Chapter 6

Challenges ahead of the banking sectors in Asia

Klaudia Zielińska-Lont*
https://orcid.org/0000-0003-3738-0468

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As the Asian-Pacific economies are maturing, the profitability of its financial institutions is slowly coming down to the global average. This comes not only as a consequence of slower economic growth or intensified competition, but also due to new policies and initiatives, such as sustainable finance. As a result, financial institutions in the region will need to seek to consolidate their businesses in order to increase their efficiency and protect their market share. The aim of this chapter is to evaluate the consequence of changing micro- and macroeconomic environment for the banking sectors in Asia as of 2013, with an emphasis on Malaysia, Indonesia and Thailand.

This chapter is divided into five sections, starting with a broad overview of the banking sector in Asia. That section is followed by a more detailed description of the developments in some of the major banking sectors in the region. The two consecutive sections provide respectively a description of the situation in the chosen banking sectors in 2019 and an outlook for the future in view of the changing environment. Last section includes concluding remarks on the current condition of the credit institutions in Asia and how they can adapt to the new market reality.

* University of Lodz, Department of International Business and Trade.

6.1. Asia's banking sector – overview

Banks in many Asian country experienced a golden age of prosperity until the late 90's, since the economic situation was extremely favourable and the need for financing was overwhelming. The revenues of credit institutions in the region was far beyond reach of most of their competitors from developed countries and the financial systems they operated in slowly evolved, moving from state-owned monopolies towards market-based competition.

Before the evolution of the banking sectors of different Asian economies is described, it should be noted that the size and development stage of credit institutions in many countries in the region is very diverse. In high-income countries, banking assets exceed the worth of the home economy's GDP, while in less developed regions, banking sector remains relatively small.

First signals of the need for reforms came along with the Asian financial crisis of 1997. From the perspective of this chapter, the main reason for the crisis would be excess optimism in the region, resulting in major financial institution's exposure to high-risk investments.[1] Authors also signal that the credited investments were misdirected, financing the development of non-traded goods and often into areas that were already overinvested.[2] The consequence of this situation was that the creditors who were allowed to uptake major debts, became very sensitive to changes in market conditions and interest rates, in turn making the undercapitalized banking sector very fragile as well (see figure 6.1.). Early signals of recession resulted in severe runs on the banking system, threatening the stability of the entire financial system in the region.

Apart from implementing direct and interim measures addressing the crisis, countries in the region have undertaken a series of reforms of their financial systems. Some of them were very structural, where financial institutions were allowed to go into insolvency and disappear from the market (e.g. in Korea, Thailand and Indonesia). Those institutions who have prevailed needed to raise their capital substantially. Minimum capital requirement has been implemented but given the size of the gap that needed to be covered, public capital injections were also necessary. Finally, prudential supervision was strengthened and banks were forced to revise their credit scoring policies.[3]

Upscaling the standards of financial institutions was a process that took time. Its duration was disappointing at times, yet it should only be said that over the next years many financial institutions in the region was back on the path of fast

1 A. Berg [1999], *The Asia Crisis: causes, policy responses and outcomes*, IMF Working Paper, vol. 99 (138), Washington D.C., p. 5.

2 *Ibidem*.

3 X.M. Fu, Y.R. Lin, P. Molyneux [2015], *Bank Competition, Efficiency and Liquidity Creation in Asia Pacific*, Palgrave Macmillan, London, pp. 5–48.

growth, despite the initial surge in GDP in the region. The global financial crisis of 2008 had a relatively low impact on the banks in the region – credit institutions were seen as stable and the national authorities were maintaining a reasonable amount of foreign reserves.[4] Situation has changed after the failure of Lehman Brothers, when the drop in investor's trust resulted in a massive overpricing of risk in the region.[5] Trade-dependent economies suffered additionally from the dry out of external sources of USD and then from a general drop in global demand. Nonetheless, after experiencing a time of recession (e.g. Singapore, Korea) or economic slowdown (e.g. China), the region started recovering already in 2009. This was yet another valuable experience in terms of severity of potential financial spill-overs that gave the necessary incentive to further reinforce and coordinate prudential supervision.

