ASIA FINANCE 2020
FRAMING A NEW ASIAN FINANCIAL ARCHITECTURE

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1. INTRODUCTION

Asia is getting richer, not only absolutely but relatively. Over the last decade, Asia increased its share of global GDP from 24% to 31%. Its vast population is increasingly urban and increasingly middle class.

With both Europe and the US struggling to bounce back from the deep recession triggered by the financial crisis, the world is again looking towards Asia as the engine of growth. However, Asia is also at a crossroads. It needs to shift from its current “old industrial” export-driven model towards a new economic model – one that is focused on domestic consumption and is more socially just and environmentally sustainable.

The Asian financial sector will need to facilitate this transformation in the real economy. Alas, it is currently ill-suited to playing this role. The Asian financial sector is dominated by short-term bank lending; it suffers from shallow capital markets and a paucity of “real money” long-term investors, such as insurers and pension funds; and it lacks the financial data, credit expertise and incentives required to lend to small firms or innovative start-ups.

In short, the Asian financial system is adapted to the “old industrial” real economy it has been serving. For Asian economies to modernize, the financial system must modernize too.

This report describes the shortcomings of the current system (Section 3) and makes recommendations for Asian policy makers (Section 4). Among other things, they should co-ordinate their policies to create an efficient and regionally integrated financial sector, increase transparency to reduce information asymmetries and facilitate the transition towards an increasingly mobile world by ensuring safety and efficiency of local payment systems. We also argue for Asian policy makers to create financing back-stop facilities as well as tax incentives to further encourage equity and other long-term funding.

If this modernization agenda is followed, we believe the 3 growth pillars (SMEs, infrastructure and trade) alone can create an incremental GDP uplift of more than 0.5% on an annualised basis and increase the financial sector’s market capitalization by as much as $2 TN.
2. THE ASIAN GROWTH STORY

Asia’s economic development to 2020 will be founded on three pillars. Small-medium enterprises (SMEs) will drive job creation and innovation; intra-regional trade will invigorate growth; and infrastructure investment will improve access to markets and resources, thereby lowering transaction costs, increasing the division of labour and improving the quality of life in Asia.

There are of course other drivers of growth, such as policy, regulatory and institutional reforms, which would increase productivity and growth, but they are outside the scope of this study.

PILLAR 1: SME

SMEs are an important part of most economies, providing employment and innovation. Between 1993 and 2009, US SMEs accounted for 65% of net new job creation, and produced 16 times more patents per employee than large enterprises in the high-tech area.

Asian economies are no exception to this rule. Indeed, in some countries SMEs play a disproportionately large role (see Exhibit 1). In China, for example, there were 50 MM SMEs in 2011, accounting for 99% of all enterprises, 60% of GDP and 68% of trade volumes.

Over the next decade, we expect SMEs to further grow in importance, as Asian policy makers embark on initiatives to improve the SME business environment, provide training and strengthen information dissemination, allowing for better informed business decisions. The Malaysian government, for example, has announced plans to lift SMEs’ contribution to GDP to 42% by 2020, up from 33% today.

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1 See FGI Brief on SMEs.
Research by the Asian Development Bank suggests that SMEs often drive local economies by creating “clusters” where SMEs are aligned in various parts of a supply chain and have mutually complementary production processes and sales channels. In such a context, SMEs can drive rapid innovation by stimulating competition. This environment is favourable to start-up businesses, and SMEs can more easily access various external economic agents such as raw material suppliers, skilled workers and trade partners\(^3\). SME development is therefore critical to growth, job creation and innovation towards a more sustainable and inclusive future in Asia.

PILLAR 2: TRADE

Taking advantage of cheap labour and following an export-driven growth model, Asia has become the leading global trade hub. We estimate that 50% of all global trade flows already have one leg in Asia and that Asia accounts for 40% of banks’ trade finance revenues.

While trade will continue to drive growth in Asia, the nature of trade will change, with intra-Asian trade growing in importance. Intra-Asian trade constitutes about 40% of total Asia-related trade (see Exhibit 2) and is the fastest growing. During this decade we expect intra-Asian trade to grow most rapidly within three sub-regions: North Asia, Greater China and ASEAN.

With Asian businesses moving towards serving regional consumers, we expect intra-Asia trade to exceed $8 TN by 2020, up dramatically from $3.3 TN in 2012. This can be reinforced by regional trade arrangements, such as those being discussed via ASEAN Economic Zone 2015, ASEAN+3 free trade negotiations and the wider Regional Cooperation Economic Partnership (RCEP). Intra-regional trade integration will support Asia’s rebalancing towards regional demand-led growth, with mutually beneficial effects across the region.

EXHIBIT 2: ASIA’S TRADE FLOW

ASIA SHARE IN GLOBAL TRADE

<table>
<thead>
<tr>
<th>% OF WORLD TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>100%</td>
</tr>
<tr>
<td>90%</td>
</tr>
<tr>
<td>80%</td>
</tr>
<tr>
<td>70%</td>
</tr>
<tr>
<td>60%</td>
</tr>
<tr>
<td>50%</td>
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<tr>
<td>40%</td>
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<tr>
<td>30%</td>
</tr>
<tr>
<td>20%</td>
</tr>
<tr>
<td>10%</td>
</tr>
<tr>
<td>0%</td>
</tr>
</tbody>
</table>

Trade finance revenue Asia trade breakdown

INTRA-ASIA TRADE FLOW DRILL DOWNS

2012, US$ BN

<table>
<thead>
<tr>
<th>TO</th>
<th>JP</th>
<th>KR</th>
<th>CN</th>
<th>HK</th>
<th>TW</th>
<th>SG</th>
<th>AU</th>
<th>MY</th>
<th>ID</th>
<th>TH</th>
<th>IN</th>
<th>VN</th>
<th>PH</th>
<th>TOTAL IMPORT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>440</td>
<td>241</td>
<td>921</td>
<td>434</td>
<td>150</td>
<td>214</td>
<td>130</td>
<td>134</td>
<td>151</td>
<td>145</td>
<td>105</td>
<td>43</td>
<td>3,241</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FROM</th>
<th>JP</th>
<th>KR</th>
<th>CN</th>
<th>HK</th>
<th>TW</th>
<th>SG</th>
<th>AU</th>
<th>MY</th>
<th>ID</th>
<th>TH</th>
<th>IN</th>
<th>VN</th>
<th>PH</th>
<th>TOTAL EXPORT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>498</td>
<td>343</td>
<td>982</td>
<td>45</td>
<td>187</td>
<td>212</td>
<td>212</td>
<td>154</td>
<td>144</td>
<td>77</td>
<td>63</td>
<td>53</td>
<td>3,241</td>
<td></td>
</tr>
</tbody>
</table>

$10 BN or less $10–30 BN $30–100 BN $100+ BN

1. Most of the intra-regional flows are in/out/within North Asia.
2. Trade within Greater China supported by geographical proximity, ethnic association and preferred regulatory access.
3. Expected to grow with further cooperation initiatives (e.g. ASEAN).

