Summary of Executive Summaries

"The Roles and Functions of the Banking Sector in the Financial System of the ASEAN+3 Region"

March, 2012

Lead Institute: The Japan Research Institute, Limited

1. General Statement

In the region banks play the key role of financial intermediary. Bank Penetration is not so high. Though capital markets are developing rapidly, there are not a variety of investors. Banks are shifting their target from corporate to SMEs and consumers. Retail banking business facilitates the booming consumption and economic growth. However, evaluating credit risk of retail customers is difficult.

In terms of soundness, banks are currently in good shape. Many financial reforms were made after the Asian currency crisis. Enhancing the competitiveness of banks is essential to the stabilization of financial systems. The integration of ASEAN economy in 2015 (AEC) would the driver for banks to become more strategic and more competitive. To improve efficiency, banks should expand profitable business, introduce advanced technologies and develop human resources.

Some issues are still remained. Firstly, developing risk management would be a more important issue. Secondly, consumer protection would be an important issue as many kinds of financial products are sold at banks. Thirdly, strengthen the management would be a critical issue. Corporate governance may be weak due to shareholder composition.

Economic growth is essential to the development of the banking sector. Banks can invest in business expansion only when they are financially sound. Banks should support the real economy, should not be pursuing their own interests and away from economic growth. Asian banks have an important role in supporting the economic growth of Asia. It is desirable that the banks support the real economy growth while maintaining their soundness.

Payment system reform is proceeding in many countries, in addition to the increase of processing power the introduction of RTGS is progressing. The possibility of chain-reaction collapse of the bank resulting from the settlement risk in the banking sector in Asia is relatively small.

2. Thailand

Thailand has traditionally had a bank-centric financial system and commercial banks have been playing central roles. After the Asian financial crisis in 1997, the supervisory authorities and the industry engaged in a wide range of reforms. As a result, the Thai banking sector has maintained its financial soundness and stability. However, there still remain some issues to be tackled, such as the expansion of financial access for the underserved, preparation against the anticipated regional competition, further strengthening of the management base to handle potential risks, and so on.

3. Vietnam

The Vietnamese banking sector is still in its infancy. The industry, dominated by state-owned commercial banks, mainly serves the large corporations which are usually state-owned. The banking penetration rate among individuals is a mere 10 to 20%. The banking sector has been going through various reforms in recent years, but there still remains a host of challenges that need to be addressed, including the independence of the central bank and strengthening of their supervisory capacity, as well as the strengthening of the capital base of the banks.

4. Malaysia

Thanks to the effective reforms mainly led by the authorities, Malaysia's financial system has continued to develop. Now, it has not only a competitive and sound banking sector, but also expanding bond markets. The future tasks for the local banks are: to further improve their competitiveness, to support the acceleration of economic growth by proper financial intermediation, and to promote regional economic and financial integration by expanding their overseas business. Also, promoting the internationalization of Islamic finance is a very important target for Malaysia's financial system.

5. Indonesia

In Indonesia, business-based micro-finance, which is different from the model of the Grameen Bank in Bangladesh, has been utilized in the whole country for over 100 years. However, there are many businesses and individuals who have no access to banks, meaning that the capital surplus of the household corporate sectors is not being fully utilized. If this state of affairs is allowed to continue, then not only will capital fail to be used effectively, but financial services will not be able to be used to help stabilize the standards of living of those at low income levels. Financial inclusion is the most important issue.

6. China

China has made progress in moving toward a more commercially - oriented financial system through different types of financial reform since the 1990s. China is a bank-based financial system, particularly the large commercial banks, which dominate almost two thirds of financial intermediation. It has not only performed well and is a sound banking sector, but is also competitive in terms of market capitalization, capital and assets with banks ranking among the Top in the world. China is the only country in the ASEAN+3 that has no deposit insurance system. Also, financial liberalization is incomplete due to strict interest rate regulation and a controlled exchange rate. As a result, informal finance and off-balance sheet activities are on the rise. The future challenge to restructure the capital market towards a more market - based system in line with Basel III.

7. Japan

Japan's banks have adopted conventional commercial bank business models, based on strong relationships with customers. While Japan's banking system is different from the models of other advanced nations, it is the most advanced in Asia. It has enabled finance to permeate throughout the country, and Japanese banks were able to realize stable profits. However, it is difficult to envisage how growth can be achieved in the years to come. Now that the economy has matured, businesses' capital demand is growing only very slowly. In the future, the market will be shrinking because Japan's population is not only aging but also decreasing in size.