After the financial crisis Asian banks have intensified their cross-border activity.[6] The total asset worth of the banking sector in the region has also grown substantially.[7] It is worth to note that in 2015, revenues of the banks from Asia-Pacific accounted for as much as 46% of the global banking profit.[8] When most Western banks have limited their activity in the region, Asian banks have clearly spotted their opportunity to extend their international presence.

6.2. Major banking sectors in the region

In terms of size and importance, China's banking sector has fast become the champion in the region with truly global aspirations. Developments in that country have been described in detail in previous section of this monography so the emphasis will be placed on other larger banking sectors in Asia.

Japan's banking sector, unlike most in the region, had to cope with many years of economic stagnation in the country that has brought down the profitability of

4 A. Filardo [2011], *The Impact of the International Financial Crisis on Asia and the Pacific: Highlighting Monetary Policy Challenges from a Negative Assets Price Bubble Perspective*, BIS Working Papers, vol. 356, Basel, p. 9.

5 *Ibidem*, p. 10.

6 E. Remolona, I. Shim [2015], *The rise of regional banking in Asia and the Pacific,* BIS Quarterly Review, https://www.bis.org/publ/qtrpdf/r_qt1509j.htm (accessed: 11.10.2019).

7 B. Kotanko, D. Woods, E.H. Lim, C. Pedersen, C.L. de Lanzos, M. Struder [2017], *Asia Banking Agenda 2017*, Oliver Wyman, https://www.oliverwyman.com/content/dam/oliver-wyman/v2/events/2017/apr/Asia_Banking_Agenda_2017.pdf (accessed: 10.10.2019).

8 V. Hv, G. Lee, K. Rajendran, J. Sengupta [2016], *Weathering the storm Asia-Pacific Banking Review*, McKinsey&Company, p. 4.

credit institutions to very low levels.[9] The entire financial system of Japan is still one of the most advanced in the world, that remained largely unaffected by the financial crisis of 2008, but the challenges ahead of it are much different than of its developing neighbours.[10] The International Monetary Fund's (IMF) 2017 Financial System Stability Assessment has already signalled that the Japanese financial institutions are turning overseas to seek profitable investments that would compensate for ever-shrinking domestic demand.[11]

The banking sector of Singapore is another specific case in the region, as it constitutes a truly global financial centre, where foreign institutions are free to compete with the local credit institutions. Strong competition, however, not only did not marginalize the domestic institutions in Singapore that are internationally recognized, but it has also led to development of advanced financial services that has reinforced the country's position in international financial intermediation.[12] Despite remarkably strong international ties, the financial sector of Singapore also remained stable both during the Asian banking crisis and the global financial crisis, which was attributed to strict prudential supervision and transparency of the regulatory authority that enshrined the investor's trust even at times of major turmoil.[13]

One example of an economy undergoing major changes in the financial sector over the past years can be Malaysia, where major restructuring plans have been implemented as of 2002 to build up financial stability.[14] At the core of these reforms was a major central bank-orchestrated consolidation of 54 domestic credit institutions into ten larger players, capable of competing with foreign institutions and serving large consumers.[15] This exercise, combined with careful oversight of commercial bank liquidity and capitalization by the central bank, have helped the Malaysian financial sector to remain stable during the global financial crisis of 2008.[16] In 2019, reports by Malaysia's central bank have indicated high level of capitalization by the central banks and ample liquidity.[17] It should also be noted

9 International Monetary Fund [2017], *Japan. Financial System Stability Assessment*, IMF Country Report, vol. 17/244, Washington D.C., p. 18.

10 R.S. Jones, M. Tsutsumi [2009], *Financial Stability: Overcoming the Crisis and Improving the Efficiency of The Banking Sector in Japan*, OECD Economies Department Working Papers, vol. 738, Paris, pp. 5–10.

11 International Monetary Fund [2017], *op. cit.*, p. 6.

12 H.K. Chow-Tan, S.F. Pei [2019], *Financial sector in Singapore*, in: U. Voltz, P.J. Morgan, N. Yoshino (eds.), *Routledge Handbook on Banking and Finance in Asia*, Routledge, London, pp. 1–7.

13 *Ibidem*, p. 7.

14 Ch. Tin Fah, M. Ariff [2017], *Competition in the Malaysia's Banking Industry, Quo Vadis*, "International Journal of Economics and Management", vol. 11 (S3), p. 898.