Source: Trademap, Oliver Wyman proprietary data.
PILLAR 3: INFRASTRUCTURE

While SMEs and trade are at the forefront of driving Asia’s growth potential, it will need to be underpinned by best-in-class infrastructure. There is a strong relationship between infrastructure investment as a percentage of GDP and the size of an economy. To reap its economic potential, Asia will have to commit to a total investment of about $8 TN, meaning its share of total global infrastructure investment will increase from 20-30% in the previous decade to 40-50% in this decade. Asia’s rapid urbanization will further add to the growing demand for infrastructure.

Asian infrastructure development will increasingly need to involve regional collaboration. A good example is the Kunming-Singapore Railway that will connect Southwest China and Southeast Asia. Due to open by 2020, the high-speed rail is expected to run from Kunming, through Laos, Thailand and Malaysia to Singapore within 10 hours, with alternate routes passing through Vietnam, Cambodia and Myanmar. The planning and execution of this project may be complicated by the number of countries involved, but its successful completion will greatly assist in unleashing Asia’s economic potential.

The real challenge for Asia is to embark on this transition at a time when the need for environmentally sustainable infrastructure is growing, requiring governments to opt for more expensive solutions. If governments avoid the immediate costs of more sustainable development, they are likely to damage long term growth, pushing up the future costs of pollution, ill-health and resource shortages, including energy. For example, poor water supply has been hindering shale gas production in China, as most gas reserves located in the driest part of the country. The World Bank estimates the cost of China’s water problems at 2.3% of its annual GDP, taking into account economic loss and damage to human health.

Each of these three pillars will crumble without reliable financing delivered through products and channels properly adapted to the needs of the real economy firms involved. This should worry policy makers because, as it stands, the Asian financial system is not well positioned to deliver financing of the kinds needed. In the next section we explain where it falls short. Then, in section 4, we recommend actions that Asian policy makers can take to improve the situation. We conclude in section 5 with our views on the agenda for future leaders in Asia Finance.
3. SHORTCOMINGS OF THE ASIAN FINANCIAL SYSTEM

Some commentators fear a new financial crisis in Asia driven by capital flight when quantitative easing subsides and US and European interest rates rise from their historic lows. For reasons we explain in 3.1, we doubt this is a serious risk. Nor should the increased costs created by Basel III be the primary concern of market participants and policy-makers (see 3.2). Rather, the problems with the Asian financial system, which may limit Asian economies’ transformation and growth, are structural (3.3).

3.1. RESILIENCE OF THE ASIAN FINANCIAL SYSTEM

The Asian financial system proved resilient during the global financial crisis (GFC). Estimated bank write-downs during the period of 2007 to 2010 amounted to 1.5% of total bank loans and securities, significantly less than the 7% and 5% write downs observed in the US and the UK.

The Asian financial sector now represents 37% of total world banking and insurance market capitalisation, up from 16% in 2003 and 28% in 2007. However, recent discussions of “tapering” by the US Federal Reserve – that is, reducing the rate of (base) monetary expansion – have caused volatility in the Asian financial system. Since May 2013, total financial services market capitalization has fallen by between 5% and 20% in major Asian markets. Investors have also withdrawn from emerging Asia, although the recent outflows account for no more than 5% of total fund investments.

Aside from a hiccup caused by the GFC, foreign bank claims on Emerging Asian counterparties (both financial institutions and corporates) remain resilient (see Exhibit 3). Japanese banks have been a notable source of funds as they seek yields that a zero interest rates environment makes unavailable in Japan.
Although a significant upward adjustment of interest rates in the US, Japan or Europe could cause a rapid repatriation of these funds, this presents relatively little risk to Emerging Asia's financing needs. Domestic deposits are being created so fast that it would take only 14 days to replace the loss of a quarter of foreign balances. Even excluding China, this figure is still only 32 days.

In short, a new Asian financial crisis caused by capital flight alone is unlikely. Nevertheless, the Asian financial system faces several challenges. The most obvious is the increased costs that will be created by Basel III.

3.2. THE EFFECTS OF BASEL III ON ASIA FINANCE

Asian regulators have been quick to sign up to Basel III⁴, which was designed primarily to address the regulatory failings that allowed US and European banks to become dangerously under-capitalized and over-reliant on short-term wholesale funding.

Because Asian banks are funded primarily by retail deposits, initial estimates indicated that Basel III would increase funding costs for Asian banks by only 2-5%, compared with as much as 35% for European and North American banks⁵.

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⁴ See FGI Brief on Basel III.
⁵ Wholesale and Investment Banking Outlook, Morgan Stanley, Oliver Wyman, 2011.
The effects on lending are less clear. Recent policy papers suggest that banks have managed to raise their capital ratios without raising the cost of credit in aggregate or seriously restricting its availability. However, we believe the real effects of Basel III on lending are being disguised by the current abundance of liquidity. This allows Asian banks to grow their loan books at low cost and few have bothered to build the data required to measure Basel III ratios on a product level.

However, when credit demand outstrips deposit creation, balance sheet resources will become more constrained and the increased costs imposed by Basel III will be felt by banks and borrowers in the real economy:

• **SME lending**: The need to hold more and better quality equity capital against loans will squeeze banks’ capacity to lend to SMEs, particularly since SME lending comes with higher expected losses than corporate lending. We estimate that the average return on equity (RoE) for SME lending will be decreased by about 3 percentage points under Basel III regulations. Banks will likely shift some of the cost to SMEs through higher interest rates, thereby reducing demand for credit.

• **Trade finance**: Increased capital requirements will also drive up the cost of providing trade finance. Although trade finance will benefit from the Basel Committee’s decision to waive the 1-year maturity and the sovereign floor for certain trade instruments in 2011, they retained the 100% credit conversion factor (CCF) for letters of credit (and other off balance sheet items) in the calculation of the leverage ratio. The leverage ratio and leverage cap will potentially restrict balance sheet capacity for Trade Finance and change the “opportunity cost” of Trade Finance vis-à-vis other banking products. Moreover, we see the treatment of receivables financing as a significant concern because these products are considered short-term lending to SMEs and therefore need to be funded 85% or 50% long-term under the Net Stable Funding Ratio (NSFR).

• **Infrastructure finance**: Infrastructure financing is long tenured. Basel III’s higher capital and NSFR requirements increase the cost of holding and funding such long maturity assets. And the type of collateral against which such lending is typically secured, such as land, can be subject to heavy haircuts. We estimate that the RoE for project finance will decrease by about 5 percentage points under Basel III regulations. Indeed, the reduction could be even greater if we take account of the increased regulatory cost of long-dated derivative solutions, such as cross-currency swaps, required by end users to risk manage these investments.

