Asian Shadow Financial Regulatory Committee

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Xiamen, China

Preventing Asset Bubbles

Asian countries hold large amounts of U.S. Treasury securities. In particular, China has been increasing its credit supplies to the United States in recent years. These investments have lowered the cost of capital in the U.S. and have boosted U.S. economic growth, consumer spending and demand for residential housing. This, in turn, has led to greater demands for Asian exports and greater capital flows back into the region in the form of FDI. These investments into the U.S. Treasury securities, however, are partially driven by the lack of suitable investment products in the region. The cost of capital in the region could be lowered if we could keep these investments. The region is suffering from these investments as the asset bubble bursts in the U.S.

There was a strong call for strengthening the regional financial markets after the Asian Financial Crisis of 1997. We now reiterate that call and propose a few measures to strengthen the regional financial markets.

First, regulators should strengthen disclosure requirements and auditing. Quality information is the first line of defense against market misperception and information manipulation. It also promotes arbitrage activities discussed below. A range of issues should be considered. For example, listed firms should aim to fully disclose their liabilities, standardize *pro forma* earnings, and disclose large shareholders and their ultimate identities. Managed funds should provide information on their investment strategies and related risks, leveraging, short selling, large positions, and liquidity. The frequency of such disclosures may depend on market condition.

Second, regulators should continue to build market infrastructure and promote financial market development. In particular, measures should be taken to facilitate arbitrage activities. Arbitrage can be an effective market force that corrects mispricing driven by behavioral biases or misinformation. To facilitate arbitrage, markets for futures and options trading should be introduced. The recent losses associated with sophisticated financial products should not discourage the use of basic derivative contracts. The availability of these contracts promotes arbitrage, price efficiency, risk management, and institutional development. In addition, stock borrowing and short selling should be allowed. Numerous studies have shown that concerns for the adverse impact from covered short selling are unwarranted.

Third, leverage should be more tightly controlled. As is well known, over-leveraging is a key contributor to all financial crises. Although margin trading is regulated in many Asian markets, there are no such regulations on managed funds, investment banks, and proprietary trading desks. Regulators should consider extending margin regulations to financial institutions and homeowners, in order to protect them and the market from their mistakes.

Fourth, regulators should discourage banks' incentive contracts that contribute to systematic risk. Bank's compensation focused heavily on short-term performance with asymmetric payoff structure encouraged reckless gambling with other people's money. As a result, not only other people's money was lost but also general taxpayers' money was put at risk. Regulators should monitor compensation practice of financial institutions, particularly those that are perceived to be too big to fail (TBTF), and encourage them to adopt incentive contracts with long-term performance orientation and also and also symmetric payoff. This will help reduce the incentives for short-term herding and excessively aggressive trading.

Fifth, super-large institutions need to be more closely regulated. Contrary to the conventional wisdom that mega institutions with diversified lines of businesses are safer, the current financial crisis has witnessed that such may not be the case. As the Lehman Brother's episode has shown us very clearly, risk taking by such mega institutions could pose a very serious systemic threat. Therefore, Asian countries need to introduce tighter regulatory requirements for "systemic" institutions as the US and Swiss governments have announced plans to do so.

Asian countries, believing that the US financial system was sound and strong, imported low yield U.S. Treasury securities in return for exports to the U.S. The current global financial crisis, however, has shown that the US financial system is also highly vulnerable to systemic risk. This awakening forces the Asian countries to reevaluate their heavy investments in the U.S. financial markets. The only way to move away from concentrated investments in the U.S. is to develop the well-functioning financial markets of their own. This requires strengthening regulatory system that is better aligned with the pace of financial innovation. Institutional reforms for better disclosure, easier arbitrage activities, non-excessive leverage, socially-beneficial incentive contract, and tighter control of systemic institutions would not only help Asian countries avoid the catastrophic financial meltdown but also develop the regional financial markets for more efficient use of savings for productive investments and also recycling of surpluses into the region.