15 R. Ahmad, M. Ariff, M. Skully [2005], *Factors determining Mergers of banks in Malaysia's Banking Sector Reform*, "Multinational Finance Journal", vol. 11 (1), pp. 4–5.

16 Ch. Tin Fah, M. Ariff [2017], *op. cit.*, p. 900.

17 Central Bank of Malaysia [2019], *Financial Stability Review*, http://www.bnm.gov.my/files/publication/fsreview/en/2019/1h/en_fs_01.pdf?fbclid=IwAR3V8OcZgiX3d12FmC4hVC8ErqskGSVgKwV1WcwNPrY8unzmzXyCOyOlsCQ (accessed: 15.10.2019), p. 9.

that Malaysia is at the forefront of developing so-called Islamic banking, conducted according to Islamic law.[18]

Thai banking sector is a fairly good example of successful reform after the Asian banking crisis. Severity of the losses incurred in 1997 delivered substantial motivation to reorganize the financial system, since the country experienced a 40% drop in GDP per capita and nearly 75 billion USD of capital was withdrawn from the country over the period of five years.[19] Through a tremendous effort of Thai authorities, trust in the financial system has been largely reinstated, although the initial restructuring took five years, followed by three phases of the so-called Financial Sector Master Plan, implemented over the period of 10 years.[20] The IMF 2019 financial stability assessment has found the banking sector of Thailand resilient to even adverse shocks.[21]

Similarly to Thailand, Indonesian economy suffered tremendously from the Asian banking crisis. Indonesian authorities were criticized for their initial lack of dedication towards tackling the crisis or implementing the agreed programmes with the IMF, eventually increasing the costs to the economy, exceeding 80 billion USD.[22] Nonetheless, the progress made until 2009 was sufficient for the country to last the global financial crisis without falling into recession.[23] In 2019 the country's banking sector was reported to be well-capitalized, profitable and on the growth path.[24]

6.3. Asian banking sector – status quo

Over the past years the profitability of the Asian banks started declining. The slowdown could be due to several factors, including steady increase in capitalization in some countries (see examples on figure 6.1.), slower economic growth, increase in shadow banking and - in some cases – an increase in non-performing loans (NPLs).

18 S. Kunhbava [2012], *Islamic Banking in Malaysia*, "International Journal of Legal Information", vol. 40 (1–2), pp. 2–5.

19 O. Fratzscher [2002], *Thailand. Financial Sector Strategy: Current Status and Future Priorities*, The World Bank, Washington D.C., pp. 3–4.

20 R.A. Baxter [2010], *Financial System Reform in Thailand*, "Asia Focus" Federal Reserve Bank of San Francisco, http://www.frbsf.org/banking/files/july-2010-financial-system-reform-in-thailand.pdf (accessed: 15.10.2019).

21 International Monetary Fund [2019], *Thailand. Financial System Stability Assessment*, IMF Country Report, vol. 19 (308), Washington D.C., pp. 9–10.

22 S. Radelet, J.D. Sachs [1998], *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, "Brookings Papers on Economic Activity", vol. 1998 (1), pp. 119–120.

23 H. Hill [2012], *The Best of Times and the Worst of Times: Indonesia and Economic Crises*, Working Paper Australian National University, vol. 2012 (03), Canberra, p. 6.

24 International Monetary Fund [2019], *Indonesia. Article IV Consultation – Press Release*, IMF Country Report, vol. 19 (250), Washington D.C., p. 17.

