What's for Asian Banking? Re-Assess, Re-evaluate, Re-tool and Re-Position?

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Twelve months ago, everyone was keen to look ahead by asking the possible extent of difficulties that the financial markets could further endure in 2009. It was part "responsible planning" and part "therapy" as if the repeated reminders would somehow ease the pains that were expected to materialize. Today, the tone of market discussions is decidedly different with most gatherings optimistic of a brighter future, seemingly confident that the worst is behind us.

The Apparent Easing of Financial Pressures

Whether we have indeed navigated the turning point or that a W-shaped path may still materialize remains to be seen. However, the market indicators today are clearly encouraging for now, in sharp contrast to the spiked levels from 12 months ago. In the fixed income market, the EMBI Composite price index has gained over 50% from less than 300 to the 458 it was a few days back. In the equity market, the MSCI Asia APEX 50 Index ? which serves as a liquid proxy to the broader MSCI benchmark ? has nearly doubled from 388 to 747 over the past 12 months. Pressures on sovereign pricing have likewise eased considerably with current CDS spreads for all of East and Southeast Asian economies significantly off peak levels in the aftermath of September 2008.

The Structural Macroeconomic Changes

I would argue however that the seemingly consistent good news from market indices should not be interpreted as suggesting that all is back to normal. Instead, we must concede the point that our sense of "normal" must change just as the regional macro-financial market landscape was changing even before the mortgage crisis broke out.

That benchmark indicators suggest market stresses have considerably eased should only make us realize the significance of these changes as we consider what may lie ahead.

In particular, it is important to appreciate that Asia deliberately took to the policy of strengthening its external trade as an offshoot of the 1997 crisis. By allowing exchange rates broadly to be traded more freely, the region was able to maintain trade surpluses with mature economies. By taking the path of an export-led growth, the region built its reserve base in the process. Asia has premised its economic prominence on this strategy, generating a growth trajectory higher than other regions. No longer was it just "Emerging Markets" en toto. Rather, that Asia had emerged.

However, as Emerging Asia became more integrated through trade with the mature economies, the (recent) economic downturn in US and European markets meant that Asia would eventually feel the shock. Thus, any prolonged weakness in these markets would clearly undermine the region's economic engine. The point here is that the economic shock to the region is itself independent of the extent to which Asian banks carried direct exposures to Lehman instruments. Those banks that had Lehman exposures had more problems than others, but those that may have had negligible credit exposures to Lehman were still vulnerable to the impairment of the economic engine.

Three added features are worth highlighting.

Data from the Asian Development Bank would show that intra-regional trade within the so-called East Asia-15 economies likewise increased from 37.7% of total trade in 1998 to 42% by 2008. When considered in the context of the cumulative expansion of the region, this 4.3 percentage point increase is significant.

Complementing this further is Foreign Direct Investments where data from UNCTAD suggest that cumulative FDI inflows within East Asia-15 rose from USD228 billion in 1998 to USD563 billion in 2005.

In addition, data from the Institute of International Finance (IIF) projects in its October 2009 research note that net private capital flows to emerging markets will round out to USD349 billion in 2009 and increase to USD672 billion in 2010. Of these amounts, USD191.1 billion and USD272.9 billion respectively are attributable to flows into Emerging Asia, by far larger than what is expected of Latin America, Emerging Europe, **and Africa / Middle East.**

Some Gaps in Regional Banking

The features of the structural change that I just discussed are relevant to the banking community for the simple reason that trade needs to be financed and capital flows require a proper venue for its disposition. The dimension of intra-regional flows is particularly significant because it is within the direct influence of the regional economies. Moving forward, there is every reason to expect that intra-regional flows will play yet an increasing role.

For the region's banks, however, the irony is that brighter prospects and the significant amounts involved only highlight some of the gaps that need to be urgently addressed. Trade finance, for example, is not deeply entrenched in all of our economies and certainly not coordinated within the region as a collective product line.

An organized Bankers Acceptance/Trade Acceptance market can potentially unlock latent liquidity that is otherwise trapped by the routine lags in trade financing. The plain objective is to provide our exporters and importers with access to good funds over a shorter economic cycle. Given the region's trade engine, this would be an important development that is eventually expected to reduce transaction costs, perhaps lower the pricing of trade-related goods while mitigating some of the cross-currency price volatilities in the process. All of these can be maximized if a working coordination at the regional level can be instituted.

This brings up the issue of developing a local capital market, let alone a coordinated regional capital market. The issuance of BAs/TAs invariably requires some amount of tradability, which in turn necessitates organized trading markets and discovered prices. At current low interest rate levels, the prospects for the fixed income market are brighter than traditionally re-priced banking credits. Let us not forget that Asia has also built its reputation on higher-than-average saving rates. Given the liquidity that is already circulating in our markets, incremental saving must find investment outlets which are increasingly cross-border in nature. Although exaggerated, there is some semblance of truth in the view that it is currently easier to buy a bond in New York using proceeds from Asia rather than do the same transaction in Emerging Asia and have the security immobilized in an Asian custodian. Surely, this is not something Asia should allow to perpetuate.

