 1983) and Mexico (observed by using dataset during 1991 to 1995) characterised by problems of illiquidity that resulted in crisis situation in those countries.

Unlike the indicators developed by Warr (2003) and Chang & Velasco (1998), which focused on a single country’s macro-economic vulnerability, Kaminsky and Reinhart (2000) focused on channels through which the vulnerability gets exacerbated in a crisis situation. Accordingly, Kaminsky and Reinhart (2000) investigated the several possible trade and financial linkages among the Asian economies using “contagion vulnerability indices”. The analysis was developed based on a sample of 20 countries spread over a period from 1970 to 1998. The development of the contagion vulnerability index involved grouping of countries into trade clusters (based on bilateral trade data and common-third party trade data taken from IMF trade statistics), financial clusters (based on grouping of countries that borrowed from US
banks and countries that borrowed from Japanese banks, using data available from BIS international lending statistics). The contagion vulnerability index thereafter is arrived at, using the noise-to-signal ratio for measuring the probability of occurrence of a crisis in the home-country based on the news of a crisis in the foreign country belonging to the respective cluster. The ratio was used to demonstrate that even in the absence of herding mentality amongst investors, the trade and financial linkages between countries present macro-economic vulnerabilities resulting in a crisis situation, given the external occurrence of a crisis in another related country.

Unlike quantitative models that focused on firm-level data for analysing cause-effect relationship at a micro-level, indicator-based studies act as useful tools for policy-makers by providing warning signals about country’s vulnerability to future crises, based on macro-economic data. Indicator-based studies, however, suffer from three important limitations. Firstly, what constitutes the incorporation of sufficient number of variables for building up a sound indicator is always debatable as it also needs to take into account the complex interplay of various real-world factors, sometimes not readily identified. For instance, all the three studies did not separately analyse the data on off-balance sheet exposures of domestic financial institutions for measuring their vulnerability, which was realised as an important missing element in the macro-economic analysis, in the aftermath of the global financial crisis of 2007 (see Acharya et al 2009). Secondly, indicator approaches cannot adequately incorporate the impact of human or institutional elements on the phenomenon being studied. For instance, while the contagion vulnerability indicator developed by Kaminsky and Reinhart (2000) could model the trade and finance linkages between nations through data available from international sources, the behavioral aspects of investors who exhibit herding behavior introduces further complexity into its construction as an indicator. Behavioral aspects generally involve factors such as political considerations, central bank policies, and communication strategies adopted by key decision-making entities/individuals. These are generally measured, in an indirect manner, through the extent of capital outflows during crisis events. However, a precise measure for factoring in the herd behavior requires a complex quantitative modeling, which will undermine the utility of macro-economic indicator as a predictive tool based on available data. Thirdly, indicator-based studies generally consider the economy in a static condition using defined parameters. However, in a dynamic environment, the economic policies are influenced by prevalent thinking at central banks, political stability, natural disasters, extent of social activism and cultural factors. For instance, the indicators developed by Chang and Velasco (1998) and Warr (2003) did not take into account the considerations that motivated the prevalent central bank thinking in assessing the adequacy
of foreign exchange reserves during the prior years (to 1997). The considerations, inter alia, could possibly include years of experience of dealing with the fixed exchange rate regimes (without the need for drastic intervention through utilisation of reserves) and the political factors restricting the ability of central banks to be more active. Such motivations may not be factored in the multiple indicator approach in a more explicit manner.

c) Research Studies that Adopted Survey-based Design

As mentioned earlier, the aspects pertaining to the nature of post-crisis reforms undertaken at East Asian nations and review of their efficacy had been subject to qualitative analysis in various other studies. In this section, a review of two research studies (Nam and Lum 2006, Parrenas 2005) that adopted survey-based research design, and qualitative analytical framework, is presented. The studies are selected based on their relevance to the research question adopted for this project. It is upfront acknowledged that survey based approaches provide data relevant for both quantitative as well as qualitative analysis. However, considering the fact that the aspects pertaining to quantitative analysis have already been covered in the previous section, this section focuses exclusively on survey-based approaches that deployed qualitative analysis for examining the stated research question.

Survey-based research studies that are undertaken for review are different from quantitative research studies reviewed in the previous section in two different aspects. Firstly, survey-based studies examined the exploratory research questions (as opposed to explanatory research undertaken through quantitative studies) focusing on aspects of post-crisis governance and risk management reforms at banks in East Asia. The objective of these studies is to provide a comparative analysis of legal and regulatory environment as well firm-specific characteristics, while analysing the reforms at various countries. Secondly, the distinction between the quantitative studies and the survey-based studies using qualitative analysis is arising from the nature of source data used for analysis. While quantitative studies used the data obtained from secondary sources, survey-based approaches, that are reviewed hereafter, used the data collected from primary sources through questionnaires.

Survey conducted by Parrenas (2005) for reviewing the risk-management practices across East Asian banks covered 52 banks - 22 from Indonesia, 13 from South Korea, 6 from Malaysia and 11 from Thailand. The survey covered general risk management as well as internal control in relation to the risk management function, and practices related to the management of credit, market and operational risks in the banks of these nations. The focus
of the survey was extended to the governance aspect of risk management by seeking the responses from banks on the risk oversight role of board of directors. The findings of the survey indicated that on an overall basis, risk management practices in the four markets conform in most part to the internationally accepted standards. The findings however indicated certain variations amongst the responses of banks - based on categorisation of banks using ownership criteria and asset size.

Survey-based research undertaken by Nam and Lum (2006) involved two types of questionnaires - one focusing on factual information directed to banks in general and the other one concerning the opinions of board members in particular. The factual information survey questionnaire covered 63 banks in East Asian region (26 in Indonesia, 14 in Republic of Korea, 10 in Malaysia and 13 in Thailand). The questionnaires sought responses from banks on various aspects of governance such as board size, composition, independence and other characteristics, CEO/director evaluation and compensation, support for outside directors and disclosure practices. Opinion-seeking questionnaires were directed to board members amongst surveyed banks. The questionnaires covered 128 board members – 50 in executive role and 78 in independent capacity at the board. The opinion-seeking questionnaires sought to supplement the factual information questionnaires by focusing on areas such as responsibilities and roles of board members, independence, election and dismissal of CEO and outside directors, information access for outside directors, director’s compensation and liability and priorities for a more effective board. The factual information and opinion-seeking questionnaires were supplemented with information separately collected on the legal and regulatory environments in each of the countries. The review of survey results indicated that while there were country level variations in the legal and regulatory environment, there is sufficient and persuasive evidence that the governance improvements are consistently observed in all the countries.

As can be observed from the above two studies, survey-based researches enabled the researchers to focus on analysing various institution-specific characteristics in a single study dealing with governance and risk management. Further, the approach adopted by Nam and Lum (2006) to supplement the information from questionnaires, with the information separately obtained on the legal and regulatory environment, enhanced the utility of the former to a large extent. Even within the questionnaires adopted for the survey, Nam and Lum (2006) could control the biases of respondents by seeking two sets of information (factual and opinions) through separate questionnaires. The enhancements thus enabled the research to analyse three perspectives - factual information on governance reforms,
authoritative opinions about their efficacy, and the environmental considerations that could impact them - in a single study through cross-country comparative analysis. The research therefore corroborates the fact that surveys profoundly influence social sciences research in so far as they deal with institutional aspects (Kerlinger 1986). Further, surveys represented an appropriate strategy as the information on aspects of governance and risk management is not available through secondary resources in a granular manner. In such a situation, survey strategy represented a relatively easy to administer, cost-effective approach as questionnaires had been used for data collection relevant for the research from first hand sources (Baker and Mukherjee 2006). Thus Parennas (2005) and Nam & Lum (2006) demonstrated that through well-designed questionnaires (that are efficient at collecting information from a large number of respondents on a wide range of topics), survey based approach can provide considerable flexibility to the analysis.

Survey-based research was however subject to criticism in academic research as it sometimes could result in collection of masses of data without any theoretical value (Roberts 1999). Operationally, surveys are generally considered inflexible in so far as they require the initial study design to remain unchanged throughout the data collection process. Bell (1996) observed that survey-based researches are prone to biases either from inadequate or inaccurate responses to questionnaires. Fowler (1993) therefore argued that designing appropriate questions that can elicit relevant responses for the research constitute the heart of survey-based research. When the questions are standardised, requiring only a choice from a prescribed list, surveys enforce uniform definitions upon the participants. This leads to the situation where answer-choices could lead to vague data sets because at times they are relative only to a personal abstract notion concerning the strength of choice. For instance the choice "moderately agree" (in the context of questions relating to efficacy of the reform measures put in place by banks) may mean different things to different subjects, and to anyone interpreting the data for correlation. Even 'yes' or 'no' answers (to key questions such as existence of risk based performance systems) are problematic because of the subjective element involved (for instance in interpreting what constitutes risk based performance system). On the other hand, if the questions are made open-ended they result in responses that are not amenable for statistical analysis thereafter. Further, in situations where the questions are open-ended, the respondents’ motivation, honesty, memory and ability to respond comes into question (Glasow 2005).

In light of the limitations involved, surveys are not generally considered relevant when the research is about understanding the historical context of phenomena (Pinsonneault and
Kraemer 1993). For such research studies, as Gordon and Howell (1959) argued, due consideration for appropriate theory and conceptual framework should be given than while administering the exploratory survey based research. This calls for an alternative research methodology to survey design involving several respondents, wherein information about limited units is analysed using a rigorous theoretical and conceptual framework relevant for context analysis. Case study research design could be one such alternative design and therefore a review of previous studies that adopted the case study design is presented in the subsequent section.

d) Research Studies that Adopted Case-Study Design

The 1997 East Asian crisis was subject to case study research in several studies in the past. As research studies with quantitative analysis are already covered in previous sections, only those case studies involving qualitative framework for analysis are primarily included for review in this section. The case studies selected for review include single case studies focusing on a particular country/bank as well as comparative case-studies involving analysis of multiple countries/banks. Case study methodology was used in previous studies to evaluate complex factors that surrounded a single phenomenon in a more contextual manner. This is considered as a relevant approach, where the research focus is not towards identification of a cause-effect relationship between variables, but to point out how the interplay of various factors would result in a situation that may not be amenable for mathematical precision.

With the above background, some of the research papers involving case study methodology is covered in the following paragraphs:

**Case studies focusing on a specific country:** Individual country experiences of East-Asian nations prior to the crisis as well as post-crisis reforms were subject to extensive research in academic literature. For instance, in the context of Indonesia, Batunaggar (2002) reviewed in a comprehensive manner as to how the bank restructuring process was handled during 1997 crisis, bringing out a range of issues associated with IMF policies, communication lapses during the restructuring phase, operational difficulties associated with bank closures, political factors, co-ordination failures amongst authorities responsible for supervision, institutional capacity issues to handle restructuring and the lapses in handling the blanket guarantee scheme during the crisis. Jomo (2003) similarly analysed the Malaysian 1998 capital controls as a case study and touched upon complex environment surrounding
Malaysia during the crisis and analysed the factors that led to the stiff policy response adopted by the country. The study further presented a comprehensive assessment of Malaysian capital controls in order to offer some general lessons of relevance to other emerging economies. In the context of Thailand, Montreevat and Rajan (2003) analysed how the foreign bank entry had influenced the Thai banking system in the post-crisis period. The case study had demonstrated how the political economy compulsions and past experiences have enabled Thailand to adopt a more gradualist approach in Thailand for internationalising the domestic banking sector. Alburo (1999) examined the Philippines country as a case study to evaluate the social and economic impact of the 1997 crisis as well as the policy response and strategy pursued by Philippines post the crisis. In the process, it was demonstrated that various macro-economic contextual forces shaped up the impact of and the response to the crisis in Philippines.

As can be observed, the case study design enabled these studies to focus on complex environment containing inter-play of several factors in a single study. Through case study approach, researchers were able to focus on a single issue in a greater depth from a socio-economic perspective. Instead of modeling country experiences using data sets, case study approach thus enabled researchers to bring out multitude of factors often assumed away in quantitative analysis.

Case studies focusing on multiple-countries: Unlike the studies that focused on single country as a case unit, there are various other studies (Sharma 2003, Walter 2008 and Sheng 2009) that focused on analysing crisis contexts in various countries for drawing out comparative perspectives. Sharma (2003) examined the broader questions of East Asian crisis using a political-economic framework and country case studies (Thailand, Indonesia, South Korea and the Peoples Republic of China (PRC)). In doing so, Sharma (2003), however, placed very less emphasis upon the quantitative data in his country level case analysis. The research focus was exploratory and examined the overall complex environment surrounding the crisis in a comprehensive manner unlike the single case study research projects discussed earlier, which focused only on a specific issue. The research project adopted a country narrative reporting format representing extensive and exhaustive survey of existing literature. Similar to the work undertaken by Sharma (2003), Walter (2008) dealt with country case studies (Indonesia, Thailand, Malaysia and Korea) in order to qualitatively evaluate the differences in the approach adopted by each country, post the 1997 crisis, to demonstrate compliance with international standards on bank governance and supervision. Walter (2008 p. 6) argued that case study approach could be justified for his work as it “can take
advantage of the fact that for compliance, the devil is usually in the detail.” Therefore, Walter placed less reliance on quantitative details all throughout the research work. However, the work of Walter (2008) could be considered a refinement in methodological approach than Sharma (2003) in view of two specific considerations – firstly, it focused on building up a comprehensive theoretical framework (before reporting the country-level case findings) using an extensive review of literature on financial regulation. Secondly, the case findings were presented in a graduated manner to avoid repetition of theory and issues. Compliance to international standards on bank supervision was explained first in the context of Indonesia followed by review of compliance with governance standards in Thailand. In the context of Malaysia, compliance to both bank supervision and corporate governance standards had been examined. Finally, in case of Korea, in addition to these two aspects, compliance issues relating to standards of financial disclosure were also considered. While Walter (2008) thus explored the manner of compliance adopted by countries, Sheng (2009) attempted to unveil the forces that could have influenced such compliance outcomes in his research project by providing a regulator’s first hand perspective on the journey of Asia from 1997 crisis to 2007 crisis. Though Sheng had retained the country-level narrative reporting format like Sharma and Walter, his work represented an exhaustive treatment of the subject for three specific reasons. Firstly, unlike the other two authors, Sheng had extensively used quantitative data (relating to macro-economic parameters - such as GDP, size of banking sector, exchange rate movements, banking sector exposures - drawn from the data sources published by international agencies such as IMF and World Bank) to support his qualitative analysis. Secondly, Sheng provided a comparative analysis of East Asian nations at two levels – highlighting the experiences of the case study nations (Thailand, Indonesia, Malaysia, China and Hong Kong) in the context of 1997 crisis and contrasting the experiences of all these nations between 1997 and 2007 crisis. Thirdly, the analysis of case experiences was further enhanced with the review of literature and discussion on aspects relating to the role of Japan and IMF, financial engineering, and financial regulation. Thus, taken together, Sharma (2003), Walter (2008) and Sheng (2009) provided a comprehensive account of East Asian experience during two crises in a span of fifteen years (1993- 2008).

However, it is useful to list down certain limitations that were observed in the works of Sharma, Walter and Sheng. Firstly, all research works adopted country as a case-unit and focused on macro-level aspects at a country-level. Institutional factors, at individual-bank level, such as their internal governance mechanisms, therefore received limited attention in these studies. Secondly, except for Walter (2008), the other authors did not adopt a comprehensive theoretical framework that could be used as a springboard for reflection of
case study findings. While Sheng (2009) attempted theoretical framework in certain aspects related to financial regulation, it was not used consistently all over the study. Thirdly, in the context of comparative case studies, findings were reported in a country-level narrative manner in which cross-country comparisons needs to be inferred by the reader. Therefore, while the research undertaken by these authors was comprehensive on a stand-alone basis, the impact of inter-play of policy decisions that were analysed from a macro-economic context on individual banks was a missing link in all these three studies.

Case studies involving a single bank: There were various academic studies in the past that analysed individual banks in the context of crisis experience of Indonesia, Malaysia and Thailand. The case studies largely focused on evaluating how the case study banks transformed over a period of time subsequent to the crisis. In particular, the studies examined internal governance and risk management developments as well as analysis of business decisions that contributed to performance of banks. It was observed during the review, that case studies of this nature were available largely in the context of Indonesia considering the transformation of state-owned banks into performing banks over a period of time. For instance, Lasserre (2004) focused on the strategic transformation at Bank Mandiri - a state-owned bank that was formed after merger of four crisis-affected banks during 1999 (Bank Bumi Daya, Bank Dagang Negara, Bank Exim and Bapindo). While the merger received widespread attention during 1997 crisis as a moral hazard case study, Lasserre focused on how the CEO and the management team were able to turnaround the Bank into a commercially viable giant post the crisis. The case study findings, presented as a four-part analysis, were also based on interviews with bank-level officials and focused on various aspects such as merger process, IT challenges, governance improvements, financial situation and cultural integration. In a similar manner, ADB (2009b) focused on restructuring experience of another oldest and largest state-owned bank – Bank Rakyat Indonesia (BRI). BRI was successfully restructured twice – one after the interest rate deregulation of finance sector in Indonesia during 1980s and once again after the 1997 crisis. The study provided insights into how state-owned financial institutions could be transformed into viable financial institutions, which become instrumental for economic growth in developing countries. The study attributed BRI’s turnaround performance to host of factors such as government’s decision to provide operational autonomy to BRI for its functioning, role of Harvard University Center for International Development in providing long-term technical assistance and effective regulation/supervision provided by Bank Indonesia in the revival of BRI. A similar research project was undertaken by Marimuthu and Ibrahim (2013) in the context of Malaysia with CIMB Bank as the case study bank. CIMB Bank took over Southern Bank
As per Bank Negara Malaysia’s merger and acquisition plan subsequent to 1997 crisis. As the merger was undertaken pursuant to crisis situation, the case study research focused on whether there was a variance in performance of CIMB Bank before and after taking over Southern Bank Berhad. However, unlike Indonesian case studies that adopted qualitative analysis, the CIMB case study was analysed using daily and weekly return data over a 3 year period around the merger announcement date using paired t-test technique. Using the analysis, it was concluded that the merger was beneficial in a long-run to the taking over entity (CIMB Bank), while in the short-run its performance had been impacted. In addition to these case studies, there were other studies that focused on banking performance improvements post 1997 crisis from business and strategic perspective. For instance, World Bank (2006) focused on small-enterprise-lending business strategies adopted by the subsidiary of Bank Danamon as part of its Rural Investment Climate Assessment Projects. The study highlighted innovations undertaken by the bank including tight targeting of borrowers, designing products suited to their requirements and leveraging upon IT capabilities for credit assessment and monitoring. Similarly, Shavyun and Pulikkiel (2005) focused on role of strategic brand building for achieving financial success using the experience of Thailand’s Bank of Ayudhya. The study focused on customer, employee and public perspectives of a bank brand using survey questionnaire administered to gather responses from respondents in each of these categories. The study explained how banks could streamline their business objectives to their vision statements through a brand-building exercise.

The case experiences thus focused largely on performance of individual banks from East-Asian region and attempted to attribute it to certain key success factors. While doing so, the impact of crisis-related organisational restructuring on their performance is also analysed in certain case studies. The data collection technique varied from case to case and so was the analytical framework adopted for examining the findings. However, the focus was largely on the contextual factors surrounding a particular bank’s experience tracing them to its historical and organisational contexts. The case studies thus demonstrate the “focus” required at institutional level to examine the certain qualitative aspects in a greater detail. However, case studies involving single bank as explained above suffer from certain limitations. Focusing solely on single case study does not allow the readers to appreciate the extent of success as there is no comparative yardstick against which case subjects could be analysed. While complex institutional factors gain attention in such studies, lack of comparable benchmarks make their utility restricted to being branded as business case studies rather than academic case studies. The other reason for such labeling was also that there was no comprehensive
theoretical framework against which these individual case studies were analysed, which could be construed as another serious limitation for above research studies.

**Case studies involving multiple banks:** As against research projects that reviewed a single bank experience, it was observed during review that there are certain country-level studies focusing on multiple-bank experiences for comparative analysis. The studies, for the purpose of review of methodologies, are grouped into two categories - one in which the governance and risk management aspects were analysed (Soon & Koh 2005 in the context of Malaysia and Srinivas & Sitorus 2004 in the context of Indonesia) and the other group in which business and technology aspects were analysed (Leng 2012 for Malaysian banks and Wonglimpiyarat 2007 for Thailand banks). Lum and Koh (2005) focused on corporate governance of Malaysian banks as they found it to be a puzzle that despite known for better bank governance regulatory regime, Malaysia was frayed to extremis during the 1997 crisis. Their objective was therefore to evaluate the bank-level variations in application of this regulatory regime to their respective governance frameworks and analyse the areas of improvement identified during 1997 crisis. The study therefore focused on ten large domestic banks and six foreign banks for drawing out comparative experiences of governance frameworks. The role of Bank Negara Malaysia’s corporate governance regulation post 1997 was also reviewed in bringing about governance improvements at individual banks. Similarly Srinivas and Sitorus 2004 focused on the case study of state-owned banks in Indonesia by initially examining their role in the Indonesian banking system prior to the crisis. The problems faced by these state-owned banks during 1997 crisis, which led to their overall restructuring was analysed in greater deal in their research study. The role of government and Bank Indonesia in the crisis, restructuring and revival of state-owned banks was elaborated using the experiences of certain individual bank restructuring cases. The conclusions were straightforward as they argue that there was no justification for existence of state-owned banks in the country’s financial system. However, as their continuation is a politically driven decision from a long-term perspective, the researchers called for steps to strengthen their governance standards in the short-term.

On the other hand, there are certain other studies that focused on the impact of human resources and technology aspects on bank performance using comparative case study approaches. For instance, in the context of Thailand banks, Wonglimpiyarat (2007) reviewed how technological capabilities evolved and how the learning process developed over a period of time. The study was undertaken in the backdrop of academic literature that focused on changes in technological regimes. The analysis of the research question was based on review
of experiences of five commercial banks (Bangkok Bank, Siam Commercial Bank, Thai Farmers Bank, Krung Thai Bank and Bank of Ayudhya). The changes in technological capabilities from mass automation to smart automation and thereafter to electronic banking regime were explored in the case study research. Based on this, it was argued that technological changes for better performance in banking sector was not a revolutionary phenomenon in Thai banks, but it occurred slowly i.e., evolved via slow learning process. A continuation of similar theme was observed in the research paper of Leng 2012 who focused on branches of two un-identified banks situated in Kuala Lumpur and Georgetown in Malaysia. The study was based on both qualitative as well as quantitative data using survey questions and interviews undertaken with teller-staff at branches. The objective of the study was to highlight that the technological changes focused on business performance demand enhancement to knowledge levels not only of the managerial staff but also the ground-level staff manning the bank branches. The study concluded that more adequate and equitable training opportunities should be widely accessible to tellers given their radical change role from tellers to sellers and ultimately thinkers.

The comparative bank case studies thus enabled researchers to focus on more than one bank to draw out contextual differences as well as variations of methodologies adopted at different banks while studying a phenomenon. It enabled to draw out a common theme across various banks, as was observed in studies dealing with technological improvements. It also brought about case-specific differences, as was observed in studies dealing with governance frameworks. The flexibility of such research studies was therefore that it allows the researcher bias to be limited by involving comparative perspectives to act as reference points for the research project. However, as explained earlier in the context of individual bank case studies, even the multiple case studies reviewed above also did not adopt a comprehensive theoretical framework that could be used as a springboard for reflection of findings against case study findings. While Srinivas & Sitorus conducted an extensive literature review for the research paper, the absence of a specific theoretical framework, occasionally might pose operational difficulties of research project moving in multiple directions and the administering of which therefore becomes a complex task.

The preceding sections (a to d) therefore presented a critical review and evaluation of four different methodological approaches adopted in previous studies that examined the East Asian experience and the governance/business performance improvements of banks in East Asia thereafter. Using the insights there from, the next section attempts to provide a context and justification to the research methodology adopted for this project.
3.2 Research Methodology for This Project

As the literature review presented in Chapter 2 suggests, regulatory reforms, as suggested by Minsky, aim at bringing about structural changes in banking sector in order to promote financial stability. However, as Chapter 2 further demonstrated, the objective of regulatory reforms confront with challenges at an institution-level, especially arising from the real-world complexities associated with bank governance and risk management. The objective of this research project is, therefore, to unfold how does the pursuit of agenda of regulatory reforms, post the crisis, influence governance arrangements at banks and assist them in maintaining resilience during subsequent episodes of crises? Against the stated objective, this section evaluates the relevance of each of the methodological approaches reviewed in the previous section, thus providing a justification and rationale for the methodology finally adopted for this project.

As observed in the previous section, quantitative modeling and building up of macro-economic indicators would not suit the research question as they may not entail comprehension of real-world complexities. In this context, it is apt to quote Kaufman from his foreword to the 2008 edition of Minsky’s book “Stabilizing and Unstable Economy” (p. viii), that even Minsky “sagely understood that mathematical equations cannot properly account for significant crucial structural changes or shifts in behavioral patterns in economics and finance”. As the project embarks upon the analysis of Minskian agenda for regulatory reforms, it is considered appropriate to continue Minskian approach of not reducing the overall thesis to mathematical formulation. The motivation to avoid quantitative modeling approach further stems from the research objective, which aims at providing policy-level recommendations, apart from evaluating certain theoretical insights, relevant for emerging economies based on the East Asian post-crisis experience. As Buiter (2009 p. 4) notes in the aftermath of the recent global financial crisis, "it would soon become clear that any potentially policy-relevant model would be highly non-linear, and that the interaction of these non-linearities and uncertainty makes for deep conceptual and technical problems". It is therefore concluded that a qualitative research design would provide appropriate methodological justification for the research project.

The decision to go with a qualitative research design resulted in the question of choosing between a survey-based approach and a case-study approach for this research project. However, as observed in the previous section, a survey-based design is considered to be an information-rich but analysis-limited approach for this project, which intends to explore
institutional nuances in a granular manner. Survey design may lead to biases of respondents, which could not be comprehensively evaluated unless respondents are interviewed personally and the complexities related to regulatory reforms are unfolded in a face-to-face discussion. The face-to-face interaction further entails designing a semi-structured questionnaire allowing the participants not to restrict their responses to the choices bucketed by the researcher. The utility of such an interaction can be best achieved if the focus of the analysis is at a bank-level in order to study the governance and risk management improvements. A case study research therefore becomes a relevant approach for consideration and warranted a review from a theoretical standpoint as well. Accordingly, a review of the academic literature concerning the case study research is presented in the following paragraphs.

Yin (2003, p. 13) defines a case study as "an empirical inquiry that investigates a contemporary phenomenon in depth and within its real life context, especially when the boundaries between the phenomenon and the context are not clearly evident". Case study research methodology is widely regarded as a necessary and sufficient method for certain important research tasks in social sciences and is known to hold up well when compared to other methods (Platt 1992). Case study is also considered as an ideal methodology when a holistic, in-depth investigation is needed (Feagin, Orum & Sjoberg, 1991). Stoecker (1991) and Stake (1994) considers case study as a comprehensive research strategy as it can be useful for understanding a complex issue or object and can extend experience or add strength to what is already known through previous research. Case studies are best suited for situations where the initial identification of research questions and theoretical framework will work best, where it is tentative - with a recognition that the issues and theory may shift as the framework and concepts are repeatedly examined against the data which are systematically collected (Hartley 2004). Case studies are thus known to produce opposite outcomes than what is anticipated at the outset, thereby allowing the thinking to be unfrozen for development of new lines of inquiry (Eisenhardt 1989).

Robson (2002) therefore considers case-study as a flexible approach as it is able to adapt to and probe not only areas of planned but also emergent theory. In this context, it is apt to discuss the relevance of case-study design for research on bank governance, based on a review of literature undertaken by Haan and Vlahu (2013). It was observed from their review that current research on bank governance suffer from three specific limitations from methodological perspective. Firstly, existing research largely focuses on evaluating the effectiveness of bank governance in enhancing bank performance or in maximizing the interests of its shareholders. Such restricted focus on shareholder value only and ignoring
regulatory distortions was argued in certain studies to have restricted the practical application of bank governance research (Laeven 2012). Secondly, it is generally difficult to define proxies for parameters that could potentially influence bank governance (see, for instance, Berger et al 2012 (who evaluated the impact of age, gender and education of executive team on bank governance outcomes) and Čihák et al 2012 (who considered forced executive turnovers as a proxy for ascertaining the strength of market discipline in the context of bank governance). The problem of identifying proxies for both dependent and independent variables thus technically implies that there exist non-linear relationships between variables when it comes to the question of effectiveness of bank governance. However, only very few existing studies incorporate such non-linear relationships into their research design (Grove et al, 2011). Non-linearity, according to Haan and Vlahu therefore result in a situation where the effectiveness of one dimension of governance research may be conditioned by another dimension. It is therefore of great importance while pursuing research on bank governance not to assess the role of each mechanism in isolation. Thirdly, existing studies on bank governance do not carefully examine the potential problem of reverse causality. It implies that the assumption of positive impact of certain parameters such as competition, board size, and regulatory environment on bank governance was only theoretical and resulted in mixed findings in real-life. For instance, Hermalin and Weisbach (1988) report that non-executive directors are often added to the boards of badly performing firms in an attempt to reverse poor financial results, but rarely with success. Similarly, while reviewing the bank governance across nations, the influence of regulatory environment on local banks is known to provide an impact which is normally not considered adequately in existing quantitative research. Against this background, it is important to reflect upon the writings of Hartley (2004 p. 323), who argued that case studies are known best for analysing a phenomenon especially when “the phenomenon is not isolated from its context (as in, say laboratory research) but is of interest precisely because the aim is to understand how behaviour and/or processes are influenced by, and influence context”. Case study design therefore has an ability to address most of the limitations identified by Haan and Vlahu in the current research on bank governance as it – does not solely focus on single variable of shareholder value, evaluates multiple dimensions of governance problem, and allows the researcher to examine the possibility of reverse causality in a given context.

Yin (2003) further supports the case study design by stating that such a design is best suited for research projects that meet the following criteria - a) the type of the research question is how or why which denotes an explanatory research resulting in explanation of a particular phenomenon based on an in-depth study and analysis b) the researcher has little control
over behavioral outcomes of the research; and c) the research subject is a contemporary event as opposed to a historical event. In the case of this research project, a case study approach seems appropriate for several reasons. This project tries to address why certain regulatory reforms were implemented in the East Asian banks post 1997 crisis and how did they help the local banks during 2008 global crisis. The project thus revolves around the complex interplay of macro-economic factors at national level and institutional nuances at individual bank level to understand their implications on regulatory reforms and bank governance in promoting financial stability and resilience. Thus the outcome of the research is dependent on the dynamics of individual case study banks and their surrounding regulatory environments. This allows the pursuit of research question in a more open form (unlike an experimental research or, to a certain extent, an assumptions-based quantitative modeling approach, which considers only limited variables). The topic chosen is contemporary, considering the fact that the current debate - post the global financial crisis - in regard to scope and dimension of regulatory reforms for improved governance is not yet settled internationally.

The research question, posed in the overall context of Minsky’s instability hypothesis, intends to examine the regulatory reforms for addressing the risks associated with “expansion of credit” stage. In studying this phenomenon, it will be difficult to isolate the contextual factors, which actually motivated the banks to consider and implement the regulatory reforms in their right spirit. In such circumstance, Hartley (2004) considered that two important controls would enhance the efficacy of the case study design - firstly, usage of multiple sources of evidence in the process and secondly, the inclusion of multiple cases in the scope of the study. These two controls will enable case study methodology to be implemented as a comparative design, for understanding the diverse perspectives surrounding the research phenomenon being studied. Even Bryman and Bell (2007) support this argument stating that comparative case study design using multiple case studies is an extension of case study design, which had become increasingly common in business and management research. A comparative design embodies the logic of understanding the social phenomenon better when cases are compared in relation to two or more meaningfully contrasting situations. A comparative case-study approach, with individual banks as multiple case-units drawn from each crisis-affected country therefore can be justified as a valid approach for comparing and contrasting the country-level and bank-level experiences at the same time. As observed earlier, researchers have already demonstrated this utility of the comparative case study design using country-level cases (see as Sheng (2009) and Walter (2008)) and (see Leng (2012) and Wonglimpiyarat (2007)) by using multiple bank studies.
This research project intends to further stretch the utility of this research design by using a theoretical framework as a foundation for the bank-level case study design (selected from multiple countries) adopted for the project.

It is therefore concluded that the comparative case study design would be a relevant research methodology for this project. Accordingly, the subsequent section focuses on implementation aspects of this research methodology in a more granular manner.

3.3 Research Methodology – Implementation Aspects

The main research question dealing with the manner in which post-crisis regulatory reforms influenced the governance arrangements at East Asian banks could be broken into four sub-questions that are explored in the course of research work. The sub-questions are listed as follows:

a) How did bank governance and risk management failures contribute to the 1997 East Asian crisis?

b) During the post-crisis period, what regulatory reforms were introduced to strengthen governance and risk management systems at local banks?

c) What considerations motivated individual banks to adapt their internal governance mechanisms to reforms proposed by policy makers?

d) How did these reforms finally contribute to resilience of banks in these nations during the 2007 crisis?

A brief overview of the implementation issues associated with the comparative case study design is provided using these research sub-questions in the following paragraphs.

a) First Research Sub-question: How did bank governance and risk management failures contribute to the 1997 East Asian Crisis?

This question forms the foundation of the study as it entails review of macro-economic factors that impacted the governance and risk management practices at East Asian banks prior to 1997. The question is further relevant from the methodology perspective in view of
its influence on selection of case study countries for the research project and the choice of the secondary resources as explained below:

**Selection of countries:** The East Asian crisis gripped much of the region, beginning in July 1997, and raised fears of a worldwide economic meltdown due to financial contagion. The crisis started in Thailand with the financial collapse of the Thai baht after the government was forced to float the baht (due to inadequate foreign currency reserves for supporting its fixed exchange rate). The Thailand Central Bank, Bank of Thailand, finally cut its peg to the US dollar in July 1997, after exhaustive efforts to support it in the face of a severe financial overextension that was in part real estate driven. At the time, Thailand had acquired a burden of foreign debt that made the country effectively bankrupt even before the collapse of its currency. As the crisis spread, most of Southeast Asia and Japan saw slumping currencies, devalued stock markets and other asset prices, and a precipitous rise in private debt. Indonesia, South Korea and Thailand were the countries most affected by the crisis. Hong Kong, Malaysia, Laos and the Philippines were also hurt by the slump. The People’s Republic of China, Pakistan, India, Taiwan, Singapore, Brunei and Vietnam were less affected, although all suffered from a loss of demand and confidence throughout the region (Sheng 2009).

Against the population of all these nations, four countries have been selected – Thailand, Indonesia, Malaysia and Philippines – for the purpose of this research project. The choice has been motivated by the writings of Akamatsu (1961) who developed a “v-shape flying geese” model to depict the development of East Asian nations. The model graphically depicted the economic growth models pursued by emerging economies by copying a successful leader, ultimately forming the global supply chain. In the context of East Asian crisis, as per the Akamatsu model, the lead goose in V-shaped pattern is Japan, followed closely by the Four Dragon Economies (Hong Kong, Taiwan, Singapore and South Korea), Four Tiger Economies (Indonesia, Malaysia, Thailand and Philippines) and then the last group comprising China and Vietnam. The crucial thread that bind this V-shaped pattern together is the fact that the leading economy has an incentive to support and shift production to followers due to rising costs, land shortages, pollution costs and the desire to develop the market share. The crisis, however, demonstrated that the East Asian Miraculous growth phase, of which the Tiger nations were a prominent part, did not last long. The Tiger Nations were once described as embracing growth models that other emerging economies can follow for their own development and prosperity (World Bank 1993). However, the crisis resulted in significant
costs to their economies in terms of the non-performing loans at the peak of the crisis and fiscal costs incurred to resolve the crisis.

It is therefore interesting to study the phenomenon of Minsky’s Instability Hypothesis in the context of these nations as they have experienced, during early 1990s, the “euphoria” that was the hallmark of the “displacement” stage of the hypothesis (see Chapter 2, para 2.3 for details of the displacement stage). The events thereafter made these nations progressively move into the subsequent stages - of expansion of credit, overtrading, revulsion and discredit. A review of these stages entails the review of the banking systems in East Asian Tiger nations, as they are bank-dominated economies, largely exhibiting these common features - a) emergence of nationalist banking systems to serve the national interest b) domestic banking systems operated under the model of “mild financial repression” which used to provide subsidised or low-cost financing to domestic industries and services engaged in competitive manufacturing export sectors c) high concentration of total resources in a handful of banks d) establishment of family owned banks by local business tycoons e) Competition scenario where the family-owned banks used to compete with state-owned and foreign owned banks (Sheng 2009). This commonality suggests that choosing one large bank from each of these East Asian Tiger nations – Thailand, Indonesia, Malaysia and Philippines – would provide an opportunity to explore Minsky’s financial instability hypothesis and evaluate his agenda for regulatory reforms. It may be acknowledged that the case units are not representative of the overall banks’ experience in each country. However, they could still form a rich source of analysis by providing certain useful insights into real-world complexities on their own thereby enhancing the outcome of the research project.

Having identified the countries, the next stage is the review of macro-economic factors and policy aspects that could potentially influence the governance and risk management practices at local banks. This calls for extensive review of country-level data for understanding the macro-economic context as well as review of literature for identification of policy perspectives relevant to the East Asian crisis. The subsequent section therefore provides a review of secondary sources that were relied upon during the course of research.

**Review of secondary resources:** Chapter 2 on the literature review and the previous sections dealing with analysis of quantitative studies provided useful inputs on relevant data points that need to be considered for evaluating the macro-economic context of the East Asian crisis. Similarly, the Chapter 2 provided alternative explanations on the East Asian crisis from policy perspective. The insights were used to crystallise the data points for research and
the alternative views that need to be included in the analysis of the research sub-question. The secondary sources accordingly were identified for gathering the relevant data points, which are reliable, as follows.

Previous studies (such as Sheng (2009), Sharma (2003), Walter (2008), Warr (2003), Chang and Velasco (1998), Kaminsky and Reinhart (2000)) identified certain macro-economic data points relevant in the context of origin of financial crisis, which include trends in - GDP growth rate, movement of nominal exchange rates, external debt, private capital inflows, domestic credit by banking sector, market capitalisation, foreign exchange borrowings, external liabilities, adequacy of foreign exchange reserves, and bank exposures. Relevant data on these parameters for the period 1990 to 1996, therefore, had been obtained largely from the World Economic Indicators data maintained by the World Bank and the IMF database. In addition, reliance had also been placed on the datasets used by Sheng (2009) and Laeven and Valencia (2008) for their analysis. However, unlike the previous studies, the data sets were analysed using the theoretical perspectives on financial instability provided by Minsky. Reliance on the secondary sources was considered adequate as the usage of these data-sets was only limited to evaluating their influence on governance and risk-management frameworks at banks, during the pre-crisis period.

After evaluating the background macro-economic data, focus was shifted to evaluating alternative policy-level explanations on origins of the East Asian crisis. The evaluation therefore began with review of policies adopted by certain East Asian nations that resulted in the miraculous growth phase prior to 1997. In this context, reliance had been placed on the World Bank publication prior to the crisis titled "The East Asian Miracle: Economic Growth and Public Policy" (1993), which explained that the high growth rate in East Asian economies was as a result of "good governance and policies" and listed out all the things which these economies did right and could be prescribed as right policies for other developing nations. Comparing the results of this study with the post crisis publication of the World Bank titled "East Asia: Recovery and Beyond" (2000) and "Economic Growth in the 1990s: Learning from a decade of reform" (2005) gives insights on how the countries misjudged the role of governance in the overall growth of the financial sector prior to the crisis. Similarly, inputs from other policy level publications (such as the ADB (2000), Nukul Commission Report (1998), and Government of Malaysia (1999)) and academic literature (such as Sheng 2009, Batunaggar 2002, Palley 2009, Walter 2008) had been used for gaining various other insights into the environment that influenced the policy-making choices of key regulatory and government authorities. The insights gained from these sources were used in critically
evaluating the Minsky’s theoretical framework in the context of East Asian crisis. Care has been taken to include alternative explanations to Minskian hypothesis dealing with the panic dimension in the context of East Asian crisis. A key element in assessing the panic dimension was the examination of the role of IMF for which relevant policy insights were gathered from the work undertaken by Radelet and Sachs (1998), Sheng (2009), Sharma (2003) as well as the IMF self-assessment report published in 2003.

Thus the research sub-question led to review of relevant data points and evaluation of critical policy level aspects to understand the factors that influenced the governance and risk management frameworks at local banks during the years prior to 1997. The sub-question thus formed the foundation for the research-work.

b) Second Research Sub-question: During the post-crisis period, what regulatory reforms were introduced to strengthen governance and risk management systems at local banks?

In order to examine the next research sub-question, inputs were gathered from semi-structured interviews conducted at field-level. The fieldwork interviews focused upon design and implementation considerations of the reforms such as - learnings from the crisis that were at the heart of the governance reforms, alternative remedies that were debated, considerations that were weighed before implementation, project plans that were visualised, implementation strategies that were chalked out, challenges that surfaced midway and finally the benefits of regulatory reforms that have been perceived by the interviewees. As can be observed, the granular break-up of the research question, therefore requires the interview questions to be posed to those who were influential forces in the reform design and implementation process.

Interviewees were, therefore, selected from key institutions such as banking regulators, local credit rating agencies, external consultants and international experts. In each of the countries, senior regulatory officials were approached to gather the regulator’s perspective of the East Asian crisis and for understanding the objective of the regulatory reforms that were undertaken in a gradual manner. Except the Bank of Thailand officials, who gave an email based response to interview questions; regulators in other countries (from Bank Negara Malaysia (BNM (Malaysia)), Bank Indonesia (BI (Indonesia)) and Bangko Sentral Ng Pilipinas (BSP (Philippines)) generously responded through face-to-face interviews and provided an elaborate account of the design aspects of reform process. Consultants in each of the nations
provided a balanced account of the implementation aspects of regulatory reforms and the challenges faced by individual banks. Thereafter, discussions with local credit rating agencies revealed greater insights in regard to one of the key reform areas - credit risk management. Meetings with officials and economists from the international financial institutions further provided the international and macro-economic context to the reform process.