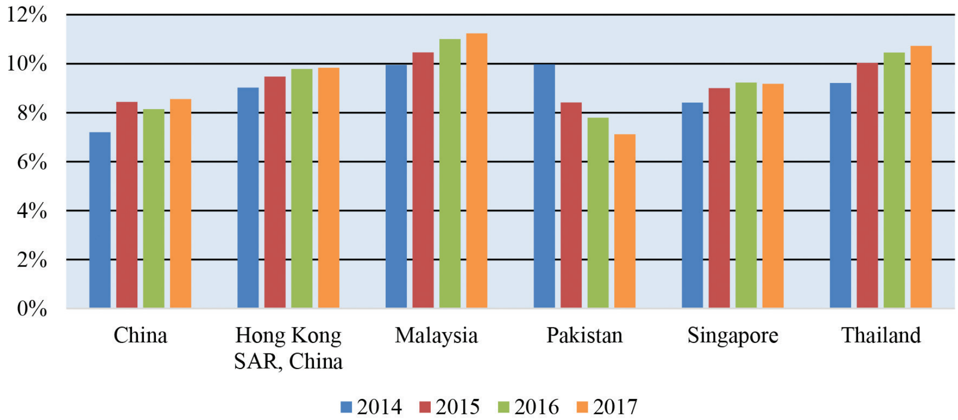

Figure 6.1. Bank capital to assets ratio (%)
Source: own elaboration based on: World Bank [2014–2017], Database, https://data.worldbank.org/ (accessed: 19.10. 2019)

The trends in the share of non-performing loans was very different across the region and often stood in sharp contrast to each other, as could be observed on the example of India and Pakistan (figure 6.2.). While the share of threatened loans was mostly stable over the analysed years, McKinsey quotes that in practice, their share may force the regional credit institutions to raise as much as 600 billion USD of additional capital by 2020 to meet the capital adequacy ratios.[25]

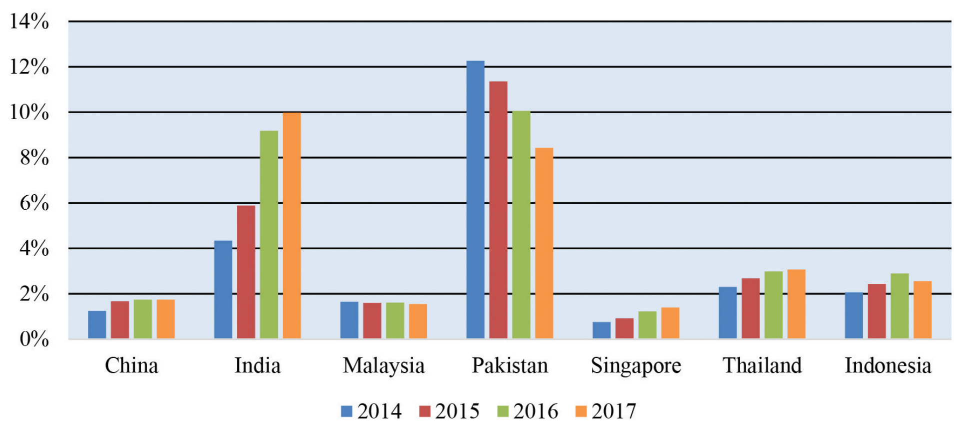

Figure 6.2. Bank NPLs (% of gross total loans)
Source: own elaboration based on: World Bank [2014–2017], Database, https://data.worldbank.org/ (accessed: 19.10.2019)

25 V. Hv, G. Lee, K. Rajendran, J. Sengupta [2016], *op. cit.*, p. 4.

Apart India, the fluctuations in share of non-performing loans in general did not look alarming, not least for developing economies, where the average investment risk can be assumed to be higher than in developed countries. If the focus is narrowed further down to the three economies of Indonesia, Thailand and Malaysia, general performance of the banking sector does not look alarming either. The information on figure 6.3. show that despite the problems of the global financial institutions, banks in all three economies were on a constant growth path. While the overall income level was rather volatile over the period, the longer trend was clearly increasing.