Many countries, including the US, are delaying the implementation of Basel III in face of the larger than expected and uncertain impacts to their financial system. Asian countries would be well advised to develop a deeper understanding of the product level implications of these regulations and build a more cohesive Asian view to be heard at the global level.
3.3. STRUCTURAL SHORTCOMINGS OF THE FINANCIAL SYSTEM IN ASIA

Although Basel III is a material concern to banking returns and economic activity in Asia, it is only the tip of the iceberg. Other problems in the Asian financial system are deeper and will take longer to remedy. In this subsection we examine five structural shortcomings of the Asian financial system:

- Over-reliance on short term, bank-funded financing
- Shortage of real money investors and a lack of risk transfer mechanisms
- Lack of financial inclusion
- Payment systems not targeted to emerging client needs
- Structural weakness in the ability to maintain financial stability

3.3.1. SHORT TERM, BANK-FUNDED FINANCING

Bank lending accounts for 47% of the total financing in Asia and 160% of GDP. The dominance of bank lending is especially evident in China, where capital markets remain under-developed. By 2012, China had about $13 TN worth of bank assets, providing 70% of total financing or 85% of total debt financing (see Exhibit 4). By contrast, US bank assets account for only 22% of overall US financing and 97% of GDP.

EXHIBIT 4: FUNDING STRUCTURE IN SELECTED ECONOMIES

* Total funding is the total sum of equity funding, corporate bond funding and bank loans.
Source: IMF, Reuters, BIS, EIU, EBF, Oliver Wyman analysis.


Exhibit 5 is an overview of Asian countries’ funding and investment structure compared to advanced economies. The funding side shows the form of companies’ funding (equity, bonds and bank loans). The investment side shows how much capital is supplied by various kinds of investors, such as insurers, pension funds, asset managers. Amounts are represented by a percentage of GDP.

### EXHIBIT 5: WORLD FUNDING AND INVESTMENT STRUCTURE

2012

<table>
<thead>
<tr>
<th>% OF GDP</th>
<th>TOTAL(^\d)</th>
<th>FUNDING(^\d)</th>
<th>INVESTMENT(^\d)</th>
<th>TOTAL(^\d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advanced economies</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>440%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>414%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>791%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU*</td>
<td>544%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>395%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>849%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1125%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hubs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>536%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>553%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>372%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>466%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>243%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growing giants</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>211%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>107%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emerging SEA countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>307%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>526%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>231%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(*\) EU refers to Euro Area only.
\(^\d\) For the funding side: Equity funding includes the market capitalisation of all stock exchanges within the country. Debt funding includes all debt securities issued by non-financial corporations and banks. Bank funding refers to total assets of the banking system to customers and other non-financial institutions.

For the investment side: Asset management includes all major sources of asset management, including mutual funds, hedge funds and private equity; pension and insurance assets have been excluded to avoid double counting. Other deposits exclude interbank business. Interbank deposits refers to deposits within the financial sector.

\(^\d\) Differences between the total of financing and total of investment in dollar amount are due to net foreign investment into or out of a country.

Source: World Bank, BIS, EIU, EBF, Oxford Economics, Lipper, EFAMA, Towers Watson, OECD, ADBI, Axco, ECB, SWF Institute, central banks, local governments, Oliver Wyman analysis.

The funding side is relatively underdeveloped in emerging Asian countries, as evident in the generally small equity pools in Asia outside Hong Kong and Singapore. However, a healthy equity market is essential as an alternative platform for financing the real sector beyond banks. Due to the underdeveloped insurance and pension sectors – typical long term investors – the investment horizon is often also shorter than desired. This means that some countries depend on foreign investment to finance their local funding needs.
Deposits in Asia account for 80% of banks’ funding compared to 70% in the US and 50% in the Euro area. While Basel III sees deposits as a superior source of funding because they are behaviourally long-dated, the reliance on contractually short-term current account/saving account (CASA) deposits can limit banks’ ability to provide long-term funding to the real economy because deposit maturities shorten dramatically during crises.

Banks’ contractually long-term funding in EM Asia amounts to only 4% of GDP, compared to about 10% in the US and 27% in the Euro area. We are not recommending the mistakes of the global financial crisis, where a significant amount of the short term wholesale funding for off-balance sheet structures rested on flawed assumptions of funding stability and asset liquidity. However, we see significant potential for Asian banks to review their approach to more active balance sheet management. For example, asset securitization can provide banks with a dependable source of stable funding, and has been successfully adopted in markets such as Malaysia and Hong Kong.

Developed Asian countries such as Australia, New Zealand and Korea have already created markets for covered bonds. By the end of 2012, total covered bonds outstanding in Asia Pacific amounted to $66 BN, with Australia contributing over 80% of the total. Regulators in Singapore and India are looking into covered bond legislation. Appetite for covered bonds should be high in both potential issuers and investors.

Such programs can also help reduce the structural balance sheet mismatches in the Asian financial system and will ultimately reduce the impact of short-term liquidity squeezes on financing the real sector.

3.3.2. SHORTAGE OF REAL MONEY INVESTORS AND LACK OF RISK TRANSFER MECHANISMS

Real money investors such as pension funds and insurers are best placed to match the long term funding needs of the real economy. Unfortunately, insurance and pension funds are still underdeveloped in Emerging Asia. Whereas insurance and pension assets are about 1.5 times the size of bank assets in the US, in Asia they are only 38%. Figures for EM Asia (13%) and China (11%) are even lower. Total insurance and pension penetration, measured by assets under management (AuM) as a percentage of GDP, is less than 20% for most emerging Asian countries, dwarfed by 64% in the Euro area, 130% in Australia and 152% in the US (see Exhibit 5).

The real money sector in Asia is underdeveloped because households in emerging Asia have little in the way of personal financial assets (PFA), and they hold a high percentage of what little they do have in cash and deposits: 55% compared to 15% for North America (see Exhibit 6). Most people in emerging Asia still depend on “traditional” retirement support – that is, their children – rather than institutionally funded support from insurance companies or pension funds.

6 Wholesale funding includes tier 1,2,3 capital, secured and senior secured debt, Oct 2013.
8 See FGI Issues Brief on Insurance.
9 See FGI Brief on Asian Pensions.
Among the emerging Asian countries, Malaysia has the deepest real money sector. Driven by a high level of mandatory pension coverage (46% of GDP), pension assets have grown rapidly and amounted to $140 BN by the end of 2012. By contrast, Indonesia only has $16 BN, which is equivalent to a pension coverage ratio of 2% of GDP.