A brief profile of interviewees is enclosed in Annexure 1. All interviewees were met face-to-face over a period of two years and were questioned on research questions relevant to them. Care has been taken to ensure that the interviewees are sufficiently qualified and relevant in terms of their stature, experience, authority on the subject being discussed. Interview questions therefore have been dovetailed to the type of interviewees with the objective to obtain relevant information from relevant people. The list of interview questions is enclosed in Annexure 2. The questions, which were open-ended, focused on genesis of post-crisis reform measures at respective nations. The questions further sought differences, if any, in the implementation approaches adopted by different countries that pursued regulatory reforms. Perspectives were also sought from the interviewees on their assessment of the efficacy of reform process in bringing about governance improvements and resilience in the nations subsequent to the crisis.

Thus the second research sub-question focused on gaining perspectives of regulators and industry officials on regulatory reform process. The key aspect of the research was, however, to evaluate how the industry reacted to these reform measures. In particular the case-study design was adopted to evaluate how institutional-level nuances, which can pose challenges to any reform process, had been addressed by regulators and industry players. The third research sub-question, which focused on this aspect and sources of data used for analysis is covered in the following section.

c) Third Research Sub-question: What considerations motivated individual banks to adapt their internal governance mechanisms to reforms proposed by policy makers?

Against the background of the information obtained in the first two stages, the next stage of the project involved field level visits to select case study banks to understand the nuances of implementation of regulatory reforms and their efficacy in bringing about modifications to internal governance mechanisms. This has been undertaken through face-to-face interviews
carried out at these banks. The details regarding the selection of the case-study banks and the nature of the interview questions are explained as follows:

**Selection of case-study banks:** As mentioned earlier, for each country, one bank was selected as a case-unit for studying the impact of regulatory reforms on the governance and risk management frameworks at banks. The four banks selected for the study are Bank Baht (Thailand), Bank Rupiah (Indonesia), Bank Ringgit (Malaysia) and Bank Peso (Philippines). At the outset, selection of banks was based on their current stature in the industry and the nature of diversity required to be maintained for gaining contrasting perspectives. From the perspective of **current stature**, each of the banks is currently recognised as large, mature player in their local markets. The key further consideration was the **diversity** required to be maintained among the case-units. The diversity is essential for comparing and contrasting the motivations at institution-level for bringing about governance and risk management improvements envisaged by the regulator. The key aspects in which the diversity was sought to be maintained in the selection of case-study banks include *contextual diversity, ownership diversity and partnership diversity*. Each of the above aspects relating to the current stature and diversity of the case-study banks is explained as follows:

**Current stature:** The banks selected for study are currently among the largest banks in the country, with varied business interests. Bank-wise details are provided as follows:

- **Bank Baht (Thailand):** The Bank is one of Thailand’s leading financial institutions measured in terms of their size (of loans and deposits put together). It is recognised as a universal bank encompassing corporate and SME businesses and leading retail companies. The Bank has a significant market share in several consumer business areas and leads the industry in personal loans and credit cards segments. The Bank’s association with its US strategic investor BB-SI (Thailand) also facilitated economies of scale through an expanded network of customers as well as through many other long-standing joint ventures and partnerships.

- **Bank Rupiah (Indonesia):** As a surviving entity in a merger of 9 banks taken over (BTO) during the Asian financial crisis, the Bank had emerged as one of the largest and strongest financial institutions in the region. The Bank is Indonesia’s largest financial institution by number of employees and operates the second largest branch network with

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3 The names of the case-study banks have been sanitised for the purpose of confidentiality
over 2,900 branches and points of sales. The Bank had history of acquiring card business from a large US player, and thereby became one of the largest card issuers in the country. Apart from the credit cards, the business interests of the bank spans into other industry segments such as mass market, SME & commercial banking and retail banking.

- **Bank Ringgit (Malaysia):** The Bank is a member of Ringgit Group which is a regional universal bank operating in the ASEAN region. Ringgit Group has a retail branch network across the region and is an indigenous ASEAN investment bank. It operates across ASEAN under several corporate entities, which include Ringgit Investment Bank, Bank Ringgit, Ringgit Islamic, Ringgit Niaga, Ringgit Securities International and Ringgit Thai. The Group’s multi-local business model is organised primarily across various areas including - consumer banking, corporate & institutional banking & markets and group asset management, insurance & Takaful. The Group has a presence in 14 countries, covering ASEAN and major global financial centres.

- **Bank Peso (Philippines):** The Bank is the Philippines’ largest bank in terms of total resources, customer loans, total deposits and assets under management. It operates as a full-service universal bank and has more than 740 operating branches and over 1,600 ATMs nationwide. Through selective acquisitions and organic growth, it provides a complete array of industry-leading products and services to the retail and corporate markets.

**Contextual diversity:** This criterion refers to the nature of association of the case study banks with the Asian crisis. The case study banks are a mix of banks which are either not affected by the crisis or represents banks which were troubled/had taken over troubled banks in the scheme of bank restructuring pursuant to the crisis. Such diversity helped the project in comparing and contrasting the historical motivations of banks in bringing about improvements in governance and risk management practices. Bank-wise details in this context are explained as follows:

- **Bank Baht (Thailand):** The Bank carefully navigated the worst of the Asian financial crisis as can be noticed from the fact that out of 15 banks in 1996 in Thailand, only three banks had their previous largest shareholders remaining at the end of 2003. Among the three banks, the family conglomerate owning the Bank Baht (Thailand) is the only founding family who had managed to remain the controlling shareholder over the bank after the crisis.
• **Bank Rupiah (Indonesia):** During 1997-98, Bank Rupiah (Indonesia) was brought under the supervision of the Indonesian Bank Restructuring Agency (IBRA) as a BTO. In 1999, the Government of Indonesia, through IBRA, recapitalised Bank Rupiah (Indonesia) and, within the same year, another BTO was merged with Bank Rupiah (Indonesia) as part of the IBRA restructuring programme. In 2000, Bank Rupiah (Indonesia) completed another merger with eight other BTOs. As part of this merger package, Bank Rupiah (Indonesia) received a second recapitalisation from the government. As the surviving entity, Bank Rupiah (Indonesia) emerged from the merger as one of the country's largest private banks.

• **Bank Ringgit (Malaysia):** Bank Ringgit (Malaysia) is a banking group that has transformed into a Universal Banking group over a period of time and with a series of mergers undertaken as a part of consolidation programme for domestic banks announced by Bank Negara Malaysia post the Asian crisis on 29 July 1999. The Group’s initial entity emerged from the East Asian crisis and other financial problems to merge with another local bank, resulting in the biggest merger in Malaysia's banking history. From thereon, after a series of subsequent mergers and takeovers, in 2006 the new Ringgit Group was born as a universal bank. Bank Ringgit forms the commercial banking entity of the Ringgit Group.

• **Bank Peso (Philippines):** During 1990s, the stance of the local central bank, BSP (Philippines), was to create more banks and encourage competition in the industry. The East Asian crisis resulted in reversal of this stance and the BSP (Philippines) urged on creation of more financially stable banks and encouraged mergers and acquisitions subsequent to the crisis. During the initial wave of mergers and acquisitions in early 2000s, the Bank Peso (Philippines) took over local operations of certain foreign as well as local banks. Bank Peso (Philippines) in the current form was thus born after the second wave of mergers and acquisitions in the Philippine banking history.

**Ownership diversity:** The Banks selected for the study were a mix of family owned banks and the banks which are listed publicly. As the existing academic literature suggested (see Hanazaki and Lieu 2003) cross-firm differences in corporate performance could also arise from governance problems stemming out from ownership roots. Further, the academic literature (see Hamilton-Hart 2002, Fan and Wiwatanakantang 2006, Walter 2008) suggests
that family-owned banks influence the governance and risk management practices in an adverse manner. So the diversity of banks, based on ownership mix, equipped the research project with comparable and contrasting experiences of banks in their attempts to professionalise their management. A brief of the family ownership nexus of two banks (Bank Baht (Thailand) and Bank Peso (Philippines)) is provided as follows:

- **Bank Baht (Thailand):** The Bank was initially owned by a family conglomerate in Thailand which has varied interests in the manufacturing, media & broadcasting industries, as well as the financial sector. The family carefully navigated the Bank in the worst of the East Asian crisis with the result that the family conglomerate was one of the only eight business groups who had been in Thailand’s top 40 in 1979 to survive in the top rankings in 2009. In the post-crisis period, where families were the largest shareholders, there were only five banks in 1998, two banks in 1999, and only one bank in 2001-2003. As mentioned earlier, the family conglomerate behind Bank Baht (Thailand) is the only founding family which had managed to remain the controlling shareholder over the bank. In order to keep control of the bank, the family conglomerate sold about 25% of the shares in local cement business to Swiss investors.

- **Bank Peso (Philippines):** The Bank is a member of one of the country’s largest conglomerates with businesses spanning across retail, mall operations, property development (residential, commercial, resorts/hotel), and financial services. Although part of a family conglomerate, Bank Peso (Philippines)’s day-to-day operations are handled by a team of professional managers and bank officers.

On the other hand, both Bank Rupiah (Indonesia) and Bank Ringgit (Malaysia) do not have any family-ownership nexus. Bank Ringgit (Malaysia) is owned by Ringgit Group, which is a widely held listed company on the Malaysian Stock exchange. Similarly Bank Rupiah (Indonesia) is also a public limited company listed on the local stock exchange.

**Partnership diversity:** The banks selected represent a balanced mix of a) banks whose governance reforms influenced by a foreign strategic/institutional investor and b) banks that have pursued governance reforms on their own initiative. The diversity helped in evaluating the additional improvements that foreign investors can bring into governance and risk management practices at local banks. For instance, one of the key aspects of regulatory reforms pursued by Thailand includes gradualist approach for promoting foreign bank entry into Thai market through various means, including strategic investments (Montreevat and
On the other hand, Malaysian approach to regulatory reforms, as explained subsequently in Chapter 6, is to promote local banks and improving their competencies. Bank-wise details in this context are therefore explained as follows:

- **Bank Rupiah (Indonesia):** A Singaporean Foreign Institutional Investor THI (Singapore) has a majority controlling stake in Bank Rupiah (Indonesia). As an active shareholder, THI (Singapore) enjoys the track record of promoting governance in its portfolio companies and supporting the formation of high caliber, commercially experienced and diverse boards to complement and guide management leadership.

- **Bank Baht (Thailand):** BB-SI (Thailand), a US-based retail corporate and a multinational conglomerate comprising a number of businesses, including financial services, is a strategic investor in Bank Baht (Thailand). BB-SI (Thailand) is known in the global market for its expertise in serving retail customers and efficiencies in process management.

The other two banks (Bank Ringgit (Malaysia) and Bank Peso (Philippines)) do not have a presence of foreign strategic investor and have instituted the governance reforms on their own over a period of time.

**Field-work interview details:** The details of the field-work interviews in terms of the profile of the interviewees and the nature of interview questions are explained in the following paragraphs.

The list of interviewees from the case-study banks is covered in Annexure 3. The officials interviewed were associated with the design and implementation of governance and risk management mechanisms at these banks. The interviewees included Chief Risk Officers, Chief Internal Auditors, Chief Compliance Officers and the officials from the Corporate Banking department. Barring the Bank Peso (Philippines), where only the Chief Compliance Officer had given access to interview, all other banks have generously consented to share their experiences. However, the inclusion of Bank Peso (Philippines) as a case study has been retained in view of its rich potential and availability of extensive secondary information about the Philippines experience of the financial crisis. All the interviewees supplemented their discussions by providing references to their internal documents and published research that can provide additional sources of information and insights useful for the research project. The
internal documents include - annual reports, internal magazines, key policy references and training summaries - which were used in the subsequent stages of the research project.

A set of interview questions used for the project is enclosed in the Annexure 4. Further, as the research project focused more on “how” rather than “what” improvements in governance mechanisms were brought in by the regulatory reforms, the approach adopted for interviews has largely been kept unstructured. The questionnaire sought responses from interviewees on aspects constituting the heart of governance and risk management framework, such as - tone at the top, risk assessment, control activities, information and communication, monitoring and reporting. The underlying focus of the questionnaire is to probe the interviewees to reveal their motivations in pursuing governance and risk management improvements, apart from the imperative of achieving compliance to regulatory norms. The questions further sought to understand from the interviewees any measures in their governance and risk management practices, which went beyond those envisaged by regulatory reforms, along with the reasons for implementing such measures. Similarly, the questionnaire also focused on the challenges that the banks encountered in implementing these improvements. Considering the complexity of the aspects covered, the questionnaire is kept in a semi-structured and open-ended format allowing the interviewees to share their interesting experiences as they speak on a particular topic.

d) Fourth Research Sub-question: How did these reforms finally contribute to resilience of banks in these nations during the 2007 crisis?

The findings of the fieldwork provided enormous amount of information and interview material that has been analysed in the last stage of the research project. The objective of this stage is to evaluate the efficacy of these reforms in bringing about the resilience of banks during 2008 crisis. The findings of the field-work were therefore analysed through the lens of the theoretical propositions obtained from the review of academic literature - in particular, the Minsky’s Financial Instability Hypothesis. Considering the relative merits of the previous studies, an analytical framework has been drawn upfront for reporting of case studies directly after the interview process. The framework is explained in the following paragraphs.

As Yin (2003) notes, in most existing case studies explanation building and analysis of the findings occurred in narrative form as the goal was to build a general explanation for identified patterns even though there is variation in details of individual case studies. This
narrative reporting format had been adopted even in the multiple case study design adopted in earlier studies dealing with East Asian crisis (see Sheng 2009, Walter 2008 and Sharma 2003). As such narratives cannot be precise, the better cases however, according to Yin, are the ones in which the explanations have reflected some theoretically significant propositions. Such an approach was adopted by Adams (2008) for his research work dealing with East Asian post-crisis experience. However, while Adams (2008) restricted his analysis to the country-level experiences, this project, as explained earlier, deals with the bank-level experiences in addition to country-level comparison of post-crisis experience.

The reporting format adopted for the project, therefore, involved presenting the interview findings under the following broad heads - a) historical context of reforms, b) expectations of policy makers, c) motivations of executives at each of the individual banks and d) analysis of their utility during the 2008 crisis. For each of the issue identified, the contextual setting and expectations of policy makers are explained using the inputs obtained from review of secondary sources (used for addressing the first research sub-question) and the interview findings (used for addressing the second and third research sub-questions). These were further supplemented with material obtained from review of academic literature. Such a theme-based reporting format, using the theoretical propositions upfront and evaluating them through field-work material was considered by Yin (2003) as the most preferred strategy for case study research. It is because the original objectives and the design of the case study presumably were based on those theoretical propositions, which in turn reflected the set of research questions, review of literature, and new hypothesis or propositions. As these propositions have also shaped up the data collection plan, Yin considers that these would have to be given priority in the subsequent stages of research work as well. The approach has also helped the project to focus attention on certain data and ignore the irrelevant data. It also helped in organising the entire case study and in defining the alternative explanations that were subsequently analysed. The arrangement of findings under theses broad parameters thus supplemented the research design adopted for the research project.

The overall research question, through a series of research sub-questions, was thus explored using the comparative case study approach as the research design for the project. The previous sections elaborated the justification for the manner of resolution of each of the implementation issues encountered during the research work. The subsequent section, therefore, focuses on limitations of the research methodology and possible ways in which the same were addressed in this research project.
3.4 Limitations of the Research Methodology

In the academic context, not all writers are convinced about the merits of the multiple case study approach and the comparative design. This section explores the limitations of the research methodology chosen for the project and the steps taken to address possible problems. The two key limitations arising from the review of academic literature in regard to comparative case study design are explained in this section.

The first limitation is that the multiple case study approach tends to result in a situation where the researcher pays less attention to the specific context and more to the ways in which the cases are to be contrasted (Dyer and Wilkins 1991). This apparent need to forge comparisons tends to mean that the researcher needs to develop an explicit focus at the outset, whereas it may be advantageous to adopt a more open-ended approach in many instances. However, Bryman and Bell (2007) state that these concerns about retaining contextual insight and a rather more unstructured approach are very much associated with the goals of the qualitative research strategy. Three interventions have therefore been used in the project to mitigate the impact of this limitation. Firstly, the project combined the insights from interview-based findings and review of secondary resources as integrated sources of inputs for this research project. Such intervention takes care of the researcher bias that may arise when focused solely on interviews for undertaking research project. Secondly, interviews were conducted both with the officials from the case-study banks as well as officials representing external environment (such as policy-makers, regulators, industry experts, rating agencies). While the external interviewees (as a part of second research sub-question) focused on the "What" aspect of regulatory reforms, the questions posed to internal interviewees from case-study banks (as part of third research sub-question), focused on the "How" aspect of implementing the governance and risk management improvements as envisaged by the regulator. The mixed profile of these interviewees enabled the overall research project to get diverse perspectives – from the regulator and the regulated, from the auditor and the auditees, from international policy making bodies and the regulators. Such a mix helped the project in seeing the perspectives which people attach to important aspect like regulatory reforms and improved bank governance in a real-life context. Thirdly, during the course of interviews, an open-ended approach was used while designing the interview questions and by allowing the interviews to specify the contextual experiences using the semi-structured interview format. All these three controls enhanced the comparative design to achieve the objective of understanding the diverse perspectives surrounding the research phenomenon.
The second limitation is that the comparative case study design is also considered generally to limit external validity compared with than survey design based on statistical analysis (Flyvbjerg 2006). However, as has been seen earlier, case studies allow for a deeper understanding of issues involved, as qualitative, non-measurable aspects receive more attention than in qualitative analysis. Further, generalising the theory, using context dependent knowledge, is argued to contribute to scientific development by supplementing the context-independent knowledge (Hartley 2004). It is known for exposing the practical considerations that will have profound influence on knowledge gained through mediums where the context is isolated or made extremely independent. In this context, the research design has been guided by the observations of Yin (2003, p.10) when he outlined that 'case studies, like experiments, are generalisable to theoretical propositions and not to populations or universes. In this sense, the case study, like the experiment, does not represent a 'sample', and the investigator's goal is to expand and generalise theories (analytical generalisation) and not to enumerate frequencies.” Accordingly, the usage of theoretical propositions gained from secondary resources and comparison of them against the findings of the field work had been adopted as an analytical tool in the research project.

So to conclude in the words of Bryman & Bell (2007 [2003], p. 69), with the controls built in the research design, the limitations or misunderstandings outweigh the key ability of the comparative case study approach to allow “the distinguishing characteristics of two or more cases to act as a springboard for theoretical reflections about contrasting findings”. The overall research methodology has thus assisted the project in gaining a multi-dimensional perspective in a cross-country setting about the role of different players and institutions in bringing about the regulatory reforms at the banks of various crisis-affected nations.

3.5 Ethical Considerations

Being a project that has been sponsored by my employer there could be possible ethical considerations that the project needs to acknowledge during the field work stage. Accordingly, each of the interviewees were contacted through the introductory letter issued by the University Supervisor and was explained the context surrounding the research. Each of the interviewees, barring couple of instances, were interviewed using a voice recording tool that facilitated sharing of transcript to the interviewee shortly after the interview. Further, interviewees were also duly briefed upon the ethical considerations surrounding the project and their right to opt out from being quoted considering the sensitivity of the matter being
pursued. Wherever references are made to a particular point made by a specific interviewee, care has been taken to ensure that the interviewee was duly informed about the context in which his observations have been used in the project.

3.6 Summing Up

After review of the literature on financial crisis, the Chapter 2 on literature review concluded with the research question for this project - **How does the pursuit of agenda of regulatory reforms, post the crisis, influence governance arrangements at banks and assist them in maintaining resilience during subsequent episodes of crises?**

The research question presented possibility of integrating a key theoretical insight - Minsky's Financial Instability Hypothesis - with the practical experience of East Asian nations subsequent to the 1997 crisis. The research project therefore embarked upon the selection of a suitable methodology to enable this integration possible in a more meaningful manner by bringing out the real-world complexities into the centre of academic discussion.

Previous studies dealing with the origins of the East Asian crisis largely adopted quantitative modeling techniques for analysing the research findings. Certain qualitative studies using survey and case study approaches exist in the literature, which examined the post-crisis regulatory reforms in East Asia. However, these studies are undertaken at a country-level and therefore relatively limited the full exposition of the institutional nuances associated with regulatory reforms. From an emerging economy context, such insights into institutional aspects assist regulatory authorities in effectively pursuing regulatory reforms with industry participants. For banks, such insights will be relevant to appreciate the contextual significance of regulatory reforms. Given therefore the focus, on institutional nuances and contextual significance in the process of regulatory reforms, the research project adopted case study methodology for pursuing the research question.

The case study methodology enabled the synthesis of the findings from the fieldwork interviews organised across East Asian nations, with inputs gleaned from secondary sources. The regulators and international experts provided the rationale for regulatory reforms, the case study banks explained the challenges they encountered in their implementation and the industry experts provided inputs on the friction involved in between and the work that needs to be further undertaken in these nations. Accordingly, interview findings were organised sequentially to address the research sub-questions, one by one. Such a narrative by way of exploring research sub-questions step by step provided a useful framework for comparing
and contrasting the experiences of regulators and case study banks in implementing regulatory reforms.

The next four chapters therefore present the contextual setting and interview findings in a sequential manner. Chapter 4 presents the macro-economic and policy environment prior to the crisis in East Asian nations. Chapter 5 deals with interview findings to evaluate the scope of regulatory reforms in strengthening the external environment surrounding the banking industry. Chapter 6 covers implementation aspects at case study banks while strengthening their internal governance and risk management mechanisms, pursuant to regulatory reforms. Chapter 7 finally analyses the East Asian experience from lens of Minsky’s Financial Instability hypothesis to evaluate the extent to which the post-1997-crisis regulatory reforms assisted these nations in bringing about resilience during the recent 2007-financial-crisis.
4) Macro-economic and Policy Environment Prior to 1997 Crisis

This chapter attempts to address the first research sub-question – How did bank governance and risk management failures contribute to the 1997 East Asian crisis? As observed in the literature review chapter, the dominant theories that so far explained the origins of the East Asian crisis are the contagion theory and the vulnerability theory. Contagion theorists (such as Bhagwati 1998, Tobin 1998, Das 2000, Radelet and Sachs 1998) argued that the crisis was as a result of the international financial contagion that created panic situation after the devaluation of Thai Baht in July 1997. Vulnerability theorists (such as Dornbusch 1997, Krugman 1998b, and Warr 2003) on the other hand explained that the East Asian financial systems exhibited structural weaknesses in their banking systems even before the devaluation of Thai Baht. According to vulnerability theorists, the devaluation was only one trigger in precipitating a crisis, which was otherwise also inevitable in light of the underlying banking sector vulnerabilities in East Asian nations. This chapter, therefore, attempts to synthesise the aspects - relating to bank governance lying at the heart of vulnerability theory and the panic dimension lying at the centre of contagion theory – by examining the macro-economic and policy environment prior to 1997 crisis.

The chapter heavily draws upon the secondary resources (such as datasets from World Bank and IMF, regional reports published by World Bank and various other existing academic literature, cited in previous chapters). The Chapter is organised in the following manner. Firstly, it demonstrates that during the period prior to 1997, East Asia enjoyed a favourable macro-economic environment characterised by robust GDP growth and stable exchange rate regime. Secondly, the chapter explains how the favourable macro-economic environment led to certain central bank policy errors, which resulted in weak regulatory oversight and undermined the governance arrangements at individual banks. Thirdly, the chapter outlines how the governance weaknesses, at bank-level, promoted risk-taking behaviour characterised by rampant related-party lending, enhanced exposure to sensitive sectors (such as stock markets and real estate) and increased funding risks at banks. Fourth, the chapter further demonstrates how the stable macro-economic environment eventually encouraged capital flight from the region and made certain local central banks (even under the guidance of IMF) ill-equipped to handle the panic situation during the crisis.
4.1 Favourable Macro-economic Environment

Prior to 1997, East Asian economies experienced favourable macro-economic conditions that were characterised by robust economic growth, stable exchange rate regime and increased capital inflows. The capital flows increased considering the implicit support of governments to their exchange rates (through maintenance of stable exchange rates). The increased capital flows enabled economic growth in these economies in a robust manner. Thus these factors were mutually reinforcing and also led to the enhanced availability of foreign exchange liquidity in the banking systems of these nations. Each of these aspects is explained further in the following paragraphs:

a) Robust GDP Growth

During the early 1990s, East Asian region was the fastest growing in the world. The average annual GDP growth in the East Asian nations during the early 1990s (with the exception of Philippines) was in the range of 7-9 percent per annum (refer to Figure 4.1 below).

**Figure 4.1: Annual GDP Growth Rate of East Asian Nations**

Note: At market prices based on constant local currency


The growth trend was consistent even for few decades prior to 1997 as the economies were doubling their GDP every 7 years during the 1960s and 1970s and roughly every 7 to 10 years during the 1980s (World Bank 1993). During the period prior to the crisis, consistent with the GDP growth trends, Thailand, Indonesia and Malaysia had also experienced real per capital income growth of over 300 percent (Crafts 1999). The inexorable shift of global power
to the East was therefore much talked about in the best-selling publications during that period (Sharma 2003).

b) Stable Exchange Rate Regime

Among the factors that contributed to favourable economic growth, the notable one was the stable exchange rate regime prevalent in the East Asian nations prior to the crisis. Officially, during the pre-crisis period, the Tiger nations adopted the Pegged Currency/Managed Float exchange rate management systems (refer Table 4.1 below).

Table 4.1: Exchange Rate Regimes of East Asian Nations (1996)

<table>
<thead>
<tr>
<th>Country</th>
<th>Exchange system</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>Pegged to basket of currencies</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Managed Float</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Pegged to basket of currencies</td>
</tr>
<tr>
<td>Philippines</td>
<td>Managed Float</td>
</tr>
</tbody>
</table>


However, the classification of exchange rate regimes based on officially announced intervention policies could be misleading because the actual exchange rate management efforts might differ from the stated objectives (Rana 1998). For instance, monetary authorities in Thailand and Indonesia used to defend local currencies by utilising available foreign exchange reserves, whenever required, even before 1997. The result was that the exchange rate policies of these nations indicated an implicit government guarantee that assured the stability of exchange rates (refer Figure 4.2 below).

Figure 4.2: Year-on-Year percentage Change in Nominal Exchange Rates

Source: Sheng 2009
It may be mentioned that Japanese Yen had appreciated against the dollar during the early 1990s (tracing its roots back to the Plaza Accord of 1985 which devalued dollar against Yen close to 50%). However, the currencies of East Asian Tiger nations (notably, Thai Baht and Indonesian Rupiah) remained relatively stable during the period. This had set the stage for surge of private capital inflows into these nations primarily from Japan in the form of debt and portfolio capital inflows.

c) Surges of External Debt and Private Capital Inflows

Apart from stable exchange rate regime, capital flows in the form of external debt and portfolio equity liabilities were also facilitated through liberalisation measures adopted by these nations, which include deregulation of interest rates, permission to domestic entities to borrow freely from abroad, liberalisation of external dimensions of financial sector enabling access to foreign funds by domestic financial institutions. Consequently, the external debt and the portfolio equity liabilities have shown a steady increase in these nations over a period of time (refer to Figure 4.3 below):

**Figure 4.3: External Debt and Net Portfolio Equity Liabilities (1991-96)**

![Graph showing External Debt and Net Portfolio Equity Liabilities](image)

**Note:** As Percentage of GDP

**Source:** Sheng (2009) and IMF (1999)

It was observed that Thailand, Indonesia and Malaysia (i.e., three of the crisis-affected Asian Tigers), were among the ten largest emerging economy recipients of net private capital flows during the period (López-Mejía 1999; World Bank 1993). However, as revealed from the above trend analysis, in the case of Thailand and Indonesia, the inflows were significantly in the form of external debt. For instance, during 1995, while the external debt to GDP for
Thailand and Indonesia stood at 60% and 55.7% respectively, the same ratio for Malaysia stood at 37.6%. On the other hand, Malaysia was known for higher portfolio equity liabilities in comparison to its peers. The portfolio equity inflows witnessed a deep decline in Malaysia during 1994 due to temporary capital controls, post lifting of which, the surge again continued in 1995 and 1996. For instance, during 1995, the portfolio equity liabilities to GDP ratio of Thailand, Indonesia and Malaysia stood at 14.35%, 2.78% and 25.5% respectively.

The impact of these capital inflows (in the form of either external debt or portfolio equity liabilities) could be seen in the expansion of bank credit in East Asian nations prior to the crisis. Before assessing the impact, the role of bank credit in national financial system is contextualised in the subsequent paragraphs by comparing the size of East Asian banking systems prior to the crisis with that of countries like Argentina and Mexico.

**d) Increased Domestic Bank Credit**

Financial systems are generally characterised as bank-based or market-based. In countries which are characterised as bank-based, the vital support functions of the economy such as provision of capital resources, ensuring market discipline amongst the firms is performed by the banks (Diamond 1984, Ramakrishnan and Thakor 1984). The bank-based view therefore highlights the positive role of banks in leveraging informational advantage about the firms for capital allocation and ensuring better credit discipline. On the other hand, the market-based view highlights the growth enhancing role of well-functioning markets in fostering greater innovation; enhancing greater market discipline and corporate governance (Jensen and Murphy 1990, Allen and Gale 2000).

During early 1990s, the East Asian nations embarked on long periods of economic growth adopting the bank-based financial systems. The financial sector deepened as macro-economic environment resulted in household savings that were intermediated through domestic banking systems. In these nations, banks are viewed as mobilisers of savings, channels for financing industrialisation and export trade and tools for national development. Even the World Bank (1993 p. 24) study noted that the domestic banking system of these nations operated in an era of "mild financial repression"; by providing subsidised or low-cost financing to domestic industries and services engaged in competitive manufacturing export sectors. This contrasted with other developing countries that experienced financial crises (Argentina in 1995 and Mexico in 1994) in which domestic financial intermediation was low (refer to figure 4.4. below):
4.2 Policy and Institutional Environment

The growth of the East Asian nations during the decades before 1990s as well as their experience during 1990s was subject to extensive policy-related debate amongst academicians, policy makers and central banks. The influence of this debate on policy-making circles, for instance, could be witnessed from World Bank publications before and after the crisis. Prior to the crisis, the World Bank attributed the robust economic growth of East Asian nations to the pursuit of market-friendly policies, which were supplemented with selective government intervention. However, subsequent to the crisis, World Bank noted that market-friendly polices did not represent “best practices” but could indeed result in diverse outcomes depending upon the state of political economy and effectiveness of institutions in each country. This section evaluates underlying reasons for this differential thinking before and after the crisis, in order to obtain relevant insights into the policy and institutional environment that resulted in the 1997 crisis.

a) Market-friendly Policies and Selective Government Intervention

In 1993, the economic growth of Thailand, Indonesia and Malaysia was subject to an influential study by World Bank, along with review of growth in five other high-income
economies of the Asian region (comprising Hong Kong, Singapore, Korea, Taiwan and China). The study, which was titled “The East Asian Miracle: Economic Growth and Public Policy” identified these eight economies as High Performing Asian Economies (HPAE), which pursued different growth strategies depending upon their country contexts. At the outset, the World Bank noted that all HPAEs understood the fundamentals of economic growth correctly (such as high level of domestic savings, broadly based human capital, good macro-economic management, limited price distortions, acquisition of technology in a liberalised market environment and export orientation) (Page 1994). The success of HPAEs, according to the World Bank, acknowledged the dominant role of market-friendly policies - epitomised by the so-called “Washington Consensus” - at the heart of any sustained growth process (World Bank 2005 p. xi).

At the outset, the World Bank report highlighted that market-friendly policies enabled the focus of HPAEs towards promotion of international trade and abolishing price controls externally, and enhanced the investments in people-education and health-care internally. The policies were implemented in HPAEs (of which Thailand, Indonesia and Malaysia are members), as far as possible, through private initiative rather than public ownership, and through market mechanisms rather than administrative controls. However, as Amsden (1989) noted, market-friendly policies tend to generally promote investment into industries that generate highest growth. In order to remedy this situation, Wade (1990) argued that diverse and flexible policy mixes were used by HPAEs to guide markets for promoting industries that would not otherwise have thrived. This resulted in selective promotion and selective intervention strategies pursued by governments of East Asian nations to alter industrial structure and promote technological learning, sometimes at the expense of allocative efficiency of markets. This selective intervention and promotion strategies, systematically and through multiple channels, took various forms such as - targeted and subsidised credit to selected industries, low deposit rates and ceilings on borrowing rates to increase profits and retained earnings, protection of domestic import substitutes, subsidies to declining industries, the establishment and financial support of government banks, and firm- and industry-specific

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4 The term “Washington Consensus” was first articulated in a paper presented by Williamson (1990), an Economist from the Institute of International Economics, US. The term is used to generalise a list of 10 broad policies, which were influential at major institutions like the World Bank located in Washington, for promoting economic growth and development. Williamson’s original list of recommendations can usefully be divided into three categories: first, steps to increase macroeconomic stability, such as reducing fiscal deficits, broadening the tax base, and reallocating government resources to build human and physical capital; second, actions to increase the role of markets in the economy, such as privatisation of public assets, appropriate deregulation, and the liberalisation of trade, interest rates, and capital flows; and third, efforts to strengthen institutions that promote investment, business formation, and growth, particularly by enhancing property rights and the rule of law (Bernanke 2011).
export targets (Page 1994). Gore (2000 p. 797) therefore stated that governments in East Asia played “a key role both in animating the ‘animal spirits’ of the private sector and harnessing the aggressive pursuit of profits, which are the motor of the system, to the realisation of the national interest”. The East Asian miracle therefore underscored the role of government-business cooperation within a framework of pragmatic developmental State for successful implementation of market-friendly development policies (Gore 2000).

Subsequent to the East Asian crisis in 1997, there were two publications released by the World Bank (East Asia: Recovery and Beyond in 2000 and Economic Growth in the 1990s: Learning from a decade of reform in 2005), which had re-examined the policy choices pursued by East Asian nations during 1990s for drawing out useful lessons relevant for shaping up long-term sustainable growth-oriented policies. The 2000 Report also acknowledged at the outset that the East Asian miracle underscores the importance of macro-economic stability, domestic liberalisation and trade-openness in promoting economic growth. The report stated that these factors enabled financial integration of East Asian nations with global markets, which witnessed surge in capital inflows in response to their market-friendly policies. However, the 2000 Report highlights that "greatest policy weakness" that contributed to the crisis of 1997 was the inability of the East Asian nations to manage this financial integration in the context of weak domestic financial institutions and corporations (World Bank 2000, p. 25). The report states that the market-friendly policies allowed poorly regulated institutions to expand rapidly in the backdrop of financial integration and the governments did not attempt to remedy the situation until they openly experienced the crisis situation. It was therefore argued in the Report that the policy choices of the East Asian nations “encouraged additional inflows and temporarily sustained growth – but also increased vulnerability” (World Bank 2000, p. 25). The 2005 Report also at the outset emphasised the role of market-friendly policies in promoting economic growth. But it had also acknowledged that these market-friendly policies “translate into diverse policy and institutional paths, implying that economic policies and policy advice must be country-specific and institution-sensitive if they are to be effective” (World Bank 2005, p. xiii).

Rodrik (2006 p. 979) therefore noted that the World Bank reports cited above indicate a paradigm shift in its thinking from the earlier wave of "market fundamentalism” to an emergent thinking rooted in "institutional fundamentalism”. He argued that prior to the crisis, the Washington Consensus principles that were used to explain the East Asian miracle in 1993, were relatively simple policy changes (viz., liberalising trade, eliminating currency overvaluation, reducing fiscal deficits). However, the lessons from the East Asian experience
during 1997 made it clear to policy-makers that standard policy reforms did not produce lasting effects if background institutional conditions remained poor for a long-time. It therefore required re-sequencing of the Washington Principles with primary emphasis on strengthening the institutions before pursuing market-friendly policies. In this context, Rodrik (2006, p. 978) argued that “sound policies needed to be embedded in solid institutions” and cited the works of Easterly and Levine (2003) who showed that economic policies do not exert any independent effect on long-term economic performance once the quality of domestic institutions is included in the regression. This shift in the thinking process leads to the re-examination of role of institutions – such as courts, customs authorities, fiscal institutions, labour-market institutions and central banks – in promotion of economic growth along-side the pursuit of market-friendly economic policies by the government.

An interesting and relevant direction for this research project arising from the above analysis is therefore to review the role of regulatory institutions prior to the East Asian crisis. The review is expected to provide the foundation upon which the nature and scope of regulatory reforms could be examined in subsequent chapters.

b) Role of Regulatory Institutions in East Asian Crisis

This section begins with the theoretical explanation of how regulatory institutions could be weakened against the backdrop of stable macro-economic environment. An explanation of this process in the East Asian context is provided in the subsequent paragraphs of this section.

Palley (2009) stated that stable macro-economic environment transforms business institutions, decision-making conventions, and the structures of market governance including regulation. The stable macro-economic environment breeds euphoric times, which give birth to the philosophy of regulatory relaxation and increased risk taking. Regulatory relaxation makes the institutional structures, which were construed as thwarting mechanisms ineffective in a phase-wise manner (Ferri and Minsky 1991). Firstly, the relaxation process begins with “regulatory capture” whereby regulatory institutions, such as central banks, are captured and weakened by industry participants. Secondly, it leads to “regulatory relapse”, whereby the regulators are willing to liberalise the regulatory regime, built over a period of time, on grounds that things are changed and current regulation is no longer needed. Thirdly, it culminates in the process of “regulatory escape” whereby the supply of risk is increased through financial innovation that escapes the regulatory net because the new financial
products and practices were not conceived of when existing regulation was written. The processes of regulatory capture, regulatory relaxation, and regulatory escape ultimately result in increased risk taking by borrowers (Palley 2009, p. 7-8). The East Asian pre-crisis experience reflects this theoretical construct as the favorable macro-economic environment during early 1990s indeed resulted in regulatory capture, regulatory relapse and regulatory escape phases. The manner in which it gradually happened is explained further in the following paragraphs.

In bank-dominated economies, central banks in their capacity as bank regulators are likely to be more susceptible to political interference and may be “captured” by powerful banks (Nam and Lum 2006). This was evidenced through weak enforcement and ineffective monitoring by supervisory agencies in the East Asian nations prior to the 1997 crisis. There were several instances in the academic literature that point out to the weak supervisory enforcement aggravating the crisis in these nations. For instance, until 1996, it was reported that BOT (Thailand) had punished neither financial institutions nor their executives for lending to risky projects. The problems began to surface when the BOT (Thailand) failed to initially detect the serious problems at few local banks that resulted in a run on their deposits in 1996 (Polisiri and Wiwattanakantang 2004). In the Philippines, the case of Orient Bank is often cited to describe regulatory forbearance as it was alleged in local media that BSP (Philippines) knew about the violations of legal lending limits by the bank, but did not put a stop to it (Gochoco-Bautista 1999). Instead, it was reported that BSP even gave Orient Bank an emergency loan whose amount was not revealed publicly. Weak supervisory enforcement was also attributed to political considerations in the context of Indonesia and Malaysia. For instance, Cole and Slade (1998) cited instances of removal of Governor of BI (Indonesia) in 1992 and Minister of Finance in 1996 who attempted to enforce prudential rules against connected borrowers. Similarly in Malaysia, it was reported that the political interventions increasingly eroded BNM (Malaysia) supervisory mandate, somewhat tarnishing its good reputation earned by it in the years before the crisis (Hamilton-Hart 2002).

A key example for the “regulatory relapse” phenomenon could be provided through the case of Bangkok International Banking Facility (BIBF) by the Government of Thailand. BIBF was a move to encourage foreign-currency denominated bank loans to Thailand (out-in transactions) and also facilitate the off-shore lending based on the foreign inflows (out-out transactions). BIBF also aimed to attract foreign banks in a bid to turn Bangkok into a major financial centre that could rival Hong Kong and Singapore. With the lifting of controls on capital flows on the borrowing side, there was a surge in the private sector debt denominated
in foreign currency. This was further fuelled with rapid expansion of number of financial institutions that could borrow and lend in foreign currencies, with the support of BIBF funding. The BIBF contributed to a surge in the international capital inflows in Thailand which doubled in the first year itself from 200.8 billion Baht in 1993 to 557.5 billion baht in 1994 to 1.3 trillion baht in 1996 (Sheng 2009). As per the 205 page Nukul Commission (constituted in Thailand subsequent to the crisis in 1998) report, when the BIBF was set up, the supervision and regulation of the facility was not sufficient that resulted in structural issues in its lending which was not envisaged at the time of its set up. In particular, as there were no restrictions as to the geographic distribution of bank lending, most of the lending was in the form of offshore lending to onshore, rather than mostly offshore to offshore, that being the objective setting up of BIBF initially. Thus, the BIBF is sometimes described as the “Trojan Horse that invaded the Thai Banking Sector; a gift it should have refused” (Delhaise 1998 quoted in Sheng 2009 p. 140).