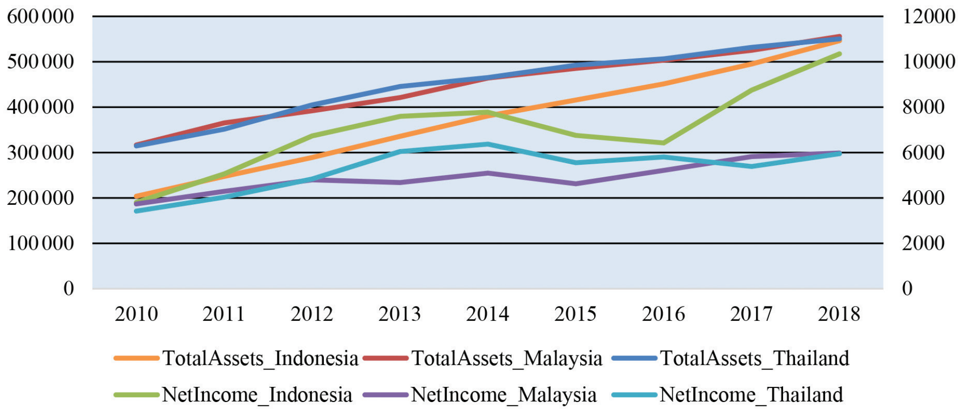

Figure 6.3. Total assets and net income of the chosen Asian banking sectors (mln USD; net income on secondary axis)
Source: own elaboration based on: IMF Data [2010–2018], Financial Soundness Indicators, https://www.imf.org/en/Data (accessed: 19.10.2019)

6.4. Asian banking sector – way forward

Despite the good financial condition of the Asian banking sectors in aggregate, more recent reports on the Asian banking sector are rather pessimistic regarding their future. The years after the global financial crisis were a time of very dynamic credit growth. While this can be read as a sign of financial deepening, Basel Committee of Banking Supervision has signalled the issue of increasing credit to GDP gap – an indicator that policymakers are to use when setting the economic-cycle related capital buffer (so-called countercyclical buffer).[26] Such early-warning

26 M. Drehmann, K. Tsatsaronis [2014], *The credit –to- GDP gap and countercyclical capital buffers: questions and answers*, BIS Quarterly Review, https://www.bis.org/publ/qtrpdf/r_qt1403g.pdf (accessed: 11.10.2019).

indicator is to signal an upcoming financial distress and is calculated as deviations of the credit-to-GDP ratio from its long-term trend.[27]

Despite the relatively strong financial condition of the credit institutions in the region – Standard & Poor signals that the local economies may be negatively affected by the escalating trade conflict between USA and China.[28] McKinsey upholds its view from 2016, signalling that Asian banks may struggle to survive in an environment of lower economic growth and lower margins.[29] The point on competition from non-banking financial service providers was also raised by Ernst & Young in their report from 2019 where they highlighted the threat to traditional banking competitiveness.[30]

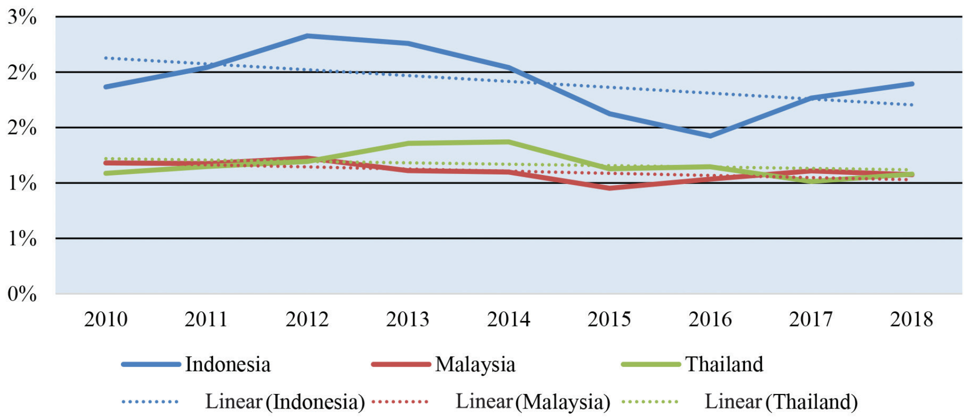

Figure 6.4. Average bank return-on-assets and the corresponding linear trends (%)
Source: own elaboration base on: IMF Data [2010–2018], *Financial Soundness Indicators*, https://www.imf.org/en/Data (accessed: 19.10. 2019)

If the information from figure 6.3. are analysed jointly, the long-term trend of the return-on-assets (ROA) over the same period, is in steady decline (figure 6.4.).

27 M. Behn, C. Detken, T.A. Peltonen, W. Schudel [2013], *Setting Countercyclical Capital Buffers Based on Early Warning Models. Would it work?*, ECB Working Paper Series, vol. 1604, Frankfurt am Main, pp. 1–2.

