THE AFTERMATH OF THE GLOBAL FINANCIAL CRISIS - OUTLOOK FOR ASIAN BANKS

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1. Introduction

The near-collapse of major financial institutions, besides resulting in massive aggregate losses to shareholders, and major layoffs, has also led to a huge transfer of wealth from the tax payers to the creditors of banks and financial institutions. The extensive infusion of capital by the tax payers has raised the question of moral hazard, banks and financial institutions take excessive risks in good times. If the risks translate to profits, then in such future good times the managers of banks and financial institutions capture most of the economic rents, leaving inadequate capital to buffer negative shocks, if and when bad times materialise later. On the other hand, if the risks translate to financial distress, (ie bad times) they simply turn to the central banks (discount windows, standing facilities and other facilities hastily arranged to shore up weak and failing financial institutions) and the governments (ie taxpayers) to bail them out. The conventional argument for such costly bailouts is that the lending and deposit-taking activities of banks and financial institutions are too crucial to the vitality of economic growth and stability, and that the actual bankruptcy of a major bank can be too destabilizing.

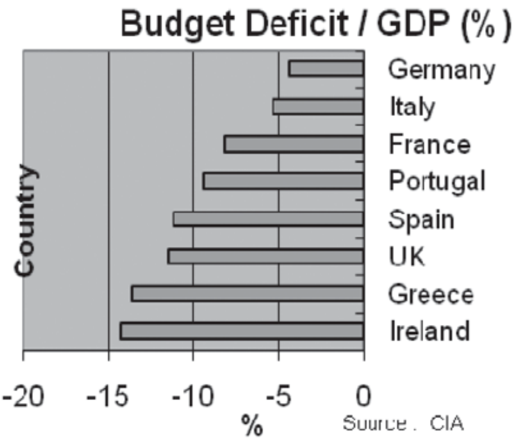
The global financial crisis has shaken the very foundations of the financial systems of the leading economies, until recently recognized as the 'movers and shakers' of global policy. Since the inception of the crisis, banking systems in the United States and Western Europe have posted losses exceeding $1 trillion, and loan quality has deteriorated significantly. This paper intends to assess the underlying causes why Asian Economies and Banks were able to withstand the crisis and assess implications and opportunities for Asian Banks.

The remainder of the paper is organised as follows. Section 2 provides an update on the Current Global Landscape, Section 3 considers how Asian Banks are different from its Western Counterparts, Section 4 identifies general themes affecting Asian Banks, Section 5 Assesses the implications of the Global Crisis on domestic and foreign banks operating in Asia and Section 6 concludes.

2. Current Global Landscape

Potential crisis in Europe dampening global recovery prospects

The mood is somber at best, following the headline crisis in Greece and concerns over other vulnerable economies of Portugal, Italy and Spain (PIGS) with huge Debt burdens of their own creating possibilities of contagion effects on other European Nations and indeed the Global Economy. There are concerns in certain quarters of the possibility of a long drawn out 'W shaped' recovery. To draw on the analogy from the treatment of a cancer patient, the current recovery is propelled by 'strong medicine' low interest rates and massive fiscal support and the withdrawal of this support either too early or too late could prove fatal.



Globalisation of banking on hold

Understandably there is a move towards protectionism with the rich nations now conceding having to take a leaf from emerging nations particularly the BRIC economies' who now exert greater influence in global policy as members of the recently reconstituted G20 summit.

Regulatory over reaction

According to the Price Waterhouse Coopers, Banana Skins Survey published in March 2010, Regulatory Over reaction ranks as the no.1 Risk Management Issue among bankers. This potentially impacts three areas. First, unhealthy politicization of lending stifling innovation. Second, Moral Hazard on account of banks 'too big to fail' being artificially propped up, and third and related issue is the unhealthy consolidation of industry with even more barriers to entry since banks 'too small to survive' exit the industry.