EXHIBIT 6: GLOBAL PERSONAL FINANCIAL ASSET (PFA) DISTRIBUTION

SHARE OF PERSONAL FINANCIAL ASSETS, 2012
HELD IN CASH, DEPOSITS AND SAVINGS ACCOUNT
FOR EACH COUNTRY

<table>
<thead>
<tr>
<th>% CASH DEPOSIT SHARE OF PFA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>South Korea</td>
</tr>
</tbody>
</table>

FINANCIAL DEEPENING AT HOUSEHOLD LEVEL, 2012*

<table>
<thead>
<tr>
<th>GDP PER CAPITA (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;3,000</td>
</tr>
<tr>
<td>0%</td>
</tr>
<tr>
<td>Occupational pensions</td>
</tr>
</tbody>
</table>

* Excludes home equity.
Source: IMF world economic outlook database, OECD, Oliver Wyman analysis.

The paucity of real money investment and consequent immaturity of domestic investment management industries increases interest rate and exchange rate volatility in Emerging Asia. While current account deficits triggered the most severe recent declines in Asian currencies, it is striking that those countries most affected all lack a strong real money sector. Large domestic real money pools imply a lower proportion of foreign financing needs and hence less vulnerability to sell-offs by foreign investors.

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10 Measured by total pension asset as a percentage of total GDP.
Moreover, inflation has recently been in the range of 3% to 13% in most emerging Asian countries. In combination with the lack of a diversified range of investment products, this has severely reduced investors’ ability to earn attractive real returns. This is particularly bad news for Asian countries with ageing populations and rising dependency ratios.

A substantial portion of derivatives transactions in mature economies are aimed at managing the risk profile of investment portfolios. The immaturity of the real investment industry in emerging Asia means that its derivatives markets are also immature. Asia accounts for only 8% of the world’s OTC derivative transactions, with more than 80% of this 8% concentrated in Japan, Singapore, Hong Kong and Australia. This also impacts the real sector as interest rates or FX risks are difficult to hedge.

This leaves the real sector in many of the emerging Asian countries exposed to basic FX and interest rate risks. If risk transfer mechanisms in these countries were more accessible, businesses would be better able to manage their risks and investors to construct portfolios in line with their risk appetites and yield requirements.

3.3.3. LACK OF FINANCIAL INCLUSION

Despite their importance to the economy, SMEs and innovative industries are underserved by traditional financing channels.

As shown in Exhibit 7, emerging markets account for only 22% of the world total credit channelled to SMEs but make up 60% of the world total SME funding gap. Among emerging markets, Asian SMEs have especially poor access to credit. Less than 15% of Asian SMEs have bank credit lines, compared to 24% in Latin America and 28% in Central Asia and Eastern Europe.

Funding gap refers to the difference between the actual financing provided to and the total funding needed by SMEs. Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises, International Financial Corporation, August 2013.
The problem is especially acute in China. 99% of Chinese firms are SMEs, contributing 70% of employment, 60% of GDP, 50% of tax revenue, and holding 65% of patents. Yet, they have access to less than 20% of bank lending.

Low SME lending can be explained by several factors: the difficulty of assessing SMEs’ credit worthiness caused by inadequate data, SMEs’ higher default rates than larger firms and higher cost to serve (as a percentage of loan size) and, in some markets, the lack of government sponsored credit guarantees. Firms focused on developing intellectual-property find it especially difficult to access credit because they lack the kind of assets that can be used as collateral.

In China, the “old industry” receives a disproportionately high share of financial resources. Despite old industry’s share of market capitalisation declining from 56% in 2007 to 38% in 2013, information and communications technology (ICT)’s share is still low at 4% (see Exhibit 8). Furthermore, the old industry still claims about 50% of total bank loans. If Asia wants to breed its own creative hub, equity and debt capital must be extended to these new industries. For example, ICT companies have a 20% share of total market capitalisation of companies domiciled in the US.
Many regulators are taking measures aimed at fostering SME lending. However, we believe that many of the current efforts, while well intended, may achieve the exact opposite of financial inclusion. For example, some of the global banks operating in India are currently looking for ways to reduce the impact of government “priority sector” lending targets, including by potentially exiting the market altogether.

On a more positive note, however, a few banks are shifting their traditional credit risk assessment towards cash-flow based lending models. These provide a more accurate view of the short-term financial health of an SME and, by relying on readily available information, significantly reducing credit application decision times. We expect this to expand the bankable client set and boost credit to SMEs by overcoming the limitations of poor client financial data. This will ultimately reduce their financing costs.

Equity markets provide capital almost exclusively to large corporates. In China, high-tech companies are queuing up to get listed, especially as the IPO market in China has been suspended since October 2012.

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12 The cash-flow-based lending approach involves real-time cash-flow based underwriting and monitoring using current account and merchant settlement data to set loan size and pricing based on level and stability of cash flows. The approach provides accurate and real-time risk assessment data, reduces operational cost in manual limit setting and creates scalable mechanism in the bank for small loan sizes.
Underdeveloped Asian equity markets result in high quality tech companies such as Tencent, Baidu, Sina, or Qihu instead getting listed in offshore markets. In addition, Asia has not yet developed a mature venture capital (VC) or private equity (PE) market, which usually has higher risk appetite for investment in innovative companies.

The underdevelopment of private market funding options means that SMEs and tech companies must depend primarily on government support. An example is the SPRING seed capital scheme launched by Singapore, which co-invests in start-ups that have obtained funding from angel investors.

To help SMEs raise equity, China is now experimenting with growing PE funds in combination with “third growth markets”. This allows limited trading in the shares of PE/VC-funded companies as a new type of exit strategy. This completes the financing life-cycle by providing financing to firms not yet qualified for the Growth Enterprise Board in Shenzhen. Many more such initiatives will be required across Asia to improve access to funding for start-ups and innovative small firms.

3.3.4. PAYMENT SYSTEMS ARE NOT TARGETED TO EMERGING CLIENT NEEDS

Many Asian countries invested in Real Time Gross Settlement (RTGS) systems early and created stability in the Wholesale market. However, current payment systems are likely to be inadequate for efficiently processing increasingly frequent small value money flows across Asian countries.

The lack of efficient cross-border settlement systems is somewhat mitigated by the fact that the US dollar serves as a cross-regional currency. However, the need for local solutions will grow as the SME and retail sectors increasingly want to transact in local currencies.

The rapid development of online commerce also demands improvements in payments infrastructure and regulatory supervision, particularly in the retail space. There were $315 BN of B2C e-commerce sales in Asia in 2012, compared to $370 BN in North America and $255 BN in Western Europe. Annual growth rates are expected to range from 30% to 75% across the various Asian countries.

Moreover, digital retail payment solutions, such as payment facilitation (e.g. Square) and virtual currencies (e.g. Bitcoin, Facebook Credit, QQ currency), are constantly pushed to the market and internet giants have started to expand into financial services. In China, Alipay holds about 50% of the market in third party payment systems, and Tencent is accelerating its venture into internet finance through Tenpay and integrating payment solutions to its market-leading mobile messaging application WeChat.

