

Issue 2 by Marc Intrater, Partner and senior member of Oliver Wyman's Finance and Risk practice in the Asia Pacific region

The Asian Century in Financial Services?

How Asian Financial Institutions Can Find
Opportunity in the Current Financial Crisis

Marc Intrater, Partner in Oliver Wyman, says as the credit crisis rages in America and Europe, leaving virtually all of the largest and most respected banks either bankrupt, merged into stronger rivals, or partially nationalized, Asia has, so far, felt only mild ripples. This presents an unprecedented opportunity for Asian banks and other financial institutions to accelerate their rise in the global financial system. Several Asian institutions, most recently Nomura with their acquisition of parts of Lehman Brothers and MUFJ with their investment in Morgan Stanley, have already started to act. Others are likely to follow. If Asian banks, securities firms, insurers, sovereign wealth funds and other financial institutions successfully rise to this challenge, securing market leadership within large parts of the global financial services landscape, future history books will indeed mark this past month as the beginning of the Asian Century in finance.

Global Credit Crisis –

The current crisis began with a downturn in US residential real estate values, leading to a rise in mortgage defaults, especially among the borderline borrowers and aggressive lending structures collectively known as “sub-prime.” Since many of these loans were sold on by their originating banks, repackaged by Wall Street, and subsequently resold in many pieces, it is unclear who will end up taking the loss from the mortgages which cannot be repaid and backed by property whose value has declined. Worried as never before about their counterparties, banks became hesitant to provide each other with the liquidity to lubricate the banking system, causing the liquidity crunch. Even banks with fundamentally sound businesses have been unable to raise the funds necessary to continue to lend to customers.

Both of these financial problems are contributing to the global recession which is now deepening:

As households have seen falling home prices and stock markets ravage their wealth, they have cut back on spending. This is especially true for many US households which have been financing their spending from house price appreciation, either directly via home equity loans or ‘cash out’ refinancings, or merely by neglecting forms of savings other than real estate.

The lack of a functioning, liquid banking sector in both America and Europe will force commercial and industrial companies big and small to delay or cut spending plans when they find that they in turn cannot raise the necessary financing.

A recession of average to high severity is now unavoidable. While Asian banks have mostly escaped contagion, the sub-prime crisis and liquidity crunch, Asia is not insulated from the Western economy. Asia is not likely to escape the next phase of developments. A severe recession in North America and Europe will lead to reduced demand for imports, largely sourced from Asia, and within a few quarters Asian exports, and Asian economies will also be affected.

Flaws Uncovered

The crisis has revealed several flaws in the world's financial institutions, which will look quite different after this is over:

Risk management insufficient: Although the financial industry has made many advances in risk management over the past two decades, these have proved inadequate to protect most banks from recent events. Likely fixes will be less technical and more organizational, and will focus on stress testing, strategic risk assessment, and liquidity management. Asian banks face a big challenge in attracting the experienced risk managers necessary for the turn towards expert judgment.

Liquidity and deposits undervalued: Liquidity is – as the word itself suggests – the water of financial services. It is usually so abundant that we take it for granted, but when it dries up it leads to fatal consequences. The majority of banks in most Asian countries have benefited from having an organic core deposit base – an unfashionable part of the banking sector, but one whose true value has been revealed by the current crisis.

Overleveraged: Banks, investment banks, and other financial institutions have improved their returns on equity by increasing their leverage, both directly on the balance sheet and through off-balance sheet structures such as structured investment vehicles (SIVs). This strategy has seen its limits exposed. The few recent scares among Asian banks have come from the most leveraged among them.

Interdependence: While the over-the-counter (OTC) derivatives market has been enormously successful and innovative, it requires banks to take massive counterparty exposures to one another, and can lead to complex and opaque cross-dependencies. This greatly increases the risk that a failure of one bank will lead to stresses in others, as we have seen after the failure of Lehman. This risk has even been magnified by some of the tools that were put in place to mitigate counterparty risk, such as collateral and margin requirements, with sudden increases in margin requirements further accentuating tightness in liquidity, leading to forced asset sales and further drops in market prices. Markets for these instruments are just beginning in most of Asia. Banks, regulators, and exchanges have the opportunity to learn from the West's

mistakes. In particular, the development of an Asian credit default swap (CDS) exchange would allow for the credit risk flexibility without the counterparty exposure concerns.

Under-supervised: Although politicians and pundits have been quick to point the finger at the lack of regulation, the more important failure from the governments has been the lack of capacity of supervisors and auditors to cover the increasingly wide range of complex instruments that banks have been taking on. This has been compounded by the fragmentation and weak coordination of regulatory authorities, both within markets (such as in the US), across borders (e.g. lack of any EU-level regulatory body), across industries (banking, securities, and insurance) and across functions (e.g. between central bank and financial regulatory authorities). Asian regulators have done a good job of choosing the best of Western models to emulate in terms of supervisory organization and regulator standards. The big challenge will be in attracting, developing, and maintaining a high quality of supervisory personnel.