The receipt and handling of foreign exchange on the other hand could be better handled with active and robust forward markets. This is the best way to take out volatility in the spot market since participants will have the benefit of forward rates to consider. This will likewise provide the useful by-product of tempering the urge of the broad public to unnecessarily analyze the day-to-day movements in spot market rates.

For regulators, price discovery, asset liquidity, mitigated volatility and forward rates are all desirable features. Given the volume of capital flows expected ? both from intra-regional trade and from within-region investments ? the case can be made that there is a clear benefit to having such a coordinated regional capital market even if, on an economy by economy basis, not all economies have the volume for a deep local capital market.

Strategic Challenges Ahead

Moving forward, the banking opportunities from the unique structure of Asia can be best tapped if indeed we address the gaps that I have just mentioned. However, doing so will invariably require a commitment to a larger capital base given the larger scale of operations and broader risks that must be mitigated. Let me be very clear though that I am not suggesting that more bank capital is the only way forward. Instead, the operating reality is that capital is the fixed resource at any given point in time and for this reason, banking operations are more akin to budgeting acceptable risk exposures for the given capital.

This takes me to the issue of managing risks which, under current international norms, is the sine qua non (literally, "without which none") of banking. Much has been said in this crisis that a large portion of the blame goes to the reliance on fancy risk models -- models that, in the end, did not connect well with how markets actually behaved. That may be so. But allow me also to pose this query: did we simply rely too much on the stylized risk models that proved to be failures, or did users fail to localize idiosyncratic features of their markets into the stylized models? Stated differently, when we use Value-at-Risk models, do we adjust the embedded standard normal distribution because we are well aware that financial markets are notorious for "skews" and "fat tails"? When we do our IRB models, do we consider the consequence of the granularity assumption because we know our portfolios are never finely granular? (That may sound too technical. But more simply stated, did we just accept the models presented to us, knowing how imperfect they were, because we knew there are no perfect models anyway?)

These are execution issues that often are not raised at strategic discussions. Yet, at the end of the day, these models are meant to be starting points. The larger exercise is to fine tune these models to best reflect our local markets. This may be seen as something better left to "quants" but the implications are fundamentally strategic: our ability to monitor the adequacy of our risk controls and exposures depends largely on the model that we are using in the first place.

A bad model will always generate bad results; better models minimize those surprises that come with bad modeling.

A better handle over risk is related to a topic that is current mainstream discussion among regulators: that of financial stability and the attendant concern over macro-prudential regulation. This is not the time and place to fully array the complications of this issue but I raise the issue with you today because the underlying message needs to be reiterated.

That message is that financial markets are too important to be governed purely by individual interests. The governance of the "bigger picture," however, is not a task that is exclusive to regulators. Since remedial measures will almost always require collective actions, financial governance is rightfully a shared responsibility among market stakeholders. We all share the gains of a financial market that works. Thus it is only fitting that we all share in the responsibility of making the market work and remain viable.

Regulators do not expect each bank to be worried about monetary aggregates but regulators do expect that banks manage their risks prudently. This is the quid pro quo of governance and strategically, this is the clear direction embedded in the Basel Accord. The Internal Capital Adequacy Assessment Program (ICAAP) under Pillar 2 of the Basel Accord is a clear case where the onus of governance rests in part with the banks themselves. ICAAP has never been simply a compliance issue and is instead the venue for the banks to articulate their own processes that identify and appropriately handle risks.

Closing Remarks

Let me close my remarks by going back to the question at hand: What is next for Asian Banking?

Precisely because our banks were more indirectly affected by the latest crisis, the Solomonic answer to the question is that we have the option to choose our answer. The unique economic structure of Asia provides banking opportunities in trade finance, in fixed income markets and in auxiliary services such as agency and custodianship arrangements. Yet, Asia has developed as an economic force faster than it has as an integrated financial hub for Asian needs. This is the irony that needs to be addressed and while the tasks ahead are non-trivial, the advantage we have is that we directly influence the outcome. It is what we make Asian banking to be.

Strategically, the future of Asian Banking rests as much on the opportunities we generate in Asia as it does on the remodelled architecture of banking. But there is also a clearer appreciation that banking is evolving dynamically. If Asia is to move further forward and consolidate its current strengths, banks need to re-assess their strategic decisions to the changed landscape, re-evaluate their core competencies, re-tool their internal skill sets, and re-position themselves to clearly defined target market. While it is an option available to those who choose to do so, re-capitalizing Asian banks so that we can be everything to everybody may now less viable a strategic play moving forward.

Amidst all the change that is happening, focus is the essential element. That leaves choosing one's market clearly, serving it well while mindful of our own respective accountabilities in our shared governance commitment. It does sound "philosophical" but stepping back a bit, the beauty of this is that it remains a choice and our choice at that. Many others would want to be in our shoes right now.

Thank you and good afternoon.