New Basel requirements

Discussions on a blueprint for what is expected to unfold in 2012 as the Basel 3 Capital Accord is now on the drawing board. The learnings from the crisis will translate in to commitments to increase the quality, quantity, and international consistency of capital, to strengthen liquidity standards, to discourage excessive leverage and risk taking, and reduce procyclicality. Key amendments to the Basel 2 accord impacting banks include;

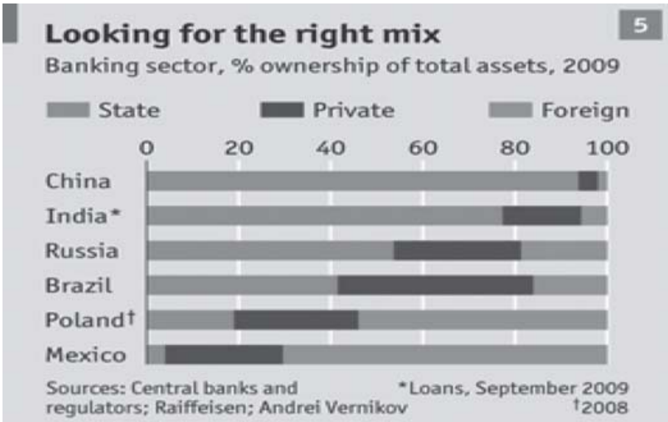
- The introduction of a leverage ratio
- Regulatory capital buffers
- Forward looking provisioning requirements
- Global Liquidity Standards
- Increased controls on derivatives and liquidity requirements

The increased pressure on capital requirements (estimated to more than double existing levels of capital of top global banks) would be an additional burden considering that most of these banks have availed of government bailout packages which also require to be settled. There is also a view that this could trap liquidity in Asia.

3. How are Asian Banks Different?

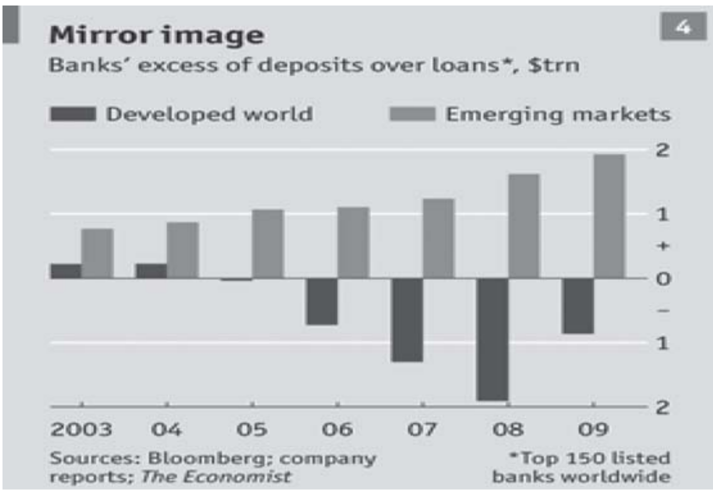
Government influence in Banking Sector

State Owned Banks account for a lion share of business in Asia, ranging from over 80% in India and China to well over 50% in most other Asian Economies. Significant state influence whilst perceived by Western Nations (perhaps correctly) as breeding corruption and stifling innovation, on the other hand is a stabilising influence to ensure intermediation is in the interest of shareholders and society and negates procyclicality impacts. What China, India and many other Asian Nations have done is to stimulate the economy through massive infrastructure developments to compensate for the drop in exports. This is the strength of 'big government'.



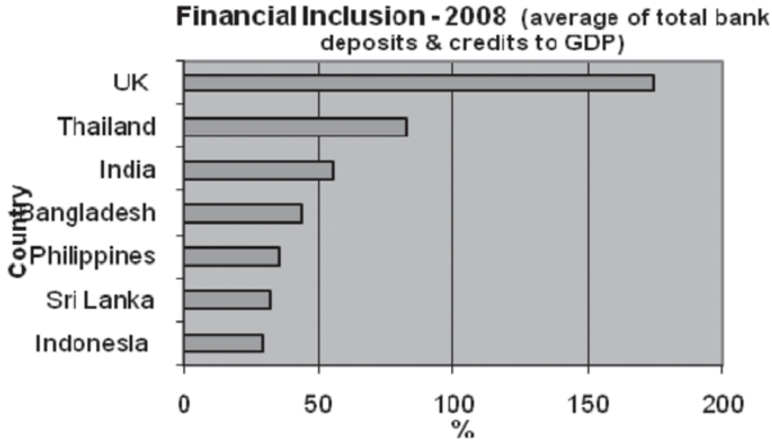
Conventional Balance Sheets

An important factor accounting for the resilience of banks in the region is their conventional business model. On the liability side of the balance sheet, deposits are the main fundinsource, while wholesale funding plays a limited role except in Australia, Korea and New Zealand. On the asset side, bank lending is typically originate-to-hold, and investments in complex innovative financial instruments have been kept at a low level.Arising from healthy Savings rates in Emerging Economies and most notably Asian Economies, the dependence on wholesale market for deposits and capital markets for borrowing is low which is a natural insulation protecting against liquidity problems. The graph below indicates that this is almost a mirror image of the position in Developed Markets. The position would be far worse if securitization exposures of $8Trillion (Off Balance Sheet) in Developed Markets are considered.



