

STATE OF ASIAN BANKING - AN THEORETICAL FRAMEWORK

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Introduction

Banking systems have returned to a more stable footing since the Global Financial Crisis. Asian banks have strengthened their position since the Global Financial Crisis. When the crisis struck Asia in 2008, there were fears of a drying up of trade finance as European banks started deleveraging and cutting back from the region. As it turned out, Asian banks stepped in decisively and trade finance volumes recovered strongly.

- Between 2008 and 2013, trade finance volumes at Chinese and Hong Kong banks have more than doubled while those at Indian banks rose more than half over the same period.
- Eurozone banks have since recovered some of their market share, but the Asian banks remain significant players.

Three Key Forces that Will Shape the Course of Banking and Finance in Emerging Asia

- Economic growth
- Financial regulation and
- Technological innovation.

Economic Growth

The near term economic outlook for Emerging Asia will be shaped by two themes: the ongoing recovery in the G3 economies and the slowdown in the Chinese economy.

- The underlying growth momentum in the US appears intact despite a disappointing start to the year.
- The Eurozone is recovering from a double dip recession and financial stresses have abated.
- In Japan, domestic demand is strengthening, following the negative consumption tax shock of 2014 April.
- However, China, which had been supporting global demand in recent years, is experiencing a deceleration in growth amid a property downturn and softer exports. Even so, targeted fiscal and monetary stimulus measures should support growth at close to 7% in 2015.

- Against this backdrop, overall growth in Emerging Asia will remain firm, at 6% in 2015.

Banks in Emerging Asia will therefore not do badly. There are, however, downside risks that they need to watch.

The scenario of a “double whammy” posed by a rise in US interest rates and a strong US Dollar could expose vulnerabilities among some Asian borrowers.

- Rising interest rates will increase the debt servicing burden of Asian households and corporates, especially those who have taken on high levels of debt at low rates.
- Asian corporates with large unhedged dollar borrowings could face increasing stress as a strengthening dollar undermines their ability to repay loans.

Banks in Emerging Asia could face higher non-performing loans. They could also face reduced US Dollar funding if there are large capital outflows from Asia. But their liquidity and capital positions are generally sound and they should be able to weather this.

What matters is the medium to long term, and here the outlook for Asia remains sanguine. To be sure, as populations age and productivity growth slows, potential growth rates around the world are projected to moderate. But Asia is poised to remain the fastest growing and most dynamic region in the world.

The Asian Development Bank projects that by 2030, the sum of the GDP of China, India and ASEAN in purchasing power parity terms could even exceed that of the US and Europe combined.

For banks, it is not just the size and growth of the Asian economies that matter. It is the composition of that growth and demand. Two trends are noteworthy for Asian banks: the rise of the Asian middle class and the regionalisation of Asian corporates.

Rising incomes and the agglomeration effects of urbanisation will significantly expand the ranks of the Asian middle class.

- In ASEAN, the middle class is projected to make up two-thirds of the population by 2030, compared to less than a quarter in 2010.

This rapid expansion of the middle class will spur demand for a wide range of goods and services. Modern services, such as telecommunication, banking and finance, have higher income elasticities of demand compared to traditional services. This means that as income rises and wealth accumulates, the demand for financial services – be it consumer credit, wealth management, or insurance – will rise more than proportionately.

As Asian economies develop and integrate further, Asian corporates will expand and internationalise. They will need more funding - not just traditional bank credit but debt and equity financing. They will need more cash management and transaction services. Asian banks who have been serving these corporates in their home markets will follow them as they regionalise their businesses.

Financial Regulation

The second driving force that will shape banking in Asia is financial regulation.

The Global Financial Crisis has spurred far-reaching financial regulatory reforms. The ones impacting banks most will be the new Basel III rules.

- Basel III calls for an increase in both the quantity and quality of capital that banks must keep as a buffer against unexpected loss.
- Basel III will also put in place a new global liquidity standard. Banks will be required to hold enough liquid assets to survive a 30-day period of cash outflows.

There are also efforts underway in advanced jurisdictions to reform banking structures. The details vary but the overall thrust is to separate retail banking from riskier activities like proprietary trading and investment banking. The objective is to simplify business models and facilitate the resolvability of large and complex banking groups.

On the whole, the reforms will help to make banks safer and financial systems stronger. But they are not without some negative consequences, and their distributional impact is uneven. For many global banks, the new regulatory standards and reforms to national banking structures will mean a fundamental review of their organisation and activities. In fact, the international operations of global banks are already being affected.

For many Asian banks, the transition to the new regulatory standards will probably be less demanding. First, many of them had already bitten the bullet after the Asian Financial Crisis and built up their capital and liquidity buffers. They are thus starting from a stronger position to meet the new standards.

- Several Asian regulators, such as China, India, Philippines and Singapore, have set capital requirements that exceed the Basel III standards.
- And banks in China, India, Thailand, Hong Kong and Singapore were already subject to liquidity requirements prior to Basel III.

Second, Asia's financial systems emerged from the last crisis less affected than their global peers, with much of their financial resources and businesses intact.

- A focus on traditional banking helped Asian banks avoid the fall-outs from the collapse of complex, structured products and risks from outsized trading desks.
- This, together with their strong deposit funding, means that Asian banks do not need to deleverage or withdraw from markets in order to meet the more stringent capital ratios or new liquidity requirements.

If Asian banks continue to maintain strong buffers and manage their risks well, they are well-placed to thrive and grow in the new regulatory environment.

Technological Innovation

A third major force shaping Asia's banking landscape is technology, specifically digital technology. This could prove both transformative and disruptive in a region where banking penetration remains low.

The broad adoption of financial technology or fintech could dramatically lower the cost of banking services. Not only will this enhance financial inclusion, it could potentially also help mobilise untapped savings, enable more efficient financial transactions, and make credit more readily available and affordable to small businesses.

Ironically, Emerging Asia's relative under-development could turn out to be an advantage. The innovative adoption of digital technology by the financial industry is enabling these economies to leapfrog into more advanced channels for providing banking services.

- A growing number of Asian customers, especially in countries like China and India with rapidly developing technology infrastructure, are using mobile banking apps for payments and funds transfers, even before customers in more advanced economies.
- In India, bank accounts can be linked to biometric identity cards issued under the national Aadhaar initiative, enabling millions who otherwise lack the formal documents required to open a bank account to have access to basic banking services.

Conclusion

The three driving forces present both challenge and opportunity for banks in Asia.

- Economic growth will be slower in the next decade compared to the last two. But the composition of that growth in an increasingly middle class Asia will benefit modern services like banking.
- Financial regulation will be tighter and will constrain all banks. But Asian banks will be affected less in relative terms given their stronger capital positions and funding structures.
- Technological innovation will threaten to disinter mediate banks. But to the extent that Asian banks themselves adopt the new technology platforms, they will strengthen their ability to penetrate unbanked markets and expand their footprint.

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