Finally, the East Asian crisis had also exposed the weaknesses in the banks’ internal compliance frameworks that signaled the attempts of the local banks to “escape” the applicable regulations. Regulatory compliance failures were cited in the literature to be rampant in the areas such as - related party lending, concentrated exposures and concentrated ownership (Walter 2008). The majority of bank shares were in the hands of the original owners, and this concentrated shareholding was argued to have created information asymmetries between the majority shareholders and the minority shareholders, investors and creditors. For instance, subsequent to the crisis, international audits of banks in Indonesia conducted by IBRA showed evidence that the concentration of ownership was correlated with unsoundness and non-compliance with applicable regulations in some of the Indonesian banks. The audits show gross violation of the legal lending limit. It was estimated that an average of 50 percent of total lending of the audited banks was to their own groups. The legal lending limit was 35 percent of equity and, assuming a CAR of 8 percent, it was estimated that intra-group lending was nearly 20 times more than the legal lending limit (Pangestu and Habir 2002). Concentration of ownership by those close to the centre of political power was also said to have led to imprudent lending because it was believed banks were 'too big to fail' or were connected to powerful groups, and would be bailed out by the government. Even BNM (Malaysia) also was criticised for failing to enforce systematically the rule that single shareholders should control no more than 20 % of a commercial bank, a rule intended to limit connected lending. It was observed that bank mergers or takeovers in the 1990s that breached this limit were not disallowed by BNM (Malaysia) as they were argued to have involved close associates of leading members of a ruling party coalition at that time.
Breath of the applicable regulations intended to avoid concentration of asset exposures were also found rampant in countries like Philippines. While the sector average is under 20 percent, some individual banks in the country, including large ones such as the PNB, have real estate loan exposures above 20 percent prior to the crisis. In the March 1996 survey, for example, one bank's ratio went as high as 28.6 percent (ADB 1999). Further, Philippine banks were also active in loan-for-property swaps. In many cases, these properties are actually unearned assets in the form of raw land and are booked as real and other property owned and acquired accounts (ROPOA) in bank balance sheets at realisable values. As per the extant BSP regulations, loan loss reserve coverage against such ROPOA assets are not required until after five years from the time the property is booked. As reported in the literature, some banks could have used this to inflate collateral value since the property market is illiquid (Gochoco-Bautista 1999).

Thus the literature provides several instances supporting the arguments that a favorable macro-environment prior to the crisis had indeed undermined the regulatory institutions and their oversight mechanisms on local banks. The result was rampant governance and risk management failures that became characteristic features of local banking system of these nations, as explained in the following paragraphs.

4.3 Factors Influencing Bank Governance

The favourable macro-economic environment had led to symbiotic relationships - between the government or political circles, banks, and big businesses - which contributed to the maintenance of lax prudential regulation, weak bankruptcy codes, and poor corporate governance standards in the East Asian nations (Satitniramai 2002, Hosono 2006, Nam and Lum 2006). This had undermined the bank governance, because prior to 1997 these relationships (among the government, banks, and big businesses), rather than the internal governance mechanism, used to direct the strategic decisions of the banks. In some countries, notably in Thailand and Indonesia, banks were part of larger family-controlled business groups, and were reported to having been abused as a tool of maximising the family interests rather than the interests of all shareholders and other stakeholders. In other cases, where private ownership concentration was not allowed, certain banks were heavily intervened with and controlled by the government even without any ownership share. Understandably, in either case, corporate governance was considered very poor and therefore occupied a central place in discussions on the East Asian crisis (Walter 2008). This section
therefore identifies four key governance dimensions that were at the heart of the crisis in the following paragraphs:

a) Competitive Pressures in the Industry

It is reported in the literature that the banking systems of the East Asian nations, prior to the crisis, had an unusually large number of players, which resulted in competitive pressures in the industry (refer Table 4.2 below):

Table 4.2: Structure of the Banking Systems before the Crisis

<table>
<thead>
<tr>
<th>Ownership category</th>
<th>Thailand</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private commercial</td>
<td>15</td>
<td>144</td>
<td>23</td>
<td>40</td>
</tr>
<tr>
<td>State-controlled</td>
<td>5</td>
<td>34</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Merchant banks</td>
<td>0</td>
<td>0</td>
<td>12</td>
<td>0</td>
</tr>
<tr>
<td>Finance/Security co.s</td>
<td>108</td>
<td>0</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>Foreign institutions</td>
<td>14</td>
<td>44</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>142</strong></td>
<td><strong>222</strong></td>
<td><strong>90</strong></td>
<td><strong>56</strong></td>
</tr>
</tbody>
</table>


As observed in the Chapter 2: Literature Review, forces of competition in any industry could influence the governance structures of the corporates. There is indeed empirical evidence that competitive banking systems are relatively less likely to suffer banking distresses (see Beck, Demirgüç-Kunt, Levine 2006; Schaeck, Čihák and Wolfe 2009). There are however alternative arguments in the academic literature, which state that the competition tend to undermine the risk management practices of banks and thereby generate instability in banking system (Marcus 1984, Keeley 1990, Allen and Gale 2000). The overall settled view in academic literature therefore stresses upon the role of central banks in understanding the nature of competitive forces and designing an appropriate regulatory regime governing industry competition in a manner conductive to overall financial stability. The East Asian experience highlights how the competitive forces, in the absence of adequate regulatory framework, tend to creative tendencies of financial instability. To understand this better, reference is drawn to a report published by World Bank in 1998.

The World Bank report (1998) titled **East Asia: Road to Recovery** stated that the ownership diversity of the banking system of these nations had contributed to broader issues of governance as it resulted in risky business strategies adopted by banks to address resultant competitive pressures. The report stated that a large number of private banks (for
instance in Indonesia) coupled with the domestic and external financial liberalisation measures had led to increased competition amongst banks for credit-worthy borrowers, reducing the franchise value of banks and induced them to pursue more risky investment strategies. Apart from banks, the financial services industry of the Thailand and Malaysia also had a significantly higher presence of non-bank-financial companies. These companies were generally less regulated and subject to weaker supervision than banks. They often lacked adequate internal, market and regulatory discipline but added additional source of competition to the banks. Their presence was also argued to have largely reduced the franchise value of individual financial institutions and undermined the incentives for prudent behaviour of banks. In the context of Indonesia, the source of competition to private banks came from the gradual de-regulation of operational aspects of state-owned banks. This had resulted in changes in incentive structures as, prior to deregulation, state banks were seen principally as ‘agents of development’ channelling funds into areas considered priority by the government. Following deregulation, both state and private banks competed actively for household deposits and commercial loans that resulted in deterioration in credit and governance standards (Sheng 2009). The report also highlighted that the competitiveness and institutional development of banking systems more generally were further hampered by the low local presence of foreign banks in all the East Asian nations prior to the crisis.

The East Asian experience thus underscores the role of regulatory authorities in putting in place adequate framework for regulating the competition in the industry for achieving overall financial stability. However, it is observed during 1990s that, instead of operating as a regulated industry, local banks (especially in Indonesia and Malaysia) were largely operating as vehicles to promote economic growth through policy-directed lending model adopted by local governments. The nuances of policy-directed lending by banks are therefore covered in the next paragraphs.

b) Policy-directed Lending by Banks

During 1990s East Asia adopted ‘finance for growth’ policy which meant that the resource allocation had for a long time been ‘policy or state-directed’, whereby the protected banking system channels resources to ‘priority sectors’. In the 1970s to mid 1980s, many Asian banks, especially the state-owned or controlled ones, still worked out credit policies that channelled lending to exports, industrialisation, trade financing and social development (Sheng 2009). The unintended consequence of directed lending programmes was that the banks in a number of Asian tiger economies were ordered or persuaded by governments to lend heavily
to companies that were not commercially viable. Policy lending was argued to have retarded development in the equity and bond markets because ‘planners’ were more inclined to be exercising control over bank lending than developing capital markets as engine of growth. Directed lending was also considered to have destroyed the banks’ incentive to exercise credit judgment and allowed the companies concerned to become overleveraged and thus vulnerable to economic downturn (Lee 2000). Two case studies exemplify how the directed lending contributed to the crisis are the ‘National Car Policy’ of Indonesia and ‘National Economic Policy’ of Malaysia, which embraced state involvement in directed lending of banks.

The ‘National Car Policy’ (NCP) was announced by President Suharto in 1990 with the objective to provide competition in the Indonesian automotive industry. The Policy gave concessions to those local companies that manufactured cars locally using an Indonesian brand name and parts. Under the aegis of the NCP, ‘pioneer’ status has been accorded to PT Timor Putra Nasional (TPN) – a car manufacturing company jointly owned by President Suharto’s youngest son and the KIA Motor Corporation of South Korea (Sharma, 2003). Further, the TPN has been granted exemption on tariffs and taxes, import permissions and pricing policy concessions, that led to undercutting of price in the market. Despite these concessions, considering the inability of the new-born company to make cars, the policy allowed the company to import cars from Korea for the first year of operation and sell under local brand name (Timor). The banking angle to this comes from the fact that fully backed by Indonesian government – BI (Indonesia) and a consortium of 4 state-owned banks and 12 domestic private banks - were made to supply an initial USD 960 million for its production and assembly facility (Sharma 2003). The company finally operated only for one year amid intense controversy (even from the Suharto regime’s staunchest supporters) before being shut down (Hale 2001).

The National Economic Policy (NEP) announced by Mahathir government in Malaysia had a similar explicit objective of promoting ‘bumiputera’ (indigenous Malay) business interests so as to counter-balance the traditional Chinese business dominance and reduce inequalities of wealth across ethnic groups. However, the policy was subsequently known for fostering close linkages between bumiputera business interests and the ruling Barisan Nasional Coalition, especially the dominant party within the coalition, UMNO (Gomez and Jomo 1999). Bank Bumiputera Malaysia, a bank established by the Government has been used under the aegis of NEP to provide loans to well-placed bumiputera entrepreneurs. It had to be rescued by the government twice in 1985 and in 1989 consequent to its breach of prudential rules and
accumulation of non-performing loans. The concentration of problems created by the governments’ directed lending policies towards bumiputera business interests was reflected by the fact that in 1999, the Bank Bumiputera group had a share of 29.32 percent of non-performing loans managed by the bank restructuring agency created in Malaysia in the aftermath of the Asian crisis (Walter 2008).

Thus through the state policy directed lending, by concentrating on perceived ‘priority sectors’, it was argued that policy makers have not developed a national risk management strategy to assess risk concentrations, diversify sources of financing and growth, and build domestic capacity for absorbing internal and external shocks (Sheng, 2009). Further, since the lending priorities are also directed by the governments, it was argued that the expertise was not developed in the banks in the areas of credit appraisal and decisioning resulting in weak credit lending decisions.

c) Implicit Guarantee of Government

Another important aspect that merited consideration in the context of East Asian crisis was the nature of implicit guarantee extended by the government to its local banks in the years prior to the crisis. Each of the Tiger nations had their own experience of a domestic banking crisis in the years preceding Asian crisis in 1997 (refer Table 4.3 below).

Table 4.3: Prior crises in East Asian Nations

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>1983-87</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1994</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1985-88</td>
</tr>
<tr>
<td>Philippines</td>
<td>1985</td>
</tr>
</tbody>
</table>


However, the crisis resolution measures adopted by respective governments and central banks impacted the way in which the governance dimension was perceived prior to 1997 by controlling owners of banks in these nations. It is pertinent to note that the prior crises mentioned above were, in part, resolved through partial or full public bailouts. For instance, in case of Indonesia only one bank was closed between 1988 and 1997, with the other problem banks being bailed out directly by the government or by corporations that the government persuaded to step in (Pangestu and Habir 2002). In Philippines, the low number
of bank closures is seen by authorities as proof that they were doing a good job (ADB 1999). The lingering effects of such policy decisions of regulatory/government authorities to deal with financial distress therefore exacerbated the governance weaknesses in these banks. As the bailouts reinforced the perception of an implicit government guarantee on deposits, or even other bank liabilities, market discipline factor has become virtually undermined. In some cases, management of restructured financial institutions was not changed even after government bail-outs, which further provoked incentives for imprudent behaviour subsequently (World Bank 1998).

From a regulatory policy standpoint, since banks were the most important entities, charged with channelling public savings by being providers of business finance, they became “too large to fail”. This meant that the banks undertook risks that would not have existed without the implicit government support either for public or private business reasons. The governance structures adopted by these banks, therefore, were designed to cater to their controlling owners more than the larger set of stakeholders under the assumption of implicit government guarantee (to bail them out in the event of failure of the bank). Thus professionalism was therefore was not an observed feature of boards of banks prior to the crisis. However, the weak governance mechanisms were not an industry-wide phenomenon. It was argued in the literature that state and family controlled banks were generally associated with low corporate governance standards while widely held banks and foreign controlled banks were associated with high governance standards (Fan and Wiwatanakantang, 2006).

The previous paragraphs thus highlight the role of - inadequate regulatory oversight that resulted in unrestricted competition, active government intervention that promoted policy-directed lending and implicit government guarantee - in providing perverse incentives to bank management. The subsequent paragraphs deal with the weak monitoring role exercised by external auditors that further undermined the governance frameworks at local banks during the period prior to the crisis.

d) Weak Monitoring by External Auditors

Banks are known for exacerbating agency problems that result in weak governance standards. Agency problems occur in any situation where decision-making responsibility is directly or indirectly delegated from one group to another group of stakeholders with different objectives and complete information needed to control the behaviour of the
decision-maker is not readily available (Alexander and Dhumale, 2001). Therefore, like publicly traded companies, banks are also monitored externally, by entities such as shareholders, creditors, other clients, and external auditors. Further, as per the agency theory tenets also, auditors play a role in enforcing governance standards and thereby mitigate agency problems in emerging economies (Fan and Wong 2001a). Considering the fact that the auditors were at the forefront of enforcing established accounting standards, their role in monitoring and enforcing governance standards in such a situation was very much established in the accounting literature. Having access to all relevant books and records of an enterprise, if the auditors fail to detect accounting manipulations or non-compliance with established accounting standards (either knowingly or negligently), the enforcement chain was considered as broken (Rahman 2000).

Apart from regulatory weaknesses, the East Asian crisis experience also offers an example of how the failure of the external auditors in monitoring governance mechanisms can exacerbate the crisis situation. It suggests that the existence of the concentrated ownership in the East Asian nations had an indirect impact on the quality of auditors and their remuneration/opinions. During the period of the Asian crisis, the region had greater presence of Big Five accounting firms and other international firms and the market for external auditors was much more vibrant than the market for takeovers or independent directors (Fan and Wong 2001b). However, during the Asian crisis, studies published by the World Bank and the United Nations Conference on Trade and Development (UNCTAD) questioned the quality of audits by Big Five auditors operating in Asia (Petersen 1998, Street & Gray 2001). Auditors were also criticised during and after the crisis for supplying variable quality across global audit markets (Johl et al 2003). The role of external audit in exacerbating the governance failures was also subsequently discussed in numerous industry-level studies/surveys of various authorities (Securities Exchange Commission of Thailand Corporate Governance Report (1999), the Asian Corporate Governance Association research report (2000)).

Monitoring failures of external auditors was argued in the literature to have led to non-transparent accounting disclosures undermining the ability of regulators to identify the problem at a much earlier date. It was generally claimed that the national standards of East Asian countries were based on International Accounting Standards. However, in reality, the financial statements prepared by business enterprises in these countries were found to rarely comply fully with the national standards or the international standards. Hence, it was the compliance mechanism, rather than the standards themselves, that was considered the weak link in the context of the Asian Crisis (Rahman 2000).
Thus the East Asian experience suggests that the external auditors were not effective in their role in acting as a monitoring agent. Supervisory authorities, influenced by either political or other considerations, were not acting as effective enforcement agencies and on the other hand provided implicit guarantee to the banks for their bail-outs in the event of failure. As all external monitoring mechanisms were found to be weak, governance as a subject-matter of importance was not flourished in the East Asian nations prior to the crisis and provided perverse incentives to bank management. In the following paragraphs, therefore, a review of risk management failures, which occurred in the banking industry as a result of these perverse incentives, is presented.

4.4 Risk Management Failures

This section deals with risk management issues that were identified ex-post in the academic literature in the context of East Asian crisis. While the overarching governance frameworks prevalent in these nations were riddled with the weak enforcement and implicit government guarantee, it was widely reported in the literature that the internal control mechanisms had also led to risk management issues. Notable among them are - problems associated with directed lending/related-party lending, concentration risk of mounting exposures to sensitive sectors, funding related risks (tenor-wise and currency-wise). Each of these issues is further explained in this section.

a) Related Party Lending

The key governance issue that led to larger debate in both academic and regulatory circles is the problem of related party lending (or connected lending) that was prevalent in these nations prior to the crisis. The nexus between the politics and business, termed “crony capitalism” that led to the related party lending was cited as one of the fundamental reasons for fragility of the banking systems in these nations (Sharma 2003). Instances of governance failures have been widely cited in the media during the crisis exposing the political and business connections of banks leading to negative consequences (refer Table 4.4 below)

Table 4.4: Related Party Lending and Governance Failures

<table>
<thead>
<tr>
<th>Country</th>
<th>Instances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td><strong>Bangkok Bank of Commerce</strong> - 40 percent of the total assets of the Bank were found to be non-performing loans, many of which were to</td>
</tr>
<tr>
<td>Country</td>
<td>Instances</td>
</tr>
<tr>
<td>-----------</td>
<td>---------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| Indonesia | • **PT Bank Bali** - Managers diverted funds in order to finance a political party (Johnson and Boone et al 1999)  
            • **Bank Andromeda** - A closed bank during the crisis was allowed to be opened subsequently within weeks of its closure, due to political pressure, and operated under another name (Bank Artameda) (Batunaggar 2002) |
| Malaysia  | **UMBC Bank** – The bank was owned by the then Finance Minister and ruling party (UMNO) treasurer and was also later sold to government-owned Sime Darby Group amidst related party lending issues (Walter 2008) |
| Philippines | **Philippine National Bank and Development Bank of Philippines** - Banks were declared technically insolvent after the quality of their asset portfolio deteriorated because of excessive exposure to connected borrowers (ADB 1999) |

Sheng (2009) and Walter (2008) provided a detailed account of the problems of the related party lending. They mentioned that the problems of related party lending were manifested because of the need of the business groups to gain access to larger scale financing. Realising the importance of banks in the national economic development, the governments ensured that the banking licenses are highly coveted and protected. Business tycoons and financial conglomerates therefore established political connections and treated banks as a part of their private cash machine or were financed heavily by the banking system. Because banks were the primary source of funding, they became “captive sources” for these politically connected business houses. Related party lending issues are also often manifested in the form of information asymmetry issues, credit assessment weaknesses and compliance issues associated with breaches of regulatory limits on related party lending. The opaqueness of the banking operations makes the information asymmetry and the agency problem particularly serious as it gave strong incentives to bank insiders to pursue their own interests (or the interests of their connected counter-parties), at the expense of the interest of other stakeholders. Thus the connected lending not only impaired credit decision, but the whole culture of imprudence spread throughout the system exposing the weakness in the credit assessment procedures of the banks. The borrowers became “too large to fail” and therefore banks lost the incentive to develop a strong credit and risk culture. The resulting situation was that they were stuck with projects with long-gestation periods without adequate cash-
flows, resulting in large non-performing loans. To get rid of these loans, banks and finance companies were found to have resorted to practice of swapping of loans by circumventing the applicable regulations (Sheng 2009). The related party lending problem thus exposed the “cronyism, corruption and nepotism” lying at the heart of the East Asia’s financial vulnerability during the early 1990s (Walter 2008, p.1).

b) Property Lending

Bank exposure to real estate and property sector was cited in the academic literature as one of the vulnerabilities of the banking system in the crisis affected nations (Koh et al 2004). As the domestic credit by the banking sector soared in the Tiger nations, property exposures of banks constituted a significant component in their overall lending portfolio (refer Table 4.5 below). When the crisis-trigger hit and the economies started experiencing contagion effects, their exposures to property sector became non-performing loans.

Table 4.5: Domestic Bank Credit and Property Exposures

<table>
<thead>
<tr>
<th>Country</th>
<th>Domestic credit to banking sector (as a % to GDP)</th>
<th>Property exposures at 1996</th>
<th>Peak to trough fall of Property indices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>146.40</td>
<td>30-40%</td>
<td>20.0%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>54.00</td>
<td>25.30%</td>
<td>24.2%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>142.40</td>
<td>30-40%</td>
<td>50.0%</td>
</tr>
<tr>
<td>Philippines</td>
<td>58.30</td>
<td>15-20%</td>
<td>66.7%</td>
</tr>
</tbody>
</table>


Other available data also suggests the vulnerabilities that existed in property lending by banks at that time. For instance, during the period 1994−1997, loan growth in the broad property sector of the Malaysian banking sector averaged about 44% per annum, compared to about 22% average growth of credit to the manufacturing sector during the same period (Sheng 2009). In Indonesia, property lending of banks increased, within a three year period (1993-96) from 6 percent of GDP to 16 percent (Pangestu and Habir 2002). The risk that the real estate sector poses to the financial stability of the East Asian nations was articulated by international financial institutions as early as in 1996 (see for example IMF 1996). A review of available academic literature therefore suggests that the real estate exposures exacerbated the crisis situation in three different ways, each of which is explained in the following paragraphs.
There were instances in existing academic literature to underscore the fact that the excessive lending to the property sector had provoked speculative elements in East Asian nations prior to the crisis. For instance, property lending in Malaysia was argued to have promoted reckless expansion of business empires with an increase in speculative investments towards real estate and housing projects, shopping malls, office buildings and even golf courses (Sadli 1998). Even in Thailand, it was reported that the reckless lending also prompted several of the real estate companies to enlarge their land banks, invest in speculative and unproductive purchases, such as vacant land, initiate projects without seeking adequate information on market conditions and demand, and subsequently become highly engaged in projects with inferior risk-return trade-off (BOT 1998). Further, the property lending led to weaknesses in end-use monitoring of funds lent by banks as they are generally fungible. Therefore, once a bank lends to a borrower, even after classified it as a manufacturer, there is no guarantee that the funds were used in this business and not in real estate. A case in point is the failure of the appliance maker EYCO from Philippines. Creditor banks lent EYCO money ostensibly to finance the expansion of its appliance manufacturing business. Yet, like many other companies, EYCO had a real estate development subsidiary to which the funds were later found to have been funneled. The loans soured when the property market collapsed (ADB 1999).

The problem of property lending not only was concerned with direct lending by banks towards purchase of property but also to other commercial loans, which are collateralised with properties given as underlying security. If these indirect property exposures are taken into account, Indonesia, Malaysia, and Thailand were deemed to be riddled with “high” risk property lending exposures (World Bank 1998). From a theoretical standpoint, models of bank behavior under asymmetric information show that collateralisation reduces adverse selection and moral hazard in two forms: first, it induces a borrower to reveal his or her default risk, acting as a signaling device (Besanko and Thakor 1987); and, second, it provides the borrower with an incentive to exert effort and reveal truthfully the state of his project after having obtained the loan (Bester 1987). However, the World Bank report and experiences cited in previous paragraphs imply that banks could have used the collateralisation process to over-lend to borrowers by inflating the collateral value.

c) Bank Lending and the Stock Market Bubble

Apart from the issues associated with property lending, the availability of foreign liquidity and increased capital flows had also contributed to the stock market boom gradually in certain
East Asian nations. The increased stock market activity was witnessed in Thailand and Malaysia on account of the capital market liberalisation measures undertaken by these nations during early 1990s. The passage of the Securities and Exchange Act in 1992 in Thailand marked a major step in the development of the local stock market. The Act was a driving force for issuance for common stocks and debt instruments, and resulted in the rapid expansion of the Thai capital market (Sharma 2003). In Malaysia, the move to promote the domestic equity market began with the delisting of the Malaysian-registered companies from the Stock Exchange of Singapore (and vice versa) from January 1, 1990. Together with capital account convertibility, there was a massive influx of foreign portfolio equity investment into Malaysia (Sheng 2009). Coupled with the stable exchange rate regime, the stock market also witnessed a significant amount of investment in the form of foreign private equity inflows. Thus, the stable exchange rate regime and the capital market liberalisation measures adopted by these nations supplemented the frenzy of the foreign investors into the local stock markets.

The increased stock market activity is witnessed in the increased market capitalisation of the listed companies and the build-up of concentration in the real estate exposures in these nations. For instance, the domestic market capitalisation of the listed companies (as a percent of GDP) surged during 1991-96 in Malaysia, which is the significant recipient of the capital inflows in the form of net portfolio equity liabilities into the economy (refer Figure 4.5 below).

**Figure 4.5: Market Capitalisation of Listed Companies (as a percent of GDP)**

![Market Capitalisation of Listed Companies](image)

**Source:** Sheng (2009)

When the domestic stock markets were soaring with foreign funds, the local entrepreneurs found a newer alternative to make money for investing in the stock market – obtaining short-
term bridge loans from banks repayable on successful listing. Exposure to stock markets (including such bridge loans) constituted 9.8 percent of the credit generated by the banking system in Thailand in 1997 (and around a similar percent in Malaysia at the time of its peak stock prices) (Sheng 2009).

The previous paragraphs thus outlined the issues associated on the assets-side of bank balancesheets in East Asia (in the form of related party lending, property and stock market lending) prior to the crisis. The nature of funding risks on the liabilities side of the balancesheet is therefore dealt with in the subsequent paragraphs.

d) Funding Risks

On the funding side, the East Asian banks exhibited three major types of risks. Firstly, there was a dependence on the foreign exchange borrowing by banks which resulted in domestic lending in foreign currency terms, often un-hedged by corporate borrowers. Secondly, much of the foreign exchange borrowings by local banks were short-term roll-over loans, whereas the lending in the domestic market was for the longer term leading to maturity mismatches. Thirdly, much of the foreign exchange borrowings by local banks were from Japanese banks leading to concentration risk in funding sources. Each of these aspects is explained in the following paragraphs.

Foreign commercial bank lending during the early 1990s became a major source of financing for East-Asian banks and corporations and steadily increased over time (refer to Figure 4.6 below). As the domestic interest rates were kept high (to attract foreign inflows) and exchange rate movements seemed predictable, the private sector borrowing in foreign currency was mostly short-term and un-hedged in the years before the crisis (Nasution 1997). Un-hedged foreign currency borrowings posed an obvious risk to the bank, in that any depreciation of the local currency during the term of the loan would mean that the amount in local currency needed to repay the loan on maturity would be far greater than the amount the borrower received upon drawing the loan. In short, local banks were faced with an un-hedged funding mismatch between borrowing short-term from abroad in foreign currency and lending long-term in local currency (Djiwandono 2000). All these asymmetries of the banks’ balance sheets added to their overall risk.
The surge in foreign borrowings was attributable to both the demand-side and the supply-side factors. On the supply side, part of the rise in lending was owing to the European banks’ goal of achieving a higher profile in emerging economies, which resulted in their increased placement of funds into these nations (Radelet and Sachs 1999). In addition to European banks, Japanese banks had also faced the impact of liberalisation in their own country which allowed their blue-chip corporations to issue their own papers in international capital markets removing their dependency on bank funding sources. That had prompted Japanese banks to seek new businesses, sometimes outside Japan. The significant chunk of these banks felt that geographical and/or cultural proximity of East Asia brings better information about borrowers and influenced positively their lending decisions (Pereira da Silva and Kuroyanagi 2000). Faced with a slumping economy and little domestic loan demand, Japanese banks therefore increasingly looked overseas and tried to tap the opportunities thrown up by the East Asian nations, notably Thailand and Indonesia (apart from Korea) as potential borrowers (Kaminsky and Reinhart 2000). Loans were not considered risky because of Japanese banks’ perception of risk (and hence the risk-adjusted return on investment), which was attenuated by an implicit guarantee provided either by local Governments or international agencies (Koo 1998).

On the demand side, the increased foreign bank borrowing was seen mostly in Thailand and Indonesia. The reason for the low foreign bank borrowings in Malaysia was that the Malaysian banks were not allowed to borrow heavily from abroad to lend in the domestic market, as in the other economies. The prevalent regulatory system in Malaysia recognised that such practices involved currency and term mismatches, which increased financial system vulnerability to foreign bankers, issue of confidence as well as pressure on the exchange rate pegs (Jomo 2003). Similarly, in the case of the Philippines, the economy’s reliance on
external loans was also relatively limited, in part because of the difficulties in accessing the international capital markets due to the debt crisis in the 1980s (Nasution 1997). However, Thailand has been the significant recipient of foreign bank loans, primarily because of the government’s liberalised regime marked with the establishment of the Bangkok International Banking Facility (BIBF). The primary source of the vulnerability is the short-term debt and the portfolio investment flows of these nations, which reached alarming levels in comparison with the available foreign exchange reserves (refer to the Figure 4.7 below).

**Figure 4.7: External Liabilities to Foreign Exchange Reserves (1996)**

![Figure 4.7: External Liabilities to Foreign Exchange Reserves (1996)](image)

**Source:** Sheng 2009, Laevan and Valencia (2008)

As can be seen above, the short-term debt in Thailand and Indonesia, as well as the Portfolio liabilities in Malaysia rose to such a significant extent by 1996 that their foreign exchange reserves could be easily depleted in no time, should there be a trigger event spiralling the reverse trend of these flows. While this was a primary warning signal, the other important concern was that Japanese Yen constituted a significant composition of the external debt. This resulted in concentration risk that any small external trigger from Japanese counterparts could prove to be a vulnerable event setting the stage ripe for a financial disaster. This can be witnessed with the significant proportion of Yen denominated debt in the overall long-term debt of these nations (refer Figure 4.8 below):

**Figure 4.8: Currency Composition of Long-Term Debt (1996)**

![Figure 4.8: Currency Composition of Long-Term Debt (1996)](image)

**Source:** World Bank (2001)
Thus, by 1996, the East Asian tigers reached a phase whereby the currency composition of their long term debt and the concentration risk of FDI inflows from Japan put them on a warning zone (Koo 1998). This was coupled with a vulnerable position of foreign exchange reserves to support any long term defence of their currencies. All that they needed was a trigger event to expose this situation into a financial disaster. The trigger event came in the form of the depreciation of Yen against the dollar in 1997 after a continuous appreciation during early 1990s. The depreciation was the response of Japanese authorities to address their own banking sector problems aggravated by the Kobe earthquake. The earthquake resulted in increased asset prices (and weak banks) and Daiwa banking scandal making access of Japanese banks to US capital relatively difficult. This has resulted in a situation where Japanese banks had to cut back on their foreign currency loans to address domestic liquidity pressures. Their obvious choice was to cut back the exposures to the East Asian nations. Hence, between June 1995 and June 1997 Japanese bank loans to Asia in general dropped by about 27 percent from its June 1995 peak of USD 383 billion to USD 278 billions (Sheng, 2009).

The risk management failures outlined in this sections (paragraphs a to d) and bank governance failures explained in the previous section therefore support the arguments put forward by the vulnerability theorists that the East Asian banking systems were suffering from structural weaknesses even before the 1997 crisis. However, the discussion on the origins of the crisis is not complete if the panic dimension that triggered the financial contagion is not reviewed. The subsequent paragraphs therefore deal with the panic dimensions in the East Asian crisis.

4.5 Panic Dimension in the East Asian Crisis

The previous sections provided a detailed account of the stable macro-economic economic growth strategy adopted by nations such as Thailand, Indonesia and Malaysia. As explained earlier, the East Asian miracle was attributed to the market-friendly policies adopted by these nations aimed at financial integration and trade openness, which resulted in surge of capital inflows into these economies, enabling them to pursue export-led domestic growth. However, as Sharma (2003, p. 31) argued, the surge in the capital inflows was “a reflection not so much of the investors’ confidence in the economic performance of these economies, as of the ability of the governments to guarantee abnormal rates of return”. Stable exchange rate regime therefore constituted the cornerstone of the growth story providing implicit guarantee of returns to the foreign investors by the local governments.
Empirical studies (see for instance Lipsey 2001, Das 2003, Chen and Khan 2003) have found that capital flows pose fewer problems if they are – long-term in nature, in the form of direct investment, propelled by the growth prospects of the economy, and invested in physical assets. However, as observed in the previous sections, the capital inflows, which surged into East Asian nations through financial liberalisation measures, were largely - short-term in nature, in the form of external debt/portfolio equity liabilities, encouraged by implicit guarantee of government and were invested in sensitive sectors such as stock and real-estate markets. In such a euphoric phase - of greater financial liberalisation and increased capital inflows - the ability of domestic institutional infrastructure to sustain the momentum is often questioned (Demirgüç-Kunt and Detragiache 1997). However, as the previous sections indicated, the East Asian experience revealed the failure of key domestic institutions - local central banks - in extending adequate regulatory oversight required during the euphoric phase of the economy. This has resulted in the rapid expansion of credit in the economy exposing the local banks to governance and risk management failures characterised by increased credit and funding related risks in their balancesheets.

Returning back to the Kindleberger-Minsky model of five-stages of financial crisis (1978, 2005), such a situation marks the beginning of the phase of “revulsion and discredit”, which raise serious doubts upon the ability of local governments and regulatory institutions in continuing the implicit support to their national currencies and domestic financial institutions. These doubts result in changing perceptions of foreign investors (such as hedge funds) who begin to speculate the downward spiral in the exchange rates. As observed earlier, the period during early 1990s was already characterised by weak regulatory oversight; all it required was a trigger to mark a complete collapse in the form of government’s declaration of its inability to further support the domestic exchange rate. The fact that collapse becomes inevitable in such situations can be explained in the words of Eichengreen (2003, p. 235):

“Where the currency peg has been the cornerstone of the government’s entire economic policy strategy, abandoning it will come as a sharp shock to confidence. If investors already harbour doubts about the government’s commitment to the pursuit of sound and stable policies, jettisoning it will be seen as the equivalent of an obese man announcing that he has stopped going to Weight Watchers; the markets will fear that the government is about to revert to its bad old ways of monetary and fiscal excess. Capital will flee, undermining economic and financial stability”.

It can therefore be argued that both the contagion and vulnerability theories fundamentally rest on the similar foundations of imprudent government growth strategy coupled with inadequate regulatory oversight. The explanation that could synthesise both these theories is
to view the vulnerability theory as explanation for events that lead up to the crisis and the contagion theory as the events that spread the crisis to the neighbouring nations. Thus while the policy mistakes constitute the premise of vulnerability theory, panic dimension constitutes the foundation of contagion theory. But at the heart of both the policy mistakes and the panic dimensions lie the failure of domestic regulatory institutions. Having reviewed the policy mistakes prior to the crisis in the previous sections, this section focuses on comparing and contrasting the actions of regulatory authorities of each of the East Asian nations during 1997 that resulted in investor panic leading to financial contagion.

a) Thailand and the Devaluation of Baht

In the East Asian context, the contagion effect began with the devaluation of Thai Baht by the BOT (Thailand) on July 2, 1997. During 1996-97, Thailand saw a period of slow-down in economic activity, coupled with closure of a bank in May 1996 (Bangkok Bank of Commerce) and a financial institution (Finance One) in March 1997 amidst the non-performing real estate property loan exposures. Further, the merger between Finance One and Thai Danu Bank, which was showcased initially as a "model for further mergers" by BOT (Thailand) failed in May 1997, thereby collapsing the merger strategy itself and demonstrated the inability of regulatory authorities in supporting their national financial system during crisis situation (Sharma 2003). This has prompted the foreign investors (notably the international hedge funds such as George Soros's Quantum Fund and traders at US financial institutions such as JP Morgan and Goldman Sachs) who begin their speculative attacks on Thai Baht by taking short positions in spot, forward and options markets, betting as much as USD 10 billion on Thailand devaluing its currency (DeRosa 2001). The situation called for extension of support from the government and the central bank in defending their national currency by utilising the available foreign exchange reserves. However, the financial position of Thailand represented one that of "international illiquidity" (see Chang and Velasco 1998 and the explanation in Chapter 3) wherein the foreign exchange reserves of Thailand are inadequate to meet up even the short-term external liabilities (see figure 4.7 above). The inadequacy of foreign exchange reserves finally led to the decision of the BOT (Thailand) to float the Baht on July 2, 1997.

Speculative attacks on currency of a particular nation will spread the contagion even to neighbouring nations, which have regional trade and financial linkages (Kaminsky and Reinhart 2000). In situations of financial panic, foreign investors exhibit herd mentality by pulling out from a group of related markets simultaneously when they spot signs of trouble in
any one of them (Calvo et al 1996). The commonality of triggers (such as weaknesses in local banking system, rapid expansion of bank credit, huge exposure to real-estate and stock-market) further corroborates their higher perceived risk of holding investments in other countries as well. In such a situation, foreign investors pull their funds from the other nations as well, pushing the nations into financial distress (Masson 1998). Thus the devaluation of the Thai Baht resulted in financial panic in the Indonesia, Malaysia and Philippines, whose ability to defend their domestic currencies is equally limited in view of inadequate foreign exchange reserves (see figure 4.7). This had eventually resulted in sharp depreciation of local currencies of these four East Asian nations, ranging from 48 percent to almost 350 percent during the peak of the crisis (refer to Table 4.6).

Table 4.6: Rate of Currency Depreciation 1997-98

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand (Baht)</td>
<td>24.4</td>
<td>38.99</td>
<td>59.80</td>
</tr>
<tr>
<td>Indonesia (Rupiah)</td>
<td>2,341.92</td>
<td>10,638.30</td>
<td>354.30</td>
</tr>
<tr>
<td>Malaysia (Ringgit)</td>
<td>2.57</td>
<td>3.80</td>
<td>47.80</td>
</tr>
<tr>
<td>Philippines (Peso)</td>
<td>26.38</td>
<td>43.80</td>
<td>66.10</td>
</tr>
</tbody>
</table>

* Local currency per USD

Source: OECD (1999)

In a falling currency regime pursuant to contagion impact, the ability of regulatory authorities in averting a financial panic therefore merits discussion. The following paragraphs therefore compare and contrast the experiences of regulators in Philippines, Indonesia and Malaysia in addressing the financial contagion that hit their countries after the currency devaluation by Thailand in July 1997.

b) The Philippines and the Impact of Contagion

A previous debt crisis experience (during mid-1980s) in the Philippines left the financial and monetary authorities in the country quite cautious about the risks posed by overextensions in lending as well as in mismatches in currency and maturity positions. So, at the time when the contagion hit in 1997, the economy was in the pursuit of regulatory reforms in the local banking systems. Accordingly, while the Philippines financial system as a whole was spared from the devastating impact of the East Asian crisis, there were certain vulnerabilities in terms of weak risk management practices, mounting external debt, fiscal imbalances and increased trade deficit at the time the contagion from Thailand hit the Philippines economy.
The difficulties of Thai baht devaluation served as a wake-up call for foreign investors to examine closely domestic vulnerabilities of the Philippines economy. The resultant reactive stance of foreign investors immediately led to the sharp depreciation of the peso - from a stable rate of 26.4 Pesos to a US dollar in July 1997 to a rate of 43.87 Pesos by September 1998.

BSP (Philippines) immediately took steps to defend the domestic currency. However, the attempts proved feeble as there were not enough foreign exchange reserves to sustain the supportive action. BSP (Philippines) therefore allowed the local currency Peso to float freely by the end of July 1997. The devaluation impacted economic and financial sectors as they resulted in increased private debt obligations denominated in foreign currency. The increased debt obligations initially endangered the viability of projects (and debtors) and threatened the financial system as a whole (Alburo 1999). However, the overall impact on the economic activity was relatively muted in the Philippines as it managed to avoid the deep recessionary conditions gradually, thanks to the financial sector regulatory reforms already undertaken in the years prior to the crisis (Amador 2009). By 1999, the Peso had stabilised, inflationary pressures were contained, interest rates had gone down and the banking system had remained generally sound. Accordingly, Noland (2000) described the Philippines experience using the simile of a sick man who merely caught a cold but did not catch pneumonia.

c) Indonesia and the Guidance from IMF

The contagion from Thailand impacted the Indonesian economy immediately on the next day of Baht devaluation, on July 8, when the Indonesian Rupiah came under pressure. While Indonesia had stronger macro-economic fundamentals than Thailand, Sharma (2003) notes that the vulnerability of Indonesia came from two principal factors – huge external debt burden and fundamental weaknesses of financial and banking sector. The initial response of Bank Indonesia was to widen the exchange rate band in order to allow the currency to experience as it happened in the previous five episodes of exchange rate volatility (Djiwandono 2000). However, as the strategy of widening the band did not result in immediate positive result, Bank Indonesia tried various other macro-economic policies such as raising the local interest rates. Even as these policies did not yield in desired result finally Indonesian Rupiah was allowed to float against the US Dollar on August 14, 1997. This has led to the sharp depreciation of Rupiah from 2,341 Rupiah in July 1997 to 10,638 Rupiah in September 1998 (OECD 1999). This resulted in the surge of Rupiah denominated value of the interest and amortisation of foreign debts, causing a serious balance-sheet problem both in
corporate and banking sectors and finally the Indonesian government had left with no choice but to concede to the IMF (Blustein 2001).