Low Financial Inclusion

Asia accounts for over 60% of the World Population and the levels of unbanked and underbanked segments are considerable. Arising from this reduction in poverty and reducing income disparities are key issues. Political reasons dictate economic and social priorities for government, particularly in highly populated countries such as China, India, Bangladesh and Indonesia. They differ significantly from that of Developed Countries and is indeed a key factor influencing massive government funded welfare programs.



4. General Themes impacting Asian Banks

Asia proven to be far more resilient than Western Markets and other Emerging Markets

The resilience of banks in the region has been a bright spot during the international financial crisis. Asian Economies have recovered well and now being (perhaps, prematurely) hailed as the paradigm of banking. They have effectively learnt from past crises - effective capital controls, liquidity rules and effective bank supervision measures assisted in a quicker economic rebound and in some instances largely insulated these economies from the global financial crisis.

Asian economies are different from other emerging markets given the breadth of their industrialised or service exports, level of value addition higher than Latin American economies (which are largely commodity based) and Middle Eastern Economies where there is excessive dependance on oil and construction.

Cross Border Export Dependance

The level of intra-regional trade at 25% pales in comparison to cross border trade which exceeds 50%. The fact that these economies have large populations and low financial inclusion levels have meant that the potential for stimulating domestic demand is high. Government efforts in this area have assisted in the recovery efforts.

The level of maturing debt almost $600bn in Asia (although small in comparison to $4 Trillion in Global Debt) is significant in relative terms and needs to be refinanced, which adds pressure to sustain and improve existing levels of export performance of Asian Economies.

Excess Liquidity in own currencies

Asian Central banks with their own fiscal and monetary stimulus measures have been surprised by the resultant levels of excess liquidity mainly in their own currencies. These funds more often than not, finds its way in to investments in Government Securities which further adds to state's influence in the economy.

Overheating Markets and 'unpredictable' regulations

Concerns over asset bubbles as most of the liquidity poured in to financial assets – equity and real estate resulted in a flood of investment funds in to the region. Asian Regulators have introduced a spate of new regulations to curb the bubbles arising from overheating markets. China is a case in point with recent measures restricting property ownership of families, surprising many. Foreign banks in China are complaining that the spate of new regulations such as funding restrictions, restrictions in opening new accounts and new branches, new approvals for new products have altered the playing field for foreign banks more than local banks.

China Influence

The Chinese economy has been holding up quite well given the significant proactive role played by the state in fuelling infrastructure spending and maintaining commodity and metal prices effectively counteracting the impact on exports. The table below indicates the level of influence China wields among East Asian Economies consequently a significant contraction in growth in China is likely to have a considerable impact on these economies. An appreciation of

China's Ranking as a Trade Partner in 2009	Exports	Imports
Malaysia	1	1
Thailand	1	2
Indonesia	2	2
Philippines	2	3
Japan	2	1

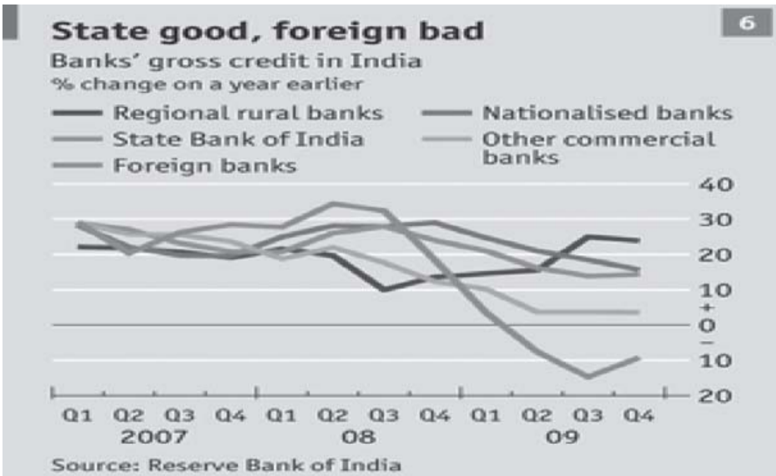
the Chinese Yuan (increasingly demanded by its main trading partner USA) would also have different mixed reactions among its Asian Trading partners.