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13 According to Tech In Asia, a popular start-up news provider, 9 out of top 10 tech companies in China are listed abroad in NASDAQ, NYSE and HKEx in 2012.  
14 See FGI Private Equity brief.
The overarching question is whether these products and services will be adequately reliable, flexible, secure and inter-operable with existing retail payment systems. The development of a sound regulatory regime to protect the end client will therefore be critical.

3.3.5. THREATS TO SYSTEMIC STABILITY

We see four threats to systemic stability in Asia.

First, around 80% of Asian cross-border trade (by value) is settled in US$. While currently abundant, a shortage of US$ liquidity has regularly exposed Asia to significant financing risks or inflated financing costs, most recently in early 2012. Worse, sufficient liquidity depends to a large extent on a handful of US institutions with access to the deep funding pools in their home market.

Second, shadow banking is growing rapidly in Asia. The Chinese shadow banking sector has grown at a 35% 3-year CAGR and reached more than $5 TN by the end of 2012, equivalent to 50% of the total bank loans and 70% of Chinese GDP15. This development received much attention during the recent Fifth Meeting of the Financial Stability Board Regional Consultative Group for Asia. However, a significant amount of the shadow banking sector simply addresses the lack of financing and investment products from the banking sector, through non-bank vehicles such as trust companies and wealth management products (WMPs). Hence, we are less concerned by the size of the shadow banking sector than by its opacity, a factor which in other markets was an important cause of the GFC.

Third, many Asian central banks operate with significantly lower levels of relevant financial data than their peers in mature markets, for example, concerning the impact of real estate price drops on borrower balance sheets, bank collateral and credit risks. This makes it difficult to observe and manage systemic risks. Moreover, relatively few Asian regulators have the tools and capabilities to properly stress test their systems.

Fourth, the efforts of regulators in Asia are not well coordinated. Historically there has been no strong, consistent Asian voice at the global negotiating table regarding regulations initiated by the West, such as Basel III or FATCA. Instead, each Asian country makes its own adaptations of global regulations according to local legal, accounting and tax regimes, or strikes separate bilateral arrangements. As a result, goals that require policy co-ordination across the Asian region risk being neglected, delayed or, ultimately, not achieved.

15 There is no official shadow banking statistics in China and there are different opinions on its definitions. The estimated outstanding volume generally ranges from RMB30 TN to RMB40 TN. JP Morgan estimates the volume as of the end 2012 at RMB36 TN, Fitch at RMB34 TN, Institute for International Monetary Affairs at RMB34.4 TN.
Asian policy-makers should develop regulations that will promote an efficient, financially inclusive and stable financial system that supports the growth of their evolving real economies. To achieve this, we believe Asian regulators should pursue six major “policy enablers” (see Exhibit 9).

Large parts of the Asian financial sector are state owned. And, all around the world, finance is highly regulated. Success along these policy “enablers” can therefore only be achieved if the public and the private sectors work together effectively.16
**EXHIBIT 9: IMPLICATIONS FOR REGULATORS ON ASIA FINANCE 2020**

**Vision**
- A regionally coordinated and increasingly self-sufficient, robust financing system
- Focused on supporting the growth of the real sector
- Underpinned by capital markets facilitating risk transfers, a secure e-commerce payment system and central bank financing back stops
- Ensuring the rebalancing of tax incentives on debt and steering the system towards equity and long-term funding

**1. Coordinated Regional policy**
- Strengthen regional policy-making apparatus
- Promote consistency in Asian regulation
- Reduce US$ dependence and hence RMB regionalization

**2. Risk and stress testing capabilities**
- Upgrade key risk management capabilities across financial institutions
- Provide data transparency to investors
- Facilitate information sharing
- Build capabilities for centrally-run stress tests

**3. Targeted central bank support**
- Provide liquidity in an approach focusing on SMEs and trade
- Support SME vendor financing e.g. Trade Bill Discounting Scheme
- Use swap lines to help backstop trade finance in RMB and local currencies

**4. SME and retail-focused payment system**
- Develop a RTGS system capable to settle multi-currency transactions
- Establish links to regional settlement system
- Integrate RTGS with SME/Retail payment systems
- Guide digital payment growth

**5. Efficient and integrated capital markets**
- Facilitate further integration in Asian capital markets
- Standardise processes and listing requirements
- Deepen local capital markets to provide more SME financing

**6. Incentives alignment**
- Devise tax and accounting incentives to attract infrastructure investment from insurance and pensions
- Embrace more sustainable finance model through risk sharing and partnering as equity holders

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**Public-private partnership**
- Establish cooperative framework to facilitate public-private partnership to achieve policy goals
- Define clear roles and responsibilities for government agencies, state-owned enterprises and private companies to avoid potential cannibalization

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4.1. **ENBLER 1: COORDINATED REGIONAL POLICY**

Financial policy in Asia is influenced by three kinds of institutions (see Exhibit 10). All face challenges in effectively providing the policy coordination Asia needs.

### EXHIBIT 10: FINANCIAL POLICY INFRASTRUCTURE – ASIA PERSPECTIVE

<table>
<thead>
<tr>
<th>POLICY ORGANISATIONS (EXAMPLES)</th>
<th>ASIA COVERAGE / FS POLICY FOCUS</th>
<th>INFLUENCE</th>
<th>SUITABILITY GAPS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inter-governmental groups</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>APEC Finance Ministers’ Process</td>
<td>• High level, pan-regional process, but also covers non-FS, and non-Asia specific issues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asia Cooperation Dialogue</td>
<td>• Primary focus on regional trade rather than financial services policy issues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Executives’ Meeting of East Asia Pacific Central Banks</td>
<td>• Strong Asia coverage and focus on key policy issues – limited resources for developing policy agenda</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ASEAN Capital Markets Forum</td>
<td>• Supports regulatory convergence in capital markets but only covers Southeast Asia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ASEAN + China, South Korea and Japan (ASEAN + 3)</td>
<td>• Broad regional coverage but limited financial services focus or policy influence</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Non-government / independent bodies</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asia Pacific Financial Services Association</td>
<td>• Focused primarily on insurance industry issues, no formal policy role</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asian Shadow Financial Regulatory Committee</td>
<td>• Academic body with strong regional focus but limited practical policy influence</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Global</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basel Committee on Banking Supervision</td>
<td>• High influence and recently increased coverage of Asian countries, but more oriented to NA/EMEA issues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>International Organisation of Securities Commissions</td>
<td>• Increasing use of Asia-specific sub-committees to tailor standards to the region’s needs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Stability Board</td>
<td>• Sub-committees provide forum to challenge FSB initiatives and their use in Asia; however, policy initiatives typically driven by Europe/America</td>
<td></td>
<td></td>
</tr>
<tr>
<td>OECD</td>
<td>• Limited focus on specific challenges facing the financial system in emerging markets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Priority/effort:  
- High  
- Medium  
- Low
The difficulty in co-ordinating policy can be observed in the recent reform of OTC derivatives regulation. Asian regulators have adopted different positions on the key issues of mandating electronic trading platforms, central clearing, trade reporting and margin requirements. For example, the rules about trade reporting differ in scope and in the mandated “collection” entity. Final rules on central clearing as well as margin and capital requirements are yet to be decided by most Asian regulators, creating further uncertainty for market participants.