The role of the IMF in further exacerbating the contagion impact in Indonesia had received wider academic attention (see Fischer 1998, Krugman 1998b, Stiglitz 2002). In particular, the IMF prescription for Indonesia was considered “misguided” at least on two different counts (Sachs 1997, Sharma 2003, IEO 2003, Sheng 2009). Firstly, the action of Indonesia in keeping the high interest rates was stated to have been under the guidance of the IMF. IMF for a long-time prior to the crisis stressed the importance of high interest rates in keeping the domestic currency holdings attractive. However, as the Indonesian experience demonstrated, this had the potential of complicating the situation of weak banks as they faced liquidity problems. In its self-assessment report, the IMF later acknowledged that the high interest rates may not be effective in stabilising exchange rates (IEO 2003). Secondly, the guidance for handling the post-crisis restructuring in Indonesia was criticised as a “scatter-gun” approach as it suggested that the IMF lacked a comprehensive bank restructuring strategy when dealing with Indonesian post-crisis situation (Hill 1999). In particular, the guidance of the IMF - in handling the weak bank closures and finalising the conditionalities associated with the assistance programme for the country - was widely criticised in the aftermath of the crisis. The Bank closures undertaken under the guidance of the IMF did not take into account issues such as: lack of expertise of local officials in handling the bank closures; the absence of a deposit insurance system in the country; strong political presence in the banking system; and the need for a comprehensive communication strategy while distinguishing between good and bad banks (Sachs 1997, Azis 1999, Blustein 2001, Batunagga 2002). Consequently, the issue of bank closures generated a panic in the system that quickly became a full-blown financial crisis. To get out of the crisis situation, IMF sought commitment of structural reforms in the financial sector before extending the rescue package to the troubled nations. However, in the process, the IMF was considered to have gone overboard at times in its demands as the Fund’s demands skyrocketed from 15 bullet points in November 1997 to 50 bullet points in January 1998 to 115 bullet points in April 1998 (Sharma 2003). The result was that, during the course of discussions with IMF in 1998, Indonesia witnessed nearly 2000 student demonstrations, 1300 rallies by non-government groups, 500 strikes and 50 riots (Feridhanusetyawan and Pangestu 2003). In its self-assessment report, IMF later acknowledged that it had misjudged the extent of ownership at the highest political level and underestimated the resistance to reform likely to be posed by vested interests (IEO 2003).
Thus, pursuant to the contagion emanating from Thailand, Indonesia conceded to IMF, whose actions thereafter subjected to wider academic debate. This experience contrasts with the stance taken by Malaysia to domestically deal with the crisis and not seek support from the IMF. This led to the imposition of capital controls by Malaysian authorities, receiving widespread criticism from all quarters. The subsequent paragraphs therefore deal with the Malaysian experience.

d) Malaysia and the Imposition of Capital Controls

In the wake of the free fall of the Malaysian Ringgit during 1997 due to contagious capital outflows, stemming from Thai Baht devaluation, and after acknowledging that there are no other regulatory tools to thwart their impact, Malaysia had immediately resorted to capital controls. It was openly acknowledged by the Malaysian famous academician Tan Sri Noordin Sopiee during September 1998 that the policy stance of imposing capital control regulations was “unfortunate because it is not a good policy; it’s not the best policy, but it seems to be the necessary policy at this point in time” (Tourres 2003 p. 180). However, imposition of capital controls was met with unanimous condemnation by the Western world with the then Federal Reserve Chairman Alan Greenspan calling it “decidedly mistaken” and the then Head of the IMF Michel Camdessus stating that capital controls “were not desirable, or even feasible, in today’s globalised economy” (Tourres 2003 p. 201).

Jomo (2003) argues that the imposition of exchange controls allowed Malaysia to regain control over monetary policy and paved the way for low interest rates in the medium-term. The reason being, as analysed in many other academic studies, Malaysian capital controls were complex and sophisticated to distinguish between short-term outflows and long-term outflows (Abdelal and Alfaro 2003). These were supplemented with co-ordinated mechanisms at the BNM (Malaysia) which continuously worked on structured communication to reassure panicky investors by answering their questions through a 24-hour hotline. Finally, even the IMF had acknowledged that the Malaysian measures were in conformity with its obligations under IMF’s articles of agreement (IMF 1999). Overall, the experience of the Malaysia suggested that a pragmatic and sophisticated approach, which relied on regulatory intervention in times of panic, helped the nation avoid the contagion impact. It may be mentioned that after the panic in 1997, Malaysia gradually relaxed the selective capital controls since February 1999 and by 2003 most of the capital controls introduced in 1998 were either removed or liberally abolished. Ultimately, in July 2005, the Malaysian Ringgit peg to the US dollar was abolished (Sheng 2009).
The previous paragraphs thus summarise the issues associated with financial contagion at various East Asian nations during the 1997 crisis. This summarises the argument of the vulnerability theorists that the crisis was as a result of panic dimension that triggered with the devaluation of Thai Baht and transmitted to Malaysia, Indonesia and Philippines.

4.6 Summing Up

In order to summarise the impact of crisis on various countries, data on certain relevant parameters is presented below:

<table>
<thead>
<tr>
<th>Country</th>
<th>Average duration of the crisis (No. of quarters) (1)</th>
<th>Average crisis depth (2)</th>
<th>Cumulative loss (3)</th>
<th>Minimum Real GDP Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>23</td>
<td>14.9</td>
<td>-33.2</td>
<td>-10.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>21</td>
<td>18.1</td>
<td>-50.7</td>
<td>-13.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>9</td>
<td>11.2</td>
<td>-13.8</td>
<td>-7.4</td>
</tr>
<tr>
<td>Philippines</td>
<td>6</td>
<td>2.7</td>
<td>-2.2</td>
<td>-0.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>NPL Ratio (3)</th>
<th>Estimated cost of Bank restructuring (USD Bn) (4)</th>
<th>Restructuring Cost as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>33.0</td>
<td>43.0</td>
<td>32.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>32.5</td>
<td>40.0</td>
<td>29.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>30.0</td>
<td>13.0</td>
<td>18.0</td>
</tr>
<tr>
<td>Philippines</td>
<td>20.0</td>
<td>3.0</td>
<td>4.0</td>
</tr>
</tbody>
</table>

(1) In number of quarters
(2) Peak-to-trough decline in GDP in per cent
(3) NPLs as a percent of total loans at the peak of the crisis
(4) Based on the estimated cost of the stock of debt issued in the restructuring process


The explanation presented so far indicate that neither the vulnerability theory nor the contagion theory alone can comprehensively account for the origins of 1997 crisis. But they collectively point out a common theme - role of regulatory institutions in providing adequate regulatory oversight in normal period and their ability to take swift corrective action in crisis period. The experience of Thailand and Indonesia demonstrate that governance and risk management failures stem from weak regulatory oversight, which lead to structural weaknesses in the financial sector. The Philippines experience indicates a relatively less
impact of the 1997 crisis in comparison to its neighboring countries (in view of reforms already undertaken pursuant to its debt crisis in mid-1980s). Indonesian and Malaysian experience contrast with each other in terms of the factors that influence swift regulatory action at the peak of the crisis. While a weak regulatory oversight was prevalent at both nations prior to the crisis (leading to domestic governance and risk management failures at banks), the response of Malaysian regulatory authorities was swift, subsequent to the crisis, with temporary capital controls amidst criticism from all quarters. On the other hand, Indonesian authorities succumbed to international financial support in view of political and institutional environment that made the Central Bank ill-equipped to handle the crisis. However existing academic literature state that the IMF guidance complicated the crisis resolution and bank restructuring process in Indonesia during the crisis.

How did bank governance and risk management failures contribute to the 1997 East Asian crisis? The Chapter addressed this through review of country experiences as indicated above, which indicated that governance and risk management failures were merely by-products of vulnerabilities posed by macro-economic, policy and institutional environment prior to the crisis. On one hand, country experiences indicated that a stable macro-economic environment led to policy mistakes on the part of regulators leading to governance and risk management failures at individual banks. This conclusion echoes the argument of vulnerability theorists who focus upon structural weaknesses in financial sector. On the other hand, country experiences also indicated that financial contagion leads to panic preventing the ability of regulatory institutions to formulate an effective response. This conclusion summarises the argument of contagion theorists. The chapter thus concludes that while bank governance dimension lies at the heart of the vulnerability argument, panic dimension constitutes the core of contagion argument. Both arguments can be synthesised if the role of central banks is brought into the forefront of discussion as they not only play a key role in thwarting the macro-economic forces (that provide perverse incentives to bank governance) but also provide appropriate institutional response to deal with financial contagion. The synthesis therefore leads to the conclusion that regulatory reforms aimed at strengthening the governance of domestic institutions represent an inevitable next step once a country experiences the crisis. The nature of these reforms, and the manner in which local banks responded to them, therefore, is covered in the subsequent chapters.
5) Regulatory Reforms Post 1997 Crisis

This chapter attempts to address the second research sub-question - *During the post-crisis period, what regulatory reforms were introduced to strengthen governance and risk management systems at local banks?* As observed in the previous Chapter, the 1997 crisis underscored the need for strengthening the East Asian regulatory institutions in order to enhance their oversight on aspects relating to bank governance, competition, transparency and disclosures, as well as improving social safety nets. The crisis also exposed the pertinent need for upgrading supervisory skills of central banks including development of early warning systems to encourage market participants to better deal with market volatility and financial panic on their own (Amador 2009). The East Asian crisis thus gathered international attention to the formulation of policy-making best practices that are relevant for reforming regulatory institutions in developing countries (Walter 2008).

A new “Compendium of Standards” (COS), comprising the international best practice guidance for financial sector regulatory authorities, was therefore finalised by the Financial Stability Forum (FSF) in the aftermath of the East Asian crisis. FSF was founded in 1999 by the G7 finance ministers and central bank governors to bring together – a) national authorities responsible for financial stability in significant international financial centres, namely treasuries, central banks, and supervisory agencies; b) sector-specific international groupings of regulators and supervisors engaged in developing standards and codes of good practice; c) international financial institutions charged with surveillance of domestic and international financial systems and monitoring and fostering implementation of standard; d) committees of central bank experts concerned with market infrastructure and functioning (FSF 2001). The COS comprises standards in 12 key policy areas designated by the FSB for sound financial systems. In many cases, COS amounted to general principles rather than detailed prescription, but sometimes these are supplemented by additional documents specifying in more detail their practical application and methodologies for assessment of compliance. Apart from enhancing the macroeconomic policy framework and data transparency as well as strengthening the institutional and market infrastructure, COS also focused on bringing about improvements in financial regulation and

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5 Subsequent to the global financial crisis, in November 2008, the Leaders of the G20 countries called for a larger membership of the FSF and for strengthening its effectiveness in addressing vulnerabilities and developing and implementing strong regulatory, supervisory and other policies in the interest of financial stability. After the April 2009 London Summit, the expanded FSF was renamed as the Financial Stability Board (FSB).
supervisory practices. The review of the post-crisis East Asian experience is therefore expected to provide useful insights on the manner in which the international best practice guidance was leveraged upon in bringing about the regulatory reforms in East Asia.

There were several academic studies in the past examining the perspectives of regulatory reforms in general and in connection with East Asian crisis in particular (see for instance, Shirai 2001, Barth, Caprio and Levine 2002, Jayasuriya 2005, Walter 2008, Nam and Lum 2006, Alexander et al 2006). The studies, however, focused on what Jayasuriya (2005) summarised as the transition of the East Asian regulatory model from developmental state (wherein there existed a “relational, discretionary approach to regulation”) towards neo-liberal regulatory state as conceptualised under the COS (where the regulators adopted a more "arms' length, non-discretionary approach") (Walter 2008 p 1). Walter however considered that the concept of neo-liberal regulatory state is based on a “naïve idea” that the creation of independent regulatory agencies (which apply international best practices representing the new consensus in Western policymaking and academic circles) is necessary and sufficient to achieve financial stability. In his view, therefore, the overall process of bringing about regulatory reforms in compliance with principles contained in the COS is “one of complex adaptation, not simple adoption” (Walter 2008, p. 3).

This chapter, therefore, goes beyond reviewing the compliance of East Asian regulators to the COS as undertaken in the previous studies. It attempts, through interview fieldwork findings and inputs from secondary sources, to bring out the institutional issues associated with the implementation of regulatory reforms. The chapter is organised in the following manner. It begins with the review of changes in the regulatory philosophy of East Asian nations subsequent to the 1997 crisis. An overview of regulatory efforts in bringing about changes in bank ownership structures is provided thereafter. The chapter further deals with enhanced role of monitoring agents (such as depositors, investors, and external auditors) in promoting market discipline. A specific discussion on aspects of financial innovation is presented towards the end of the chapter. The chapter concludes by stating that the East Asian experience represents a further enhancement to the COS as it reckons, apart from the international best practices contained in COS, certain region-specific nuances based on the learnings from the 1997 crisis.

**5.1 A New Regulatory Philosophy**

The new regulatory consensus built up, through the COS was that the key policy agencies should be independent of political influence and staffed by technocrats implementing strict,
transparent rules. While there were cross-country variations in implementation approach, fieldwork interviews broadly indicated a paradigm shift in regulatory philosophy in providing a more active oversight on domestic financial institutions. The regulatory oversight was observed to be exercised by adopting a three-pronged approach aimed at improving domestic bank governance. The cross-country commonalities and contrasting experiences in implementing the same are therefore provided in the following paragraphs.

a) Participative Guidance-based Approach to Regulation

An important aspect, observed during the fieldwork, was the shift in the approach followed by regulators for handling regulatory policy formulation and implementation, subsequent to 1997 crisis. The new approach was one which is characterised by identifying areas of financial regulation from international best practices, implementing the same in domestic context through industry consultation and providing guidance to the industry for achieving compliance thereto. International best practices forming part of the COS, therefore, were widely used for formulating various regulations by local central banks (in areas such as asset classification norms, prudential provisioning, capital adequacy, and good governance norms (relating to board independence, risk oversight and conflict of interest management)) thereby giving message to the industry on the need to strengthen governance standards. Consultant 1 from Indonesia had summarised the way the regulatory approach had an impact on governance frameworks stating that:

“The central bank pushed it and the banks took the lead therefrom. I think there is a lag effect in all these measures but they did happen eventually. As a result of this, banks have over a period of time worked on their internal mechanisms around balancesheet management, liquidity management, asset management, reporting procedures around these areas and mechanisms for checking these reports. Banks that survived through the crisis and underwent restructuring understood that this is the only choice they have – to take the lead for improved governance from the regulator and work on it for their own good.”

In order to ensure that local circumstances are considered before implementing international best practices, regulators adopted a stakeholder-participation approach while formulating regulations and provided industry-guidance support while implementing them. However, during the course of fieldwork interviews, a subtle difference in the manner of implementing this participative guidance-based approach was observed between Malaysia and Indonesia. In Malaysia, the spirit of the regulatory-approach continued to be market-friendly and there were specific instances quoted by local banks on how regulators could be convinced, about
hardships in implementation of regulations, by providing appropriate rationale. On the other hand, in the case of Indonesia while the stakeholder-consultation approach was articulated by the regulator explicitly, case-study banks indicated diplomatic skills of the regulator, in convincing industry participants, while communicating its restrictive stance on certain aspects. These differences in the country-contexts are explained in the following paragraphs.

The nature of regulatory approach adopted was articulated in the Financial Sector Master Plans (FSMP) prepared by the respective regulators in the aftermath of the 1997 crisis. For instance, the FSMP (2001 p. no 40) of the BNM (Malaysia) announced its shift from a "regulator knows best" approach to a "supervised market approach". BNM (Malaysia) stated explicitly that "this will create an environment for innovation and creativity to be further encouraged. Market forces, rather than regulations will play an increasingly important role in determining the future landscape of domestic competition". In keeping its statement, the BNM largely focused, subsequent to the crisis, on greater supervision of market integrity with minimal regulation imposed on business decisions. Similarly, the Master Plan for Indonesian banking system prepared by BI (Indonesia) (termed as the Indonesian Banking Architecture (IBA) released in 2004) categorically stated that it "expects to have in place an effective system for formulation of banking policy within the next two years that provides for stakeholder participation in the policy making process". While the FSMP of BNM (Malaysia) indicated a higher scope for influence of domestic market participants on regulatory policy, the Indonesian plan expected larger stakeholder participation (not just the domestic market forces) considering the severity of crisis it underwent in comparison to Malaysia. However, the common theme across both plans is the emphatic assertion of regulator in assuming a responsible prudential stewardship, post the crisis with support from industry.

The perception of industry participation and the nature of regulatory guidance in the context of Malaysia are explained by the Bank Official 5 at Bank Ringgit (Malaysia) in the context of a regulation relating to proprietary trading business. The regulation requires that if a bank is advising a particular company, then it cannot engage in proprietary trade with respect to such company’s scrips. In the words of Bank Official 5:

"We told the regulator that we can’t comply with the regulation, as you are effectively saying, we cannot do proprietary business. Because most of the banks in Malaysia don’t have prop trade and therefore this regulation may not impact them. Their boards have not given the liberty to them to do proprietary trading. We said if you do that across the industry, it also defeats the purpose of having a Chinese wall. The Chinese Walls are there to facilitate business and what proprietary desk is doing and what the corporate advisory is doing are two distinct things. So if you say now,
that the moment the banks provide advisory services, they can’t do the prop business, you might have to just do away with the concept of Chinese wall. When we explained this position to the regulators, they bought the idea”.

The experience, on one hand, indicated the receptiveness of Malaysian regulators resulted in a regulation that was conductive for market players. But on the other hand, it has also thrown up subtle issues relating to the manner in which the regulator needs to avoid the problem of being captured by the industry. In this context it is apt to quote Consultant 1 from Malaysia, who tried to address this issue broadly, while accepting the associated challenges:

“The regulator’s stance here is very clear – conformance is not the same as performance. So you are required not only to comply in letter but in spirit as well. How do you measure that? It is quite debatable”.

However, in the context of Indonesia, the fieldwork interview revealed a slightly contrasting experience as narrated by Official 2 from Bank Rupiah (Indonesia). He mentioned that BI (Indonesia) adopts a diplomatic approach when it wants to convince industry participants on its intention to adopt a restrictive stance. For instance, the Bank Official 2 stated that, when BI (Indonesia) is not comfortable with any application made by their bank for launch of a new product, it “adopts an interesting strategy - they will not directly reject any new proposal of business put forward to them by us. They will rather say that we should do THIS instead of THAT. They call it as advising rather than rejecting”.

The above experiences indicate subtle differences in the formulation of regulatory guidelines and the way regulators convince, or get convinced by, the industry with regard to their implementation. However, in all countries visited for the field work, a commonality observed across regulatory approaches was in the area of risk-focused and enhanced supervisory and enforcement stance, post the crisis. The details are explained in the subsequent section.

b) Enhanced Risk-focused Approach to Supervision

As observed during the course of fieldwork, the participative guidance-based regulatory framework was observed to be largely supplemented with enhanced risk-focused supervisory approach in East Asian nations. The rationale for this appears to be the recognition that regulation and supervision are two independent tools that must go hand-in-hand in order to exercise a holistic oversight on the industry. If the supervisory arm of regulator adopts an intrusive stance by undertaking a transaction-level scrutiny, the participatory stance of regulator comes into question and will not find favor with industry players as a credible
implementation strategy. On the other hand, if the supervision is weak, then the regulatory oversight will not be effective for achieving the desired results. Supervision therefore should be risk-focused, focusing on key risks faced by banks rather than on transaction-level compliance, and thereby giving credence to the participative approach adopted while formulating the regulation.

The focus on risk-focused supervision as a supplementary tool for regulatory oversight seems to have stemmed from the Basel II regulations, as noticed during the fieldwork interviews. For instance, in the context of Malaysia, Consultant 1 stated:

"In the context of conventional banking, there was a lot of push by the central bank to take the Basel II pillar 2 and pillar 3 also very seriously. So through the tool of supervisory assessment, the aspects of risk management, disclosures, and transparency will all get rapt attention under the governance framework”

BSP (Philippines) was similarly motivated by Basel II guidance as it categorically stated that this deliberate shift in the supervisory focus towards a risk-based approach subsequent to the crisis was intended “to enhance the banks’ ability to identify and manage risks rather than merely identify violations of regulations” (Amador 2009, p.289). To quote the words of Philippines Bank Official:

“...In terms of the Basel principles, Philippines regulators are very clear from 1997 that local banks and regulator themselves follow best practices. The risk-based approach has therefore been articulated in regulations and is very evident in the examination process.”

Accordingly, the BSP’s risk-focused approach laid down emphasis on the measurement of banks’ risk exposures and on risk management, instead of mainly concentrating on financial audit and compliance review. BSP is now interviewing back officers at banks on their comfort about collaterals offered by borrowers. Earlier, instead of discussing the same with back-officers directly, inspecting officials used to go by paper-documentation and merely box-tick the availability of collateral. The shift in the supervisory approach is also acknowledged by the industry as explained by International Expert 1 at Philippines who works with banks on structuring financial transactions. She stated that while working at banks she now spends considerable time in deliberating “how regulators would perceive a particular piece of collateral, before actually suggesting the same to be obtained by the bank”. The supervisory approach, according to her, therefore resulted in consciousness amongst banks that they
need to obtain valid collateral, and to demonstrate its effectiveness, when there is a supervisory inquiry.

Apart from supervisory focus, enforcement stance of regulator also underwent paradigm shift in years subsequent to the crisis, particularly in Thailand and Indonesia. Prior to the crisis, as observed in the previous chapter, the enforcement action by regulators was found to be weak. In the course of fieldwork, it was observed that this weak pre-crisis supervisory stance had in fact resulted in occasional instances of corrupt practices, even at banks, while implementing restructuring packages during the crisis. For instance, Investment Banker 1 at Thailand recollected that during the crisis in 1997, “BOT (Thailand) had to send in separate teams to individual banks to ensure that the restructuring programme is in the interest of depositors and borrowers and not for bank officials personally.” He contrasted this with the supervisory stance of BOT (Thailand) adopted post the crisis, which required banks to rely not just on the reputation, but also on assessment of adequate collateral, while lending to a borrower. He stated that, subsequent to the crisis:

“On an exceptional basis, if banks were to lend to borrowers when not relying on the collateral, BOT examines whether such decisions are alright from a prudential perspective. So, over a period of time this has created awareness amongst the banks that BOT is closely supervising them”.

Similarly, in Indonesia, the enforcement track record of BI (Indonesia) was found to have improved, post the crisis. “Enforcement used to be a big joke during pre-1997 times, but now it is not”, says the International Expert 1 from Indonesia explaining the change in the enforcement stance of BI, which had “moved a long way forward – that is now they have freed themselves from the control of government to their own control”. This fact is further corroborated by BI official who remarked in a lighter tone that currently, “Bank officials are really scared about BI”, as he recollected his personal experiences of utilisation of supervisory authority to put errant officials behind bars in certain previous episodes. Philippines Bank official shared similar insight but in a slightly moderate manner. He stated that, given the stiff supervisory and enforcement stance, the regulator and the regulated “may not like each other all the time, but they all work together when the banking industry is required to be strengthened.”

As explained above, the common shift in the regulatory philosophy post the crisis was to ensure that the regulatory function should be supplemented with supervision of banks undertaken in an enhanced and risk-focused manner. This had provided flexibility to the
regulator to guide the industry through regulations and identify the risks through supervision without intruding into their business decisions, unless in areas that warranted from a financial stability perspective. Further, enforcement actions post the crisis was stringent, in order to send out the message of a balanced regulator who could guide the industry and assess risks, but at the same time, who would not tolerate attempts of non-compliance by industry participants. The impact of these initiatives could be summarised in the words of Consultant 1 from Malaysia, who stated that “naturally when the issue is taken seriously by the regulators and the government, the compliance will pick up and people will like to take the next steps”.

c) Co-operative Regional-focused Approach for Capacity-building

In order to address the capacity building issues that could possibly arise from the demands of balancing between a participative guidance-based regulatory approach and an enhanced risk-focused supervisory approach, a number of regional initiatives have been taken by the Asian region (of which Thailand, Indonesia, Malaysia and Philippines – the focus countries of this research project – form a critical lot) in the aftermath of 1997 crisis. The initiatives are broadly related to - enhanced interactions amongst central banks through regional forums, regional financing arrangements, dedicated regional policy-making bodies for certain aspects of financial regulation, and training initiatives aimed at improving central banking skills in the region.

The East Asian crisis resulted in strengthening of the then existing regional central bank networking forums (such as South-East Asian Central Banks (SEACEN) association, Executives’ Meetings of East Asia and Pacific (EMEAP) central banks) and the birth of new initiatives (such as the ASEAN Central Bankers Forum (ACBF) in 1997) for strengthening the co-operation amongst regional central banks (Valdepeñas, Joyosumarto and Mooy 2007). The forums are used for exchange of views among members on issues such as conduct of monetary policy and general economic and financial matters, as well as to foster a common ASEAN position in its relation with other regional and international institutions. The meetings of these forums are organised regularly and encourage members to bear in mind that in pursuing individual country objectives, it was important not to lose sight of the wider implications of policy actions on other member countries in the region. Through these forums, members were encouraged to share experiences which helped anticipate economic and financial risks and exchange technical assistance and policy advice when appropriate, on possible solutions to economic and social issues (Capanelli 2011).
Apart from regional interactions, initiatives of co-operation were also undertaken in the Asian region to enhance regional financing arrangements. The impetus for such arrangements came from the experience of East Asian nations during the crisis as they were subjected to several conditionalities by international financial institutions (such as the IMF) before extending the bailout assistance. In fact, International Expert 1 in Indonesia subtly remarked that he “can bet that none of the East Asian Nations would ever want to go back to IMF again”. The intention was also evident with the early repayment of IMF loan by both Thailand and Indonesia respectively in 2002 and 2006 much earlier than what was envisaged at the time of extension of loan by the IMF. The tensions surrounding policy conditions attached to IMF rescue packages and the launch of monetary integration in Europe led many East Asian countries accumulate foreign exchange reserves themselves as a backstop cushion for dealing with crisis episodes by focusing on regional financial cooperation (Amyx 2005).

In this context, it is apt to refer to Aizenman, Chinn and Ito (2008) who observed that the emerging economies, in particular the East Asian nations, are holding voluminous foreign exchange reserves, since the 1997 crisis. They argued that such an accumulation helped these economies pursue both a higher level of exchange rate stability and a higher weighted average of the other two central bank policy goals (viz., interest rate stability and openness of economy) through active foreign exchange interventions. Similarly, Obstfeld, Shambaugh and Taylor (2008) argued that reserve accumulation, as a key tool for managing domestic financial instability, is used by central banks to protect the domestic banking sector, and domestic credit markets more broadly, while limiting external currency depreciation. Further, there are other studies (see Sharma 2003, Sheng 2009, Capanelli 2011) in the context of regional financial co-operation that highlight the regional flavour to the reserve accumulation process by referring to the Chiang Mai Initiative (CMI) and the Asian Bond Market Initiative (ABMI). CMI represents a plan to construct a network of bilateral currency, through currency swap arrangements, for enabling a country beset by a speculative attack to draw on reserves of other nations. The ABMI is focused on the vulnerability exposed by East Asian crisis - absence of stable long-term debt markets - which resulted in movement of savings deposited in local banks to international financial centers and then back into the region as short-term foreign currency loans, resulting in maturity and currency mis-matches. Through the creation of Asian Bond Funds, the ABMI aimed at facilitating development of efficient and liquid debt markets in Asia and better utilisation of “Asian savings for Asian investments” (Sheng 2009, p.313).
A further notable development in the regional focus approach to financial regulation was the constitution of regional policy-making bodies in line with international bodies to facilitate better regional dissemination of international standards. The Asia Pacific Group on Money Laundering (APGML) is an illustrative initiative to demonstrate this development. Established in 1997, APGML is an autonomous and collaborative international organisation, which aims to coordinate technical assistance and training in the Asia/Pacific region on the global Anti Money Laundering (AML)/Combating Financing of Terrorism (CFT) standards. It helps member countries to participate in, and co-operate with, the international anti-money laundering network and with other regional anti-money laundering groups. APGML also assists its members to establish coordinated domestic systems for reporting and investigating suspicious transaction reports. In all these activities, APGML actively uses global Financial Action Task Force (FATF) 40 Recommendations on AML as guiding principles.

Apart from regional interaction, financing arrangements and policy-making guidance in key regulatory areas, the aspect of regional co-operation also extended to an important area of capacity building of regional central banks. Notable initiatives in this regard include the SEACEN Training centre, IMF Singapore Regional Training Institute and APEC Financial Regulators Training Initiative – that have increased their research and training focus in recent times to provide relevant expertise to regional regulatory authorities. The IMF-Singapore regional Training Institute was set up in 1998 to enhance the economic and policy-making capacity of the member countries of the IMF in the Asia Pacific region by providing high quality training in the formulation and implementation of macroeconomic and financial policies to officials of Asian-Pacific countries. The Asia Pacific Economic Co-operation (APEC) Financial Regulators’ Training Initiative was established in 1998 to provide sustainable, efficient and cost effective training programmes, for junior and mid-level staff and potential instructors of bank supervisors and securities regulators, in priority technical areas where courses are not otherwise available in the region. During recent times, SEACEN centre had undertaken several region-specific research studies on aspects of central banking interest - such as review of asset-price bubbles, household indebtedness, capital flows and liquidity management, all with a regional focus. The findings of these studies as well as other relevant inputs are shared amongst its member central banks through periodic training programmes.

The previous paragraphs therefore indicated that the paradigm shift in the regulatory philosophy was to assume prudential stewardship and oversight of the industry through balanced mix of regulation and supervision, and to take steps for enhancing the skill-sets relevant to both these functions. The subsequent paragraphs will provide an overview of the
ground-level impact of this paradigm shift concerning ownership structures and market discipline - the two key components in the context of evaluation of bank governance.

5.2 Changes in Ownership Structures

As explained earlier, across the East Asian nations, the priority areas of regulatory reforms were outlined by regulators through their respective FSMPs. A key priority area that was common across all Master Plans was the need for bringing about changes in ownership structures of local banks, in order to improve the performance and thereby enhance the standards of governance and internal risk management systems. For instance, the Indonesian Banking Architecture unveiled by Bank Indonesia (FSMP-IBA 2004) also targeted bank ownership restructuring with a focus “on improving good corporate governance, quality of risk management and the operational capability (including risk management), which will strengthen bank operational performance”. A similar emphasis on ownership restructuring was laid down by other regulators (in Thailand and Malaysia as well) through a combination of measures, chiefly by the sale of ownership interests in troubled banks to other domestic banks (through mergers) and/or to foreign banking groups/investors. The national banking systems were thus expected to achieve significant gains in internal strength in a phase-wise manner conducive to the objective of regulatory reforms.

Interview findings revealed the impact of this regulatory focus on ownership restructuring in two different aspects: first, the consolidation of local banking sector, which gave birth to stronger entities through merger of weak banks and closure of insolvent banks; and, second, the entry of foreign banks into domestic banking landscape, either through increasing their strategic stakes or through other modes of presence (branch or a subsidiary). The following paragraphs deal with the country-level variations associated with each of these factors:

a) Consolidation of the Local Banking Sector

This section provides the directions given by the regulator in respective FSMPs for consolidation of the local banking sector, and the consequential experience of the case study banks in each of the countries visited for fieldwork.

Malaysia: The Malaysian FSMP (2001) attempted to build a financial sector that would be resilient in facing future challenges. In order to achieve this, the FSMP underscored the need for robust financial institutions that would have strong risk management capabilities and
credit skills as well as sound corporate governance. Recollecting the objectives of FSMP, Consultant 1 from Malaysia therefore stated:

“The Malaysian FSMP in 2005 recognised, quite pointedly, that the size of Malaysian banks was very small at that point in time and with that size they may not compete with overseas banks. That resulted in the idea of consolidation of banks after the crisis”.

The experience of the case study Bank Ringgit could be used to explain the impact of this regulatory focus on consolidation of banking industry. This bank transformed into a universal banking group over a period of time with a series of mergers. These were orchestrated by BNM (Malaysia), as a part of consolidation programme for domestic banks announced in the aftermath of the 1997 crisis. Pursuant to the steps taken by the regulator, Bank Ringgit (Malaysia) undertook a series of mergers (including a biggest merger in Malaysia's banking history) during early 2000s, which finally resulted in the increased size and stature of the new Ringgit Group. The increased size is reflected as strength of the Bank Ringgit (Malaysia) during the course of interview with Bank Official 1, who categorically stated, “In today's scenario, the size does matter. Size allows us to absorb certain losses – it allows us to make certain genuine mistakes – without killing ourselves – you see the Citibank case?” The response resonates with the objective of FSMP that explicitly recognised that the “competitive environment in the banking sector is likely to result in few large, broad based institutions with differentiated strategies based on their strengths and market niches” (FSMP 2001 p. 28).

**Indonesia:** The Indonesian Banking Architecture (FSMP-IBA 2004) outlined the direction and structure of banking system in the next five to ten years. Similar to the roadmap laid down by regulator in Malaysia, the Indonesian plan envisaged that the eventual direction of the local banking system is to have two or three internationally active banks, three to five locally important players and 30 to 50 banks which are focused players in chosen business segments. The various ways in which the consolidation process was sought to be achieved by the regulator include - addition of fresh capital either from existing shareholders or new investors (including foreign entities), secondary issue of shares in the capital market and mergers of weak banks with stronger ones.

The impact of this regulatory emphasis on consolidation can be evaluated using the experience of case study Bank Rupiah (Indonesia). Similar to Bank Ringgit (Malaysia), even Bank Rupiah (Indonesia) undertook series of mergers in the aftermath of the crisis in 1997 as a part of the restructuring programme orchestrated by the regulator. During 1997-98, Bank
Rupiah (Indonesia) was brought under the supervision of the IBRA as a taken-over bank. In 1999, the Government of Indonesia, through IBRA, recapitalised Bank Rupiah (Indonesia) and, within the same year, another taken-over bank was merged with Bank Rupiah as part of the IBRA restructuring programme. In 2000, Bank Rupiah (Indonesia) completed a series of mergers with eight other taken-over banks. As part of this overall merger package, Bank Rupiah (Indonesia) received a second recapitalisation from the government. The impact of the consolidation programme and recapitalisation initiatives on internal processes is explained by Indonesia Bank Official 2 in the following words:

“The IBRA advised all member banks which were categorised as BTOs to submit a statement like "Goodwill Intention" to indicate the time period in which the banks are required to repay the capital support back to IBRA. The Statement acted as a kind of commitment to improve upon the internal processes of the Bank to become more efficient and repay the dues to the IBRA.”

The Official explained that pursuant to the goodwill intention, the repayment of support extended by IBRA was made by the two largest support recipients (one of which being Bank Rupiah (Indonesia)) by 1999. Bank Rupiah repaid the dues in cash and through recapitalisation programme orchestrated by the regulator, which involved foreign stakeholder participation, the details of which are covered in the subsequent section.

**Thailand:** The first FSMP of Thailand entails re-engineering of financial institutions landscape by promoting competency driven consolidation and modification of relevant prudential guidelines. In doing so, the Plan had forecasted the long-term outlook and needs of Thailand’s real economic sector by coming out with market-based prescriptions. These prescriptions sought to address root causes of deficiencies in financial sector such as dominance of bank lending, fragmented industry structure, and convoluted supervisory framework that undermined player performance (Montreevat and Rajan 2003). “This is done with a view to provide the direction for development of the industry” noted Rating Analyst 2 from Thailand, “as a part of the plan, the BOT (Thailand) has closed the finance companies and also allowed entry of foreign banks into the banking industry.” Subsequent to the crisis, the regulator had suspended the operations of as many as 58 finance companies (representing the 50% of the players in the industry prior to the crisis) between June and August 1997 (Hewison 2001). Further, the Thailand FSMP Handbook released by BOT (Thailand) in 2004 laid down specific recommendations, which emphasise the need to reform the financial infrastructure - specifically the rationalisation of roles and types of financial institutions and implementation of sustainable means to improve access to financial services for the urban and rural retail segment, and to “prevent regulatory arbitrage” (FSMP 2004, p.
The arbitrage was earlier caused by the existence of numerous types of licenses that competed for the same customer group based on artificial differences in costs of funding and regulatory restrictions. Thailand’s FSMP therefore was not restricted to consolidation of banks, but also applied similar exercises across various players in the industry in order to lessen the regulatory arbitrage. Further, through a proposal mooted in the FSMP – the regulator permitted financial conglomerates, to have only one type of deposit-taking financial institution within their group. This proposal was also aimed at prevention of regulatory arbitrage, support industry consolidation and to better capitalise on the economy of scale of the financial conglomerate. It is interesting to note that, before this proposal, financial conglomerates in Thailand were allowed to have a commercial bank, finance company and international banking facilities that were all taking public deposits.

Philippines: In the area of consolidation of banking industry, the approach of BSP (Philippines) is slightly different in comparison with its stated stance prior to the crisis. In the pre-crisis era, BSP (Philippines) urged the creation of more banks, encouraging competition. However, the Asian crisis eventually forced the central bank BSP to facilitate creation of more financially stable banks, starting the waves of mergers and acquisitions. Bank Peso (Philippines) is a case in point to demonstrate the impact of these regulatory developments. Between 2001 and 2009, the Bank had completed five mergers or acquisitions of other banks. “This has led to larger and merged banks. On one hand, it is good because the banks are stronger, but on the other, only a few banks now control the financial sector. But it is better to have stronger banks” says the Professor 2 from Philippines commenting upon the approach of BSP to consolidation of industry.

While the consolidation of banking sector thus paved the way for rationalisation of number of players in the industry (and indirectly address the competitive forces, which influence governance arrangements), the entry of foreign players into the domestic banking landscape had directly influenced standards of governance during the period subsequent to the crisis. The details in this context are covered in the following section.

b) Entry of Foreign Players

A review of country experiences in allowing the entry of foreign players in domestic banking system offered mixed insights. Countries that were largest recipients of IMF rescue package (such as Thailand and Indonesia) opened up their domestic banking systems to the foreign players, pursuant to conditionalities associated with the rescue package. On the other hand,
the role of foreign players in local banking systems of Philippines (which received a relatively smaller IMF rescue package) and Malaysia (which imposed capital controls during 1998 and was therefore denied the IMF support) was quite different. Each of these aspects is explained in the following paragraphs.

The case study banks in Malaysia and the Philippines indicated that governance arrangements were developed largely through domestic institutions themselves and not through entry of foreign players. Malaysia had opted to maintain restrictions on foreign participation in the banking sector. Further, given the significance of private domestic banks compared to foreign banks, mainly arising out of a favourable policy by the government to encourage domestic consolidations and privatisations, it was difficult for foreign banks to expand their presence in Malaysia. The case study Bank Ringgit (Malaysia) thus is an example of domestic universal bank which has grown in size and stature through its local mergers and acquisitions and without any support from a foreign player. The approach of the Philippines with regard to the entry of foreign banks is different from Malaysia, but the outcome was however not successful. In 2000, the General Bank Law passed in the Philippines also created a conductive environment for foreign players as it allowed a foreign bank to acquire up to 100 percent of the voting stock of only one bank, with the aim of instituting global standards in the domestic banking system. “But I am not sure as to very great strategic investments from foreign participants” says the Philippines Bank Official from Bank Peso (Philippines) indicating that the impact of the law is not much visible on the ground. At Bank Peso (Philippines), the largest shareholder still continues to be a local family owned conglomerate. In recent times, a major international financial institution however made a strategic infusion by exercising its option to convert its convertible loan into the common stock in 2007. But the proportion of the same in the overall capital of the Bank Peso (Philippines) is not very substantial.

The case study banks in Thailand and Indonesia however highlighted the role of foreign players in their efforts to strengthen the domestic banking systems. Pursuant to its grand master plan, Indonesia had eased restrictions on foreign participation in existing banks and removed obstacles that prevented the opening of foreign branches. In Thailand, limits on foreign shareholding of banks were lifted, albeit for a limited duration of time, after which foreign held equity must fall to 49 per cent. The Master Plan of Thailand served as the basis for the changing ownership structures at banks, which resulted in better standards of governance at banks. International Expert 1 from Indonesia summarises the impact of these
developments (albeit in the context of Indonesia, but can be applied to Thailand as well) in the following words:

“These two were to me are the fundamental reasons for improved governance of banks – You have a central bank which is much more independent and you have foreign bank presence which is much more serious.”

The impact of the foreign players on the case study banks is witnessed in two different contexts. Firstly, foreign bank entry enhanced the quality of human capital in the domestic banking system by importing high-skilled personnel to work in the local environment as well as through knowledge spillovers to local employees. Secondly, foreign bank entry helped these nations by way of reductions in cost structures through improvements in operational efficiency and introduction of new technologies and banking products. The skilled human resources and the improved technology systems are expected to strengthen the internal control environment at the case study banks – a key component of governance framework – through better assessment of risks and improved decision-making process. In this context, the experience of Indonesian Bank Rupiah and Thailand Bank Baht as revealed during the course of interviews is summarised in following paragraphs.

**Bank Rupiah (Indonesia):** Subsequent to the 1997 crisis, a new banking law was introduced in Indonesia in November 1998, which relaxed the restrictions on foreign participation in the country’s domestic banking industry. The key elements of that law included permitting foreign banks to take over Indonesian banks and investing in unlisted and listed banks, subject to certain restrictions. Pursuant to this law, in 2003, shareholding in Bank Rupiah (Indonesia) was acquired by a Foreign Institutional Investor from Singapore (THI Singapore) which took a majority controlling stake. The foreign stakeholder presence began a transformational change of existing business model and strategy through a 180-day programme. A key component of this programme is the flexibility given by THI Singapore to the existing management in implementing the transformation programme. Indonesian Bank Official 2 recollected that THI Singapore, though appointed an external professional President Director as the CEO, had restricted its role “right from day one, in the area of strategy formulation”. This can be further explained in his words:

“THI Singapore ensured execution responsibility is rested with the executive management, who are not connected with strategic owners but are professional directors. This is achieved, wherever required, by appointing new Directors and a few senior managers to fill key positions within the company who were taken from a
major international bank. Therefore lot of our policies has got the resemblance to those at that international bank”.

Expert officials from an international bank were appointed in key positions such as Risk Director and Chief Economist thereby giving impetus to strengthen risk management initiatives and to improve governance standards at Bank Rupiah (Indonesia).

Bank Baht (Thailand): In Thailand, an important regulatory reform in the Financial Sector Master Plan, following the 1997 crisis, was to allow 100 per cent foreign ownership of the domestic financial institutions for a ten year period. After that, foreign banks were not allowed to take up additional equity unless they held less than 49 per cent of equity. The new regime allowed foreign players to have a bigger role in the Thai Financial System by establishing their presence in Thailand either as a branch or subsidiary. Pursuant to these regulations, Bank Baht (Thailand) went in for a strategic partnership through infusion of additional capital from a US based corporate (BB-SI Thailand), who specialised in the retail business. The impact of this strategic partnership as revealed during the course of interviews and from the material gathered from online interviews of the CEO of the Bank Baht is outlined in the following paragraphs.

Bank Official 1 from Bank Baht (Thailand), heading the risk management function (and is appointed to that role on behalf of BB-SI Thailand), began the interview discussions clearly articulating the role of the strategic partner in the Bank. In his words:

“We are here as partners to provide the risk management expertise, to provide the technology expertise, to provide the consumer finance expertise and mainly to provide management, CEO, best practices in HR, taxation and treasury management. So the finance head is also from the BB-SI (Thailand). So it is a Marriage of Convenience - I don’t know whether saying this is correct - but I used the term because, both parties gained from each other.”