Sub Institute: Angelo King Institute

The ASEAN+3 financial system can be characterized as a bank-dominated system with rapidly developing capital markets. Bank credit remains as the main source of financing in several ASEAN+3 economies, while bond and equity financing have both become an increasing funding source in recent years. Bank credit has grown steadily over the past years, exceeding the GDP levels for most countries in the region.

In our assessment of banking sector performance in the ASEAN+3 region using the CAMELS approach, we find that banks' capital holdings remain adequate, that their asset quality is relatively high, that their profitability levels are positive, and that their liquidity conditions are stable. Specifically, capital adequacy ratios are above the minimum capital requirements set by their home country's central banks/monetary authorities and the Bank for International Settlement. Non-performing loan (NPL) ratios were on a downward trend in recent quarters, while profitability indicators—the return on asset (ROA) and return on equity (ROE) ratios—were on an upward path. And the liquidity asset and loan-deposit ratios are at stable levels.

In the ASEAN+3 banking system, we find that the regulatory measures and supervision are in place and well-functioning, with compliance of Basel requirements already being implemented or are in progress. However, there is significant heterogeneity across supervisory structures and practices, ranging from multiple supervisory structures in some economies to an integrated supervisory framework in others. Such differences may be influenced by the level of financial and economic development, institutional underpinnings, and legal frameworks.

We employed empirical tests to assess the potential impact of economic, regulatory, and bank-specific characteristics on bank intermediation and credit creation in the ASEAN+3 region. We utilized bank-specific data on the top ten largest banks in ten ASEAN+3 economies— namely, the People's Republic of China (PRC), Indonesia, Japan, Republic of Korea, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. (Brunei Darussalam, Cambodia, Lao PDR, and Myanmar were not included due to lack of bank-specific data.) The data covers the 2006-2010 period and is culled from Bankscope. Overall, our results reveal that: i) Focusing on liquidity reduces net loans but reduces net interest margin; ii) Bigger banks reduce net interest margin compared to small ones but they are in a position to make more loans; iii) Bank equity matters in net interest margin but not in the determination of net loans; iv) Market structure matters in financial intermediation but they do not affect net loans; and v) Regulations do not have uniform effects. Furthermore, financial intermediation cost is increased by the existence of reserve policies, deposit insurance and activity restrictions. Of this set of regulatory variables, only reserve policy matters in the net loans to asset ratio. A surprising finding which may require further empirical validation and verification is the ability of debt–to–GDP ratio to improve the number of significant predictors.

Although the banks in the region have remained stable in the light of the current European financial difficulties and the US crisis a few years back, the outlook for banking systems and economic performance in Europe and the US is not positive. These may have repercussions on the health of ASEAN+3 banks. Against this backdrop, there is an impending need for ASEAN+3 policymakers to exert efforts that aim to mitigate the downside risks that can create financial vulnerabilities. Specifically, ASEAN+3 policymakers must continue monitoring closely financial sector and economic developments in the global economy and in their respective countries in the region in order to better prepare and insulate local banks from external shocks. Moreover, there is a need for policymakers to strengthen their financial cooperation efforts in dealing with and preparing for sudden capital reversals owing to a loss in market confidence, as well as in times of banking crisis situations. Timely sharing amongst policymakers of bank-specific data and information on their respective markets may be helpful in order to come up with "real-time" or immediate and appropriate policy responses. Constant bank stress tests and transparency in their findings may also be called upon by policymakers to ensure that banks are capable of withstanding the worst-possible scenario.

Problems on managing banks' liquidity risk hinges from the absence of a strong framework for the management of liquidity. In this light, harmonized prudential regulations related to capital adequacy and liquidity may be desirable and are important to a strong collaborative arrangement among countries in the region. However, this exercise may be quite difficult as the financial developments among countries in the region are quite diverse.

Given all these issues and implications, regulatory mechanisms should consider addressing the issue of flexibility in the implementation of safeguard measures given the thrust towards standardization of requirements. The move towards international statutory standards including the Basel Accord may pose some problems on several grounds including the variability of bank size, differences on the causes of financial crisis, uncertainties of the exposure and vulnerability to crisis, and the need to manage national concerns and financing needs as well as differences in the resolution measures for banks under siege.

Resolving the conflict between standardization and flexibility in regulatory measures will have an impact on the spatial jurisdiction of regulatory bodies. We do not discount the value of international accords on prudential banking and protection against risks but we likewise value the role of national regulatory agencies on banks that may define national concerns. Aside from defining national jurisdiction over global statutory requirements there is a need to define the role of regional bodies. The optimal role is to bridge the gaps between universal standards and national flexibility. In particular, a regional approach also needed to oversee how national regulations and supervisory measures on banking are addressing systemic risks and other risks relative to global standards. The concern for regional cooperation on this matter lies on the need to a have a stable financial system for the entire region.