Variation in local regulation of some matters, such as investor protection, will not create material systemic or arbitrage risk, although the costs for firms operating in multiple countries might increase. However, other matters require co-ordination to avoid unintended systemic effects. OTC derivatives regulation, discussed above, is an example. Deposit insurance is another, particularly as the RMB internationalises.

We do not think that the RMB will completely replace the US$ but it will reduce Asia’s dependence on it. The opening of China’s capital account will increase access to a RMB funding pool of up to RMB100 TN (~$16 TN) which consists of onshore interbank lending, retail and corporate deposits. To put this figure into perspective, US$ liquidity held within Asia is estimated at $1 TN. If the RMB does become a convertible and more widely used currency in Asia, variation in deposit insurance levels could lead to significant cross-border money flows. The recent flows from Southern to Northern Europe should be a warning sign.

We recommend a formal Asia-oriented policy-making apparatus with sufficient technical focus and decision authority to allow Asian regulators to influence the global agenda on regional systemic issues and reach regional consensus where required. Such coordination will also help counterbalance the emerging trend towards “balkanization” of banking, where local regulators focus on protecting local customers and, in the process, drive up the costs of cross-border transactions.

4.2. ENABLER 2: RISK MANAGEMENT AND STRESS TESTING CAPABILITIES

We believe that Asian regulators should shape the “risk agenda” along four dimensions:

- Upgrade risk management capabilities in the private sector
- Lead transparency efforts and support the creation of a pan-Asian credit rating agency
- Support the growth of the wealth management industry by moving further towards a portfolio risk approach
- Build the required capabilities to centrally run stress tests
4.2.1. UPGRADE RISK CAPABILITIES

Asian regulators should lead the industry in upgrading risk management capabilities, reducing its reliance on purely quantitative risk models and forming a deeper understanding of the underlying uncertainties and stress factors. This will require financial institutions to go beyond the traditional risk areas of credit, market and operational risk to develop a comprehensive framework addressing all the following questions:

- **Strategy**: What is the risk taking strategy? How large is the firm’s risk appetite?
- **Uncertainties and scenarios**: What are the critical uncertainties and how could they develop under various scenarios?
- **Governance**: What functions are covered by the risk committees? What are the limits and how are they set up? What are the processes and policies for risk governance?
- **Management processes**: How to conduct strategy planning and capital allocation? How to develop and price products? How to oversee asset-liability management and investment management?
- **Measurement**: How to compute economic capital, risk appetite analytics and value measurement?
- **Reporting**: What to include in internal management reporting and external communication?

These developments are needed to overcome the recent over-reliance on quantitative risk models which address specific “risk buckets” under normal conditions but often ignore critical uncertainties.

At the same time, financial institutions should focus on upgrading their traditional risk capabilities for SMEs, trade finance and infrastructure finance to ensure they have the capacity to support these key growth drivers. This will involve strengthening the underwriting processes and credit culture, enhancing the analytics for portfolio management, establishing robust processes for monitoring risk concentrations, ratings migration and portfolio sensitivity to macroeconomic and geopolitical factors and improving data on SMEs.
4.2.2. INCREASE TRANSPARENCY

To build investor confidence, Asian regulators need to promote market transparency. The data collection and analysis itself can and, in most cases, should be provided by private suppliers, such as Mortgage Asset Risk Quantification (MARQ) in Australia. MARQ is a recently formed mortgage market “infrastructure” supplier, providing data and risk measures for individual mortgage loans in Australia (see Exhibit 11). This gives investors access to the information they need to confidently enter into risk transfer transactions without having to rely solely on rating agency opinions and correlation assumptions. Another example is the Credit Bureau Singapore which was set up as a private company with support from the government to facilitate credit analytics.

EXHIBIT 11: KEY BENEFITS OF MARQ

<table>
<thead>
<tr>
<th>Data</th>
<th>Reporting</th>
<th>Analytics</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Loan level data collection, storage and standardization</td>
<td>• Intuitive graphical displays to support portfolio risk analysis</td>
<td>• Standard MARQ score for each loan/portfolio/tranche allowing absolute apples to apples comparison</td>
</tr>
<tr>
<td>• 24 loan characteristics for each individual loan</td>
<td>• Extensive benchmarking capabilities</td>
<td>• Scenario analysis (house prices, interest rate and borrower income stresses)</td>
</tr>
<tr>
<td>• Granular and regularly updated data facilitating continuous risk monitoring</td>
<td>• Granular reports with multiple views of the data set allowing drill-downs into portfolios at loan-level</td>
<td>• Customized analysis enabled by user defined parameters</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Possible calibration to Expected Losses to provide an absolute measure of risk</td>
</tr>
</tbody>
</table>

Source: MARQ, Oliver Wyman analysis.

Given the importance of transparency to investor confidence, we support calls for an Asian regional credit agency. While the market is dominated by the “big-three” credit rating agencies, their coverage in Asia is limited. Almost a third of all US-dollar bonds issued by Hong Kong-listed companies in 2012 were not rated by any of the three main agencies, which prevented many institutional investors from investing.
4.2.3. SUPPORT THE GROWTH OF WEALTH MANAGEMENT

By 2020, 20% of global wealth is expected to reside in Asia (excluding Japan), up from 14% today. Regulators need to change their approach to the wealth management industry, away from their current approach of primarily looking at specific “product risk” and towards overall portfolio risk/return considerations and risk diversification.

Major banks in the US and Europe have invested in data infrastructure to revamp their advisory processes – for example, by developing more sophisticated client profiling, computing risk ratings for individual clients and facilitating point-of-sale discussions and ongoing communication with clients.

Wealthy Asians are commonly thought to be more “hands on” with their investing and not amenable to these kinds of sophisticated advisory offerings. However, we believe the do-it-yourself approach of private Asian investors is equally a consequence of the sky-high load fees that mass affluent investors17 face for products such as mutual funds. Initiatives such as the Retail Distribution Review (RDR) in the UK and the Future of Financial Advice (FOFA) in Australia and the Financial Advisory Industry Review (FAIR) in Singapore18, if applied in Asia, could trigger a new attitude to advisory services and ultimately a rebalancing of the asset allocation of Asian investors. This would also be a catalyst for a regional Asian fund management industry which is now emerging as various forms of regional “passporting” arrangements are being discussed.