The advantages to Bank Baht (Thailand) from this strategic partnership, in terms of technology efficiencies, process improvements and improved governance, could be further corroborated with additional insights in an interview (given by CEO of the Bank Baht gave to Asian Banker magazine in April 30, 2007, the transcript of which is available online) as follows:

“First and foremost is better data analytics. It becomes an analytics-backed decision making process versus a more experienced-based decision making process, that’s fundamental. The second aspect is more about operational efficiency - here is
another thing that I think the BB-SI (Thailand) really brings a lot of value to, which is essentially the lean approach to operational efficiency, and shortening the turnaround time of our delivery. The third one is using better analytics for risk management that is something the more developed banks are very strong at. As a developing bank, Bank Baht (Thailand) can benefit greatly from this, from a risk management perspective. Last but not least would be the corporate governance issues. Here, we’re talking about not just the letter of the law but more the spirit of the law issues which we are starting to introduce into the organisation, and setting up even stricter controls over compliance. These are the four main areas in which we will be building upon.”

The strategic partnership with BB-SI (Thailand) therefore resulted in Bank Baht (Thailand) undertaking a lot of work around building a better data warehouse, through which the bank can generate the information that it needs to make good decisions, and undertake propensity analysis to be able to target the right product streams/services to clients. Data analytics thus helped the Bank to be a more performance-oriented organisation. “In the past, without the added data, we wouldn’t exactly know what is profitable and what is not, and how we improve profitability in a particular customer sector or product stream”, explained the CEO reflecting the changes pursuant to the strategic partnership of Bank Baht (Thailand) with the BB-SI (Thailand).

As indicated in the beginning of this section, the FSMPs of each individual nation recognised that the stability of domestic financial system is achieved through successful financial institutions having strong fundamentals. While there were country-level variations, regulatory reforms for building sound financial institutions was undertaken by respective regulators through consolidation of domestic banking sector, and in certain countries by permitting the presence of foreign players into the domestic banking landscape. The experiences of case study banks, as revealed during the fieldwork, indicated that banking sector consolidation resulted in increased size, improved efficiency and performance, reduced competition and avoidance of regulatory arbitrage. The experiences of case study banks in Indonesia and Thailand further underscored the role of strategic foreign players in bringing key improvements in terms of – skilled human resources, better data analytics, improved technology leverage and process improvement. It can be thus observed in this section that the regulatory reforms orchestrated under the FSMPs resulted in an improved internal environment conductive to enhanced corporate governance. The next section therefore evaluates the impact of regulatory reforms on the external environment (representing the role of market discipline in influencing the bank governance framework).
5.3 Enhancing Market Discipline

Rochet (2008) stated that the market discipline can be conceptually categorised into two types when put to use by central banks – i) Direct market discipline, which aims at inducing market investors to influence the behavior of bank managers, and works as substitute for prudential regulation; and ii) Indirect market discipline, which aims at inducing market investors to monitor the behavior of bank managers, and works as complement to the prudential regulation. The existing academic literature and the thrust of the COS focuses largely on direct market discipline by reviewing the extent of influence the market investors tend to exercise on disciplining the banks. However, Rochet stated that the prudential regulation and market discipline should work more as complements than substitutes; one cannot work efficiently without the other. He states that, in the context of bank governance, an effective regulatory reform is the one which uses the indirect market discipline with an idea that it “provides new, objective information that can be used by supervisors not only to improve their control on problem banks but also to implement prompt corrective action (PCA) measures that limit forbearance” (Rochet 2008, p. 7-8). Regulatory reforms in East Asia for enhancing market discipline therefore focused on strengthening the external monitoring framework comprising depositors, investors and external auditors. This section therefore presents country level experiences and issues encountered in implementing these regulatory reforms.

a) Depositors

With the exception of Philippines, at the time of 1997 crisis, the other East Asian nations did not have explicit deposit insurance mechanisms. Further, as most depositors did not have necessary information or incentives, eventually the responsibility of monitoring and rescuing the banks fell squarely on the government or central banks. For instance, in Indonesia, failed private banks were generally absorbed by BI (Indonesia) and insolvent banks were allowed to remain in the system in recapitalised form or otherwise supported by BI. There were some instances (such as Bank Summa in early 1990s) where the insolvent bank was closed, but all depositors were compensated (Sato 2005). Such actions by government eventually resulted in implied assumption of depositors about the possible government support in the event of crisis. Backed with such implicit government support and lured by attractive interest rates, depositors did not really consider themselves as effective monitoring agents of bank governance prior to the crisis. “Bank Andromeda, a local bank, was offering deposit interest rates at 60% at the time of crisis. You can understand the hanky panky that can go behind
with such kind of interest rates” quips the Indonesia Bank Official 2 from Bank Rupiah explaining the situation at that point in time.

Post crisis, regulatory reform debate therefore was extended to the appropriate form of deposit insurance system considering the possible impact of deposit insurance on risk-taking behavior and the governance standards at banks. The interviews however, offered mixed findings in this context with variation of practices across crisis-affected countries. Countries such as Thailand, Indonesia and Malaysia chose explicit full-scale deposit insurance to protect depositors, immediately during the crisis. But the migration to an explicit limited deposit insurance scheme - which could reduce the risk-taking behavior of banks - is still underway. Further country experiences and the underlying contexts are narrated in the subsequent sections to illustrate this point.

Bank Official 2 from Bank Rupiah (Indonesia) stated that, during the period of crisis and the associated bank run phase, “the government initially tried to rectify the situation with partial guarantee and subsequently introduced the blanket guarantee. But this dual approach has not yielded the desired result”. Accordingly, Indonesia continued the blanket guarantee covering all deposits until 2005 when a new Indonesian Deposit Insurance Corporation (IDIC) became fully operational. The initial deposit insurance coverage upto USD 500,000 was expected to protect roughly 98.5% of all individual depositors. Given the significant state and foreign ownership of banks in the country, the prevalent wisdom was that the removal of blanket guarantee can cause abrupt shifts in deposits from private banks to state and foreign banks. Accordingly, it was initially decided to provide high levels of coverage for insured depositors, while continuing full blanket protection, for deposits of systemic banks. The plan was eventually to bring this amount to USD 100,000 by 2007, but with the global financial crisis in 2008, the coverage amount currently stands at USD 200,000 (Hamada 2011).

The experience of Thailand was similar to Indonesia with the introduction of new Deposit Insurance Agency regulation implemented in 2008. The deposit insurance initially began as a blanket guarantee of deposits extended during the wake of Asian crisis. This was gradually reduced to USD 1.58 million per depositor by August 2011 and the coverage currently stands at USD 30,000 from August 2012. The Bank of Thailand statistics indicate that even this amount covers 98% of the individual depositors and 40% of deposits in value (Tummanon 2011). Further, recognising the associated pitfalls and unwarranted effects on the risk-taking behavior of banks, the government had provided the insurance agency the right to demand
confidential information from financial institutions in cooperation with Bank of Thailand and other financial regulatory agencies.

Malaysia had taken advanced steps in the matter of deposit insurance, as unlike Indonesia and Thailand, systemic bank runs did not occur in Malaysia during the crisis. However, considering the flight to quality for depositors during the 1997 crisis, the Government had introduced a comprehensive blanket guarantee of deposits in 1998, which was finally withdrawn with the creation of Deposit Insurance Agency in 2005. Since then, the country embarked upon implementation of a differential premium insurance concept for Malaysian banks along the lines of that in Canada. It is widely believed by market participants that the decision to create a stand-alone deposit insurance agency for Malaysian Banks (PIBM) as a separate entity (however within the overall umbrella of BNM (Malaysia)) has impacted the banks risk management practices, at least theoretically. To explain this in the words of Rating Analyst 1 from Malaysia:

“PIBM will go and review the entities and interestingly there is lot of focus on the review of credit risk management practices at the banks by the PIBM. That review assessment could translate into differential deposit insurance premium. If that premium becomes costly, then there would be impact on the governance framework, as it would then require a re-look”.

Consultant 1 from Malaysia, however, shared an alternate practical perspective when he said, “Currently the differential in insurance premium is very minimal and is not huge enough driving factor for governance improvements at banks”.

The East Asian post crisis regulatory reforms thus found to be still in an evolutionary phase, though in the right direction, with respect to bringing about requisite impact on governance mechanisms through institution of appropriate deposit insurance framework in the respective countries.

b) Investors

With the development of local capital markets, participation of foreign players (in certain countries) and presence of fund managers and financial service providers - the awareness on the role of investors (strategic/institutional) in the bank governance framework has grown considerably since 1997 crisis. The participation of these investors in the expanded ownership of banks made banks realise an important aspect of governance dimension in their overall
functioning. Interview findings, however, reveal country-level variations in this context. Banks such as Bank Ringgit (Malaysia) and Bank Rupiah (Indonesia), which had institutional investors as substantial shareholders, cited major improvements through the presence of such investors. On the other hand, at banks like Bank Baht (Thailand) and Bank Peso (Philippines), where there is significant presence of family ownership, the presence of institutional investors is not observed significantly. However, Bank Baht (Thailand) boasts of the impact of the US strategic investor (BB-SI Thailand) for a lot of changes in operational and technological excellence in its day to day operations. Each of these experiences is explained in subsequent sections.

**Bank Ringgit (Malaysia):** The role of institutional investors in the Malaysian context was explained by Rating Analyst 1 stating that:

"From a stakeholder perspective, the Malaysian financial institutions moved away from a state where individuals used to hold banking groups to a situation where more institutional shareholders are holding banking groups now. Thus you will find most of the members of the board of banking groups to be either ex-bankers or representatives of institutional investors."

Moving towards the role of Employees Provident Fund (EPF) stake at banks, the Rating Analyst 1 further stated that:

"Typically corporate governance problems step up because there is one single individual group which is holding the stake and obviously that person can influence the decision making process within the bank. But the central bank since 1997 has moved in a direction to institutionalise the shareholding at banks. This has raised the governance standards at banks. For example, the Employees Provident Fund (EPF) and a large insurance company are holding stake in banks and therefore the tone at board meetings has undergone a change."

At Bank Ringgit (Malaysia), the shareholding pattern is reflective of this changing dynamics at Malaysian corporates where the provident and pension funds, the insurance funds and the unit trusts are emerging as big shareholders. The substantial shareholders at Bank Ringgit are Khazanah Nasional and Employee Provident Fund (who were holding 28.61% and 12.93% shareholding as per the Ringgit Group’s 2010 annual report). It was further

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6 Khazanah Nasional is the investment holding arm of the Government of Malaysia and is empowered as the Government’s strategic investor in new industries and markets established with an objective to promote economic growth. The official website of Khazanah (www.khazanah.com.my) indicates that it has investments in over 50 major companies, both in Malaysia and abroad, and is also the key agency mandated to drive shareholder value creation, efficiency gains and enhance corporate governance in companies controlled by the government, commonly known as Government-Linked Companies. In this respect, Khazanah’s role as an active strategic investor now involves driving and creating greater shareholder and strategic value. The first involved financial returns, the second, generally, in terms of enhancing capabilities.
presented by the Malaysian Minority Shareholders Watchdog Group (MSWG)\(^7\) the “Most Diverse Board” award as part of its Malaysian Corporate Governance Index Awards 2010.

**Bank Rupiah (Indonesia):** Bank Rupiah (Indonesia) cites similar experience with the presence of one key institutional investor – THI Singapore (a foreign institutional investor from Singapore). In June 2003, THI Singapore acquired 51% stake in Bank Rupiah (Indonesia). THI Singapore thus became a new shareholder of Bank Rupiah (Indonesia) leading to constitution of a new board and management team, though some of the existing management was retained as per IBRA regulations. For the initial days, the bank had put in place a 180-day strategic initiative, to enable Bank Rupiah (Indonesia) capitalise on its vast resources. Since then, Bank Rupiah (Indonesia) recorded structural improvements in its governance regime as disclosed in successive annual reports. “THI Singapore is very keen in ensuring that compliance culture is elevated to international standards and best practices” informed the Bank Official 2 at Bank Rupiah (Indonesia), while explaining changes the Bank witnessed since THI Singapore took the controlling stake. International Expert 1 also explained the impact of the presence of institutional shareholder on the governance framework at Bank Rupiah (Indonesia) in the following words:

> “By paper, Bank Rupiah might be a local bank, but strictly speaking it is an entity of THI Singapore and is a foreign bank. It happens to have a name that is given to it fifty years ago and that’s all local it has to itself. That makes a big difference. So apart from central bank independence when there is a presence of foreign and global banks, governance mechanisms are bound to improve in any way”.

The most visible external change as a part of this influence could be seen in enhanced disclosures in successive annual reports of Bank Rupiah (Indonesia). For instance, the section of the annual report dealing with steps taken by the bank to strengthen the implementation and control over good corporate governance (GCG) framework provides comprehensive overview of control environment at the bank.

**Bank Baht (Thailand):** The experience of Bank Baht (Thailand) sharply contrasts with that of Bank Ringgit (Malaysia) and Bank Rupiah (Indonesia) as it has three major shareholding groups - BB-SI Thailand (US-based strategic investor), local family conglomerate and independent shareholders. The interview discussions therefore focused on the role of family ownership having significant stake in the company, instead of institutional investors. The

\(^7\) The Minority Shareholder Watchdog Group (MSWG) was established as a government initiative in the year 2000 as part of a broader capital market framework to protect the interests of minority shareholders through shareholder activism.
Thailand Bank Official 1 (who was appointed as the risk management head by the BB-SI Thailand) provided a comprehensive explanation to this apprehension stating that:

“If you see how the family has managed the businesses, there is absolutely no cause of concern whatsoever. The family is very well known in the market. They own the local cement company, local TV channel. Both of them are independently extremely cash rich companies. They don’t require taking any cash or taking any loans from the banks. We don’t have any apprehensions at all. In fact, it is not that the family has liquidated their stake in the Bank. They diluted their stake, which means that the BB-SI Thailand came in with more capital into the Company. The family owners did not take the money back, they did not sell one cent of share. It is augmenting of the capital that they did. It is all professional and there is no interference of the family into the management – in terms of credit decisions, especially, there is no pressure, there are no major inter-company dealings. But normal business dealings, you have to have right?”

The conviction in the above statement is supported by the advantages that he and his colleagues as well as the external rating agency officials cited as having accrued to Bank Baht (Thailand) with the induction of the BB-SI Thailand as a strategic partner. In 2006, the family owners expressed their interest to leverage upon the expertise of the BB-SI Thailand since they have long term business interests with each other prior to the strategic infusion. According to the Thailand Bank Official 1, “While the systems improvement started at all banks way back immediately after 1997 crisis, what the BB-SI Thailand did to Bank Baht (Thailand) is to bring in more acceleration into the learning process with the introduction of more professionalism”. A similar remark was made by Thailand Bank Official 4 also in the following words:

“What we got from the strategic investment into the bank, is the reputation and brand of BB-SI Thailand. They are AAA rated. And together with their investment they have also brought in strong compliance and risk management culture which they were known for in the market”

The internal inputs were further corroborated during the course of discussion with rating agency officials. Rating analyst interviewed for this project in Thailand considered that the presence of strategic shareholder is strong support factor for Bank Baht (Thailand) from a governance standpoint while arriving at the rating. The support was more in terms of capital infusion, which helped the bank in addressing concerns of recapitalisation, which was prevalent couple of years back. The capital support put Bank Baht (Thailand) in a strong position as the bank was able to utilise the capital for making some key acquisitions as well bringing in place some key improvements in its operations itself. Rating Analyst 1 from Thailand explained this further:
“These improvements were expected to yield results to Bank Baht (Thailand) from a medium term to long term prospect. Thus while we consider the majority shareholder support as a clear strength while rating the financial institution, the rationale is not the name of the stakeholder but the financial and operational support that they expect to bring on to the board by virtue of their shareholding, which really counts in the rating process”.

Interview findings had thus thrown light on the role played by various investors - strategic and institutional - in promoting internal standards of governance, at case study banks.

c) External Auditors

Apart from the depositors, institutional investors and independent directors, external auditors represent the important monitoring agents in the overall corporate governance framework. While internal auditors form part of the internal control function, the role of external auditor was debated much in the East Asian context, as observed in Chapter 4. Providing the version of external auditors in the debate, Consultant 3 from Malaysia stated:

“When you talk about external auditors, there is always this debate as to whether they are watch dogs or hound dogs and the auditors generally argue that they present an overall picture and not necessarily the specifics related to wrong doings or potential wrong doings”.

However, the regulatory requirements are now very clear that external auditors play a crucial role in the governance framework of Asian banks from two different standpoints. Firstly, there is heightened awareness and the resulting reliance on the work of auditors amongst independent directors. Secondly, regulatory authorities have cast various responsibilities on external auditors, post the crisis, enlarging the scope of work of auditors. Consultant 3 from Malaysia explained this as follows:

“We observe that the directors who would have taken typically backseat earlier are nowadays becoming more critical. They are concerned with non-compliance matters as they don’t want to compromise their control frameworks and are looking upto auditors in these matters. These matters are being dealt with seriously through the audit committees”.

The remarks outline the need for auditors who are vigilant in their approach so as to meet the requirements of the audit committees and independent directors. The scope of authority outlined for the audit committee of Bank Baht (Thailand) illustrates this point further. As per the board resolution adopted in 2004 (reproduced in the 2010 annual report), the bank’s
audit committee had also been entrusted with following responsibilities (inter alia, along with other regular responsibilities), which are not quite common in the context of corporate governance practices generally.

- To question bank executives, internal auditors and the bank’s auditors about important business risk levels and measures taken to control or reduce such risk;

- To examine and evaluate the auditing plans of the internal auditors and the bank’s auditors;

- To coordinate with the internal auditors and the bank’s auditors to review auditing procedures in order to eliminate redundancies and reduce expenses;

- To coordinate with the internal auditors and the bank’s auditors to examine the adequacy of the bank’s internal auditing mechanisms and identify any major weaknesses;

The resolution of Bank Baht (Thailand) therefore indicate that, apart from auditing the truth and fairness of the financial statements, the auditors also come under intense pressure to keep the audit committee and other board members updated on propriety aspects as well.

The situation was observed to be similar even in Indonesia during the discussions with Consultant 2 from Indonesia, who commented as follows:

"The requirement of the BI is to have the internal audit framework to be assessed every three years by the independent assessor. The normal regulatory standards for internal audit issued by Institute of Internal Auditors require such assessments carried out internally and externally for every five years. However, BI has gone a step ahead since 1999 and issued guidelines which are relatively stricter."

This is an important provision in the BI (Indonesia) regulation that cast responsibility on the statutory auditor to assess the adequacy of the internal audit function. The regulations issued by BI (Indonesia) concerning internal audit also requires the independence of internal audit function from business, apart from mandatory external auditor review. As per this regulation, the report on internal audit is required to be submitted to the BI (Indonesia). While the appointment of the auditor is by the management, the final report goes to the BI (Indonesia). "Sometimes, BI (Indonesia) also call us and discuss some of the findings", the
Consultant 2 from Indonesia added further indicating the seriousness with which this report is pursued by the local banking regulator.

As explained above, interview findings and surveys of academic literature reveal that there is a conscious effort on the part of regulators to enhance the role of monitoring agents in the governance framework of banks, post the 1997 crisis. However, the efforts are varied across the class of monitoring agents. The role of depositors as monitoring agents, to a certain extent is undermined and is still evolutionary nature with the institution of new deposit insurance arrangements in recent times. The findings, however, offer some evidence regarding the positive developments brought in by the institutional/strategic investors. Finally, external auditors were observed to be subjected to regulatory pressure to act as a key monitoring agent in the overall governance framework.

After examining the shift in the regulatory philosophy, and its influence on ownership structures and monitoring agents, the next section reviews an important influence of regulatory reforms on a key aspect of bank risk management - financial innovation.

5.4 Financial Innovation and New Financial Products

New financial products offer a wide range of investment opportunities with lower transaction costs. They provide investors with the opportunity to transfer or trade, the risk components they do not want, to other parties that are willing to accept them at the agreed cost. Provided this mechanism is used correctly, it reduces the overall cost of risk bearing and increases returns, thereby improving market efficiency (Das 2006). Choices of funding also increase with the evolution of certain new financial products (viz., securitised products allows loan originators to transform illiquid assets in the form of bank loans into cash market or more liquid tradable assets). Certain other innovative financial products provide opportunities for diversification of portfolio at lower costs (viz., collaterised debt obligations (CDO) and index futures). Financial innovations therefore find favor with banks, which are in constant search for increased yields, by transforming their business models from “traditional retail-banking” to “wholesale originate-to-distribute” models (Sheng 2009, p. 330).

As new financial products largely operate in an over-the-counter (OTC) mechanism, it is very important to thoroughly understand their structure and characteristics, including their embedded risks both during normal situations and in more volatile market conditions. OTC products are difficult to appropriately price and value considering their inherent complexity.
and underlying assumptions (Mihaljek et al 2010). Even the credit rating agencies have difficulties in assessing risks of such OTC instruments and rely on mathematical or quantitative models for claims emerging from cash-flows of a portfolio of correlated assets. Many of these mathematical models make simplifying assumptions that when one sells or buys new financial products in the market, there is only one doing so, undermining the herd mentality implicit in operation of such products. Models can be imperfect thereby producing inaccurate calculations of expected losses (Persaud 2007). The losses to investors eventually endanger financial stability of the system as a whole. Thus, while new financial products help to deepen domestic financial markets and allocate capital more efficiently, the dispersion of risks increases the financial system’s and the economy’s vulnerability to shocks (Dewati 2012).

Considering the risks associated with financial innovation and new financial products, the East Asian regulators realised that the level of available central banks in the region had not yet attained, in the words of Reddy (2011, p. 148), “synchronisation between regulators’ skills and sophistication in the financial markets”. Such a discomfort of regulators is understandable considering the fact that they recovered from the ashes of the crisis only in early part of 2000s, and the regulatory skills to handle financial sophistication is difficult to develop in short run. The approach adopted by East Asian regulators in handling financial innovation and new financial products is therefore covered in this section.

a) Experience of East Asian Nations and Case Study Banks

Central banks in East Asian nations had put in place, post the 1997 crisis, stringent prudential regulations on issuance, marketing, distribution and risk management of new financial products. The reasons for such stringent stance appear to be regulatory concerns about the ability of individual banks to launch new products and their capability in assessing and understanding the underlying risks involved - particularly in the context of new products dealing with foreign exchange. This is reflected in the very low percentage share of selected Asian market turnover compared to the global market turnover of foreign exchange products. In April 2010, the percentage share of Asian economies such as Thailand, Malaysia, Indonesia and Philippines were much less than 0.5%. These shares were very small compared to the 37% market share turnover of the United Kingdom and 18% of the United States (BIS 2010).
In this context, Consultant 1 from Indonesia mentioned, "subsequent to the crisis, the general understanding in the industry and the message that they got from the regulator is not to take up anything new that they do not fully understand. The regulatory influence also enabled them to stick to core banking issues". The message from the regulator was also acknowledged by banks considering their own experiences of handling foreign exchange liquidity during the years prior to 1997. In the words of Investment Banker 1 from Thailand:

"The banks have become more matured this time, especially when they have been approached by the foreign investment banks for investments into the CDO and other exotic products. But this time the banks have been smart enough either in asking more questions and if they were not comfortable with what they have been presented with, by restricting their investments to small amounts or staying away from the same".

The responses of interviewees mentioned above, however, represent only a partial story. There are certain alternative perspectives thrown up by certain industry experts on this subject. This section therefore deals with the experiences of case-study banks and the alternative views of the industry experts with regard to regulatory restrictions on financial innovation.

**Bank Peso (Philippines):** Of all visited countries, BSP (Philippines) appears to have approached the new product approval process through a licensing route. BSP provided regulatory guidelines listing down the products that can be offered by banks under various categories of licenses. The Bank Official from Bank Peso (Philippines) explained this as under:

"For instance, offering of structured derivative products, is not permitted for every bank unless they hold a specific license in this regard. Even in respect of foreign exchange products, there are certain basic products which the banks can offer under one category of license, but if you have to offer, advanced foreign exchange products, there is separate license requirement. These are defined by law. If you go beyond boundaries, you are required to keep the regulator updated".

This explanation provides insight into the way in which new products are regulated for Philippines’ banks. This approach of graded regulatory approval sharply contrasts with the approach adopted by regulator in Malaysia, which lays down emphasis on stringent internal risk management mechanisms of individual banks while dealing with new financial products.

**Bank Ringgit (Malaysia):** The regulatory philosophy of BNM towards financial innovation had been summarised in a single phrase often used in the course of interviews by case study
bank officials - "what is not forbidden is allowed’. During the interviews, the impact of this regulatory philosophy on local banks had been touched upon. It had been revealed that Malaysian banks were approached by foreign investment banks for investing into new complex investment products. And there were instances where some banks have made significant investments considering the pitch made by foreign banks based on the AAA rating of such products. The Rating Analyst 1 from Malaysia stated in this context:

"At that point in time, if you have not invested in these products, people might have thought that you are not savvy. And there are technologically savvy institutions in Malaysia which could have picked up investments into these products. But in Malaysia, the regulatory conservatism had prevented the local institutions from investing in these products”.

More specifically, it was explained during the interviews that the BNM regulations require new financial products to be cleared from internal teams - compliance, legal as well as respective product owners. “All new products must be signed off by the internal audit that we understand the product and are able to audit the product in future” says the Bank Official 4 from Bank Ringgit (Malaysia). Consequently, the Bank Ringgit (Malaysia) adopted a rigorous product approval process through which the top management (in particular, the risk management department and the internal audit department) needs to collectively establish the operational readiness of the product before it gets launched. And to the question on the number of new products launched during 2009, the Malaysian Bank Official 1 smilingly replied:

“NIL. It is because of the market volatility and other external conditions. There are small product variants in terms of structure that could have happened here and there but if you are asking about absolute new and only new products – the answer is on an average we would have roughly – two to three products that are brand new products. I think this is the same case for every bank”.

The interview findings in Malaysia thus revealed the attempts of BNM to move away from micro-managing to entrusting more responsibility to individual banks. However, the overall tone of regulator was one that of restrictive stance requiring rigorous internal approval process before launch of such products. The result of restrictive stance was also evident in the limited new product offering by Bank Ringgit (Malaysia) as observed during the course of interviews. This experience was observed to be different from the experience of Bank Baht (Thailand), which had limited exposure to new financial products during the 2007 global financial crisis.
Bank Baht (Thailand): In line with BOT (Thailand) regulations, Bank Baht (Thailand) had adopted a new product introduction (NPI) process. As per the NPI, once the product concept is ready and approved by the teams involved in its preparation, it will be sent for approval by the support groups including risk, compliance, systems etc. Once these teams also review and clear the product, it will be finally approved by the operational risk management committee (ORMC). This process is applicable equally to the entirely new products that are introduced first time into the market by the bank or to the significant enhancements that will be made to the existing products. Despite this rigorous process, the Bank Official 3 from Bank Baht (Thailand) accepted the need to strengthen the existing set up for approving new products. In his words:

“This is something we must confess. We did have some investments made. We have certain risk management systems in place but they need to be better enough. There were some investments which we wrote off subsequently. In fact, these have been sold to us by some very reputed investment banks. And the entire events happened just overnight, that even the best of the risk management models would not have predicted what is in store for the financial institutions”.

It was however clarified by the Bank Official that the losses were not substantial. This situation was further corroborated by Investment Banker 1, who outlined that:

“Post the crisis in 1997, the tendency of the Thai banks is more towards becoming real banks and not just stay as investment banks, investing in the debt paper and profiting from market movements. It does not mean that they do not invest in such products, but in small proportions as a means to understand and appreciate the working of the products and not as means to seriously improve their profits.”

Compared to the limited loss experience of Thailand banks, the derivative deals concerning the Indonesian banks made media news also. The regulatory philosophy of BI (Indonesia) and the context in which the derivative deal undertaken by Bank Rupiah (Indonesia) made media news is therefore covered in the subsequent section.

Bank Rupiah (Indonesia): In Indonesia, after internal clearance, the product proposals are also required to be taken to BI (Indonesia)’s approval. Every year, BI (Indonesia) requires the banks to submit their annual plans in advance with regard to the new product offering. Bank Rupiah official explained this further by stating - “we have to plan in advance. We cannot think today to offer and tomorrow go into market. We have a yearly programme to work on meticulously before we take to BI (Indonesia).” The impact of this advanced
planning of new product offering pursuant to regulatory guidelines is explained further by
Bank Official 2 at Indonesia as follows:

“Initially BI (Indonesia) allowed some investments in derivative products - not all, but some. But gradually BI (Indonesia) regulations made it restrictive for such investments. Internally, the focus at Bank Rupiah is also quite different. 50-55% of the business is mass market, micro lending and consumer lending through its franchisee. The focus of the bank therefore is not on such innovative products even before the crisis.”

Despite the restrictive environment prevalent in Indonesia, some banks went ahead and also made investments in these products, resulting in certain business causalities. Bank Rupiah (Indonesia) is one among them. During 2008, Bank Rupiah (Indonesia) faced a legal dispute in regard to a derivative deal with a local corporate. It was however clarified by the Indonesian Bank Official 2 that:

“The problem is more to do with the legal system in the country, which always tried to protect the interests of borrowers. And courts also did not really understand the implications of the derivative deal. Their first assessment is that they are considered as gambling transactions”

To sum up the discussion on new financial products, it is therefore widely agreed that there must be proper controls and regulations in place to prevent the products from being used for speculation purposes. The previous paragraphs thus outlined the differences in the country-level experiences which highlighted various concerns of East Asian regulators relating to approval requirements, internal risk management, new product approval process, integration of new financial products with overall business plans of the bank and the need to have a robust legal environment surrounding such product offering. The concerns finally led to the restrictive stance adopted by regulators and limited product offering by the industry.

b) Alternate Views

During the course of interviews, alternative views were articulated in the context of improving regulations to foster markets development and protect consumers from excessive risks embedded in new financial products. The objective of regulations concerning new financial products is that the bank depositors as well as bank creditors are not exposed to undue risks. In this sense, prudential regulations must be implemented to ensure that banks do not run into a situation of illiquidity or insolvency that can potentially trigger a banking sector collapse and an economic crisis. However, “to say that the governance improvements
and regulatory developments have reached a level to insulate the country from any crisis is a bit of stretch” says the International Expert 1 from Indonesia. While he acknowledged that there are certainly doses of improvements, including regulatory developments and awareness in the context of financial innovation, they may not be over-emphasised. He states that there is an over-emphasis of role of regulators in East Asian nations during the episode of recent global crisis. His argument is that the regulatory developments hindered the progress of financial innovation in these nations as he explains:

“The banking guys here are the most profitable guys in the region - they have the best margins, they are well-capitalised. But to what extent this benefit is getting translated into the benefits for the real sector. If you see, the loan to deposit ratio is one of the lowest in the region. The regulatory environment has been encouraging the Net Interest Margin (NIM) of say 6 basis points. Now if that is the support these banks receive from regulators, then where is the point for them to innovate? On the other hand, see the guys like the Citibank, they have been bleeding to just produce the next one percent NIM. So the question of innovation comes for them. The actual testimony therefore for the regulation is to what extent it can incubate and allow the co-existence of innovation and rather not curtail the same”.

An explanation to address the concerns outlined by the International Expert is however covered in the subsequent chapter, which deals with internal institutional nuances associated with regulatory reforms at case study banks.

5.5 Summing Up

This chapter addressed the second research sub-question – “During the post-crisis period, what regulatory reforms were introduced to strengthen governance and risk management systems at local banks?” The Chapter introduced the international focus, subsequent to 1997 crisis, in bringing about reforms to financial sector regulations through the COS formulated by FSF in 1999. However, using interview findings and review of secondary sources the Chapter argued that there were certain distinctive approaches adopted by East Asian regulators, subsequent to the crisis, beyond the principles contained in COS. Firstly, regulatory reforms initially focused on introspection of their own institutional weaknesses by regulators, for gaining credibility rather than directly attempting a regulation leading to a burdensome regime on individual banks. Secondly, regulatory stance was to supplement formal regulations with prudential supervision and indirect market discipline requirements aimed at “monitoring” the governance arrangements at banks. Thirdly, until the regulatory skill-sets are enhanced to a comfortable extent, regulators have ensured that market participants are not exposed to new financial products. Thus the regulatory reform process in East Asian
region went beyond the scope of the principles contained in COS. It has taken into account issues of regional co-operation, appropriate mix between regulation, supervision and market discipline and assessment of regulatory comfort in permitting the free use of new financial products and promoting financial innovation. Thus the chapter adequately covered the changes in the external environment as a part of the regulatory reform process. The challenges associated with the internal environment at individual case study banks and the manner in which the regulatory dealt with them is therefore covered in the subsequent chapter.
This chapter addresses the third research sub-question - *What considerations motivated individual banks to adapt their internal governance mechanisms to reforms proposed by policy makers?* As the previous chapter evaluated the shift in the regulatory philosophy and reforms that influenced banks’ external environment (in the area of ownership structures and monitoring framework), the focus of this chapter is to evaluate internal considerations at individual case study banks in pursuing regulatory reforms. The chapter therefore attempts to analyse challenges faced by regulators at ground level from banks and the manner in which they have addressed, while implementing regulatory reforms. The chapter primarily draws from findings of fieldwork interviews and is supplemented, wherever necessary, with inputs from secondary sources.

The contextual setting to this chapter could be made in the words of Sheng (2009, p.16) who argued that the regulatory reform process should reckon the following perspectives of governance:

> “Governance stems from three factors: law, the enforcement process and ultimately individual will. Laws and processes are all theory until put into practice. What ultimately determines whether policies are implemented or pushed through is the individual will. In all matters of governance, the best policies are useless if the leader is unwilling to push unpleasant reforms through huge obstacles, including the entrenched bureaucracy.”

Interview findings however reveal that regulatory reforms received a warm reception at individual case study banks (especially in Thailand and Indonesia) as the 1997 crisis experience flashed at the back of their mind at all times. In the words of Investment Banker 2 from Thailand:

> “The crisis in Thailand is very much deep and has touched the life of the people directly. Many lives were ruined during the 1997 crisis. So the Thailand people have learnt the lessons the hard way and therefore the experiences always flash back of their mind.”

During the course of interviews, it was further observed that the aforementioned observation was applicable not just in the case of Thailand, but across all East Asian nations, though in varying intensities. The chapter therefore argues that the lessons from the East Asian crisis shaped up certain perspectives at banks conductive to governance and risk management improvements.
expected by regulatory authorities. In particular, the chapter outlines the motivations of individual banks in pursuing governance and risk management reforms in three different areas – professionalising the board of directors, enhancing the risk management focus and bringing about a culture of compliance.

As the board of directors set the tone of any governance and risk management reforms, the chapter begins with initiatives at case study banks to professionalise their respective boards. In particular, the chapter focuses upon - fit and proper requirements of directors, their continuing education and the information systems put in place at individual banks to support board decision-making process. The chapter thereafter reviews steps taken by the professional board in bringing about the risk management focus at individual banks. The risk management improvements, especially in the area of credit and liquidity risks -risks that were at the heart of the 1997 crisis - were evaluated in a greater detail subsequently. Recognising that the initiatives of risk management would succeed only if employees comply with internal processes as well as external regulations, and investors are presented with transparent disclosures, the case study banks focused on improving their compliance culture. The initiatives in this area are therefore reviewed towards end of this chapter.

6.1 Professionalising the Board

A key aspect pursued during the post-crisis reforms across the East Asian region was professionalising the board of directors at local banks. As observed in the previous chapter, each of the East Asian regulators issued several regulations for bringing about changes in ownership structures and enhancing the role of monitoring agents. However, the central piece of the governance reforms continued to be – board of directors – as they set the tone and direct the strategic course of action at the banks (Nam and Lum 2006). Accordingly, the key aspects that underscore the functioning of effective boards at individual case study banks were reviewed in this section against the backdrop of lesson learnt from the 1997 crisis. The section begins with a review of regulatory measures put in place for ensuring that the directors are competent for their respective jobs. The role of independent directors in the governance framework is covered subsequently. The ongoing support to board decision-making process through independent control groups and information systems is reviewed thereafter.
a) Competency of Directors at Board Level

An important aspect of board decision-making is that the directors comprising it should be, for all practical purposes, competent to handle such a responsible position. They are expected to be free from pressures of political or local business interests that could pose conflict with their role as bank directors. When directors are free of any conflicting interests they can act in a professional manner while taking all strategic decisions. In order to ensure that directors are competent, regulatory reforms focused on - fit and proper criteria for directors, and their training requirements. Each of these aspects is explained in the following paragraphs.

The regulatory requirements at each of the individual nations stipulated the “fit and proper” criteria for appointment of directors, which requires that individuals, appointed as directors of banks, not only are free from conflicted interests, but also demonstrate certain level of expertise in the area of risk management. During the course of interviews it was observed that the extent of application of “fit and proper” requirements varied from country to country. In Malaysia, for instance, the BNM (Malaysia) guidelines look into the fit and proper criteria of directors even at holding companies, which own a bank, as outlined by the Rating Analyst 1 from Malaysia with a practical example:

“For instance, if you look into the RHB group and if you look at when it was a part of the UBG group, there were times when BNM has direct influence on the holding company directors”

The fit and proper requirement also echoed a regulatory expectation that the directors are required to discharge several strategic responsibilities in a diligent manner. Such a regulatory expectation posed certain practical challenges as explained by International Expert 1 from Indonesia:

“It is very hard to find out new Commissioners in Indonesia. Given that there are restrictions in terms of the persons qualified for the top level posting, there are only handfuls of people who can handle that responsibility. There are around 125 banks. Each bank requires 4 to 5 Commissioners. So where are we going to find out these 600 guys is the question. And we want them all to be competent. That’s the real problem”.

However, he explained that with the kind of influx of people into the Indonesian industry from abroad and the kind of people movement that the industry has seen in recent times, the situation was slowly improving, though it requires much further work.
In Philippines, Malaysia and Thailand, banks had to a certain extent attempted to address this problem with the support of the central bank and accreditation programmes. For instance, there is a lot of push by BNM to educate all directors in aspects related to governance, through the Financial Institutions Directors Education (FIDE) programme. Commenting upon the scope of the FIDE programme structure, the Consultant 1 from Malaysia remarks:

“I have not seen this type of programme for directors anywhere else in the world. It is not unique. But it is quite different from other locations in the sense that the initiative is completely driven by the Central Bank in Malaysia. Like, they have put lot of funding into it; they used a lot of moral suasion to make directors use most of the courses. So they decided to go about it very seriously”.

He recollected one programme where the participant directors interacted with the chairman of the Deposit Insurance Corporation of Malaysia. The chairman was recruited to his present post from the Canadian Deposit Insurance Corporation for implementing the differential premium insurance concept in Malaysia in lines of the deposit insurance scheme operating in Canada. Consultant 1 further explained that he received feedback from various director-attendees of FIDE programmes that such interactive sessions enhanced the outcome of FIDE programme. In Thailand, similar steps have been taken through the establishment of the Institute of Directors (IOD) wherein the BOT, SEC and Securities Exchange of Thailand (SET) were key contributors. The programmes offered by IOD are also aimed at enhancing awareness levels of directors through specific focus given to regulatory responsibilities in the course content. SEC requirements in Philippines similarly require all directors to attend professional courses. Accordingly, there are various accredited certification programmes aimed at imparting requisite knowledge to directors in Philippines offered by institutes such as - Institute of Corporate Directors and the Asian Institute of Management.

Interview findings therefore revealed a two-pronged approach for ensuring that the directors are competent for their respective roles - appointment of “fit and proper” directors and ensuring that they are regularly trained in regard to their regulatory responsibilities. The requirements relatively easier for implementation in case of executive directors who are in continuous touch with the business requirements. The challenges however arise from applying these requirements to independent directors, who are non-executives. In respect of independent directors therefore a greater focus is extended during interviews and the findings are summarised in the following paragraphs.
b) Independent Directors

Independent directors constitute the central pillar in the governance framework at East Asian banks primarily after the Asian crisis in 1997. A significant regulatory reform therefore in all four countries is the application of “fit and proper” requirements even to the appointment of independent directors on the board. Interview findings - from the perspective of expected role of independent directors, regulatory requirements regarding number of independent directors, their attendance at committee meetings, and their training requirements as well as periodic interactive forums - are therefore covered in following paragraphs.

Expected role of independent directors: During the course of fieldwork, there was a debate on the role of independent directors, as there were diverse perspectives thrown by various interviewees. International Expert 1 from Indonesia opened up the debate by stating that:

“The executives at banks may not always like those many Independent Commissioners controlling them. They will always wonder when the responsibility is cast on them personally why they need to get an explicit clearance from an outsider. Infact they have the tendency to think that they own the bank and they are capable to run them on their own”.

The viewpoint was supported by Malaysian Bank Official 1 who stated:

“It is also not correct to leave everything to board. If that is the case, then where is the need of executive management? Because, at the end of the day, the executives are paid full-time, whereas the board members meet only once in a month for oversight purposes”

The debate was critical as the regulatory requirements in Malaysia and Indonesia were stringent in the sense that many key decisions were reserved for a full-board, which should comprise independent directors only. The only executive represented in the board is the chief executive. Therefore, the debate is relevant in understanding the board dynamics where the independent directors, who come and meet only at periodic intervals, are expected to discharge significant responsibilities including the strategy formulation. Consultant 1 from Malaysia however offered an alternative perspective on leveraging upon knowledge requirements of independent directors while formulating bank strategy. In his words:

“When you are talking about strategy, risk management and way forward, you don’t require that much of knowledge about the specifics. In fact, it is the other way
round. Your eyes are blinked with that detail if you are in the possession of that information, which bars you from seeing the broader perspective, independently, which is what the board is supposed to do.”

While the debate is not without merits, the regulatory guidelines finally acknowledged the requirements of having independent directors appointed on the board and even stipulated the minimum number of such members.