Priorities for Asian Financial Institutions

As the credit crisis reconfigures the financial landscape in America and Europe, Asian financial institutions have a once-in-a-lifetime opportunity to position themselves as major players on the world stage, creating significant value for their shareholders as they do so. Oliver Wyman sees four priorities for institutions to meet this challenge:

Buy global presence: Some global financial institutions have gone out of business and many more remain under substantial pressure. Given this context, there is a once-in-a-career opportunity for some Asian financial institutions to acquire North American and/or European businesses. Several transactions (GIC's investment in UBS, Mitsubishi UJJ's rescue of Morgan Stanley) have made headlines, but most of these have been merely financial investments. While these may very well prove to be financially successful, they represent only the beginning of the opportunities.

For a small number of Asian institutions with a credible global ambition, such acquisitions will fulfill the objectives of strategic expansion, e.g. enabling Asian capital markets players to offer Asian corporations North American/European listings and issuance; enabling Asian wealth-managers to offer Asia's wealthy off-shore investments; etc. For buyers with sufficient management talent, imagination, balance sheet strength, and risk appetite, there are fundamentally healthy businesses which can be purchased as bargain prices and leapfrog their buyers into the global top ranks.

Buy/steal Asian market share: The shake-up of the global financial industry will create opportunities for Asian banks to expand their market share both in their home markets and across the region.

In wholesale banking as well as in wealth/asset management, this will come primarily at the expense of troubled Western banks. Whilst we expect Asia, given its strong growth prospects, to remain a strategic priority for those surviving global players, an inevitable consequence of the global de-leveraging of these institutions will be lower risk appetite and growth expectations. At its boldest, this can be achieved via selective acquisition of Asian operations which come up for sale (such as Nomura did with much of Lehman's operations). Beyond acquiring entire operations, the current market context offers attractive opportunities to grow via more organic means. A stronger relative capital and liquidity position will enable

Asian institutions to take on the globals, winning mandates and prizing clients away from them. Similarly, global pressure on bonus pools should allow Asian banks to attract talent – senior managers and entire teams – to build out their wholesale banking and wealth/asset management offerings.

If the banking crisis does come to Asia, there may be opportunities for the stronger banks to expand at the expense of their more troubled peers. Who will be the Asian North Carolina National Bank (NCNB) (now Bank of America) or Santander, two mid-sized regional banks which rose to global status by acquiring failing rivals on the cheap.

Monetize liquidity: Liquidity has proven to be the most crucial commodity in the banking sector with the Federal Reserve and European Central Bank doing everything they can to pump liquidity into the system, and still banks are failing due to illiquidity. On the other hand, many Asian banks are quite long liquidity, especially in domestic currency. This puts them in a very strong position vis-à-vis western banks that are desperate for liquidity. Finding ways to monetize this advantage (e.g. by buying distressed assets, investing in long-term financing, or providing liquidity back-up lines), while at the same time managing the related currency, ALM and credit risks that arise from cross-border liquidity transformation, will be a key mechanism for Asian banks to assert their newly-found strength.

Learn from the mistakes of others: with the crisis still in full swing and a global economic downturn all-but inevitable, there is no room for complacency in terms of tight management of the business and general preparation for the global downturn. To avoid frittering away their current advantage, Asian banks should rapidly enhance their risk management capabilities.

Two exposures are likely to cause trouble in the next year and banks need to be preparing now: International counterparty exposure management is a particular priority - getting a handle on existing counterparty exposures and mitigation and reviewing policies, processes and systems to prevent further exposures building up are a must. Domestically, Asian banks should review their credit exposure to borrowers likely to be affected by the downturn, including exporters, commodity producers, and their key suppliers. Preparatory steps include an immediate review of collateral and its management and a strengthening of credit workout capacity for the coming increase in problem loans.

Although Asian banks have been making large investments in risk management, much of this investment has been technical and tactical in nature. Looking forward, Asian banks should seek to improve their strategic risk management. A historical focus on domestic branches and caution in foreign investments has been a survivor strategy so far in this crisis. However, for most Asian banks, these strategic elements were the result of their history, not a conscious risk management decision. In order to expand successfully especially in the coming choppy economic conditions, it will become vital to have a strong executive led risk governance framework, supported by a strategic risk assessment capability.

The last month has seen a remarkable chain of events, the speed and scale of which we have probably not witnessed in the global financial markets for more than 70 years. This phase of creative destruction is almost certainly not yet completed and further turmoil is likely, not least as the knock-on effects of the economic downturn cascade into the Asian economies in the coming months.

While this turmoil poses increased risks for all, the Asian financial services sector has been largely unaffected to date by the crisis and thus will find unprecedented opportunities for the best managed amongst them to rapidly expand their franchises and cement new leadership positions. Broadly speaking, Asian entrepreneurs, investors, financial institutions and regulators now have an opportunity to define the successful innovations and institutions for the sector both regionally and globally.

Commentators have been talking for many years now of the 21st Century as being the Asian Century. And yet the last decade has, at least for the financial services sector, still very much been the gilded age for financial markets and institutions in North America and Europe. **The crisis in Western financial markets has presented a rare opportunity. If Asian banks manage to successfully seize it, the Asia Century in Financial Services will have begun.**

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