4.2.4. CENTRAL STRESS TESTING

Governments should quickly build the required capabilities to run finance sector-wide stress tests. The Bank of Spain stress testing exercise19 in 2012 and the yet-to-be-undertaken asset quality review (AQR) work by the ECB are good examples of assessments of the banking system’s ability to withstand a severely adverse scenario of deteriorating macroeconomic and market conditions. Regulators should also increase their expectations in terms of seeing how financial institutions make the link between stress-testing results and multi-year risk appetite with their strategic planning efforts.

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17 Mass affluent investors refer to customers with more than US$250 K in investible assets.
18 The Retail Distribution Review (RDR) is a consumer protection strategy focuses on the retail investment market in the UK. The Future of Financial Advice (FOFA) is a reform with the objective to improve trust and confidence of Australian retail investors in the financial planning sector through tackling the issue of conflicts of interest and ensuring quality of financial advice. The Financial Advisory Industry Review (FAIR) Panel was set up in 2012 with the primary objective to enhance the standards and professionalism of the financial advisory industry.
4.3. **ENBLER 3: TARGETED CENTRAL BANK SUPPORT**

Trade finance is the life-blood of the Asian economy. Because trade finance is short term and self-liquidating by nature, banks typically reduce trade exposures rapidly during periods of financial stress, thereby exacerbating the problems of the real economy. To reduce the impact of this negative spiral, central banks should provide support that sustains the flow of trade finance to the real economy during periods of financial stress. We advocate a “rifle shot” approach rather than quantitative easing (QE) or long-term refinancing operation (LTRO), adopted by the US Fed and the ECB respectively, which have primarily helped banks repair their balance sheets.

An example is the “Trade Bill Discounting Scheme” (see Exhibit 12) which was operated by the Deutsche Bundesbank to support of SME vendor financing. It keeps the credit risk in the commercial banking system but absorbs the liquidity risk. A side benefit of this initiative was the development of SME risk models using a database of self-collected financial statements. This is another area of immediate applicability to most Asian markets.

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**EXHIBIT 12: DEUTSCHE BUNDESBANK’S TRADE BILL DISCOUNTING SCHEME**

**Example: Supplier Financing**

1. LARGE CONGLOMERATE PURCHASER
2. SME SUPPLIER
3. SUPPLIER’S BANK
4. DEUTSCHE BUNDESBANK

**Liquidity**
- Bundesbank is the end-provider of liquidity
- Accepted trade-bills extend across multiple structures (supplier finance, vendor finance)

**Risk**
- Original liability to pay sits with the SME (in this case, the supplier):
  - Supplier’s bank takes “first loss” in event of supplier default
  - Bundesbank liable in case of default of both the end SME and the supplier’s bank

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* Article 19 of the Bundesbank Act states that the Bundesbank, in the case of default by any of the parties involved, reserves the right to sell the collateral by auction or at current market price.

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20 This program was halted in 1999 as part of institution of the third stage of the Economic and Monetary Union (EMU).
The People’s Bank of China (PBOC) has accelerated the development of swap lines with foreign central banks. After inking agreements with counterparts in the UK ($32 BN), Hong Kong ($63 BN), Korea ($57 BN) and others, PBOC has recently agreed to create a currency swap line with the European Central Bank (ECB) ($55 BN)\textsuperscript{21}. We believe that such liquidity schemes could also help the initial internationalization of the RMB and, more importantly, reassure sceptical foreign companies about using RMB as a functional currency in cross-border trades.

4.4. ENABLER 4: SME AND RETAIL FOCUSED PAYMENT SYSTEMS

Asian regulators should seek to improve current payments systems by:

- Ensuring the provision of payment and settlement infrastructure with multiple-currency capabilities and extended services covering lower value transactions.
- Supporting international standards on e-payments to enhance efficiency and connectivity.
- Closely monitoring and ensuring the security of digital payment solutions which emerge in the private sector.

The growing volume of cross-border transactions requires a real time gross settlement (RTGS) system capable of handling many currencies. This is reasonably well addressed in Asia, with markets like Hong Kong conforming to “best practice”, serving as an integrated hub for US$, EUR and RMB settlements. However, Asian regulators will need to cooperate to ensure connectivity and alignment to the China International Payment System (CIPS), the future offshore RMB clearing system.

Future state-of-the-art technology should ensure systems compatibility across RTGS, retail payments, e-commerce and e-government. Exhibit 13 gives an example of an overarching framework for a payment system.

\textsuperscript{21} Total of global RMB FX swap agreements is about $350 BN, including agreements with Korea ($57 BN), Hong Kong ($63 BN), Malaysia ($28 BN), Indonesia ($16 BN), Singapore ($48 BN), Thailand ($11 BN), Australia ($32 BN), UK ($32 BN), ECB ($55 BN), and UAE ($6 BN).
On top of the system design, we believe that supportive legislative actions on e-payments, such as the implementation of Electronic Bank Account Management (eBAM) and ISO 20022 standardized format in information transmission, will improve efficiency and connectivity to the rest of the world, ultimately reducing costs to end clients. Solutions such as the Bank Payment Obligation (BPO) can also help to reduce the costs of the highly paper-based or "manual" Letter of Credit financing system.
Similarly, BPO can even be expanded into areas such as cross-border e-commerce. Cross-border e-commerce in Asia is relatively underdeveloped, compared to the fast growing e-commerce in China. The use of low cost electronic approaches can potentially solve the biggest challenge for cross-border e-commerce in Asia: namely, the “cash on delivery” mentality that arises from the fear for fraudulence.

Finally, we see the emergence of e-wallet solutions and retailer sponsored payment apps. Regulators can help to create consumer confidence by ensuring the security of these new payment solutions, and, indeed, of those that have already emerged. For example, the HKMA swiftly addressed public concerns about the float management of OCL (issuer of the Octopus Card) by authorizing OCL as a depository trust company and bringing it under the HKMA’s regulatory regime. Regulators must also ensure a level playing field for online financial service providers and the banking system with regard to deposit protection and the associated prudential requirements.

4.5. ENABLER 5: EFFICIENT AND INCREASINGLY INTEGRATED CAPITAL MARKETS

Effective capital markets are a cornerstone of economic growth. In addition to the shortage of real money investors that we discussed in Chapter 3.3, Asia suffers from market fragmentation along national borders. This reduces liquidity and thereby increases costs for end investors. Further integration across Asian countries should be actively pursued.

We are seeing the emergence of regional coordination in ASEAN and Greater China capital markets. However, to build more integrated and efficient capital markets, policy makers should contemplate standardizing processes and documentation on listing requirements, market execution practices (e.g. trading lots, trading hours, circuit breakers), tax treatments and, as investment flows increasingly regionalize, potentially even tax collections.