**Number of independent directors:** Regulatory requirements in regard to minimum number of independent directors serving on the board differed from country to country and their compliance from case study bank to bank. In Indonesia, independent commissioners should make up at least 30% of the total number of board members. The requirement in Malaysia is that at least one-third or at least two members of the board must be independent directors. In Thailand, the composition of the board should have at least three independent directors or at least one-quarter of the board should be independent directors. In Philippines at least 20% of directors or a minimum of two, should be independent. The impact of these regulatory requirements on independent directorship is analysed through a review of disclosures in 2010 annual reports of case-study banks. It was observed during the review that the higher number of independent directors was associated with the presence of strategic/institutional shareholders (viz., Bank Rupiah (Indonesia) and Bank Ringgit (Malaysia)). However, where the bank had a significant controlling shareholding with a family conglomerate (such as in the case of Bank Baht (Thailand) and Bank Peso (Philippines)), the extent of independent directors appears to be just meeting regulatory requirements.

**Board/committee meetings:** Apart from the number of directors, the frequency of the board/committee meetings demanding their participation also indicates the improvements in the governance framework (at least in form). In line with the international best practices, at all case study banks, it is observed that independent directors discharge their responsibility through mandatory committees that include Audit, Risk and Nomination & Remuneration Committees. Further, independent directors are also required to participate in board meetings that happen at shorter intervals than a quarter which is considered the usual norm. For instance, the board meetings at Bank Ringgit (Malaysia), Bank Peso (Philippines) and Bank Baht (Thailand) are more frequent - usually once in a month. At Bank Baht (Thailand), these meetings are generally at pre-defined dates (fourth Wednesday of the month). In addition, at Bank Baht (Thailand) non-executive directors also meet among themselves at regular intervals in order to freely discuss problems affecting the bank and possible solutions.
Reckoning the frequency of meetings at Bank Ringgit (Malaysia), Bank Official 4 stated as follows:

“We are quite very fortunate to have a very active Audit Committee. In fact, the Audit Committee meets once in every three weeks. If you go through the Annual Report and see the number of Audit Committee meetings, you will find supporting data to this statement. This is quite unusual when compared with other banks in Malaysia. I have met a senior official from another banking group and he is so surprised that our audit committee meets once in every three weeks. At his institution, the committee meets only once in a quarter.”

The intense requirements to attend periodic meetings therefore raise the question of the awareness of independent directors about the business nuances for them to discharge their role effectively. The initiatives taken by case study banks in this regard are provided in following paragraphs.

**Training of independent directors:** Apart from the external support from the regulator, fieldwork interviews revealed that independent directors at case study banks receive induction training and periodic inputs through continuing business awareness programmes. In this context, the practices followed at two case-study banks (Bank Ringgit (Malaysia) and Bank Baht (Thailand)) are presented in following paragraphs.

**Bank Ringgit (Malaysia):** Periodic training is recognised as a key requirement at the bank for enhancing the independent directors’ knowledge on latest developments and key challenges in the financial sector. New independent directors at Bank Ringgit are therefore introduced to the group’s business via an induction programme organised by the management. Heads of divisions brief new independent directors on their respective areas of responsibility to equip the later with the background knowledge of the Group as well as to provide them with a platform to establish initial interaction with management. Apart from internal training programmes, new independent directors are also encouraged to attend training programmes as well as conferences and seminars, which are organised internally and by external parties. The company secretary maintains a comprehensive list of all such available programmes and sends the same to all directors at the beginning of the financial year. Further the board of the bank on a quarterly basis also reviews the training topics relevant for the director development programmes.

**Bank Baht (Thailand):** The bank sponsors its independent directors for periodic programmes organised by the Thailand’s Institute of Directors (IOD). New directors further
attend a lecture that provides an overview on the business of the bank and other relevant information. The corporate secretarial department at Bank Baht, on a quarterly basis, circulates the list of seminars and training courses that are relevant to directors in discharging their roles and responsibilities and other additional duties assigned to them as chairman of committees.

**Interactions of independent directors:** Attendance at training programmes, however, may constitute only a box-ticking approach for enhancing the awareness of independent directors about their roles and responsibilities, as there is no identified measure to link the quality of the board decision-making to the efficacy of the training the directors are subjected to. During the course of interviews with bank officials the focus was therefore extended to other avenues of interaction available to independent directors to enhance their decision-making frameworks. The findings revealed different approaches followed at various case study banks in this context. For instance, at Bank Baht (Thailand), the nomination and remuneration committee of the bank had organised a separate meeting amongst the non-executive directors during 2010, without the presence or participation of executive directors, for discussing the matters of mutual interest. On the other hand, at Bank Ringgit (Malaysia) independent directors attend the group’s annual management dialogue - where the senior management brainstorm and discuss the current trends and future direction of the Group.

While there was a debate on the expected role of independent directors and variations in terms of number of independent directors, interviews with case study banks indicated the enhanced role of independent directors in the governance framework at their respective banks, post the crisis. Industry experts consider such an enhanced role of independent directors helps banks to get an outsider perspective on bank strategy. On the other hand, the bank officials consider that leaving everything to the independent directors may undermine the role of executive management. However, considering the regulatory environment, the consensus achieved appears to be enabling the independent directors to discharge their role through participation in board meetings (where the chief executive can interact with independent directors) and committee meetings (where the executive management updates them on internal developments). In addition the periodic interactions amongst independent directors and the regular training arrangements ensure that the independent directors are capable of discharging their responsibilities diligently.
c) Information Systems for Board Decision-making Process

During the interviews, bank officials indicated the existence of information systems to support the board decision making process, especially considering that the board meetings are attended largely by independent directors. Therefore the focus of case study banks is to institute information systems which ensure independent directors are kept up-to-date about what is happening in the bank. The context is set by Professor 1 from Philippines, who explained the quality expected out of an internal information system in the following words:

“I think the first and foremost important step is to make internal managers and officials accessible to external directors through periodic conversations; thereafter comes the quality of accessibility to information and documents - through which the external directors are facilitated to gain insights into the company functioning”

Consultant 3 from Malaysia, however, offered the following word of caution in the context of information systems needed for independent directors:

“It is not that the non-executive directors do not know about the business. In fact, all the directors go through the screening of the Bank Negara Malaysia before they are taken on to the board. And there are certain pre-requisites which they need to meet before they are approved. For instance, Bank Negara requires certain amount of past banking experience and knowledge for the director designates. Similarly, for Islamic banking institutions the director designates also need to demonstrate that they have knowledge of Shariah principles as well. So it is not that non-executive directors are totally lacking practical exposure, they do come with a stature and expertise, post the screening process”.

The viewpoint is further endorsed by the Professor 3 from Philippines, who also stated, “The conscious independent directors always find a process themselves to get updated on the critical issues and understand the working of the company”. However, since the typical board meetings happen only periodically, the independent directors cannot get into the detail ground level issues relevant for their functioning solely relying on their experience and expertise at all times. It is at this juncture, the role of independent control functions (such as risk management, internal audit, compliance) comes into play, which helps the independent directors in receiving the relevant information for their functioning, in an organised manner. Malaysian Bank Official 1 at Bank Ringgit explained how his organisation perceives the information requirements of Independent Directors, as under:

“In discharge of their responsibilities and to offer their perspectives on any policy level issue, the board is always free to ask for whatever information it wants to have and can get it. And it is the question of trust that they need to place on the
executives and rely on the integrity of the executive management. In my case, I keep informing the board members as to areas that require their attention with a rationale as to why they need to look into that area and I will clearly outline in the presentations that made to the board.”

Thailand Bank Official 1 from Bank Baht adds further dimension to this perspective by stating:

“A lot of times, it is a push by the management, through the independent directors into the Board. And in my view, any Board will never say no for any discussion, if it is rightly communicated to it. It is for the management therefore to decide what extent of engagement they want to have with their board”.

However, as the independent control functions represent the executive management of the bank, the reliance of independent directors on the information provided by such functions opens up two specific issues. Firstly, it raises the question about the nature and extent of reliance to be placed by independent directors on information from executive management. Secondly, it also underscores the nature and extent of independence required for the control functions to ensure that the information produced by them is reliable for decision making of independent directors.

Commenting on the question relating to reliance being placed by independent directors, Consultant 1 from Indonesia shared an interesting perspective as follows:

“Being an independent director one should have at the minimum the knowledge of the industry and a sound understanding of the nuances within which their bank operates. Instead of the same, relying on the internal functions does not really add any value to their role. Because that is the test to find out whether the independent directors are truly adding value to their role or are they being characterised as Figgie hairs. It is easy to say no to the proposals of executive management sitting in the capacity of the independent directors. But the real charm lies in saying why you are saying no, what are the alternative possibilities that one could work on. While it is a reasonable approach to rely on these independent departments for their support, it is equally important to focus on capacity building for the independent directors.”

While it may sound an extreme interpretation, it underscores the independence stature which director has to bring into the board decision making process. Therefore, on one hand, one cannot rule out the possibility of support of control functions in providing base level information and leave the decision-making to the wisdom and experience of the independent director. Such a possibility therefore brings into forefront the nature and extent of independence given to the functioning of control groups (such as risk management, internal audit and compliance) at various case study banks. The experience of individual case-study
banks in this context offered two different approaches in ensuring independence of control groups – through information reporting arrangements and administrative reporting arrangements. Each of these is explained in the following paragraphs:

**Information reporting arrangements (Bank Ringgit (Malaysia) and Bank Baht (Malaysia))**: Independence is achieved in the context of these two banks through the access provided to control groups for reporting necessary information to the board and independent directors. For instance, Malaysian Bank Official 1, handling the Risk Management, at Bank Ringgit stated:

“During the board meetings, we do make a presentation on the risk position. The presentations are quite independent in the sense that they were not shown to the Group CEO beforehand and it is made directly at the Board”

Highlighting the spirit of the above response, Malaysian Bank Official 5, handling compliance function, also commented:

“When I mean independence – it is so independent in the sense that when I give my paper to the board, nobody has access to it. The only time when CEO looks at it is at is in the board meeting. So I don’t even run the report with anybody for approval. I prepare the board report and go straight to the board and submit it to the company secretary. For the first time, the directors look at it when it is circulated and questions are, if at all, asked during the board meeting, so it’s totally independent”.

Malaysian Bank Official 4, dealing with Internal Audit function, added similar emphasis to this aspect stating that:

“There is no sharing with the Group CEO. The Group CEO does not at all involve in the process of internal audit reporting to the audit committee. The reporting is directly to the audit committee. Of course, the findings are shared with the divisional heads and the heads might go to the CEO for clearance of response that can be submitted.”

The experiences shared by the heads of risk management, compliance and internal audit at Bank Ringgit (Malaysia) therefore indicated the direct access they were given to approach the board, without the need to subject their discussions to prior screening by executive management.

The experience at Bank Baht (Thailand) appeared to be slightly different from that of Bank Ringgit (Malaysia) - while the control groups claim independence stature, the access to the
independent directors is provided through a formal forum. Thailand Bank Official 2, handling the compliance function, explained this process further in following words:

“We have a Compliance Review Committee (CRC) to which we will submit all the reports - but for ACKNOWLEDGEMENT only. The CRC comprises of the management who will review the matter, but do not have a right to modify the same. Because we firmly believe that howsoever independent function compliance or risk may be, they cannot function without the support of the management. So we discuss the key issues with the management before escalating it to the board. They will offer their inputs, but as per the design, they cannot over rule us. And any issues, where there are conflicts, will be raised to the board of directors for final decision and that is how this whole compliance reporting mechanism works”

**Administrative reporting arrangements (Bank Rupiah (Indonesia) and Bank Peso (Philippines)):** Unlike Bank Ringgit and Bank Baht, which focused on reporting of information, discussions with Bank Rupiah focused on administrative reporting arrangements put in place pursuant to local regulatory requirements. For instance, the compliance director at Bank Rupiah reports on monthly basis to the board of directors and then to the board of commissioners. A unique feature in the reporting arrangement is that the compliance director is also required to report to Bank Indonesia, pursuant to its regulatory guidelines. Similarly, Philippines Bank Official handling the compliance function also stated that at his organisation the compliance function reports directly to the board committee. He even mentioned that it is the same case even in the case of chief risk officer and the internal auditor, who also similarly report to the board.

While there have been variations in the reporting practices of individual banks, the important aspect that was impressed upon by the interviewees is the enhanced role their control functions have assumed in the post crisis reform period indicating their crucial role in the governance framework at banks. Recognising this enhanced role, the regulations strive to preserve the independence stature of these functions and make them report only to the highest level, either administratively or through periodic information sharing to the board and/or independent directors.

The previous paragraphs (a to c) thus indicated the efforts undertaken by the case study banks in professionalising their boards by – ensuring competence of directors, enhancing the role of independent directors, ensuring the existence of information systems to support board decision making process. The effectiveness of the direction provided by such professional boards in pursuing regulatory reforms in the area of risk management, at each of the case study banks, is explained in the next section.
6.2 Regulatory Reforms in the Area of Risk Management

A key aspect that resulted from the experience of the 1997 crisis is the recognition of enhanced role of the risk management department at respective case study banks. Each of the case study banks now has formal risk management departments with senior level functionaries heading the same. As Thailand Investment Banker 2 puts it across:

“The function of risk management has gained prominence post the crisis. It’s not that the pre-crisis does not have a risk management department, but it is only post the crisis, the stature of the department expanded at the banks.”

Similarly, even the Rating Analyst 1 at Malaysia echoed a similar argument in more detail as he said:

“At the institution level, if you look at the organisation structures, before 1997, in the senior management team of banks, there is no Chief Risk Officer (CRO) position. Even if it existed in one or two odd cases, the CRO is very much in a backroom position. At that time, the existence of Risk Officer is more of a function without any stature or status in the bank in the sense that the officer would not be in a position to make or break the decisions. But now the banks have more CRO positions almost equivalent to the CFO positions. CRO is now a powerful position and the risk management committee in the banks is now a very senior and serious level body within the bank.”

The significant departure from the pre-crisis position is not only with regard to the setting up of the risk management function, but its continued engagement in the decisions relating to business strategy and credit approval - by offering risk-related inputs in an independent manner. Further, during board meetings, risk officers of case study banks are required to make presentations on the risk position. As explained earlier, these presentations by chief risk officers at respective banks are quite independent in the sense that they were directly made to their boards/directors and are not subject to modifications by the business groups, though they will be discussed with them, whenever required. At an operational level, the risk management function is expanding its scope by deploying initiatives for integrated risk management and fine-tuning the tools used for risk assessment. Each of these factors is explained below.

a) Board Involvement in Setting Risk Strategy

The banking laws and regulations at all four countries defined the role and responsibilities of the board of directors quite clearly. As specified by respective banking laws and regulations,
the board was required to get involved in all major tasks in the banks, namely: i) nominating, replacing, and monitoring the CEO and key executives, ii) formulating, reviewing and guiding corporate strategies, and iii) **approving and reviewing risk management and the internal control system.** In this context, Consultant 1 from Indonesia mentioned:

“The regulatory expectation is that the people appointed as directors of banks have to demonstrate certain level of expertise in the area of risk management. Obviously this is a requirement flowing from the learning of the financial crisis earlier.”

In a similar tone, International Expert 1 from Philippines stated that, in the post-crisis era, risk management issues are explicitly considered by boards of the banks. In his words:

“I think without the support of their boards, the banks would not have put in place risk management departments, look into their credits more closely or would not have brought about improvements in their internal policy frameworks”.

As observed during the interviews, boards of the case study banks, through the constitution of Risk Committees, were able to formulate the risk management policies, set the risk appetite for the bank and periodically review the risks faced by the bank through internal reporting mechanisms. The risk committees at case study banks were therefore found to be active in recent times with increased frequency of deliberations through committee meetings. For instance, during 2010, the risk management committee at Bank Baht (Thailand) met 12 times and at Bank Peso (Philippines) met 11 times, whereas the risk monitoring committee at Bank Rupiah (Indonesia) met 10 times. Thus the meetings of risk-related committees of the Board in most cases happen almost on a monthly basis. The focus of discussions at these risk committee meetings is on formulation of risk management policies and setting up of risk appetite, the details of which are explained in the following paragraphs.

**b) Formulating the Risk Management Policies**

As noted from the fieldwork interviews, the respective regulatory requirements now require case study banks to use new risk management policy frameworks for increasing the accountability of bank managers in their day-to-day decision making. While the extent to which more market-oriented or sophisticated risk management policy frameworks and tools have been adopted varied considerably, the basic architecture of the risk management policies appear to be a more common amongst the case study banks. At Bank Baht (Thailand), the board of directors assigned the risk management group the authority to formulate risk management policies and procedures. The policy prescriptions, in line with the
Bank of Thailand’s risk-based approach to commercial banking, sets guidelines for assessing core risks such as strategic risk, credit risk, market risk, liquidity risk, operational risk, legal risk, and other forms of risk which may have an impact on the bank’s reputation. At Bank Ringgit (Malaysia), the board risk committee assumed the ultimate responsibility on behalf of the boards of directors for the supervision of risk management. Further, the committee decides on the yearly allocation of risk capital to support all risks taken by the bank. The disclosures of Bank Peso (Philippines) also indicate that it proactively manages risks arising from volatility in the financial markets using methodologies, which have also been subjected to third party validation.

Reflecting upon this general trend on increased awareness of banks to risk matters, the Consultant 3 from Malaysia commented:

“What we have been observing in recent times is that certainly the interest levels of the directors in ensuring that they have right frameworks and right committees with them have increased over a period of time. Of course, this is partly being driven as a compliance agenda at the moment and partly driven by the need to observe the best practices.”

The board and risk committees at case study banks therefore focused on risk management by prescribing certain areas of policy formulation to risk committees, which included i) the quantification of various risks; ii) the pricing and allocation of credit; iii) the approach to valuation, including marking to market or fair value assessments; and iv) the provisioning and the allocation of capital on the basis of risk assessment. However, at the core of these initiatives is the key aspect - setting the risk appetite - which directs the tone and sophistication required for all risk management policies. The details regarding the process of setting the risk appetite at case study banks is therefore dealt with in the following section.

c) Setting the Risk Appetite

Interview findings at each of the case study banks indicated that risk appetite statements are finalised by their respective risk committees using a bottom-up approach and are defined based on the periodic internal deliberations. The deliberations take place at the level of business heads where the risk management function has a fair representation at senior level. The risk appetite statement of the Bank is further reflective of the level of sophistication of its risk management framework and the extent of tools and frameworks available at its disposal.
for risk measurement. Against this background, different case study banks have adopted different granular approaches to formulation of risk appetite as explained below:

**Bank Ringgit (Malaysia):** Discussing the role of the board in the context of risk appetite, the Bank Official 3 from Bank Ringgit (Malaysia) mentioned that “the regulators would not expect the board to become executive board and start approving the loans. The board, therefore, will not approve loans or approve deals, but they set the risk appetite – how much risk that we can bear”. Risk appetite at Bank Ringgit (Malaysia) is therefore defined as the confidence level to be used for undertaking quantifiable risks, maximum size and frequency of losses for risks along specific business lines. The board of directors is authorised to approve the risk appetite statement while the risk committee, performs the oversight function for capital allocation and overall management of risks, within the risk appetite approved by the board. The Bank adopted risk control self assessment process to ensure that regular checks are carried out for ensuring an overall alignment between risk exposures and group risk appetites by means of thresholds used in the evaluation of risks.

The risk appetite setting process at the bank is further explained during the course of interviews by referring to the forum at which it is set. Internally known as the Annual Management Dialogue - chaired by the CEO of the bank - the forum facilitates the risk appetite setting process as business heads present their outlook for the forthcoming year. Malaysian Bank Official 1 explained this process as under:

“The risk team also presents its inputs to the bank’s strategy through that forum. And risk inputs are sought not just at the meeting, but during the discussions before the dialogue – where the proposals are put forward and are finalised in consultation with the risk team. So we do share our experiences across various entities”

The explanation emphasises the role of risk management department in the context formulation of business strategy and setting risk appetite. Apart from being an affair purely driven by internal executives, the Annual Management Dialogue also incorporates key inputs from an international advisory panel (IAP) established by the bank in 2006 to assist the board and top management in formulating strategies and generating ideas for global business expansion. IAP members comprise a range of nationalities whose collective experience spans a broad spectrum of markets and industries - domestic, regional and international - in various leadership capacities including policy formulation and academia. IAP meets every year before the Annual Management Dialogue so that the views of IAP are incorporated into the business plans and strategies for the coming year.
Bank Rupiah (Indonesia): At Bank Rupiah (Indonesia), the risk appetite statement merely implies a top-level emphasis on the conservatism and low appetite for risk. Bank Official 1 mentioned that at Bank Rupiah (Indonesia), “risk goes beyond compliance with regulations. It requires an assessment of external conditions as well as the Bank's internal risk appetite and strategy.” Accordingly, as part of the risk appetite statement that has been formulated, Bank Rupiah (Indonesia) established capital buffers to be maintained by the bank. The buffers ensure that all risks that can be identified have been taken into account for Bank Rupiah to be able to survive amidst the pressure.

Bank Baht (Thailand): The board of directors of the bank is responsible for setting the risk appetite and the risk management, an independent function within the bank, is responsible for implementing the same. The risk-appetite description at Bank Baht is however broad based - as it is not articulated in the form of a statement but is reflected through its credit policies, underwriting processes, monitoring, control and good corporate governance principles. The stated focus at the bank is to ensure an adequate risk-reward balance through maximisation of return-on-equity, adequate pricing and implementation of credit risk mitigation strategies. The bank also manages long-term capital planning based on the growth strategy and capital forecasting based on stress tests.

d) Operationalising the Risk Strategy

Subsequent to setting the risk appetite, significant risk management efforts of banks focus on operationalising the same across the organisation. From this perspective, interview findings revealed two important features. Firstly, while the case study banks have been able to deploy integrated risk management frameworks across a particular category of risk, they are still in the initial phases of implementation of enterprise-wide level risk management frameworks. Secondly, while the basic level of risk management architecture was found to be similar across the case study banks, the level of sophistication of risk measurement tools deployed, however, varied across the banks. Each of these aspects is explained below.

Deployment of risk management frameworks: Risk management frameworks can be implemented at banks at two different levels. Firstly, the frameworks could be used for integrating each type of risks - market, credit, liquidity - across all activities of the organisation. Secondly, they can take the shape of an all encompassing enterprise-wide risk management (ERM) framework, for integrating all risks across all activities of the bank into a single dashboard for monitoring the overall risk of the bank.
“ERM is considered to be the next area of focus” says the Consultant 3 at Malaysia, who further explained this as under:

“Even as results of our recent survey indicate, people acknowledged that earlier the risk was not identified in a holistic manner. And one of the key messages of the survey is that despite existence of several risk management initiatives, there is situation where your left hand does not know what your right hand is doing. This is where the requirement of ERM comes in for the banks; where there is a need to have a helicopter or holistic view of overall risks the bank is exposed to”.

In this context, it was observed that the case study banks were currently at various stages of implementation of risk management frameworks. For instance, at Bank Rupiah (Indonesia) risks are integrated across various risk types (viz., credit, market and operational). Bank Ringgit (Malaysia) however employed the ERM framework for providing the board and its management a tool to anticipate and manage both the existing and potential risks across the organisation. The ERM framework at Bank Ringgit (Malaysia) takes into consideration the changing risk profiles as dictated by changes in business strategies, operating and regulatory environments, and functional activities throughout the year.

**Usage of risk assessment tools:** During the course of interviews, it was observed that banks had been adopting more advanced tools and techniques for risk assessment, such as VaR, stress testing and credit scoring. Risk assessment at the case study banks is now being used as the basis for daily transactions and for arriving at the limits to different positions. However, the level of sophistication of the risk measurement tools is still somewhat a long way to go in light of the impending challenges of availability of data, integrity of data and reliability of risk modeling. The finesse required to be achieved in risk assessment often also raises tensions internally with heightened deliberations between risk and business officials on the cost-benefit analysis expected out of such exercise. The fieldwork findings revealed certain challenges in this regard as discussed below:

First, modern techniques of risk management, reflected in the methodological approach of Basel II, involved the estimation of probabilities of default on the lender’s loan portfolio, as well as of loss-given-default. These envisage availability of industry databases about borrower credit history. Case study nations were therefore found to be taking steps to improve data availability at individual banks in an overall effort to improve the data quality across the industry. For example, Malaysia and Thailand have respectively established a centralised credit registry (for households and corporations) and a credit information bureau to which even the case study banks periodically submit the required credit information.
However, as the experience is relatively recent, it was explained during the course of interviews that certain small banks in the industry are reluctant to share information on borrowers, even when credit information bureaus already exist. In the absence of credit information data, the interview officials outlined that the outcome of the modeling exercises to arrive at the probabilities of default will largely be a limiting factor of the sophistication of risk assessment tools of individual banks.

Secondly, where the data is available on certain risk information, integrity of the sources through which it was generated becomes critical for its relevance to business decision-making. It was outlined during the interviews that the case study banks were therefore making significant IT investments to ensure integrity of data used as input for risk assessment and business decision-making. For instance, at Bank Ringgit (Malaysia), IT tools are used internally to manage risk, hedge, and optimise the net interest income/net interest margins of the Group. IT tools help in these areas by providing complex logic required for modeling and projecting sensitivities to risks. The usage of these tools was therefore rolled-out across all regions of the bank. Similarly, Bank Baht (Thailand) had embarked on project styled as “Electronic Data Management” which aims to build a robust enterprise data warehouse equipped with a globally recognised banking data model to ensure data integrity and to effectively support business functions, risk management functions and new requirements of regulatory reporting.

Thirdly, banks are still in the process of experimenting with various techniques for designing and calibrating models to evaluate alternative scenarios relevant to their operations. For instance, Bank Rupiah (Indonesia) assesses collective impairment using statistical modeling of historical trends of the probability of default, timing of recoveries and the amount of loss incurred. The output is adjusted for management’s judgment as to whether current economic and credit conditions are such that the actual losses are likely to be greater or less than suggested by historical modeling. Default rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure that they remain appropriate. Similarly, Bank Baht (Thailand) had implemented a statistical internal rating model for probability of default (PD) for the commercial portfolio in 2011. The Bank also had undertaken steps to implement Moody’s risk adjusted performance management (RAPM) model, which is expected to optimise the risk return equation and maximise the return on equity. At Bank Ringgit (Malaysia), the Group Risk Management function develops, implements and validates all internal rating and scoring models and closely monitors the
usage of the rating and scoring systems to ensure relevancy to current market conditions and integrity of the ratings.

The above developments with regard to risk management policies and sophistication of risk assessment tools are largely gathered from the disclosures of the banks in their respective annual reports and discussions during the interviews. However, it would be interesting to evaluate the impact of sophisticated risk assessment tools on the business decision-making. The fieldwork interviews therefore proceeded in this direction and the findings revealed that the impact is seen in two critical areas – related to the management of credit and liquidity risks – which are now being perceived in a different manner by the case study banks in comparison to their approach during pre-crisis period. Another visible impact of the prominence of risk management focus is in the conscious decision of case study banks to desist the pursuit of new financial products in a big way post the crisis. Each of these aspects is dealt with in greater detail in subsequent sections.

e) Credit Risk Management Focus

The core objective of credit risk management is to ensure that credit-related losses are within stipulated risk-appetite levels. It establishes a framework of controls to ensure that the risk-taking is within defined parameters while ensuring that risk-reward objectives are met. Credit risk teams at banks continuously endeavor to improve the quality of the portfolio by upgrading infrastructure, processes, and risk management tools. Credit risk management begins at the stage of processing customer credit requests and progresses all the way up to ensuring timely repayments of obligations and, where necessary, ensuring collection of past-due payments.

During the course of fieldwork interviews, the importance of credit risk management is underscored through a narrative regarding pre-crisis experience offered by Malaysian Bank Official 3. The experience was related to two large infrastructure projects – one related to the port construction at Malaysia and the other one related to developing the sea-crossing-link between Singapore and Malaysia. Each of these projects was very large and aimed at improving infrastructure in Malaysia (particularly port-related infrastructure) and improved travel corridor between neighboring states. Malaysian banks undertook financing of these projects indirectly by guaranteeing the bonds issued by the project sponsors, based on government approvals. However, as the crisis hit, the sponsors went out of the money and the projects were financially affected. Though the sea-crossing-link project was pushed
through subsequently, the countries were badly hit by the crisis by that time. Even the port project has been affected, and Maersk, a private player, stepped in and put in money for completion of the project. Malaysian Bank Official 3 explained that the experience resulted in introspection in these economies about the need for instituting robust credit risk assessment practices before taking up projects for funding. The key aspect of credit risk assessment is to ascertain the comfort banks should gather on the revenue-generating ability of projects for ensuring that the banks have matching funding resources to support them. The narrative thus underscored the perceived need of the region - development of a bond market that can take on financing projects of this scale, with a more matching funding profile, compared to commercial banks. While the bond market was existent before prior to the 1997 crisis, it was functioning primarily on the basis of guarantees extended by the commercial banks. Banks used to provide such guarantees simply based on availability of government approvals. However, the Official explained the reversal of trend, post the crisis, at Bank Ringgit (Malaysia) in the following words:

“Especially at Bank Ringgit, we said no to provide such guarantees. We did not encourage the bond investors and other agencies to just invest in the market with their eyes closed and invest just on the strength of the guarantees issued by the banks”.

The decision, such as the one taken by Bank Ringgit (Malaysia), became an industry-wide phenomenon thereafter. This had resulted in a systematic process for evaluation of bond investment by everyone involved, which led to development of risk appraisal systems across the board. As a part of the evaluation, everyone started looking at the cash flow issues, project feasibility rather than simply relying upon the bank guarantees. The rating agencies were also therefore encouraged to do a better job to evaluate the cash flows and appraise the issue in a more objective fashion, post the crisis. The concept of rating watch was developed gradually and there were issues such as rating downgrades, but it all resulted in everybody in the system eventually growing up and enhancing their underwriting standards independently. Thus the overall environment in Malaysia was to move towards robust credit appraisal standards post the crisis. As explained by the Malaysian Bank Official 3, the risk management policies, risk appetite statements and the risk assessment tools are only operational parameters that further catalysed this broad industry trend into credit approval process.

Apart from the experience offered through the afore-mentioned narrative in Malaysian context, the interview results indicated that the impact of credit risk management focus was
visible at case study banks. Firstly, all case-study banks have now moved to a committee-based structure for approval of credit instead of individual authority approval prior to 1997. Secondly, all case-study banks explained that they have discontinued the so-called “name-lending” practices, which was quite prevalent in the industry prior to 1997. They have now moved towards a more advanced credit appraisal standards involving collateral/cash-flow based assessments while sanctioning the credits. Thirdly, there has been a growing tendency of top management oversight in the area of credit monitoring using technology based credit modeling tools. Each of these aspects is further explained as below:

**Committee-based credit approval structure:** Each of the case study banks has now put in place the committee-based credit approval structures. Official 2 from Bank Rupiah (Indonesia) compared and contrasted this with the pre-crisis experience as under:

> "Previously the credit is not as well structured as it was now. While previously the bank branches are allowed to approve the credit as per their authority, now the requirement is to take approvals from a central authority defined in the internal policies."

For instance, interviews at Bank Ringgit (Malaysia) further indicated that the Bank had adopted a multi-tiered credit approving authority spanning from the delegated authorities at business level to various credit committees. The credit committees are set up at various levels in the bank to enhance the efficiency and effectiveness of the credit oversight. This was further intended to streamline the credit approval process for all credit applications originating from the business units. Official 2 from Bank Ringgit (Malaysia) narrated the developments in credit appraisal at his bank, in the following words:

> "The Bank has a committee approval structure for credit lending, for Initial Public Offer (IPO) handling, and for capital market transactions. This is quite different from quite a lot of other financial institutions in Malaysia where there are individual approval mechanisms. And why this is the case at Bank Ringgit? Certainly, this is because of the learnings from the crisis. The committee structure enabled us to exercise the oversight required on the lending approvals, which was quite non-existent in the individual approval mechanism. And these committees have representation from the risk management department."

The discussion with various interviewees, even in the context of other case study banks, also indicated that the committee-based approval structure now involves taking inputs from the risk management department at the time of credit approval. This constituted a significant departure in the area of credit risk management since the 1997 crisis.
Advanced Credit appraisal standards: Prior to 1997, it was very eventful for the industry as credit decisions were driven largely by business potential rather than risk considerations. In certain cases, decisions were also motivated by political considerations (as explained in Chapter 4 earlier). Cash-flow analysis as a credit appraisal tool was largely absent from the credit decision-making process at banks, prior to the crisis. During the interview, Thailand Bank Official 3 at Bank Baht recollected the pre-crisis days, stating that:

"During that period, the lending decisions were largely motivated by the commercial terms to be agreed with the borrower. The analysis of borrowers' balance sheet did not form part of the credit approval process. We tend to use mostly our feelings about the customer reputation (name lending) rather than based our approval decision on any analysis of the customer's business. The understanding is that if the customer has survived this long in the business and is of this much repute, he would be able to repay the loan to us. Thus it is more based on gut feeling rather than financial or analytics driven".

As explained by various interviewees, subsequent to the crisis, regulatory authorities had taken steps to stop these practices. For instance, BI (Indonesia) introduced various regulations requiring local banks to institute standard credit operating procedures, legal lending limits, and know your customer requirements. Similarly, pursuant to the regulatory and supervisory focus of BOT (Thailand), local banks instituted certain good practices in credit lending, which included - arriving at the right interest rate for the lending decisions and focusing on covenants while lending. The interviewees from Thailand referred to BOT (Thailand) regulations, which require banks to set interest rates considering borrowers' credentials and collateral evaluation. The usual trend is therefore that while BOT (Thailand) normally do not step in interest rate-setting decisions, banks are required to ensure that guidelines on lending rates (including prescription of minimum lending rates in certain situations) are duly complied with. Further, if banks were to lend to borrowers when not relying on the collateral, BOT (Thailand) started examining, post the crisis, whether such decisions are justified from a prudential perspective. As a result, over a period of time, there was awareness amongst local banks that BOT (Thailand) is closely supervising them. The fieldwork findings thus indicated the nature of regulatory influence on lending decisions of banks.

Credit monitoring oversight by top management: During the period prior to 1997 crisis, as the credit decisions were at individual level and were solely based on the reputation of the borrower, there was no active oversight by the top management on credit monitoring
aspects. The situation in the region was explained by International Expert 1 from Philippines in the following words:

“Just because of the particular name of borrower, the banks used to offer clean working facilities, probably not taking into account the total leverage extended by all banks put together to that particular borrower or what could be the impact on the debt service coverage ratio of the borrower. The kind of thinking at that time was not rigorous – the focus is to just get business, get customers, get assets on board”

Post the crisis, not only did the developments in the area of risk management impact credit appraisal, but they have also enhanced the oversight of the top management, who now are very active in undertaking portfolio credit reviews. At Bank Rupiah (Indonesia), in recent times, credit reviews and rating are conducted on the credit exposures on an annual basis and more frequent when material information on the obligor or other external factors come to light. The same is the case with Bank Ringgit (Malaysia), where the exposures are actively monitored, reviewed on a regular basis and reported monthly to the internal risk committees. This enabled the Bank Ringgit (Malaysia) in ensuring that deteriorating exposures are identified, analysed and discussed with the relevant business units for appropriate remedial actions including recovery actions, if required. At Bank Peso (Philippines), in recent times, a monthly credit portfolio report including information on portfolio quality in terms of segmentation by facility, ratings, geography, industry, ageing etc., is also circulated to the top management at periodic intervals.

Credit risk infrastructure was also found to be continuously enhanced in the period post the crisis to enhance the credit monitoring by deploying new technology based credit modeling tools. For instance, as indicated earlier, the Bank Baht (Thailand) completed the development of statistical internal rating models (probability of default) for the commercial loan portfolio and also initiated the development of loss given default and exposure at default models. Similarly, Bank Peso (Philippines) also leveraged upon the newly developed credit scoring models for its unsecured consumer lending business to improve portfolio quality and increase profitability. A credit-scoring model was also adopted in the area of collection management to optimise collection strategies and improve collection efficiency.

**Impact on borrowers:** As outlined in the previous paragraphs, the credit risk management focus, subsequent to the crisis, led to the deployment of various credit risk mitigation techniques such as appropriate credit structuring, and posting of collateral and/or third party support form an integral part of credit appraisal process. Such mitigants are considered
necessary to rely upon secondary recourse for the credit risk underwritten. However, such enhanced focus on credit risk mitigation and improvements in the credit appraisal standards have at times resulted in a lot of credits that were rejected in recent times, which would have passed by the banks prior to the 1997 crisis. As Thailand Investment Banker 1 remarks:

“The banks have now started doing the business in the old fashioned way especially after considering the fact that they have burnt their fingers in the past. Now they do the credit analysis first, take a credit decision, observe the credit history for some period, try to work around the repayment periods in case of observed stress, if possible through in-house or sell it to the asset management companies”.

From the industry standpoint, this changed behavior of banks towards credit sanctions had produced a ripple effect. An example in this regard, cited by one of the interview officials at Thailand, is in regard to players in the property sector who used to earlier resort to upfront collection of payments from the property buyers. These upfront payments were not returned back to property buyers when the projects were stopped in between. This was the situation prior to the crisis, which led to large scale defaults in retail mortgage portfolio of banks as borrowers abandoned the homes where there were substantial construction delays. However, subsequent to the crisis, even the property developers modified their practices and did not insist buyers on making upfront payments. They focused on the construction of houses using bank funding, which are then show-cased to the borrowers for inspection. The mechanism was facilitated with the introduction of property escrow accounts wherein the buyers would deposit the money with the developer. A portion of escrow account also helps in securing the buyer’s interest and thereby the bank's interest, to some extent, in the event of non-performance of the developer in the future.

The impact of the regulatory reforms, focused on improved credit risk management, on the borrowers can therefore be summarised in the words of Indonesian Bank Official 2 in the following manner:

"Thankfully, subsequent to the crisis, borrowers including corporates and other firms, have shown the understanding of the need for credit due diligence. Given the continuous engagement with borrowers, they were more educated now. The regulatory measures therefore resulted in making the borrowers also learn over a period of time that the controls are good for their own sake only”
f) Liquidity Risk Management Focus

Apart from the focus on improved credit risk management, the regulatory reforms also focused upon improvements in another key area of risk management – liquidity risk. Liquidity risk is defined as the current and prospective risk to earnings, shareholders' funds or the Group's reputation, arising from the bank’s inability to efficiently meet its present and future (both anticipated and unanticipated) funding needs or regulatory obligations when they are due, which may adversely affect its daily operations and incur unacceptable losses. Liquidity risk arises from mismatches in the time of cash flows.

As explained in Chapter 4, the 1997 crisis underscored, apart from credit risk management, the need for ensuring adequate focus on liquidity risk management as well. During the period prior to the crisis, when there was abundant liquidity, in the form of foreign inflows, there was lot of domestic lending in East Asian nations mostly in the form of foreign currency loans. As there were hardly any movement between the local exchange rates (especially Thailand Baht and Indonesian Rupiah) and the US dollar rates, in the three years prior to the crisis, the local corporates preferred taking loans from banks in foreign currencies to benefit out of the low interest rates. Apart from the corporate borrowers, the exchange rate stability also facilitated foreign currency loans to individuals interested in making property investments. Such foreign currency loans contributed to the surge in the property prices with increased demand for property backed up by foreign funds availability at cheaper interest rates through local bank credit. Foreign currency loan also facilitated huge investment in local stock markets. The overall environment characterised by huge foreign exchange liquidity thus represented euphoria prevalent in the economy.

However, when the euphoria was not found to be sustainable and the Thai Baht was devalued in July 1997, the countries went into trouble. In the euphoric period, as the cost of hedging was not justified (considering the apparent stability of exchange rates), most of the bank exposures remained un-hedged by borrowers. After the devaluation, all the foreign currency loans became inflated and the borrowers started becoming bankrupt. The insolvency of borrowers resulted in problems to balancesheets both on assets and liabilities side. On the assets side, the banks had to write-off large exposures, as the borrowers were insolvent. On the liability side, banks were caught up in the problem of liquidity squeeze as the foreign banks were largely reluctant to roll-over their funds to local banks, after the devaluation.
Subsequent to the crisis, therefore, while assets side problems were addressed through institution of credit risk management practices, on liabilities side, initiatives on liquidity risk management have increased in stature and prominence. These initiatives, as Rating Analyst 1 from Thailand indicated, focused on “ensuring matching funding, concentration on asset liability mismatches and ensuring that the foreign exchange exposures are appropriately hedged”. This section therefore summarises three visible improvements observed during the fieldwork interviews, in the context of liquidity risk management. These are related to - a) increased oversight of top management to liquidity risk b) reduced reliance on foreign funding and c) increased reliance on stable & matching funding options, as explained in the following paragraphs.

**Increased oversight of top management:** As indicated during the fieldwork interviews, the stature of liquidity risk management function had been enhanced, subsequent to the crisis, at the case study banks by considering it as a core component of integrated risk management. Liquidity risk was therefore subject to varied top management oversight mechanisms as revealed through the review of liquidity risk management practices disclosed in annual reports and discussions in interviews.

At Bank Rupiah (Indonesia), oversight on liquidity aspects is exercised through regular monitoring of liquidity ratios. The ratios indicate, in particular, the proportion of banks’ total assets in the form of liquid assets, which are determined based on the bank’s analysis of balance sheet structure and market conditions. The Bank’s disclosure contain reference to the process of arriving at liquid assets that act as a buffer for addressing potential demand for liquidity – in normal and in stress situations. Liquidity ratios are monitored by the top management of the bank on daily basis to ensure that enough liquid assets are available to meet debt repayment requirements. Minimum target levels are put in place to provide indications of possible courses of action needed to enhance the liquidity situation.

During fieldwork interviews, Bank Official 3 explained the role played by board in the context of liquidity risk management at Bank Ringgit (Malaysia). He stated that the “board also monitors the liquidity as a part of the risk monitoring exercise through the group risk committee. This is also undertaken granularly at each of the units – Islamic, conventional and the investment banking”. He further explained that management action triggers have been established at Bank Ringgit (Malaysia) to alert management to potential and emerging liquidity pressures. The annual report of Bank Ringgit (Malaysia) further indicated that liquidity positions are monitored on a daily basis and complied with internal risk thresholds.
and regulatory requirements for liquidity risk. The monitoring is undertaken both quantitatively and qualitatively and involves monitoring depositor behavior, economic conditions, financial markets, and the competitive environment as well. The Bank’s contingency funding plan, consisting of an early warning system and a funding crisis management team, has also been put in place to alert and enable management to act effectively and efficiently during a liquidity crisis and under adverse market conditions.