5. Focus Areas for Emerging Asian Banks

A. Foreign Banks

Back to basics

The retreat of foreign banks from the Asia-Pacific region provides domestic banks with an opportunity to expand their operations and fill the gap in products and services. However, risks in the region have intensified as the crisis has deepened and spillover effects have become apparent. Most foreign banks (HSBC, SCB and Citi are possibly exceptions) have experienced a significant contraction in their loan books due to headoffice policy constraints. Consequently the priority will



be to go back to doing what they do best, which is wholesale banking and sticking to affluent segments in Retail. Latest PWC Research in China indicates 70% of foreign banks expecting status quo or contraction in business in 2010 from only 15% just two years ago.

Develop partnerships and alliances

An opportunity arrises to collaborate with local banks to gain access to markets such as leasing, securities and trust companies, capital market activities in general, corporate finance and asset management.

Leverage on expertise in Treasury and Capital Markets

Areas of focus would be on Debt Capital Markets, Internationalisation of local corporates, syndications, SWAP products etc. A recent study revealed that foreign bank participation in cross border loans have declined by over 25% in Malaysia, Korea, Taiwan and China, which indicates the potential captured by domestic banks.

Shore up capital

Other foreign Banks are likely to follow SCB's recent successful fund raising efforts in India with a view to looking at possibilities of shoring up capital from the more liquid Asian Markets.

B. Local banks

Aggressively penetrate Corporate and Trade Finance business

Local Banks are likely to move in to market segments previously dominated by foreign banks.

Diaspora Banking

Emerging Asian Banks now have an opportunity to provide more value than ever before by identifying and customizing products to the large diaspora community. Given the depressed state of Western Markets alternate investment opportunities open up in Asia for Real Estate, Equity or even plain Deposit Products which offer better value. e.g. HNB in Sri Lanka has developed an equity linked, (capital guaranteed), deposit product which enables expatriates to benefit from a burgeoning stock market whilst ensuring the original investment is protected.

Competitive Advantage

Asian Banks have the opportunity to capitalize on its highly skilled lower cost labour for services to global banks such as outsourcing Back Office operations and Technology Development.

New Delivery Channels

Opportunities open up for leveraging on emerging delivery channels such as mobile phone banking and palm top banking, where in addition to the benefits of substantially lower cost than the conventional alternatives of 'brick and mortar' branch presence or ATMs' is an opportunity to tap the vast unbanked and under banked populations given the very high penetration levels.

'String of Pearls' Acquisitions Strategy

Opportunities for inorganic growth open up for ambitious private commercial banks to establish a footprint in Asia, whilst state owned banks would tend to be more focused on stimulating the domestic economy. One area of focus would be greater influence in Capital and Debt markets which have been a mainstay of foreign banks. Very few banks have ventured beyond local markets, (ICICI India is an exception) and this could be one cause for the low intra-regional trade but this could change quickly in the next decade.

6. Conclusions

Finally, the causes and spillovers of the international crisis may spark a discussion about the trade-offs associated with financial liberalisation. While there is a consensus about the benefits of deregulating financial markets, liberalisation can also be costly in terms of increased susceptibility to external financial crises. To balance this trade-off, it is crucial that financial liberalisation, particularly in the context of financial innovation, should be accompanied by the appropriate framework of sound financial regulation, targeted towards ensuring adequate levels of risk management, prudential buffers and transparency

Asian Economies have gained significantly and have a lot more to gain from globalisation in terms of exports, FDI's and Capital flows, but more work needs to be done to insulate economies from contagion impacts.

- When to prick asset bubbles and who should take responsibility for this
- Grow intra-regional trade e.g. Apparel post GSP+ in SL
- Structural issues such as Tax avoidance, Legal frameworks, bankruptcy laws, employment practices and state bureacracy need to be addressed. Potential improvement varies across countries in Asia.

In this context, there is a need to assess the impact of the recent BIS Committee recommendations (the fore-runner to Basel 3) specifically on Asian Banks and use the increased influence on the global policy platform to demand necessary amendments. Clearly no longer should global policy be dictated by Western Nations!

Local banks will grow market share over foreign banks, state banks will be focused on playing a greater role in the domestic economy whilst ambitious private banks may venture overseas.

Greater focus on Technology Collaboration of banks within countries and intra-region likely to take place in areas such as core banking platforms and Delivery Channels.

Financial Inclusion will become a bigger priority and big government will influence / encourage efforts in this area. All Banks – local, foreign, private or public will need to venture out of their comfort zones with different models to address the microfinance segment.