Capital markets will also be critical to “liquefying” Asian wealth, especially in China. There are wide-spread concerns that China will now fall into a “middle income trap” – that is, get stuck at the middling level of income it has now attained. We agree with the view that income is increasingly concentrated; the Gini coefficient in China has reached 47%, which is among the highest in the world. However, this concern can be assuaged by noting that real estate wealth in China is very widely spread. The home ownership rate in China is 90%, compared with 69% in the UK, 65% in the US and 44% in Germany. The problem is that this real estate wealth – which at a total of about $22 TN is equal to the total value of Japanese real estate wealth – remains entirely illiquid. Capital market solutions and innovative banking products will be able to selectively liquify this wealth or allow home owners earn additional income, for example, via reverse mortgage products. This will not solve the long term problem of income inequality but can support broader income distribution as China further rebalances its economy.

See Oliver Wyman’s paper “Can Retailers win the mobile payments war?” for further details.

22 The Gini co-efficient is a measure of income inequality. When everyone has the same income, the co-efficient is 0. When one person has all the income and the rest of the population none, the co-efficient is 1.
Our global Personal Financial Assets (PFA) database shows that PFA in markets such as China and India are now about $4,500 per capita, with 57% saved in cash deposits (see Exhibit 6). If PFA per capita were to double to $9,000 by 2020, PFA saved in cash deposits are forecast to drop to about 40%, based on prior patterns observed in emerging markets. The delta is expected to flow into capital market solutions and achieving attractive real returns in these products will be another means for Asian economies to break out of the middle income trap.

4.6. ENABLER 6: INCENTIVES

Incentives are an important part of supporting the changes we have advocated in this report. This is a broad topic, but we would prioritize three areas:

• Incentives to grow the Asian real investor money base
• Incentives for Asian real investors to invest into long term assets
• Better aligning incentives and ensuring more “risk sharing” instead of just risk shifting

Growing the real money investor base will require more favourable accounting policies and tax allowances on insurance and pension contributions. Many countries have already done this. For example, Denmark, Netherlands and Australia, the top three countries ranked in Mercer’s Global Pension Index Report, all offer some degree of taxation incentives for contributions.

To encourage investment in long-term or illiquid assets, we recommend considering measures such as tax holidays and reduced tax rates on income from preferential assets such as residential mortgages, SME-lending-backed securities, infrastructure financing or covered bonds. Moreover, current regulatory disincentives to invest in long-term and illiquid assets should be relaxed. Even in a mature market such as Australia, where superannuation funds have allocated more than 5% of their asset base to infrastructure, liquidity requirements provide a disincentive to long-term investing, despite the long term nature of superannuation.

Finally, we see an opportunity for Asia to learn the lessons of the GFC beyond just implementing Basel III. The GFC was triggered by financing solutions which embodied too much apparent risk transfer and too little risk sharing. While Islamic Banking comes with various issues of its own – for example, the need for strong governance and risk management over and above the role of the Sharia Council – we believe that a number of its underlying elements, such as disclosure to mitigate information symmetry or achieving higher levels of risk sharing, are worth embracing in a broader shift towards a more ethical and sustainable finance model. For these reasons, Asian regulators should rethink the traditional tax advantage of debt over equity created by the fact that interest payments are treated as a tax-deductible business expense while dividend payments are not.
5. CONCLUSIONS

Asian economies have grown rapidly over the last decade. However, Asia is also at a crossroads. It needs to switch from its current “old Industry” export-driven model towards a new model focused on domestic consumption that is more socially just and also environmentally sustainable.

To unlock Asia’s potential, its regulators must redesign policy in ways that better direct financial resources towards the important parts of the real economy and reduce the predominance of short-term bank funding. Growing the underdeveloped capital and wealth management markets should be a priority. This will do much to provide the kind of finance needed by the “three pillars” of Asian economic development: SMEs, trade and infrastructure.

We believe that by 2020, with the right public-private cooperation and appropriate reform package, the Asian financial system will have transformed from a bank-dominated model to a more balanced model with deeper and wider capital markets. Equities and bonds will play a greater role in financing the real sector, accounting for about 210% of total GDP compared to 180% today. The gap to the US for equities and debt securities will likely have closed by 40%.

Insurance, pension and asset management will also experience significant product proliferation, supporting the development of the capital markets. We expect the total penetration of these three sectors (as a % of GDP) to grow from 130% today to about 150%, representing growth from $27 TN in 2012 to $50 TN in 2020 (see Exhibit 14).

EXHIBIT 14: TARGET STATE OF ASIA FINANCE 2020

KEY METRICS OF APAC CAPITAL MARKET GROWTH

<table>
<thead>
<tr>
<th>% of GDP</th>
<th>70% &gt; 85%</th>
<th>110% &gt; 125%</th>
<th>130% &gt; 150%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Market cap</td>
<td>14</td>
<td>26</td>
<td>44</td>
</tr>
<tr>
<td>Debt securities</td>
<td>24</td>
<td>34</td>
<td>50</td>
</tr>
<tr>
<td>Pension, insurance and AMC assets</td>
<td>27</td>
<td>22</td>
<td>22</td>
</tr>
</tbody>
</table>

* % of gap filled defined by base case estimates against asset penetration (as a % of GDP) in the US as a benchmark of attainable target in developed markets.

Source: EIU, World Bank, Central banks data, Oliver Wyman Analysis.

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If properly executed, we will see a more resilient, integrated financial system that can contribute to stability and growth of the global economy, and the emergence of several Asian leaders in Finance by 2020. These leaders will start embracing change now, with particular focus on:

- Offering innovative products that serve the emerging needs of Asian clients: for example, around their healthcare, retirement and wealth management needs. We also expect to see the emergence of products that help increase the liquidity of assets (e.g. reverse mortgages)

- Becoming significantly more customer-centric by strengthening customer trust, by aligning bank staff and customers’ interests, by providing transparency in fees, by ensuring authenticity in customer communications and profiting by promoting customers’ interests rather than exploiting their indifference, indiscipline and ignorance in financial matters

- Increasing balance sheet turnover, by building new securitization products based on transparent data about the underlying assets

- Defending the high ground in payments against new technology competitors by at least “owning” the core infrastructure for retail and SME payments

- Upgrading risk management capabilities by reducing reliance on quantitative risk models and strengthening real judgment about critical uncertainties and stress factors

If the key stakeholders in the Asian Financial System could enact the reform agenda outlined in this paper, the increased financing volumes for the 3 growth pillars (SMEs, infrastructure and trade) alone, can create an incremental GDP uplift of more than 0.5% on an annualized basis and the market capitalization of the Asian financial system may see an incremental growth of $2 TN.

These stakes are high, warranting swift and decisive action.
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