The top management therefore found to have been exercising oversight on the liquidity risk, post the crisis. The impact of such oversight is primarily seen on the reduced reliance on foreign funding sources, observed at case study banks, subsequent to the crisis as explained in following paragraphs.

**Reduced reliance on foreign funding sources:** Before the crisis, borrowers used to take advantage of exchange rate fluctuations and used to borrow in foreign currency as it was very cheap. Sometimes this has also resulted in speculative funding, as the returns from the property sales used to be far more higher compared to the exchange rate fluctuations. It would be easier for an individual therefore to take a foreign currency loan at low rate of interest, invest in a property and after sometime, sell it at a significant property. The stable exchange rate regime ensured that the exchange rate fluctuation and the interest cost during the intervening period, is far lower than the profit made in the property transaction. The demand for property loans was therefore rampant during the years prior to the crisis in foreign currency terms. Backed up by consistent demand in domestic markets and uninterrupted supply through short-term foreign funding sources, banks did not perceive the need for hedging their foreign currency risks. However, subsequent to the crisis, the case study banks seemed to move way forward in this regard as explained by Thailand Bank Official 3:

“A significant difference between the 1997 experience and the 2007 experience is the way we learnt to manage our liquidity and hedging of foreign currency exposures. Back in 1997, nobody really bothered about hedging because of the confidence they have on the currency. Now people really understand where and how things go wrong and when currency became hot topic in 2007, they have been able to address it with better hedging strategies”

The need for appropriate hedging of foreign currency positions was also flowing out of the regulatory requirements in these nations, subsequent to the crisis. The regulations ensured that the attraction of foreign financing option, as a low cost option, is to a certain extent discouraged by increasing the cost of hedging required for such finance. Apart from
influencing the cost considerations, the regulatory environment, post the crisis, also resulted in making the foreign funding not a very attractive option to borrowers even in operational terms. The regulatory environment now made it mandatory that wherever such foreign currency loans are extended, the banks are required to ensure that the borrowers demonstrate the need as well as the ability to manage such foreign currency loans. For instance, BI (Indonesia) has come out with regulations requiring banks to insist on requirement to produce the evidence for underlying activity when a borrower makes a request for foreign currency loan. Therefore, borrowers are now required to prove to the Bank that the loan is for a particular operation, and not for a speculative purpose by demonstrating the relevance of such loan with the underlying requirement - for export, for import or may be for a letter of credit. As explained by interviewees, this operational modification had actually curtailed the usage of foreign funds for speculative purposes.

Apart from reducing the reliance on foreign funding options, focused liquidity risk management initiatives at case study banks ensured that case study banks pursue stable funding options for meeting their liquidity requirements. The experience of case study banks in this context is explained in following paragraphs.

**Increased reliance on stable funding options:** The case study banks, subsequent to the crisis, were found to have been managing their liquidity requirements with the objective to ensure stability of funding through long-term resources. Such an emphasis on liquidity also seems to be partly motivated by regulatory considerations as well, as explained by Thailand Bank Official 1:

“Liquidity risk management is going to be crucial in coming years. One of the things that happened to Washington Mutual is the liquidity risk. So there is a fair amount of expectation that if the bank is having a concentrinc exposure to a particular industry, and if the stress test reveals any kind of strain, then the BOT (Thailand) expects the bank to hold sufficient capital buffer for that.”

Further, in order to ensure stable funding, case study banks focused upon reducing their dependencies on short-term funding resources by undertaking frequent bond issuances. The issuances enabled case study banks to proactively tap markets for meeting their funding requirements, based on assessment of their liquidity position. For instance, in 2010, Bank Baht (Thailand) and its subsidiaries raised funds through debenture, subordinated debenture, and bills of exchange issuances replacing most of the long-term debt that was matured and recalled. Debentures issued by the Bank’s subsidiary twice in February and May 2010 and the
subordinated debentures in June 2010, were very well received by customers, with full subscription episodes within three days. Bank Rupiah (Indonesia) also tapped the capital markets during 2010 by issuing long-term bonds to enhance its liquidity position in anticipation of strong balance sheet growth in 2011. Similarly, Bank Ringgit (Malaysia) lowered its overall cost of funds in 2010 by replacing higher interest rate debentures and subordinated debentures with lower cost issuances and deposits.

It was further observed during the course of fieldwork that the increased reliance on stable funding options resulted in fine-tuning of business models and product features at case study banks. For instance, Bank Ringgit (Malaysia) developed products and services for savings and investments which not only serve customers’ needs but also buttress liquidity management initiatives and reduce concentration of funding sources at the bank. Similarly, the Bank Baht (Thailand) also tuned up its product innovation strategy from liquidity perspective and launched the “Min and Max Special Savings Account” - a product designed to better manage costs and increase deposits by combining the flexibility of a savings account with the higher returns of fixed deposits. The combination was aimed at attracting the customer deposits, which can serve as a stable funding source to the bank. Further, at Bank Rupiah (Indonesia), the consumer banking division continued its activities to develop its funding franchise in a focused manner. The bank had also put in place plans to source funds from customers in the micro segment. The objective was to ensure matching funding profile by focusing on sourcing of funds from the customers who constitute the primary segment of bank for its loan business.

Liquidity considerations thus constituted the heart of the risk management initiatives at the case study banks in a more visible manner in the recent times.

6.3 Promoting the Right Compliance Culture

Apart from the initiatives that were driven top-down as outlined in earlier sections of this chapter, it has been observed that the case study banks had taken steps to promote right compliance culture at their respective organisations. Interview findings reveal that this had happened in two different ways. Firstly, there had been a visible conscious effort internally within banks that aimed at raising awareness levels of employees on aspects related to compliance. Secondly, on an external front, case study banks have been found to be taking steps to enhance the transparency of disclosures in their balancesheets. Each of these aspects is explained below:
a) Building up Compliance Awareness across Employees

“Our constant endeavor is to be mindful of the human element in management decision-making which could be influenced by variety of factors like greed etc”, stated the Bank Official 2 at Bank Baht (Thailand). He explained how Bank Baht has taken steps to inculcate the right kind of compliance culture amongst its employees. Prominent among them included the following: a) A “spirit and letter” document which is used in internal trainings to explain the expected code from employees while dealing with regulatory norms b) a gifts and entertainment policy – which clearly says – whom the employees can entertain and who can entertain the employees and on what terms c) An in-house session (titled Session D) across employees that focus on ensuring right compliance culture.

Officials at Bank Ringgit (Malaysia) too have indicated similar efforts that are continually undertaken at their banks in order to instill right compliance across their employees. “The psyche within the group and of the front-level management is that you must know the compliance as your own duty - you meaning each and every individual within the organisation” stated the Bank Official 5 at Bank Ringgit (Malaysia) indicating the bank’s underlying philosophy with regard to regulatory compliance. To enable employees meet this expectation, the bank periodically organises activities - such as road shows/awareness programmes and a CEO talk on Monday mornings (that gets updated on company blog) – in order to sensitise the employees on the compliance responsibility.

It was thus observed during fieldwork interviews that the independent stature of compliance function is further supplemented, at case study banks, with the tone at the top emphasising the need to ensure regulatory compliance at all levels of the organisation. Fieldwork interviews therefore further focused on whether such a commitment to be compliant is met by case study banks when they deal, as an organisation, with external investors. The discussions in this regard therefore focused on the quality of market disclosures at case study banks and the findings are provided in following paragraphs.

b) Upholding Transparency in Communication and Market Disclosures

The 1997 crisis also exposed the issues of transparency in balancesheet disclosures across the industry (including corporates) prevalent in the years prior to the crisis. Reflecting upon the same, Consultant 1 at Malaysia remarked as follows:
“Governance is one of the reasons that were cited by the western investors when they pulled back their capital during the period of 1997 crisis. These investors felt that the Malaysian companies’ actual risks were \( x \) in reality, but in the annual reports they disclosed only \( y \). They cited this lack of transparency as the reason for not doing business any more with the local corporates”

From that stage, the banks in East Asia, and in particular the case study banks (with exception of Bank Peso (Philippines)) were found to have taken steps to enhance their balance sheet disclosures. The balancesheets now provide granular information on the risks faced and the initiatives taken by them to mitigate the same. This was observed largely due to the local regulatory requirements, which now lay emphasis on the enhanced balance sheet disclosures and cover the micro-aspects that need to be informed to all stakeholders. Reflecting the focus of regulators on transparency aspects, it was observed that the annual report of Bank Rupiah (Indonesia) publishes almost a 100 page report on its compliance with “Good Governance” principles. The report is published as part of annual report disclosures, with the approval of Audit Committee, and elaborates the initiatives taken by the bank to enhance internal governance mechanisms during the year.

Similarly, disclosures in the annual report of Bank Ringgit (Malaysia) cover several aspects of their risk governance framework. They indicate the effort on the part of the bank to engage in a transparent communication with the investors. The overall tone of the communication in the annual report is one of humbleness as further explained by Bank Official 2 at Bank Ringgit (Malaysia), during the course of interviews:

“We are from a region which was hit by the crisis; therefore it is more to sell ourselves as nations first – as safe investment destinations – and thereafter focusing on selling ourselves as companies. More importantly the role of the communication department is to ensure that the governance structure behind the messaging to the outside world is really in place within the organisation”.

As revealed during the interview, several aspects of corporate communication philosophy at Bank Ringgit (Malaysia) - including the equation between the CEO and the communication department, the extent of importance board gives to the aspect of communication, use of branding a strategic communication tool - are found to be driven by the imperative of upholding transparency as key to the success of governance framework.

The post-crisis experience of case study banks thus indicated an emphasis on ensuring regulatory compliance in a coordinated manner – by promoting compliance awareness across
the employees and focusing on communication aimed at transparent disclosures to all stakeholders.

6.4 Summing Up

The chapter addressed the third research sub-question - *What considerations motivated individual banks to adapt their internal governance mechanisms to reforms proposed by policy makers?* In particular, it discusses the role of regulatory reforms in bringing about improvements in key areas at case study banks – such as professionalising the board, improving the risk management focus and promoting compliance culture. Each of the areas presented challenges to both case study banks and regulatory authorities, and the interview experiences captured the manner in which these challenges are addressed while implementing the regulatory reforms.

While professionalising the board of directors, the key challenge is to ensure that only “fit and proper” directors are appointed to the board. As such professionals are short in supply in the market, regulatory authorities promoted capacity building initiatives by providing funding to director training institutes (as observed in Malaysia) or advised the directors to undergo accredited training programmes themselves. In the context of independent directors, the problem was further complicated as there were differing views between banks and industry experts on the value-addition to the board by such directors. However, considering the regulatory requirements in this area, the banks were found to have been undertaking appointment of independent directors, ensuring that they are duly inducted into their business through training programmes and are facilitated through internal networking forums. Further in order to facilitate the board decision making process, the support of independent control groups is sought, which was further subjected to much debate during the course of fieldwork interviews.

In the context of pursuing regulatory reforms in the area of risk management, the key challenges are with regard to moving to Enterprise-wide Risk Management frameworks by banks. Currently, banks are integrating risks according to risk-types, by the sophistication of risk assessment tools required to integrates all risks into a common risk profile across organisation is still underway at most of the case study banks. Further, the case study banks are found to have been at varying levels of maturity and sophistication with regard to risk assessment tools. Despite these individual variations, the focus of case study on key risk areas - such as credit risk and liquidity risk - is found to be
reflective of learnings from the 1997 crisis. In the area of credit risk management, the banks now ensure approval of credit decisions through committee-based structures after ensuring that the borrower is subjected to due credit appraisal. Similarly, the credit portfolios at banks are periodically monitored at top management levels. In the area of liquidity risk management, case study banks attempted to provide top management oversight to monitoring liquidity ratios at a broad level. At a more granular level, liquidity risk management also encompassed reducing reliance on foreign funding sources and increasing reliance on stable funding options. This has even led to small-scale product innovation for ensuring matched funding requirements and large-scale bond issuances for retirement of high cost debt.

In order to ensure that the regulatory reforms pursued by case study banks are appreciated in the right context by all employees, case study banks engage in continuous engagement with employees to promote compliance culture. The need for such engagement also stems from the added focus of case study banks on corporate communication aimed at transparent disclosures across stakeholders (in particular to investors and customers).

The chapter thus builds upon the findings of the previous chapter to provide a holistic perspective to regulatory reforms in East Asian region. While the previous chapter provided the reforms concerning the external environment around the case study banks, this chapter highlighted the internal nuances especially from the perspective of improved bank governance and risk management. It is however, important to evaluate whether these alternatives provided any credible support to case study banks during the recent global financial crisis. Such an analysis helps in triangulating the research findings with the theoretical insights relating to Minsky’s Financial Instability Hypothesis. The next chapter therefore focuses on these aspects for analysing post-crisis experience of East-Asia from Minskian perspective.
7) A Minskian Analysis of 1997 Crisis and Regulatory Reforms

7.1 Introduction

Having examined the macro-economic and policy environment prior to the 1997 crisis, regulatory reforms initiated in subsequent years and improvements in governance and risk management at case-study banks, this chapter proceeds to address the last research sub-question - How did regulatory reforms finally contribute to resilience of banks in East Asian nations during the 2007 crisis? The question is relevant in light of severe impact of the 2007 financial crisis on economies of advanced nations. However, certain available academic studies argue that 1997 crisis-affected nations have withstood the 2007 financial crisis better than most of advanced economies (Adams 2008, Brunschwig et al 2009, Lee and Park 2009, Mohanty and Turner 2010). For instance, of the total USD 1.5 trillion in write-downs and credit losses reported worldwide since July 2007, only USD 39.0 billion, or about 2.7%, comes from Asian financial institutions - the bulk of which is concentrated in Japan and, to a lesser extent, the People’s Republic of China (PRC) (Lee and Park 2009). It is therefore now widely acknowledged in certain policy studies that East Asian nations had entered the 2007 crisis with a “sound set of economic and financial fundamentals” (BIS 2009, p.22), exhibited “resilience” during the post-2007 years (ADB 2009, p.2) and had indeed emerged “stronger” from the global crisis (World Bank 2010, p. 3).

A review of academic literature concerning the impact of the 2007 crisis on East Asian nations however suggest that there are alternate arguments behind the East-Asian resilience - one that attributed to post-1997-crisis regulatory reforms and the other one that attributed it to the long-term structural changes in banking systems of these nations. The purpose of this chapter is therefore to review these alternate arguments and attempt to resolve them with the help of Minskian financial instability hypothesis and fieldwork findings presented in previous chapters.

A section of academic literature attributes banking sector resilience in East-Asia to improved governance and enhanced regulatory supervision. As early as in 2005, Nam and Lum considered that governance reforms are key to success of banking systems in post-crisis Asia. Evaluating the host of policy and regulatory reforms in the banking system - especially in
areas of risk management, supervision, disclosure, and market discipline - they observed that regional regulators adopted a greater emphasis on a more balanced approach to policy reforms by supplementing them with rule-based regulatory guidelines to guide the practice of corporate governance in the banking institutions. On the eve of 2007 financial crisis, Adams (2008) argued that substantial improvement in the health of banking sector, upgraded supervisory and regulatory systems, significant progress in improving risk management, sizable prudential cushions and improved efficiency, have provided significant comfort to East Asian banks. Dixon (2009) argued that these developments had left these banking systems much better placed to face a major crisis, than the West, and perhaps, any other part of the global system. Ito et al (2009) attributed the resilience to solid domestic institutions, especially in the financial sector, arising from swift policy responses pursued by East Asian nations to strengthen their national banking systems. Briguglio and Piccinino (2012) used a “growth-with-resilience” index (GWR) (for measuring the extent to which a country can absorb or counteract external shocks and at the same time promote economic growth) and argued that the East Asian region fares better than US region on this index. The success of regulatory reforms in East-Asia thus caught wider academic attention and even the attention of policy-makers in advanced economies. In the words of Bernanke (2011 p.14):

"Indeed, advanced economies like the United States would do well to re-learn some of the lessons from the experiences of the emerging market economies, such as the importance of disciplined fiscal policies, the benefits of open trade, the need to encourage private capital formation while undertaking necessary public investments, the high returns to education and to promoting technological advances, and the importance of a regulatory framework that encourages entrepreneurship and innovation while maintaining financial stability” (words italicised for emphasis by the author)

However, there are certain other studies in academic literature, which hold the view that attributing the East-Asian resilience to the efficacy of regulatory reforms is premature. For instance, Mohanty and Turner (2010) question the argument that micro-economic reforms after the 1997 crisis have greatly strengthened banking systems in Asia. In their view, this conventional argument does not take enough account of the macroeconomic background. In support of their argument, they refer to recent developments such as a sharp rise in domestic savings, combined with the recent large-scale sterilised intervention and easy monetary policy that led to expansion of easy financing conditions, bank credit and large investment of banks into government bonds. Therefore they warn that the very liquid position of most banking systems in East Asia in recent times may result in a situation that the significant (but so far only latent) increases in market and credit risk might go undetected. Kang and Ma (2007) point out to the lack of historical data on losses for many
business areas in East Asian economies that have expanded so rapidly in recent years. They argued that it might expose banks to credit risks that they may be less equipped to manage well in the long-run. Arner & Schou-Zibell (2010) argue that the East Asian nations should not be complacent with the shorter-term situation and should indeed focus on enhancing mechanisms to address economic and financial stability, to balance and diversify economies, and to develop more effective domestic, regional, and global financial systems.

This chapter however argues that aforementioned contributory causes of East Asian resilience – which focus on regulatory reforms at banks on one hand, and structural changes in economy on the other hand - do not appear to be conflicting with each other, if they are analysed from the perspective of Minsky’s financial instability hypothesis and his agenda for regulatory reforms. The chapter therefore examines, by providing Minskian perspective to fieldwork findings, the role of regulatory reforms in bringing about structural changes in the economy and in achieving resilience in the longer run. In particular, the chapter begins with the application of Minskian insight to East-Asian crisis that a stable macro-economic environment results in weak regulatory oversight, and thereby brings about instability in the system. The chapter thereafter explains how regulations influenced incentive mechanisms at East-Asian banks by acting as thwarting forces. It demonstrates how incentive mechanisms had driven business strategy and competition by shaping up risk-reward ratios of banks. The chapter further articulates how this regulatory influence on industry competition promoted conduct, improved risk management and enhanced governance at banks. The chapter thus outlines the manner in which revamped regulatory mechanisms contributed to improved governance regime that was argued in existing academic literature to have brought about resilience in East-Asian nations during the 2007 crisis. In addition, this chapter also explains limitations of this analytical argument in the final section.

7.2 Destabilising Effects of a Stable Macro-economic Environment

As observed in the Chapter 2 on literature review, Minsky argued that instability in an economy is mainly an endogenous phenomenon that depends upon balance sheet liability structures of banks and corporates. In his view, the momentum of stability over a period of time breeds instability in the economy. Stable macro-economic environment results in attributing the buoyant growth phase to the success of policy choices adopted by national authorities. In the context of East-Asian growth, this can be explained by giving reference to the World Bank report “East Asian Miracle” published in 1993 (discussed at length in Chapter 4). It attributed the growth story of High Performing Asian Economies (HPAEs) to their
correct understanding of policy fundamentals and their pursuit of market friendly policies. However, Minsky (1984, p.155) argued that robust economic growth results in euphoric economy and in such a “taut, euphoric, and potentially explosive economy ...there is much scope for error by the central bank.” The errors in the context of East Asia, for instance, relate to inadequate regulatory oversight by central banks that did not commensurate with nature of challenges involved in growth phase of economy during early 1990s. These errors, as explained in Chapter 4, resulted in governance and risk management failures at local banks, which resulted in the period of instability in the region during 1997.

Minsky (2008 [1986], p. 11) however stated that instability should not be construed as a result of "incompetence or ignorance of policy makers" as it endogenously “emerges as a period of relative tranquil growth is transformed into a speculative boom” (Minsky 2008 [1986] p. 193). It implies that the stable macro-economic environment indeed has a natural potential to influence the behaviour of corporations and banks - key constituents of modern economy. This influence, during the stable macro-economic phase, is further facilitated by actions of external auditors, regulatory authorities and national governments. The result of behavioural change is the manner in which market participants over a period of time tend to undermine their, what I term as, economic responsibilities. For instance in the East-Asian context, carried away by the availability of huge foreign currency liquidity in the economy prior to the crisis, local banks facilitated risk-intermediation in an economically irresponsible manner. This was evident in huge credit and market risks assumed by East Asian banks in years prior to the crisis. Similarly, the availability of low-interest rate foreign currency credit undermined the economic responsibility of corporations to hedge their foreign currency exposures. The East Asian crisis further underscored the failure of external auditors in discharging their economic responsibility as they facilitated balance sheet choices of banks and corporations and did not comment upon underlying transparency issues associated with accounting disclosures. Underlying at the heart of such irresponsible behaviour (of banks, corporations and auditors) was policy choices pursued by East-Asian governments for achieving growth, which undermined their economic responsibility to develop strong regulatory institutions. Central banks, on their part, did not discharge their economic responsibility to provide adequate oversight on individual banks, which ultimately reflected the lack of effective institutional mechanism in East-Asian nations to deal with instances of financial instability. Minskian endogenous phenomenon can thus be used to explain that the stable macro-economic environment results in undermining of economic responsibilities by all players in the economy.
Minskian model however assumes a closed economy where the credit to operating units is driven by financial institutions such as banks. However, the East Asian pre-crisis experience demonstrates that the Minskian argument needs to factor in three additional perspectives, when applied in the context of emerging open-market economies - role of political forces in exacerbating the crisis, ‘impossible trinity’ challenges confronted by central banks and managing the contagion impact and financial panic generated by volatile capital flows. Each of these additional perspectives is therefore explained in following paragraphs.

As explained in Chapter 4, the role of political forces in exacerbating the crisis was observed in the context of Indonesia and Thailand, to a large extent. During the interviews, it was candidly acknowledged by Consultant 1 at Indonesia that during the pre-crisis period, “the political circles also helped the connected conglomerates to adopt certain of the non-transparent practices while offering collateral for their loans”. Interview findings further revealed that stable macro-economic environment poses not only risk management challenges to banks directly but also indirectly impacts the political situation in the economy. This aspect was explained by the Investment Banker 3 at Thailand, who stated that after the announcement of Baht devaluation, the local borrowers “were angry because they perceived the devaluation as a political decision and they are not prepared to bear the consequences of the political decision on their business. That resulted in the problem of mounting NPLs in the banking sector”. Thus, interview findings demonstrate that a favorable macro-economic environment on one hand has the potential to be misused by politicians by exerting a negative influence on banks to undermine their risk management mechanisms. On the other hand, a negative macro-economic environment is also considered as a political failure and can lead to non-cooperation to bold moves attempted during reforms process, complicating the recovery efforts of banks and thereby aggravating crisis situations.

Minskian analysis further needs to factor effects of volatile capital flows in the context of emerging economies. These capital flows present “Impossible Trinity” problem to the central bankers, which states that it is impossible for a central bank to have all three of the policy goals following at the same time – a) a fixed exchange rate, b) free capital movement (absence of capital controls) and c) an independent monetary policy (Aizenman 2010). This was explained in Chapter 4 using the experience of Thailand in defending its currency. During the pre-crisis period, BOT (Thailand) focused on free capital movement and had defended local exchange rate for ensuring its stability - in the bargain it gave up its monetary policy independence and continued to maintain the interest rates too high for a prolonged period. The actions of BOT (Thailand) (similar to that of Indonesian experience during pre-crisis)
gave an impression of stable exchange rate regime in the economy further leading to undermining of economic responsibilities by banks and corporations, as explained earlier. However, as the situation was untenable in the long run given the limited foreign exchange reserves, in July 1997, the BOT (Thailand) stopped defending Thai Baht and devalued it against the dollar. The Baht devaluation added to the macro-economic problem on two counts - one it has impacted the export industry and made the banks’ exposures to this industry problematic. And on the other hand, it has also impacted the financial industry directly in light of foreign exchange exposure that the banks were permitted to undertake prior to the devaluation. This problem became further rampant with the fact that much of the foreign exchange exposure undertaken by the banks was un-hedged. The ‘impossible trinity’ considerations thus demonstrate the manner in which emerging economies are pushed into periods of instability occasionally through global macro-economic forces and not necessarily always through endogenous phenomenon conceptualised by Minsky.

The devaluation of Thai Baht further ignited speculative attacks on neighboring currencies and consequential capital flight from these nations. While Malaysia could insulate the impact of these attacks and temporarily arrested the capital flight through imposition of temporary capital controls, Indonesian experience underscores the need for building up central bank efficiencies in managing capital flows in a more responsible manner during periods characterised by stable macro-economic environment. In this context, International Expert 2 explained that “the magnitude of contagion of the regional financial crisis underscored the need to further improve the institutional and policy environment in the financial sector to effectively address challenges of increased international financial integration”. The contrasting experiences of Malaysia and Indonesia thus indicate that the endogenous explanation of financial instability needs to be revisited in the context of emerging economies to factor in the role of contagious shocks, emanating from neighboring nations, in promoting financial instability.

Minsky’s financial instability hypothesis examines the complex interaction of forces arising from increased money supply during normal times, in setting the animal spirits of operating units into motion, through the mechanism of bank finance, which leads the economy into expansionary inflationary growth mode. The findings from the research project indicate how the money supply increases in emerging economies (such as the Tiger economies in the East Asian context) are influenced by the increased liquidity in developed nations (such as Japan), resulting in an impression of favourable macro-economic environment in emerging economies. This increase in money supply has the potential to undermine the risk-
management structures, influence political decisions, aggravate impossible trinity considerations and finally result in contagious impact leading to episodes of regional financial instability. Without consideration of all these factors, it will appear that weak bank governance standards in emerging economies contribute to financial instability. However, incorporation of these factors into Minsky’s financial instability hypothesis provides an explanation as to how governance arrangements at profit-seeking banks in emerging economies are influenced by macro-economic considerations.

7.3 Role of Regulation in Stabilising an Unstable Economy

After explaining that financial instability is as a result of internal market processes, Minsky turns to the role of regulation in stabilising an unstable economy. In his words (Minsky 2008 [1986], p. 280):

“The regime of regulation by the authorities, chartering restrictions, and central bank determination of the volume and effectiveness of bank reserves is intended to control the destabilizing forces inherent in banking and finance.”

In this section, therefore, findings from Chapter 5 (dealing with post-crisis regulatory reforms) are analysed from a Minskian perspective. At the outset, it appears that the focus of post-crisis regulatory reforms in East-Asia was primarily influenced by the Compendium of Standards (COS) formulated by the Financial Stability Forum in 1999. However, when analysed from the Minskian perspective, success of regulatory reforms in East-Asia could be attributed to three key aspects – use of regulation as a means to promote recognition of economic responsibilities by participants in the economy, judicious use of supervision and market discipline as complimentary tools to regulation and recognition of capacity building issues associated with regulatory reforms. The East-Asian experience further provides additional perspectives to Minskian analysis when applied in the context of emerging economies - role of regional co-operation and use of central banking tools to deal with volatile capital flows. Each of these aspects is explained in the following paragraphs.

Minsky (2008 [1986] p, 281) stated that “if the disrupting effects of banking are to be constrained, the authorities must drop their blinders and accept the need to guide and control the evolution of financial usages and practices”. The findings in chapter 5 indicated how East-Asian regulatory authorities - either under the influence of IMF conditionality (in case of Thailand and Indonesia) or as a result of self-realisation from learnings of the crisis (in case of Malaysia and Philippines) - introspected their institutional weaknesses before they
attempted to overhaul the financial sector. This has resulted in increased independence and regulatory oversight of East Asian central banks subsequent to the 1997 crisis (see table 7.1 for certain illustrative references to utterances by regulatory authorities collated during fieldwork to support this argument).

**Table 7.1: Increased Stature of Central Bank Oversight in East-Asia**

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<th>S. No</th>
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| 1     | Malaysia  | “In achieving the end game of creating an effective, efficient and stable financial sector, the respective building blocks of the various parts of the financial sector need to be put in place to form the solid foundation on which further progress can be built. The (FSMP) recommendations therefore are focused on enhancing domestic capacity and capability before proceeding with the introduction of an increasingly more competitive environment and subsequently towards greater international integration.”  
- Regulator from Malaysia (from the preface to Financial Sector Master Plan (FSMP) document of BNM (Malaysia) p no: 5) |
| 2     | Indonesia | “While we cannot put any “method” quantitatively to assess corporate governance, we were able to institute qualitatively “mechanisms” to increase awareness of stakeholders about its importance in achieving growth.”  
- Regulator from Indonesia |
| 3     | Thailand  | “The growing availability of new financial services and technology that allows risk to be priced, diversified, and shared cross borders further requires a modernization of both players and supervisors. Business wise, this meant employing comprehensive risk management tools, IT systems and continuing efforts to strengthen banking income through cost-cutting measures, improved credit underwriting standards, and new income channels such as fee-based services and retail banking. To assist these initiatives, integral commercial banking laws, regulations as well as supervisory efforts are also being updated, thereby enhancing supervisory flexibility and adaptability suitable for rapid financial innovation.”  
- Regulator from Bank of Thailand (from the preface to Thailand’s Financial Sector Master Plan Handbook, p no i) |
| 4     | Philippines | “We have issued various regulations on corporate governance, but we have kept them at principle level and made it very clear to the banks that the board and the senior management is...” |


The independence of central banks and their assumption of regulatory oversight in a more effective manner, post the crisis, is further highlighted even by industry and bank officials during the course of interviews in the context of Thailand and Indonesia, wherein the interviewees have narrated the instances of how the local central banks learnt the art of pushing through the regulatory reform even amidst political pressures. For instance, referring to certain political pressures that led to the pendency of passage of newly articulated Financial Institutions Act, the BOT (Thailand), as explained by Rating Analyst 2 at Thailand, has “started using its regulatory powers to issue the guidelines for providing lending”. In the context of Indonesia, the International Expert 1 recollected that:

“The independence of BI (Indonesia) is therefore the main driver in improving the governance mechanisms of local banks. The regulations were also meticulously followed up with enforcement actions also. BI (Indonesia) was earlier notorious for passing regulations that were never implemented. From that stage they have moved a long way forward – that is when they have freed themselves from the control of government to their own control”.

Regulations issued by independent central banks thus assisted the nations in promoting awareness and recognition of economic responsibilities by other participants in the economy. This has been observed in all the three countries in one way or other. First, in Thailand and Indonesia, there had been an acknowledgement of interviewees about the awareness of borrowers, post the crisis, to have their foreign exchange exposures appropriately hedged. This was attributed to the awareness created by regulators about their limitations in managing exchange rates and interest rates simultaneously in a stable manner, calling for vigilance on the part of banks and corporates also to monitor their respective foreign exchange exposures. It was observed that this was achieved on one hand through moral suasion, and on the other hand through appropriate use of regulation, which was aimed at increasing the cost of hedging thereby decreasing the incentives for deployment of foreign exchange sources by borrowers. Secondly, interview findings in Thailand have also provided examples of changes in business practices in the property sector whereby the property developers have started the concept of pre-built houses (instead of upfront collection of payments as prevalent during 1997 crisis) and borrowers have resorted to the mechanism of

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<td>primarily responsible for running the bank in a safe and sound manner.”</td>
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<td>- Regulator from Philippines</td>
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escrow accounts for depositing their money till the property is built. Thirdly, interviews in Malaysia have also outlined the manner in which the regulators emphasised upon undertaking credit appraisal before issuing bank guarantees. This has led to the realisation amongst the provident fund industry segment that they can no longer simply rely on bank guarantee for subscribing to bonds issued by infrastructure project sponsors. They are also now required to undertake their own credit appraisal before subscribing to bonds, which led to the development of market for credit ratings for such bonds. Enhanced regulatory oversight on banking sector had a downstream effect on the behavior of other market players (corporate borrowers) as they are now required to take adequate precautions to ensure that they do not default on their loans to banks and contribute to crisis situations once again.

The focus of regulatory reforms not only extended to regulatory frameworks but has resulted in appropriate mix of supervision and market discipline as a complementary tool to regulation. The emphasis on supervising banks through examination closely resembles an important Minskian perspective as he underscored the limitations of customers (depositor) and competitors in influencing portfolio preferences of banks. While depositors are challenged from the perspective of information asymmetry, competitors exacerbate the crisis situations by emulating, instead of influencing, the practices adopted by a bank, if they also found them to be profitable. “With the attenuation of customer and collegiate surveillance” Minsky (2008 [1986], p. 268) therefore stated, “bank examination becomes increasingly important as an instrument for constraining the exposure to risk of banks”. The fieldwork findings, in the context of Thailand and Philippines indicated how East-Asian banks are now careful in ensuring that the collateral accepted by them meets with the test of regulatory scrutiny during a subsequent examination. The requirement is also reflected in discussions with an official from international financial institution from Philippines who mentioned that they insist on posting of valid collateral, when they advise their clients on certain lending structures. Such comments reflected Minskian insights to consider bank examinations as “a conditional economic analysis of the bank’s operations if it is to function as a substitute for customer and collegiate surveillance” (Minsky 2008 [1986], p.269). In addition to these insights, fieldwork findings (especially in the context of Indonesia) further highlighted the attempts by East-Asian regulators in obtaining supervisory inputs by leveraging upon market discipline. Two examples in this context include the prescription by BI (Indonesia) – a) to banks, for publication of an exhaustive Good Governance Implementation report as part of annual report disclosure and b) to external auditors, for submitting a separate report to regulator regarding their assessment of internal audit function.
Another important finding in the course of interviews is the recognition of regulators that they need to address capacity building issues as they catch up market trends. In this context, it is relevant to quote Minsky (2008 [1986], p. 281) who stated - “In a world of businessmen and financial intermediaries who aggressively seek profit, innovators will always outpace regulators; the authorities cannot prevent changes in the structure of portfolios from occurring”. Against these remarks, the East-Asian experience indicated the steps taken by regional regulators to enhance their skill-sets through various region-specific initiatives, which helped in building regulatory institutions with individuals having relevant regulatory expertise. However, realising that the capacity building issues in certain key areas such as financial innovation and new financial products are yet to catch up industry trends, the regulatory authorities resorted to a restrictive approach on subscription to such products by local banks. While there are cross-country variations, and criticism by certain industry experts, on an overall basis, the restrictive stance adopted by East Asian regulators is explained (during fieldwork interviews) to have prevented large-scale investments by local banks in the exotic products that led to the recent financial crisis in 2007.

The East-Asian post-crisis experience thus suggested the attempt of regulatory authorities to act as thwarting mechanism against endogenous destabilising forces that push the economy into occasional periods of instability. In this context, regulatory reforms covered – an independent central bank guiding the market participants on their economic responsibilities, supplementing regulations with prudential supervision as well as indirect market discipline, comprehensive assessment of regulatory skill-sets, and choice of restrictive regulatory stance (in the context of financial innovation) based on regulatory (dis)comfort. However, the interview findings further highlighted two additional initiatives taken by East-Asian regulators over and above the prescription under Minskian agenda of reforms. These additional regulatory initiatives include steps taken by East Asian nations to a) accumulate foreign exchange reserves, b) leverage upon regional economic linkages and c) manage risks arising from volatile capital flows. As outlined in chapter 5, research studies subsequent to the crisis indicated that accumulation of foreign exchange reserves indeed helped the East Asian nations address ‘impossible trinity’ considerations. Chapter 5 further indicated that the regional co-operation amongst regulators had taken shape, post the crisis, in various forms - such as enhanced interactions amongst central banks through regional forums, regional financing arrangements, dedicated regional policy-making bodies for certain aspects of financial regulation, and training initiatives aimed at improving central banking skills in the region. Initiatives such as these offer useful insights to other emerging economies in dealing with volatile market environment through effective regional co-operation. The initiatives thus
constitute an additional perspective to recommendations of Minsky in instituting effective regulatory reforms.

7.4 Central Bank Efforts to steer the Evolution of a New Banking Business Model

The standard analysis of banking, according to Minsky, could be viewed as a game that is played by central banks (termed as authorities) and profit-seeking banks. According to Minsky, it is an “unfair game” as “the entrepreneurs of the banking community have much more at stake than the bureaucrats of central banks”. In such a situation, he states, “the profit-seeking bankers almost always win their game with the authorities, but in winning, the banking community destabilizes the economy; the true losers are those who are hurt by unemployment and inflation” (Minsky 2008 [1986], p. 279). Minsky therefore advises the central banking authorities undertaking regulatory reforms to view their task as a “learning game” for affecting the performance of a changing system. In such a game “central banking can be successful only if central bankers know how the institutional structure at banks behave for sourcing its funding and correctly assess how this behavior affects the system” (Minsky 2008 [1986], p. 359). In other words, central banks “have to steer the evolution of the financial structure” (Minsky 2008 [1986] p. 359). Against this background, an attempt has been made in this section to outline the manner in which the East-Asian regulators attempted to evolve a new financial structure by influencing the business strategies of local banks.

The business strategy of a bank typically aims at a) enhancing the ability of the banks to deliver products and services in a more efficient and effective manner, and b) mitigating the risks that arise from all walks of external environment. Regulatory reforms, in particular those that aimed at improving the risk management frameworks at case study banks, therefore are bound to influence the business strategies and financial innovation practices of banks. Accordingly, during the course of fieldwork, a review of business strategies and innovation efforts pursued by each of the case study banks was undertaken. The review was carried out by probing bank officials interviewed for the project and by examining published reports of individual banks. The findings are analysed to evaluate the efficacy of regulatory reforms in influencing business strategies at local banks.

A visible influence on business strategy that consistently emerged across experiences of all case study banks is aptly summarised in words of Rating Analyst 1 from Thailand:
"I think the important aspect, visible after the Asian crisis in the local banks, is that they started believing in their core strengths in domestic markets and never really got back onto offshore market, post 1997 in a big way”.

The consistent philosophy of focusing on business from known markets seems to have been primarily motivated by two important considerations – regulatory priorities articulated subsequent to the crisis and internal apprehensions of case study banks. It was observed during the fieldwork that the priorities laid down in Financial Sector Master Plans (FSMP) of respective nations, subsequent to the crisis, focused on enhancing efficiencies and competition within the system rather than globalising their local banks. For instance, FSMP of BOT (Thailand) stated that “the developments”, referring to measures outlined in the plan, “were aimed at providing the commercial banks with more flexibility to position themselves in such a manner that best leverages their expertise and strategic preference” (FSMP 2004 p. 2). The regulatory guidance to banks in the context of business growth was therefore to pursue it by building up internal efficiencies rather than by expanding into new territories. For instance, the FSMP of Malaysia categorically stated this guidance in following terms (FSMP 2001, p. 52):

“The survival of domestic banking institutions will be dependent on their ability to improve their efficiency and effectiveness in product offering so far as to be at par with the world class players. As market forces assume a greater role, domestic banking institutions must be proactive in their strategies in order to compete with global players. Innovation and strategic reengineering will be vital as the process will eventually see domestic banking institutions having to redefine their focus and find their own niches with broad oversight by the regulatory authorities.”

It was thus observed during the fieldwork that the focus on business strategy at each of the case study banks was to enhance their ability to deliver products and services in a more efficient and effective manner by focusing on known markets for business. This was visible through the innovation efforts of case study banks which concentrated on simple aspects such as process and operations streamlining and leveraging on IT capabilities for their existing business, rather than achieving financial risk management finesse through innovative derivative products, considering the restrictive stance of regulatory authorities with regard to financial innovation.

In this context, Table 7.2 below provides certain corroborating references drawn from Annual Reports of Case study banks for 2010. It can be observed from these references that the innovation & IT improvements at Case Study banks pursued at East-Asian banks are still in evolutionary stage. From being a mission statement (at Bank Peso), innovation efforts at
banks (such as Bank Rupiah, Bank Baht and Bank Peso) focus on providing integration of systems and processes to ensure seamless access to customers to all products and services of respective banks.

**Table 7.2: Extracts from Annual Reports of Case Study Banks**

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<th>S. No</th>
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| 1     | Bank Peso (Philippines) | “To be the preferred bank in every market we serve by consistently providing innovative products and flawless delivery of services, proactively reinventing ourselves to meet market demands, creating shareholders value through superior returns, cultivating in our people a sense of pride and ownership, and striving to be always better than what we are today...tomorrow.”  
- Corporate Mission  
Annual Report                                                      |
| 2     | Bank Rupiah (Indonesia) | “We rolled out our New Core Banking Systems into Bank's entire branch network. Combined with our efforts in customer service improvement, this new technology platform will not only allow us to provide superior service quality, but also enable the Bank to improve the speed of bringing to market new products so that we can be more competitive and efficient.”  
- Report from the Board of Directors:  
Annual Report (P No: 45)                                           |
| 3     | Bank Baht (Thailand)  | “We focused on integrating our newly-acquired retail businesses under one umbrella....Our business units operated with a clear strategy with the overall objective of creating a fully-integrated, universal bank with leading retail businesses....New equipment was installed to enable front-end employees to provide better service and ensure more efficient communication with customers. Consolidation of back-end systems supported better integration leading to greater efficiency and long-term cost effectiveness.”  
- Nature of Business  
Annual Report (P No: 24 & 25)                                      |
| 4     | Bank Ringgit (Malaysia) | “We continued to enhance our sales capabilities at our branches, and focused on delivering innovative products to our customers to complement our traditional suite of products and services. Our investment in the 1View sales and service platform has seen early success, with the first phase deployed in all branches by March 2011. In the near future, our customers will enjoy more personalised service at our branches, which will have the ability to track customer product holdings and their requests in real-time, allowing our sales personnel to offer more customised...”                      |
The focus of East-Asian banks (on enhancing technological capabilities internally) thus stands in contrast to the focus of banks from advanced nations (on risk-management capabilities and structures) prior to the 2007 crisis. The experience of each of the case study banks from this perspective is explained in subsequent paragraphs.