28 Standard & Poor's Global [2018], *Asia-Pacific Banking Outlook 2019 – Headwinds are picking up*, https://www.spglobal.com/_assets/documents/corporate/apac-bankingoutlook2019_ratings-.pdf?fbclid=IwAR1VH4hMp2-M3Hc4ux4uTKNNqctA5LnHyxTyrClqs3zuAi2jk9qvn5i07lI (accessed: 11.10.2019), p. 7.

29 J. Dahl, V. Giudici, J. Sengupta, S. Kim, E. Ng [2019], *Asia-Pacific Banking Review 2019. Bracing for consolidation: the quest for scale*, McKinsey & Company, p. 2.

30 Ernst & Young [2019], *Banking in Asia-Pacific. Time to reinvent the digital landscape*, https://www.ey.com/Publication/vwLUAssets/EY-banking-in-asia-pacific-2019/$File/EY-banking-in-asia-pacific-2019.pdf?fbclid=IwAR2irPmvAsJBxlpddeR-UBDnIukePHh0vNQfdwI1R1qvycpjyjEOKZYDeGI (accessed: 11.10.2019), p. 3.

This would confirm that the negative trend exists, yet this does not need to be surprising in itself, since the economies are maturing and competition becomes more intense. It is therefore the combined set of unfavourable conditions that altogether bring the rating agencies to the conclusion that the banking sectors of the developing Asian economies are heading towards a difficult time, in particular due to:

- slowing economic growth;
- stricter prudential requirements;
- high household debt;
- increasing market volatility.

As the economies mature and are slowing down, the banking industry is moving onto a different business reality, where the margins on customers are dropping and competition for new clients is on the rise. This new reality exerts pressure on the credit institutions to seek economies of scale that would protect their profitability and increase their resilience to bad loan write-offs. Therefore, the author agrees that the maturing economies in Asia are moving into a stage of intense mergers between the banks that are to help them endure in the new market conditions. Consolidation in the banking sectors should also be encouraged through the intensified competition from shadow-banking.

Besides the fundamental changes on the microeconomic side, the banks in Asia will also be facing significant changes in the macroeconomic environment. The entire region depends heavily on trade and exports to the largest markets of the World, including China, the EU and USA.[31] This became particularly relevant due to an escalation in the trade war between China and USA. While the Asian Development Bank (ADB) is rather positive about the general exports level from the developing countries in the region, it does not analyse in detail the consequences of an economic slowdown in China.[32] It should also be noted that ADB does confirm the existence of collateral damage caused by the trade conflict on Asian economies and has expressed concerns over the potential drop in investor confidence in developing countries. From Asian credit institution's perspective, a notable slowdown in economic growth can result in serious problems, through an increase in NPL, drop in credit demand and shrinking capital inflows from abroad.

31 Deloitte [2019], *Voice of Asia*, https://www2.deloitte.com/content/dam/insights/us/articles/apac22437_voice-of-asia-5/DI_Voice-of-Asia-5.pdf?fbclid=IwAR0ylIrJM2l7OrLkj9qV6ilqomihXwF6RbTq2eJJdGRnWWg4Xk9OQde9EpE, pp. 15–22 (accessed: 11.10.2019).

32 A. Abiad, K. Baris, J.A. Bernabe *et al.* [2018], *The impact of trade conflict on developing Asia*, ADB Economics Working Paper Series, vol. 566, Manila, pp. 26–28.

Conclusions

Steady maturation of the Asian economies brings their banking sectors to a new reality, where credit institutions need to make an effort to find a customer and to attract investors. The new reality also comes with the gradual opening of the sector to competition, not only from foreign banks but also from non-banking institutions providing financial services.

Currently, Asian credit institutions are in good financial condition and are well-capitalized. Authorities in the region have made substantial progress in terms of prudential supervision and regulation of banks since the Asian financial crisis that was sufficient to protect their economies from major disturbances during the global financial crisis of 2008. Remarkable resilience of the Asian financial institutions should be appreciated by the investors especially in view of the challenges ahead of the entire sector.

Economic slowdown and growing competition have resulted in a steady drop in banking profitability. Profits should be expected to drop even further in view of the trade war between USA and China. In order to adjust to the new reality, credit institutions will need to merge their businesses and improve their competitiveness. Progress in this respect will constitute an interesting subject for further studies on the development of the banking industry in Asia and its interactions with the global financial system in the future.