CAU Asia Focus

COUNTRY ANALYSIS UNIT FEDERAL RESERVE BANK OF SAN FRANCISCO SEPTEMBER 2008

**Report on FRBSF Conference "The Changing Landscape: Asia's Role in Global Finance"**

The evolution of Asia's role in global finance was the topic of the Federal Reserve Bank of San Francisco's conference held on June 18 and 19, 2008. This international conference attracted over 150 central bankers, bank regulators, commercial bankers and market participants from North America, Asia, and Europe. This *Asia Focus* report summarizes the major themes raised in the conference discussions, looking first at challenges facing Asian economies and financial markets, then examining the outlook and market trends in Asian financial centers, consumer banking, Islamic finance, and China's growing role in global banking.

## Current Challenges in Asia

### Economic Environment

Conference participants commented that although some Asian financial markets demonstrate a lack of sophistication in their "cash rich" corporations and overbanked financial sectors, their focus on traditional, relatively non-complex banking has also served to shield the region from much of the subprime turmoil that has affected the U.S. and Europe. At the same time, Asia is experiencing an indirect impact of the subprime-related credit crunch through a decline in exports, as growth has slowed in U.S. and European markets. Participants noted that this indirect impact provides evidence that the Asian and U.S. economies have not become fully decoupled, as some analysts had predicted only a few years ago. Asian economic growth continues, though at a relatively weaker rate than in 2006 and 2007 when double-digit growth in India and China led a booming region. Inflation—driven by growth, energy and food price increases, a weak U.S. dollar, and an unwillingness among certain government leaders in Asia to tighten monetary policy—is now Asia's primary challenge, according to speakers at the conference.

Panelists voiced differing opinions about the prospects and rationale for strengthening underdeveloped Asian bond markets. On the one hand, deep and liquid capital markets were noted as an objective of emerging economies in Asia. Developed bond markets offer greater choices for investors and function to diversify risk. As Asian economies grow, bond markets will also offer lower costs of capital for larger borrowers who continue to expand globally. Proponents of this argument suggested that deeper capital markets will propel Asian economic growth.

On the other hand, other conference speakers were uncertain that there is sufficient demand to drive the development of bond markets in Asia. They noted that bank-centered financing has effectively provided market liquidity to Asian businesses even without more sophisticated capital and bond markets. Larger Asian businesses can also access global markets for needed capital, rather than relying on local bond markets. One speaker also noted that Asian banks may resist the development of bond markets because they would tend to divert revenues from commercial banks.

### Banking environment

Asian regulators at the conference commented that their own regulatory bodies and the institutions they supervise were better prepared for the subprime turmoil because of their experience in working through the 1997-98 Asian financial crisis. They cited a more conservative regulatory culture, for example, which includes instructing banks not to engage in risky off-balance sheet activities. Because of this relatively conservative approach, banks in Asia have generally not invested in exotic collateralized debt obligations or other instruments. "Plain vanilla" deals were more common given their risk appetite.

In general, however, conference participants noted that risk management culture in Asia is not as advanced as it is in the U.S. or Europe. One speaker remarked, for example, that enterprise risk management programs in Asian banks are far less robust than in the U.S. with respect to regulatory compliance, information technol-

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ogy security, business continuity, litigation, hazard and insurance, reputation, privacy, and strategic risk. While Asian banks have made progress in developing (but not yet fully implementing) best practices for credit risk management, conference speakers generally observed that market risk tends to be "monitored" rather than "managed" in many Asian countries, and that only lip service is paid to operational risk.

Infrastructure shortcomings also contribute to the continued weakness of risk management in Asia. For example, credit bureaus have a relatively recent history in Asia, capital and bond markets are underdeveloped as noted earlier, ratings may not be available for local companies (as opposed to multinationals), and bankruptcy laws are not in place in some countries.