**Bank Rupiah (Indonesia):** “The Bank has consciously focused on the mass market which currently accounts for a major portion of its loan portfolio. The mass market portfolio represents loans to small scale enterprises and motorcycle loans”, mentioned the Bank Official 1 when questioned on the strategy adopted by Bank Rupiah. This reflected the learnings of Indonesian banks subsequent to the crisis, which is further facilitated through prescriptive guidelines from the regulator. The BI (Indonesia) regulations required local banks to prepare a thorough, comprehensive and realistic business plans based on prudential principal and risk management to monitor strategic risk. This business plan should be submitted to BI (Indonesia) by the end of November before the beginning of a new business year. Local banks, like Bank Rupiah (Indonesia), therefore adjusted the timing of their business plans and strategies to ensure compliance with this regulatory prescription. The underlying thought process at local banks in this context is outlined by Official 1 from Bank Rupiah (Indonesia) as under:

“I think a painful experience like the 1997 crisis has been an important reminder that our economy and business goes in cycles and is not a smooth linear progression. Like the weather, we are no better in predicting the timing of storms. In fact, the frequency and the intensity of the storms are becoming more intense with globalisation and improved technology. As a result, we have to better prepare for the storms in an appropriate manner but not lose sight that we still need to take calculated risks to ensure our business also grows in the future.”

Accordingly, it was observed that the Bank Rupiah (Indonesia) positioned itself externally as a universal bank focusing on financing the micro, SME and commercial businesses, and on automotive financing. However, “internally, the focus at the bank is quite clear. 50-55% of the business is mass market, micro lending and consumer lending. The focus of the bank therefore is not on innovative products” mentioned the Official 2 from the bank. The analysis of the strategy of the bank further revealed that it has chosen to remain focused on

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- Business Review Annual Report (P No: 021)
Indonesia, a market that it understood better and focus on a business line (mass market) that commensurate its operational and technical capabilities. For instance, during FY2011, through its subsidiary arm, the bank focused on motor cycle financing, motivated by the relatively lower interest rate environment, which made auto financing loans more affordable, thus supporting loan expansion strategy of the bank both for cars and motor cycles. The strategy was also based on the assessment of the bank with regard to low penetration of motorcycle ownership in the country and limited public transportation that have benefited the automotive industry. In addition it suited the local environment as Indonesia also enjoys its appointment as a base for MPV (Multi Purpose Vehicle) for regional markets and also a promising marketing spot for affordable city cars.

In order to promote growth in this segment, the bank had further focused on developing its funding franchise from matching sources and enhanced its operational capabilities. From a funding standpoint, the bank had undertaken steps to source funds from customers in the micro segment which has been the primary segment contributing to bank’s loans. Along with matching funding strategy, the bank also implemented a cost strategy that is aimed at seeking ways to improve productivity and efficiency. Initiatives in this direction included introduction of further synergies, consolidation and centralisation of back office processes and business process enhancement to deliver maximum utilisation of existing capacity and to better manage the bank’s cost to income ratio. This is achieved through initiatives taken by internal operations teams that supported the bank’s branch activities and managed the centralised processing centers in the region and in the head office.

The case study experience of Bank Rupiah (Indonesia) thus reveal the focus on domestic markets supplemented by initiatives to ensure matched funding and improved internal processes.

Bank Baht (Thailand): “I guess the strategy would be in line with general market approach, except that in the marketplace there will be some institutions taking a more product biased strategy. Ours is a service-led strategy supported by product and market innovation” states the CEO of Bank Baht (Thailand), in an interview given to Asian Banker magazine in April 30, 2007. Bank Baht (Thailand) thus positioned itself as a bank to which a broad spectrum of customers could look for all their financial needs without having a need to go elsewhere. In order to pursue to this business strategy within acceptable range of risk, the Bank has embarked on aspects of product innovation and process delivery.
With regard to product innovation “pricing mechanism is something we want to tweak. Flexibility with payment schedules, product design itself, different types of features on the asset side – this is all on the loan side” states the CEO of Bank Baht (Thailand) elaborating on product innovation as a means to achieve the bank’s business strategy. Two such product innovations, with just tinkering of design features that were observed on the liability side during the field work stage include the concepts of - “Just Code, No Card” and “Insurance Box”. “Just Code, No Card” launched in association with another financial institution, is a product concept that aimed to provide flexibility and convenience to more than six million customers nationwide, whereby money can be withdrawn from any ATMs of Bank Baht around the clock. The withdrawal could be made using codes received through a mobile phone or online instead of cards. Similarly, the “Insurance Box” concept denotes a new sales approach to non-life insurance policies. Insurance boxes available at bank branches contain policies aimed at personal accident coverage, car insurance, cancer coverage, and home insurance coverage. Insurance box is distinguished by the ease of its application process for all policies together – by picking it up from the branch, a customer receives instant coverage without having to submit separate applications for each policy.

“We talked about the service-led strategy, it’s not just about the face-to-face element of servicing, it is also about the efficiency of the process, so that the customer is not burdened with a long drawn-out multiple interaction process” says the CEO of Bank Baht, outlining the philosophy of the bank to leverage upon process improvement and systems enhancement as a means to achieve its strategy. The Bank had streamlined work flow and processes in order to improve service delivery and applied LEAN techniques to reduce redundant processes. Three such examples noticed during the fieldwork phase are explained below – a) The Bank had conducted in-depth customer analysis to better understand, anticipate, manage, and personalise its customer offerings. The derived knowledge has been incorporated into a newly developed “Customer Intelligence Tool”, which was rolled out nationwide to equip front-line staff with comprehensive customer profiles to let them suggest offers appropriate to each customer. The tool helps the employees to provide better service and turn customer interactions into sales opportunities. b) In order to improve the efficiency of operations and credit procedures, the Bank introduced a scanning technology, which contributes to a faster pre-approval process. Thus, the approval results for 90% of credit applications are known within one day. c) A credit review system called “Appraisal One” has been integrated into the collateral valuation process, which is linked to a database from which collateral value information can be retrieved and electronically transmitted to credit analysts. The application resulted in providing a quicker, more accurate appraisal value for real estate, and at a lower
cost by eliminating the paperwork expenses and reducing the turnaround time for processing the application (from 5 to 3 days).

The strategy of Bank Baht (Thailand) thus reflects influence of its strategic partner BB-SI (Thailand), whose expertise of operating in a retail market and with improved technological processes was leveraged upon to enhance the profitability of the bank.

**Bank Ringgit (Malaysia):** The strategy of the Bank Ringgit (Malaysia) has been to become one of the fastest growing consumer banking franchises in the Asia Pacific region in addition to being the leading indigenous investment bank. The strategy has been articulated further by Malaysian Bank Official 1 as follows:

“You have to understand this way - If you are a bank and you have a business, it is important that this business is something which we understand better. And as far as Bank Ringgit is concerned, we feel that we understand Malaysia better. And by virtue of the close economic connections, we also feel we understand the ASEAN nations better - we understand the customers here, the banks here - and therefore we tend to focus ourselves more as a regional bank - and not as a global bank, and if you think about it, it is the global banks that are exposed to the sub-prime crisis in 2007”

Accordingly, the analysis of Bank Ringgit (Malaysia) strategy reveals that the focus has been to acquire a size by operating as a regional player rather than focusing on product or process innovation to get differentiated in the local market like Bank Baht (Thailand) or Bank Rupiah (Indonesia). Unlike the other two banks, which embarked on IT and operational efficiencies in a focused manner, the tasks in the case of Bank Ringgit are “really challenging, especially when you reckon the fact that 30% of the bottom-line at Bank Ringgit is coming from businesses that are from outside Malaysia”. For instance, it had to take into account regional implementation of Financial Reporting Standard (FRS) 39 dealing with loan loss provisioning across all its operations in the region, making it a huge project with an ability to proactively detect and provide for impaired loans. Similarly, the Group Information and Operations Division (GIOD) at the bank had managed over 200 projects in 2010 the region to streamline the internal processes. Each project has to be rolled out in a phase wise manner taking one location at a time and tweaking it to nuances of the next geography subsequently. The philosophy of these projects is articulated as DOME (Developing Operations Management Excellence), through which operations management framework underpinning internal processes were combined with industry best practices and continuous improvements to drive better productivity and cost efficiencies. First launched in Malaysia in 2009, it was
subsequently extended across Indonesia, Singapore and Thailand in 2010 to create a regional culture of operational excellence.

Another interesting project aimed at creating operational efficiencies and in line with the regional focus of the Bank Ringgit is the launch of Tele-Presence (TP) system. Vastly superior to video conferencing, TP allows the employees to have face to face conversations in almost real-time, greatly increasing productivity, and reducing traveling costs, even as the bank’s operations becomes more and more regional. This is an important tool to faster decision-making in regional context, especially related to credit aspects. However, this strategy is not without its share of challenges. A challenge that has been outlined by the Malaysian Bank Official 1 in this regard is as under:

“When we are embarking on creating a regional credit committee, there seems to be some regulatory issue to that – the actual decision is taken outside the country – so it is a work in progress – we are still working on this – because theoretically also when these committees take a decision, then it is like head office staff taking decisions on behalf of subsidiaries, so there can be integrity issues – so we are working on evolving the right kind of structure taking into account all these nuances”

The Bank Ringgit (Malaysia) thus aimed to become a leading regional player serving the markets it understands better. While there are challenges in building up scale across various locations and meeting domestic regulatory requirements, the focus of the bank has been to achieve operational excellence as a part of the strategy.

**Analysis of business strategies:** A review of business strategies of case study revealed the manner in which the regulatory focus on building up internal efficiencies, and refraining from financial innovations, resulted in certain new business models, which focused on domestic markets, rather than the one prevalent prior to 1997 crisis. Findings of interviews and review of experience of individual banks provides an insight that the restrictive nature of the regulator was only with respect to pure innovations aimed at growth of bank balance sheets. These were the typical innovative financial products that need careful handling as they have potential to expand the balance sheet by derisking their assets at the level of individual bank, while accumulating the risks at the system level. Instead of encouraging such type of financial innovation, regulators attempted to promote financial innovations that promote long-term economic growth in the nation. For instance, the objectives of efficiencies echoed in all the FSMPs has led to the enhanced focus of industry on a) financial process innovation rather than on financial product innovation; and b) credit-delivery-side innovation of distribution channels rather than funding-source-side innovation of liability instruments.
The subtlety of this distinction led a shift in the focus of innovation capabilities of the industry to leverage on their IT capabilities (as was demonstrated in the case of Bank Baht (Thailand) and Bank Ringgit (Malaysia)) to enhance customer experience and improve faster processing of customer applications. Further, it has provided comfort to the regulator that the innovation does not contribute to increased supply of funding sources that have the potential to escape regulation. Instead, the innovation efforts were channeled (as was demonstrated in the case of Bank Rupiah (Indonesia)) to improve credit delivery in the sectors (such as Small and Medium Enterprises and Automotive financing segment critical for the Indonesian economy). It has also resulted in efforts of banks concentrating on innovation in savings bank products that can address the liquidity risks and not just the credit risk (as was demonstrated by Bank Baht (Thailand)).

The review of business strategies of case study banks and their efforts to innovate therefore reveal that the regulatory approach, subsequent to the 1997 crisis, led to adoption of business models that regulators are more comfortable in dealing with - such as regional banking focus in case of Bank Ringgit (Malaysia), retail banking focus in case of Bank Baht (Thailand) and SME banking focus in case of Bank Rupiah (Indonesia).

7.5 Business Strategy, Risk Management and Bank Governance

Minsky considers banking as a dynamic and innovative profit-making business and stated that “bank entrepreneurs actively seek to build their fortunes by adjusting their assets and liabilities, that is, their lines of business, to take advantage of perceived profit opportunities. This banker’s activism affects not just the volume and distribution of finance but also the cyclical behavior of prices, incomes, and employment” (Minsky 2008 [1986], p. no: 252). It follows from these remarks that banks pursue business models so long as they found them to be profitable. Given the fact that the East-Asian regulatory stance was restrictive towards development of new financial products that were considered lucrative during early yearly years of 2000s, in this section an analysis of individual banks’ perception of business models on their impact on profitability and growth is initially presented. It is thereafter argued in this section that as banks were comfortable with business models encouraged by regulators, they went about building up internal governance and risk management arrangements around such business models compatible with regulatory expectations.
Minsky (2008 [1986] p. no 264) explained that “a bank that increases leverage without adversely affecting profits per dollar of assets increases its profitability.” He further explained this in greater detail as he writes:

“If we assume that operating costs are under control, a bank’s profit rate will increase if either net earnings per unit of assets or the ratio of assets to owner’s investment increases. The first implies a search for ever larger spreads between interest rates on liabilities and assets. The spread among rates reflects relative riskiness and the time to payment, which can be reduced to a risk factor....The attempt to increase the spread between asset and liability interest rates leads banks to improve the services they provide to depositors and borrowers by creating new types of paper; new financial instruments result from pressure for profits” (Minsky 2008 [1986], p. no: 265)

As observed from previous sections and earlier chapters, on one hand regulators had taken a restrictive stance on innovative financial products at East-Asia and on other hand promoted banks to adopt a new business models focused on domestic markets and efficiencies in internal processes. However, interactions with case-study bank officials revealed that they were also convinced that their new business models are profitable from a risk-reward trade-off perspective. This can be corroborated through a summary review of annual reports, which further acknowledged the positive impact of these business models on their profitability and growth (refer to Table 7.3 below). It could be observed from these extracts that, during 2010, case-study banks indeed considered their traditional banking business models as profitable and pursue process innovation as driver for future growth:

### Table 7.3: Positive Impact of New Business Models on Profitability & Growth

<table>
<thead>
<tr>
<th>S. No</th>
<th>Bank</th>
<th>Extracts from Annual Report 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bank Ringgit (Malaysia)</td>
<td>“The successful regionalisation of our products and services is fundamental to our business model which is premised on creating value from economies of scale across markets.”</td>
</tr>
<tr>
<td>2</td>
<td>Bank Baht (Thailand)</td>
<td>“As productivity gains were achieved, the proceeds were channeled into investments in new technology infrastructure, the branch network, Group branding, and employees, which will deliver increased benefits and profitability going forward.”</td>
</tr>
<tr>
<td>3</td>
<td>Bank Rupiah (Indonesia)</td>
<td>“The improved earnings were supported by a broad based loan and deposit growth...The Bank continued to reach out to millions of micro, small and medium enterprises...Deposits grew during the year with emphasis in garnering current and savings accounts...In addition, the</td>
</tr>
<tr>
<td>S. No</td>
<td>Bank</td>
<td>Extracts from Annual Report 2010</td>
</tr>
<tr>
<td>-------</td>
<td>------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bank continued with its policy of diversifying its funding...These positive developments underscore the strength of Bank’s business model and franchise as well as the result of continuing investments in risk management, network expansion, information technology and human capital. We shall continue to judiciously invest in these areas to further strengthen the organisation and to enable sustainable growth.”</td>
</tr>
<tr>
<td>4</td>
<td>Bank Peso (Philippines)</td>
<td>“The profit growth was a result of a more diversified and sustainable earnings stream from the Bank's core lending, deposit-taking and service businesses.”</td>
</tr>
</tbody>
</table>

The extracts mentioned above can be correlated to the analysis presented in previous section. It can be argued that case-study banks during later part of 2000s were found to be adopting business models that are conductive to their profitability objectives. Considering this and the restrictive regulatory stance, it can be stated that the pace at which financial innovation fostered in the region remained relatively low. Thus, the regulatory reforms at East-Asian region resulted in risk-reward trade-offs (whereby banks were found to be averse to risky financial innovations and were comfortable to pursue business models that were rewarding them from a profitability standpoint). The risk-reward perceptions arising from pursuit of new business models in turn found to have promoted acceptable risk-appetite, enhanced risk-management practices and improved risk & compliance culture at case study banks (as outlined in paragraphs 6.2 & 6.4 in Chapter 6).

For instance, Thailand Bank Official 1 at Bank Baht (Thailand) explained this process in the context of credit risk management by drawing out references to their annual report, which stated as follows:

“The core objective of credit risk management is to ensure that credit-related losses are within stipulated risk-appetite levels. It establishes a framework of controls to ensure that the risk-taking is within defined parameters while ensuring that risk-reward objectives are met. Credit Risk Teams continuously endeavor to improve the quality of the portfolio by upgrading infrastructure, processes, and risk management tools. Risk management begins at the stage of processing customer’s credit requests and progresses all the way up to ensuring timely repayments of obligations and, where necessary, ensuring collection of past-due payments.”

The extract thus traces the top-down effect of the risk-management initiatives at high-level (in the form of risk-appetite statements) getting translated into operational activities (relating
to processing of customer requests and monitoring their dues). Similarly, in the context of Bank Ringgit (Malaysia), Bank Official 5 observed that the efforts to drill-down the regulatory guidelines with focus on risk-management across the levels of organisation through stipulated internal processes had resulted in a “psyche within the group and front of management that you must know the compliance as your own duty, you meaning each and every individual within the organisation”. Along with further such examples from Chapter 6 it can be stated that the regulatory reforms at national level enabled enhancement of risk and compliance culture – the two cornerstones of bank governance, across all levels in the organisation. The explanation thus synthesises alternative arguments presented at the beginning of the chapter by explaining that the Minskian-style agenda of reforms, modified to suit local circumstances, enabled business models and financial structures conducive to overall resilience at macro-economic level and promoted enhanced governance and risk-management at bank-level.

The entire process can therefore be pictorially represented as follows for answering the fourth research sub-question:

![Diagram](image)

In light of the above, it is apt to conclude this analysis by stating that the regulatory reform experience of East-Asian regulatory authorities corroborates the following conclusions of Minsky (2008 [1986] p. no: 281):
“If the authorities constrain banks and are aware of the activities of fringe banks and other financial institutions, they are in a better position to attenuate the disruptive expansionary tendencies of our economy.”

7.6 Limitations to the Analysis

The analysis presented in this chapter is however subject to three key limitations which can undermine the sustained outcome of regulatory reforms in East-Asia - capacity building issues of regulators, inadequate credit-information sharing infrastructure and macro-economic imbalances that may arise after withdrawal of stimulus provided by advanced economies to avert the downside of 2007 crisis.

The chapter analysed the East-Asian post-crisis experience and the nature of regulatory reforms and argued that the East Asian experience can be characterised as having exhibited “cautionary restraint” position, which helped them in achieving the perceived resilience ascribed to them in the literature. However, it can also be argued that this strategy has been adopted by regulators in their bid to ensure “economizing on scarce talent” (Alexander et al 2006 p. 257). The strategy is resorted to by regulators, when confronted with scarce regulatory talent to deal with a phenomenon in financial sector, by restricting the particular phenomenon from occurring in the financial sector. For instance, as their skill-sets did not match the sophistication required to deal with risks of financial innovation, East-Asian regulatory authorities adopted various restrictive strategies while dealing with innovative financial products. The situation temporarily might have prevented the economies from making large scale investments in the complex products However, in the long-run this may not enable the economies to exploit the benefits of financial innovation in an effectively regulated (rather than restricted) environment. The possible challenge to East Asian regulators is therefore to acquire the skill-sets required to regulate the financial innovation in a manner conductive to promote financial stability rather than simply restrict the financial innovation in an attempt to prevent episodes of financial instability.

Secondly, much of the credit risk management improvements at case-study banks involve usage of risk-assessment tools with various levels of sophistication. However, risk-assessment tools in the context of credit risk management envisage existence of robust infrastructure in the nations to share credit information amongst market participants. As Stiglitz and Weiss (1981) stated, the problems of adverse selection and information asymmetry involved in bank-lending can be mitigated with the availability of high-quality credit information in the
industry. However, as the World Bank (2012) report on "Rethinking the role of state in finance" observes, much of the credit information sharing arrangements in the East-Asian region represent only credit registries, to which the information should be reported by virtue of regulatory requirements. Unlike credit registries, credit bureaus (privately owned commercial enterprises) are generally considered as a superior credit information sharing infrastructure, as they strive to collect very detailed data on individual clients. Further, as the scope of credit bureaus extends to variety of financial and non-financial entities (including retailers, credit card companies and micro-finance entities), the services provided by them tend to be comprehensive and better for assessing and monitoring the creditworthiness of borrowers. While the East-Asian nations fare well against other developed nations in terms of credit registries (covering 8.2% of population as against 8.0% population coverage for OECD nations), the coverage of credit bureaus (currently at 17.3% of population) is strikingly lower than the coverage at OECD nations (currently at 61.1% of population). Till the time the coverage of credit bureaus improves, as Mohanty and Turner (2010) apprehend, currently significant (but so far only latent) increases in credit risk might go undetected. This largely undermines the impact of efficiencies achieved through risk management initiatives in the long run.

Thirdly, the improvements in the area of liquidity risk management always tested when the nations are squeezed from liquidity. Currently, considering the learnings from the crisis, East-Asian nations have built in substantial foreign exchange reserves to act as a sufficient cushion against unforeseen foreign currency illiquidity scenario. However, the adequacy of the same is currently not yet tested, considering the quantitative easing policy adopted by the advanced nations, notably the US. Once the quantitative easing policy is withdrawn by these nations, the liquidity across the emerging nations is constrained and the flight to quality results in competition for dollar resources. In such a scenario the ability of East-Asian nations in effective utilisation of their foreign exchange reserves will be tested. Till such time, the current environment characterised by adequate liquidity, represents the situation prior to 1997, when the environment appeared to be stable.

The East-Asian experience therefore highlights that resilience can be achieved subsequent to a crisis episode through structural changes to business models of banks, orchestrated by regulatory reforms aimed at improved governance and risk management practices. The experience, subject to issues highlighted in this section, provides useful policy-level recommendations, which are covered in the subsequent chapter.
8) Conclusion

At the peak of East-Asian crisis, Kregel (1998, p. 2) wrote that even Minsky would have been “curious to discover the sources of financial fragility that produced financial breakdown in the Asian region.” A similar curiosity motivated this research project, on the eve of 2007 financial crisis, to examine the East-Asian experience (covering and pre and post crisis period) from the perspective of Minsky’s financial instability hypothesis. Such a review of East Asian is expected to offer useful lessons to regulatory authorities, especially from emerging economies, in steering regulatory reforms at their respective nations.

Against the above background, the previous chapters presented the contextual setting for the research project, the findings from fieldwork interviews and their analysis from a Minskian perspective. This chapter concludes the research project by outlining its contribution to academic literature, highlighting the policy implications and providing the pointers for future research.

8.1 Academic Contribution and Policy Implications

The research project explored the research question - How does the pursuit of agenda of regulatory reforms, post the crisis, influence governance arrangements at banks and assist them in maintaining resilience during subsequent episodes of crises? The project adopted a comparative case study approach involving a mix of review of secondary resources and the fieldwork interviews (spanning across forty plus interviewees). Using the research question, the research project provided a critical review and systematic application of an important academic theory in the context of financial crises – Minsky’s Financial Instability Hypothesis, to the East-Asian crisis. Using Minskian insights, the project attempted to synthesis alternative arguments about a) origins of the 1997 crisis (either as a contagion or a vulnerability); and b) attribution of East-Asian resilience during 2007 crisis (either to improved governance or to structural transformation of banking sector). In doing so, the project interpreted the post-crisis experience of the East-Asian nations from the perspective of regulators and banking industry professionals. The project further evaluated certain ground-level nuances that were found to be missing in the existing academic debate but whose careful evaluation in a structured manner has the potential to extend the practical validity of academic theories into a broader professional practice. The research project,
therefore, humbly claims originality of application, interpretation and evaluation, which are considered as building blocks for "academic contribution" to the existing literature on financial crises.

The originality of the academic contribution can be translated into a conceptual insight, which highlights the role of regulation in bringing about, recognition of economic responsibilities amongst market participants in an emerging economy. The academic debate so far focused upon aspects such as financial instability, regulatory reforms and bank governance, individually. Using the Minskian insights and the East-Asian post-crisis experience, the research project integrated these individual aspects and provided a coherent analysis for enhancing their practical utility. In doing so, it highlighted the economic responsibilities of regulators, boards and senior management, independent directors, monitoring agents (such as depositors, investors and external auditors), and corporate borrowers in bringing about a structural transformation of the banking business conducive for attaining financial stability. The contribution of the research project is, therefore, to bring into the forefront of academic discussion a key role of regulatory reforms in emerging economies: creating awareness amongst individual actors about their collective economic responsibility in attaining the financial stability.

The role of regulatory authorities in promoting awareness of economic responsibilities can be further explained from four different dimensions. Firstly, it emphasises the role of ex-ante regulation and regulatory expertise required for continuously monitoring the global macro-economic forces and the innovative banking practices in order to limit their perverse incentives on banks. Secondly, it points out to the participative approach to be adopted by regulators for reminding the boards and senior management of banks about their role in instituting robust internal governance and risk management mechanisms as well as for enhancing market discipline. Thirdly, it highlights the regulatory focus required for enhancing the expertise of independent directors and promoting responsible conduct of external auditors for bringing about safety and soundness of banks. Fourth, it reminds the role of regulation in disciplining the corporate borrowers and sensitising them on the need to make judicious use of bank finance for operating purposes, rather than for speculative purposes, by focusing on their business cash-flows rather than on collateral values. Thus the argument of research project on the enhanced role of regulation in promoting economic responsibilities has certain policy implications in the emerging economy context – for regulators, for banks, for monitoring agents and for corporate borrowers.
From the perspective of regulators, the findings call for significant investment in information systems and development of regulatory policies on data dissemination and analysis for generating information that is up-to-date, reliable and are relevant for monitoring the impact of global macro-economic forces. The research findings highlight the central bank policy independence required for financial stability, by enhancing the definition of “independence” to include the ability of the central bank to pursue regulatory policies not only amidst the pressures of political forces, but also against industry influence, pressures of economic growth and international advice. The findings further indicate that a liberal regulatory policy stance can be complemented with risk-focused supervision and enhanced market discipline that are aimed at providing policy triggers for timely supervisory intervention and stricter enforcement action by regulator, whenever required. The research findings also underscore the need for differentiated regulatory policies required separately for encouraging stability-enhancing technological process innovation and for discouraging instability-augmenting financial product innovation.

From the perspective of banks, research findings emphasise the responsibilities of professional boards in instituting governance and risk management policies at their respective banks. Using the East-Asian experience, the findings indicate policies that can be developed by boards and senior management for bringing about an eventual transformation of their business models conductive to the overall attainment of financial stability. In particular, the areas requiring policy attention stemming from the research project include – nature of proactive engagement with regulatory authorities, extensive deliberation on risk-appetite, substantial reliance on internal control frameworks, and management focus on innovation aimed at improvements in bank’s long-term performance.

From the perspective of monitoring agents, the research findings indicate three important policy dimensions. Firstly, the research underscores the need for enhanced capacity building initiatives, with the support of regulator, aimed at building up expertise in the community of independent directors and external auditors. Secondly, the findings require the formulation of regulatory policies that blend the nature of independence expected from independent directors with the extent of reliance that they can place on the bank’s internal information systems. Thirdly, the findings call for enhanced role of independent directors in promoting the effective use of supplementary supervisory tools (such as enhanced market discipline and targeted audit reports) by regulatory authorities in addition to relying on primary regulatory tools.
From the perspective of corporate borrowers, the research findings indicate the need for formulation of regulatory policies that promote conductive borrower culture for attaining the objective of financial stability. In particular, areas that require regulatory policy attention include – ensuring availability of diverse funding sources in the economy (so that the borrowers do not overly rely foreign liquidity), encouraging appropriate hedging of exposures denominated in foreign currency, promoting the culture of sharing of quality credit information amongst market participants, influencing the corporates to place extensive reliance on business cash-flows rather than on collateral values, and enhancing judicious use of bank finance for long-term economic growth by not involving in speculative activities.

### 8.2 Pointers for Further Research

The research project thus contributes to the existing academic literature and provides useful insights having policy implications relevant for emerging economies. In doing so, it has further identified various areas that have the potential for further empirical research. In particular, these relate to the capacity building initiatives and communication policies of central banks, and the cash-flow dimension of corporate governance. Each of these aspects is explained further below.

The existing literature on financial crisis focuses on the corporate governance aspects such as rational behavior, remuneration and risk-focus required for boards and senior management of banks. Based on lessons from East Asian experience, the research project identified the area of regulatory governance that can be subjected to larger empirical research in emerging economy context. In particular the aspects such as - personal motivations that shape up operational-level decision-making behavior at regulatory agencies, compensation trends of regulators in comparison to that of industry players and structured risk-management frameworks required for central banks for addressing risks from global macro-economic forces - can be targeted for wider empirical research. Considering the role of regulatory governance aspects in deciding the future course of long-term financial stability, the current attention to these aspects in existing academic literature is relatively limited, which needs to be enhanced going forward.

The existing literature on communication policies of regulators extensively focuses on the monetary policy and price stability aspects of central banking. There has been emerging literature on the role of macro-prudential banking regulation in the ambit of monetary policy framework post the 2007 financial crisis in the context of developed economies. The research
project, however, identified pointers regarding communication approach adopted by East-Asian regulators for ensuring that industry players appreciate the objective of regulatory reforms in right spirit. In particular, given the problems of Impossible Trinity on the pursuit of prudential monetary policy, examining the **role of effective banking regulation as a substitute for transparent central bank communication** can be another interesting area of research in the context of emerging economies.

The traditional corporate governance literature focuses on the role of financial statements in board and senior decision-making framework. In particular, the controls on financial reporting in the overall internal control environment received wider attention especially after the Enron episode and the corporate failures during dotcom bubble. However, Minsky’s financial instability hypothesis, as analysed in the East-Asian context, offers an alternative financial evaluation perspective with extensive cash-flow orientation in the context of bank governance. The role of **cash-flow statement** in determining the risk-appetite by bank board as well as in shaping up the supervisory stance by the supervisory authorities is another potential area of research in the context of emerging economies. In particular, efforts needed for translating the Minsky’s classification of borrowers, based on cash-flow categorisation for loan repayment, into useful governance and regulatory mechanism needs further empirical research work.

### 8.3 Summing Up

The objective of the Manchester Business School Doctor of Business Administration (DBA) programme is “to study a real business issue in depth and then immediately apply that knowledge in working life, directly improving commercial outcomes within the organisation and beyond”. Against the stated objective, the research project embarked on a key policy aspect from the financial services industry that is a subject matter of extensive debate in recent times. The findings of the project demonstrated the originality of application, interpretation and evaluation of key academic insights, which are considered as building blocks for “academic contribution” to the existing literature on financial crises. The findings of research project provided policy-level recommendations and pointers for future research relevant for pursuit of regulatory reforms in emerging economies.
### Annexure 1 - List of external interviewees

(Industry officials/experts from external agencies)

<table>
<thead>
<tr>
<th>S. No</th>
<th>Name of the Interviewee</th>
<th>Referred to in the project as</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A</strong> Malaysia</td>
<td></td>
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<tr>
<td>1</td>
<td>Chairman&lt;br&gt;Local Consultant &amp; Training Solution Provider</td>
<td>Consultant 1</td>
</tr>
<tr>
<td>2</td>
<td>Managing Director&lt;br&gt;Local Consultant &amp; Training Solution Provider</td>
<td>Consultant 2</td>
</tr>
<tr>
<td>3</td>
<td>Executive Director – Financial Risk Management Multi-national consultancy firm</td>
<td>Consultant 3</td>
</tr>
<tr>
<td>4</td>
<td>Manager – Financial Risk Management Multi-national consultancy firm</td>
<td>Consultant 4</td>
</tr>
<tr>
<td>5</td>
<td>Head – Financial Institution Ratings&lt;br&gt;Local Credit Rating agency</td>
<td>Rating Analyst 1</td>
</tr>
<tr>
<td>6</td>
<td>Senior Manager – Islamic Ratings&lt;br&gt;Local Credit Rating agency</td>
<td>Rating Analyst 2</td>
</tr>
<tr>
<td>7</td>
<td>Officer – Regulation &amp; Supervision Administration&lt;br&gt;Bank Negara Malaysia</td>
<td>Regulator</td>
</tr>
<tr>
<td><strong>B</strong> Thailand</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Senior Executive Vice President&lt;br&gt;Local Investment Bank</td>
<td>Investment Banker 1</td>
</tr>
<tr>
<td>9</td>
<td>Managing Director&lt;br&gt;Global Rating Agency</td>
<td>Rating Analyst 1</td>
</tr>
<tr>
<td>10</td>
<td>Executive Vice President&lt;br&gt;Local Rating Agency</td>
<td>Rating Analyst 2</td>
</tr>
<tr>
<td>11</td>
<td>Vice President&lt;br&gt;Local Rating Agency</td>
<td>Rating Analyst 3</td>
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<td>12</td>
<td>Deputy Vice President&lt;br&gt;Local Rating Agency</td>
<td>Rating Analyst 4</td>
</tr>
<tr>
<td>13</td>
<td>First Vice President&lt;br&gt;Local Investment Bank</td>
<td>Investment Banker 2</td>
</tr>
<tr>
<td><strong>C</strong> Indonesia</td>
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<tr>
<td>14</td>
<td>Director</td>
<td>Consultant 1</td>
</tr>
<tr>
<td>S. No</td>
<td>Name of the Interviewee</td>
<td>Referred to in the project as</td>
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</tr>
<tr>
<td>15</td>
<td>Leader, Advisory Services Multi-national consultancy firm</td>
<td>Consultant 2</td>
</tr>
<tr>
<td>16</td>
<td>Senior Manager, Advisory Services Multi-national consultancy firm</td>
<td>Consultant 3</td>
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<td>17</td>
<td>Director Global Rating Agency</td>
<td>Rating Analyst 1</td>
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<td>18</td>
<td>Director Global Rating Agency</td>
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<td>19</td>
<td>President Director Global Rating Agency</td>
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<td>Lead Financial Economist International Financial Institution</td>
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<td>Advisor International Financial Institution</td>
<td>International Expert 2</td>
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<td>Assistant Director Bank Indonesia</td>
<td>Regulator</td>
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<td><strong>Philippines</strong></td>
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<td>23</td>
<td>Partner Multi-national consultancy firm</td>
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<td>24</td>
<td>Partner Multi-national consultancy firm</td>
<td>Consultant 2</td>
</tr>
<tr>
<td>25</td>
<td>Operations Officer International Financial Institution</td>
<td>International Expert 1</td>
</tr>
<tr>
<td>26</td>
<td>Senior Country Economist International Financial Institution</td>
<td>International Expert 2</td>
</tr>
<tr>
<td>27</td>
<td>Executive Director – Centre for Corporate Governance Regional Business School</td>
<td>Professor 1</td>
</tr>
<tr>
<td>28</td>
<td>Economics Professor (email interview) Local University</td>
<td>Professor 2</td>
</tr>
<tr>
<td>29</td>
<td>Assistant Governor Bangko Sentral ng Pilipinas</td>
<td>Regulator</td>
</tr>
</tbody>
</table>
Annexure 2 – Questionnaire for External interviewees

1. Can you briefly elaborate on contributory factors of the 1997 crisis in your country?

2. Academic literature cites two main theories for 1997 crisis – the contagion theory which talks about panic impact that triggered the currency crisis and the vulnerability theory which talks about the governance and risk management failures which triggered the banking crisis. Which theory do you think is relevant to explain crisis in your country in 1997?

3. Can you throw some light on micro aspects, more importantly measures that the local banking regulator has taken since 1997 to improve governance levels at individual banks?

4. How did banking regulator go about implementing corporate governance strengthening agenda in your country? Are there any similarities or differences between the approach adopted by your regulator and the one adopted by regulators of neighboring nations?

5. How did the industry react to these regulatory developments on governance? What is the prime driver of corporate governance improvements at individual banks?

6. Apart from the regulatory driven agenda, do the local banks take the issue of corporate governance seriously post 1997?

7. Can you give illustrations of areas of improvement in corporate governance since 1997 in local banks? Did you notice any remarkable change in the way boards function at local banks since 1997? Do they have a mere compliance orientation towards regulations?

8. The success of the board in its functioning is largely driven by quality of information that it receives and utilises in the decision making process. This information comes in wide variety of ways including through external sources such as consultants and auditors. So, in this backdrop, did you see any enhancements in roles of consultants and auditors in the corporate governance framework in recent times in your country?

9. During 1997 crisis, lot of capital has been withdrawn from East Asian Nations and given these corporate governance initiatives both at the level of banking regulator and at the institution level, do you see any reversal of trends and increased investment in these nations in recent period?

10. Did regulatory reforms and governance improvements since 1997 crisis play any major role in maintaining resilience during the recent sub-prime crisis with respect to local banks?
<table>
<thead>
<tr>
<th>S. No</th>
<th>Name of the Interviewee</th>
<th>Referred to in the project as</th>
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</thead>
<tbody>
<tr>
<td><strong>A</strong></td>
<td><strong>Bank Ringgit, Malaysia</strong></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Chief Risk Officer</td>
<td>Malaysia Bank Official 1</td>
</tr>
<tr>
<td>2</td>
<td>Head, Group Corporate Communications</td>
<td>Malaysia Bank Official 2</td>
</tr>
<tr>
<td>3</td>
<td>Chief Credit Officer</td>
<td>Malaysia Bank Official 3</td>
</tr>
<tr>
<td>4</td>
<td>Group Chief Internal Auditor</td>
<td>Malaysia Bank Official 4</td>
</tr>
<tr>
<td>5</td>
<td>Director &amp; Head, Group Compliance</td>
<td>Malaysia Bank Official 5</td>
</tr>
<tr>
<td><strong>B</strong></td>
<td><strong>Bank Baht, Thailand</strong></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Chief Risk Officer</td>
<td>Thailand Bank Official 1</td>
</tr>
<tr>
<td>7</td>
<td>Executive Vice President – Compliance</td>
<td>Thailand Bank Official 2</td>
</tr>
<tr>
<td>8</td>
<td>Senior Vice President – Financial Institutions and Transaction Banking Division</td>
<td>Thailand Bank Official 3</td>
</tr>
<tr>
<td>9</td>
<td>Vice President – International Banking and Financial Institutions Department</td>
<td>Thailand Bank Official 4</td>
</tr>
<tr>
<td>10</td>
<td>First Assistant Vice President - International Banking &amp; Financial Institutions Department</td>
<td>Thailand Bank Official 5</td>
</tr>
<tr>
<td><strong>C</strong></td>
<td><strong>Bank Rupiah, Indonesia</strong></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Chairman, Audit Committee (email interview)</td>
<td>Indonesia Bank Official 1</td>
</tr>
<tr>
<td>12</td>
<td>Executive Vice President – Chief Economist</td>
<td>Indonesia Bank Official 2</td>
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<td>13</td>
<td>Vice President – International Institutions</td>
<td>Indonesia Bank Official 3</td>
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<td>14</td>
<td>Vice President – Corporate Banking</td>
<td>Indonesia Bank Official 4</td>
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<td><strong>Bank Peso, Philippines</strong></td>
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<td>15</td>
<td>SVP &amp; Chief Compliance Officer</td>
<td>Philippines Bank Official</td>
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Annexure4 - Interview Questionnaire for Case Study Bank Officials
(viz., officials from risk management, compliance, internal audit and business groups
at Case Study banks)

1. General understanding

   a) Could you briefly give an overview of your relationship to the company – years involved
   and primary responsibilities held?

   b) Would you be able to recollect the failures at local Banks generally that would have
   resulted in the 1997 Asian Financial Crisis? How are these problems, if at all existed
   earlier, fixed subsequently?

   c) Did your bank make a conscious decision to initiate a major change or transition in your
   department since 1997? What was the process by which you developed key strategies
   during the transition era – not what decisions you had taken, but how did you go in
   about making them?

   d) What was the role, if any, of following parties in making such key decisions:
      • Regulators
      • Institutional Investors
      • Board of Directors
      • External advisors and consultants

2. Tone at the top

   e) To what extent the Board of Directors is involved in providing strategic direction to your
   department? For e.g.,
      • Does it approve the major policies governing your department?
      • Is the Policy framework made applicable for all Group-entities? If yes, how does it
        get percolated across all entities in the Group?

   f) How do you get commitment and alignment from business at senior management level
   and at individual employee level for implementation of the Board approved policy? Can
   you cite any examples to illustrate this?

   g) The important challenge of any support function, such as yours, is in protecting
   independence of the function. How do you manage this independence factor especially in
   your organisation structure and reporting lines?

3. Risk assessment

   h) Is the policy framework, approved by the Board for your department, risk-based? If yes,
   what critical risks pertaining to your department get Board attention frequently?

   i) What role does Board Committees and Independent Directors play in approving risk
   assessment applicable for your department?

   j) How do you address the paradoxical role of performance compensation (applicable for
   the business units) coming in way of achieving objectives of your department? How far
inputs provided by your department considered in deciding the performance incentive, especially of senior management?

k) Is the Board appraised about talent management or other training initiatives applicable for your department? How are budgetary constraints applicable to your department generally perceived by the Board?

4. Control activities

l) What role does your department play while key strategic decisions (such as entering a new line of business, approving a new product etc) are taken by the Board?

m) Are controls, as explained by you, documented formally in product or process notes?

5. Information and communication

n) In what fashion do the executive directors of your board communicate to employees about the importance of your department in the governance framework?

o) How frequently do you engage in conducting workshop or training to your departments about the role of your department in the overall control environment?

6. Monitoring and reporting

p) Do you have independent monitoring process to see that your department is having full understanding of the activities undertaken by the business?

q) Do you periodically review the Policy framework put up in light of business developments? If so, does review findings updated to the Board?

r) What sort of departmental MIS pack you develop that will provide an overview of the effectiveness of your department to the senior management and to the Board?

s) Are there any independent channels available to your employees to raise any of their concerns to you directly irrespective of any formal reporting structures? Does such stray instances updated to the Board?

7. Others

In each of areas mentioned above, what additional initiatives are taken by your department over and above the ones that are mandated by your regulator? How does your Board encourage such additional initiatives and provide feedback on the same?
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