

BANKS AND FINANCIAL INTERMEDIATION IN EMERGING ASIA: REFORMS AND RISKS

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Abstract

The Asian banking systems have been hit by several large shocks over the past decade. A financial meltdown in the late 1990s almost crippled the Asian financial intermediation process, leading to a massive loss of output and subsequent efforts by Asian authorities to overhaul the banking system. This was followed by the 2001 global slowdown. The 2007-08 global financial crisis proved to be a huge stress test for the Asian banking system. Up to the time of writing, however, most of Asian banks seem to have weathered the crisis rather well. The conventional view about the transformation of the banking system since the Asian crisis goes something like this. Prior to the 1997 financial crisis, Asian banks had become exposed to very large credit risks, which were badly managed and poorly supervised. Moreover, the banks were inadequately capitalised for the risks they were running. And too many risks were concentrated in the banking system because capital markets were insufficiently developed. In the decade since the crisis, banks have reduced their legacy bad assets, managed credit risk more effectively and have become better capitalised. Because private capital market development has been slower, banks remain the dominant channel of finance in Asia. All this reduced Asia's exposure to the recent global financial crisis. This paper thus seeks to summarise the complex forces acting to change financial intermediation in Asia

Keywords: *global slowdown, Asian crisis, sterilisation, Bank Balance Sheets, Foreign Funding, Bank Credit*

Savings, Foreign Exchange Intervention and the Asian Banking System

The classical view is that the investment needs of developing economies generally exceed available domestic saving, leading to a current account deficit in the balance of payments. Banks facilitate financing of this investment by borrowing beyond their deposit resources, and often in international markets. A large part of the surplus savings in Asia was channelled into bank deposits. Such a trend was reinforced by the strong rise in risk aversion among households, leading to a shift toward risk-free assets. What matters for the financial system and the economy is who holds sterilisation bonds. When households and non-bank firms hold such bonds, bank deposits are likely to fall because bond purchases replace cash holdings in banks. In other words, in a country with a deep and diversified bond market, sterilisation is more likely to be complete: households and non-bank firms reduce their holdings of monetary assets and increase that of non-monetary assets such as government bonds - the so-called portfolio substitution effect. In many Asian economies, however, the limited development of the bond market implies that it is banks, not the non-

bank private sector, that have taken up the bulk of the expanded issuance of central bank and government securities.

In sum, the macroeconomic policy environment appeared to have affected the Asian banking system in two important ways. First, large surplus saving and sterilised intervention by central banks to resist currency appreciation led to a sharp expansion of bank balance sheets in many countries in the past decade. Second, as banks invested heavily in government and central bank securities, the share of liquid assets in their total assets grew rapidly.

Key Changes on the Asset Side

Several changes to the asset side of bank balance sheets have reduced some of the past vulnerabilities of the Asian banking system. This section reviews two such developments: (i) the quality of assets held by banks; and (ii) the transformation of their lending functions.

The lack of comprehensive statistics on borrower default rates and inadequate protection of lenders' rights in many countries.

The implicit guarantee from governments masks weak "stand-alone" ratings. This increases moral hazard problems in the banking system, reducing the incentive for efficient management of risks.

The high cost nature of Asia's banking system. The operating costs of banks in many Asian economies are not only high but have also tended to rise in recent years.

Issues in the Liability Side of the Bank Balance Sheets

A much-highlighted aspect of the emerging market banking systems in the 1980s and 1990s was their vulnerability to funding pressures from volatile capital flows. Financing difficulties in international markets too often translated into sharp reductions in bank lending. In addition, short-term foreign currency borrowing created severe currency and liquidity mismatches in banks' balance sheets. The 1997-98 Asian crisis was but one illustration of this vulnerability.

Domestic Versus Foreign Funding

A key structural feature of Asian banking system is its access to a large and growing pool of domestic saving. Table 6 shows this through a simple identity, linking the growth in banking system's lending to various financing sources. Although the asset and liability positions of banks are not mutually independent, as a change in one may well affect the other via the credit multiplier and other dynamic processes, the table provides a useful static analysis. The idea is that banks can finance their credit expansion by one or more of the sources: expanding deposits; net borrowing from abroad; drawing down reserves with

the monetary authority; reducing net lending to governments; or increasing borrowing from other sources, particularly wholesale bond markets.

The Dynamics of Emerging Market Vulnerability

Severe stresses in international interbank and short-term markets in major currencies, combined with a generalised “flight to quality”, in September 2008 led to heavy pressures on emerging markets, which until then had been largely spared from the disruptions afflicting the main financial centres. Greater worries about counterparty risk, liquidity hoarding, efforts by holders of domestic assets to purchase foreign currency and the effects of intervention in foreign exchange markets combined, in various degrees, to produce severe liquidity strains in many local currency markets. In Hong Kong SAR, for instance, the difference between three-month Libor and the yield on three-month Exchange Fund bills, a conventional gauge of credit risk, rose sharply from about 100 basis points in September 2008 to about 450 basis points in mid-October. In India, the overnight call money rate traded much higher than the call rate, exceeding 15% by October.

In sum, changes in the liability side of the balance sheets of Asian banks have reduced some “old” vulnerabilities but have created new risks. A key factor in the reduction of vulnerability was their access to large retail deposits.

A Panel Model for Bank Credit

This section reports on a very simple test of the relative influence of some of the important changes discussed above on bank credit through a panel model. A key objective is also to see if there are significant differences in lending behaviour across emerging market economies.

The dependent variable of the model is the percentage change in real bank credit to the private sector. The model examines the specific role of balance sheet variables in bank credit: in particular, to what extent banks’ funding conditions affected their capacity to lend. The variables considered are: (a) deposits; (b) access to other funding sources, particularly wholesale and bond markets; and (c) the availability of capital to absorb risks. The framework provides one way to test how far bank credit is constrained by deposits or capital. All funding sources are included in the equation with a lag so that current lending decisions depend on the level of deposits (or funding) in the previous period. The model includes non-performing loans as a proxy for banks’ willingness to lend and operating costs to capture the possible implications of banking system’s efficiency for its lending behaviour.

Conclusion

The past decade has seen a considerable transformation of the Asian banking systems. A strong balance sheet and reduced currency mismatches mean that Asian banks

are now less vulnerable to financial crisis than they were in the past. With their lending functions more diversified as well, banks have become more profitable and more resilient. Asian banks were therefore able to weather the recent global financial crisis rather well. One issue is how well banks have managed their risks. As the analysis in this paper revealed, banks in Asia appear to be well capitalised and better managed than before.

The stronger balance sheet position of Asian banks is due not only to microeconomic reforms, but also to a favourable combination of macroeconomic circumstances. A sharp rise in domestic savings, combined with the recent large-scale sterilised intervention and easy monetary policy, has led to very easy financing conditions for banks. In addition, banks have accumulated a large stock of government bonds. How these conditions will change and how this will affect banks in Asia is uncertain. One implication is that Asian banks' exposure to market risk has risen sharply in the recent years: a fall in bond prices would hurt the banks. And efforts to slow currency appreciation in some countries may have distorted the foreign currency borrowing choices of the non-bank private sector.

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