Given the current challenging banking environment, conference participants emphasized that Asia's growing role in global finance necessitates heightened focus on enterprise risk management. Several speakers noted that this idea is supported by the March 2008 Senior Supervisors Group[1] report, which highlights characteristics of banks that performed relatively well during the current turmoil. According to the report those financial institutions whose senior management had, as one Asian CEO put it, made risk management a "value driver for the bank, not just a regulatory obligation," performed better. In conjunction with risk management, further discussion revealed that structures of remuneration can advance or hinder prudential behavior throughout an institution. As one speaker noted, risk management staff who warn of coming floods are discounted, and are not as well compensated as the "rain-makers." Finally, conference participants commented on the vital role played by strong communication among internal management and across silos within the organization. Furthermore, senior supervisors at the conference noted that their own communications with senior management at financial institutions were an important component of effective regulatory frameworks and policies around risk management.

## Outlook and Market Trends

### Financial Centers in Asia

The potential for further development of financial centers in Asia was also a topic of discussion. Although Hong Kong and Singapore rank third and fourth behind London and New York in the Global Financial Centers Index, conclusions were mixed on the potential for further development of other Asian financial centers. On the one hand, initial public offerings in 2007 in Asia were valued at $201 billion, versus only $77 billion in the United States. In addition, sovereign wealth funds from Asia and the Middle East are aggressively looking for investment opportunities in Asia due to its rapid economic growth. On the other hand, conference speakers believe that while Hong Kong and Singapore rank highly in terms of factors viewed as important for financial centers—such as a progressive regulatory environment, a highly-skilled workforce, global connectivity, and trust—they are the exception. Tokyo, a city with ambitions to join this group, is seen as having a more opaque regulatory regime and a shortage of personnel able to perform at an international level. On a more micro level, conference speakers observed that while banks in many Asian countries are strong, they mostly operate domestically. Cross-border banking and more sophisticated financial operations are often handled by multinational banks and their branches in Asia. These issues further limit the potential for continued development of financial centers in Asia.

### Consumer Banking in Asia

Demographics and economic growth are the two factors driving dramatic market growth in consumer banking in Asia since 1997. In India, for example, the middle income "consuming class" has grown remarkably from 260 million to 350 million over the past seven years, and is expected to grow by another 70 percent over the next five years. Economic growth has changed the mindset of Indian consumers, making them more willing to borrow—rather than use savings—to finance home purchases. Looking at another burgeoning consumer

[1]Comprised of regulators from France, Germany, Switzerland, the U.K., and U.S., whose March 2008 report is entitled "Observations on Risk Management Practices during the Recent Market Turbulence."
www.frbsf.org/banking/asiasource/events/2008/0618/SSG_Risk_Mgt_doc_final.pdf

market, one Indonesian financial institution representative at the conference cited annual growth of 86 percent in consumer lending during the past decade.

However, conference participants also cautioned about the risks of overly aggressive expansion into consumer lending. In Korea in 2003, for example, aggressive issuance of consumer credit cards caused bank losses equivalent to six percent of GDP. In Taiwan in 2006, the existence of the Credit Information Center—a non-profit entity that has been collecting credit data on individuals for over 20 years—was not enough to prevent similar losses. In India, where national credit bureaus do not exist, only ten percent of retail loans are supported by credit information from a regional credit bureau, according to one conference participant. While underdeveloped credit bureaus may be acceptable at this stage of credit lending in Asia, bankers at the conference commented that more granular credit information will be needed in the future to help them better analyze loans, and to make better use of information technology to develop scoring models for all retail loans. The dramatic growth of internet and telephone banking makes this even more crucial, as these technologies provide avenues for banks to provide new products and services to an expanded client base. One conference participant noted that in India, for example, seven million new mobile phone subscribers are being added per month, probably one of the highest growth rates in the world.

## Growing Significance of Islamic Finance

Economics and demographics are also driving the growth of Islamic finance in Asia. Defined essentially as a financial transaction that complies with Islamic, or Shariah, law, an Islamic finance transaction often looks similar to a conventional transaction, but uses Shariah-compliant methods to reach its goals.

In Islamic banking, for example, banks are required to share borrowers' risks, meaning that depositors are treated more like shareholders, earning a portion of profits. Financing deals generally resemble lease-to-own arrangements, joint purchase and sale agreements, and partnerships. However, taxation questions arise due to the need to recognize these transactions as essentially equivalent to traditional bank loans, and Islamic authorities are challenged to acknowledge the overriding standing of the civil legal contract over Shariah law. Tax and other legal issues, therefore, pose some challenges to the growth of Islamic finance.

Conference speakers commented that Islamic finance is growing due to the significant size of financial resources in Islamic countries, namely petrodollars, and economic growth in those countries. Using the size of the Muslim community worldwide as the benchmark, one conference participant estimated that the potential market for Islamic banking represents US$4 trillion. At the same time, currently, 60 percent of Islamic bank customers in Malaysia are non-Muslim, suggesting that the market for Islamic banking products is not limited to the Muslim community.

## China's Growing Role in Global Banking

Major Chinese banks have undergone significant reforms and are now ranked among the largest in the world based on market capitalization. Both financial indicators and governance standards have improved considerably in a relatively short period of time. For example, one presenter noted that a state owned commercial bank's earnings per share is three times what it was in 2003, its return on assets is up 50 percent in the same period, its loan loss allowance fully covers its classified loans, and its capital adequacy ratio is well above the Basel minimum standard of eight percent. According to the same presenter, the mindsets of both policy makers and the industry have changed irrevocably. These changes are reflected in both improved standards of corporate governance, with banks appointing more independent directors, and in the emergence of a strong regulator, the China Banking Regulatory Commission (CBRC). Presenters noted that the recent turmoil in global markets has brought increased awareness and understanding of risk management to Chinese financial institutions. As one panelist stated, the global credit turmoil has also reinforced the focus on shareholder value (whether private or public), and has strengthened the call for more complete disclosure of accurate performance measures.

Despite this progress, Chinese banks are not expected to compete directly in the global financial marketplace in the immediate future. Chinese banks are still challenged to find skilled personnel, and to retain them with appropriate pay and incentives. Rather than competing directly against global banks, panelists expected Chinese banks to primarily provide trade finance and other products for Chinese ventures in various countries, and for Chinese citizens residing in other countries.

Beyond the realm of international competition, conference participants remarked that for many years China's banks have benefited from domestic interest rate policies, which are set by the People's Bank of China (PBOC). Although the PBOC raised benchmark rates six times during 2007, the rate for demand deposits experienced only slight fluctuations. Therefore, a Chinese bank can pay as little as 0.72 percent on deposit accounts yet lend the same funds at rates above seven percent. As a result of these policies, many Chinese banks reported a wider net interest margin in 2007. One conference panelist noted that high net interest margins could account for up to 40 percent of the reported increase in 2007 after-tax profits of one of China's major banks. In the long term, further liberalization of China's interest rate policies is likely to put pressure on net interest margins and to encourage banks to diversify their income sources, namely by developing business lines that produce fee income and other non-interest revenue. Thus, while Chinese banks have generally seen a rapid improvement in financial indicators and governance standards, they have not yet been challenged by a fully market-driven, commercial banking environment with completely liberalized interest rates.

## Conclusion

Conference presentations and discussions suggest that the extent of Asia's role in global finance will depend on individual countries' ability to enhance risk management while creating and implementing products and services to fully capitalize on the region's demographic and economic growth. At the same time, Asian countries are not insulated from regional or global economic forces, and slowdowns in the United States and Europe may continue to have repercussions in Asia. Successfully balancing external risks with internal challenges will remain key to Asia's growth in the future.

**AGENDA**

June 18, 2008

Opening and Welcome
**Janet Yellen**

Keynote Address: "Global Outlook: Something's Gotta Give"
**Peter Fisher,** *Managing Director, Blackrock*

Panel I: Asia's Economic and Financial Outlook

Panel II: Development of Asian Financial Centers

Concurrent Breakout Sessions:
•Issues and Opportunities in Islamic Banking
•Financial Risk Management in Asian Banks
•Consumer Banking in Asia: Growth, Profitability & Risk

Panel III: Financial Market Regulation: Lessons from Recent Turmoil

June 19, 2008

The Global Financial Turmoil and its Implications for Asia
**David McCormick,** *Undersecretary of the Treasury for International Affairs*

Panel IV: Chinese Financial Institutions as Global Competitors & Partners

Panel V: Strategic Directions: A Conversation with Asian Banking Leaders

*Video footage and presentations from "The Changing Landscape: Asia's Role in Global Finance" conference are available online at:*

www.frbsf.org/banking/asiasource/events/2008/0618/index.html

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