

ADB Annual Meeting
ASIA: BANKING SECTOR REFORM FORUM
16 May 2004

Ms. Shamshad Akhtar
Director General
South East Asia Regional Department

I would like to welcome our distinguished panelists and participants/guests at this afternoon's banking sector reform seminar. This seminar will bring to forefront experience and perspectives on Asia's banking sector reforms both representing regulators/government as well as private sector view.

Asia's banking landscape is now substantially transformed and restructured. The sheer magnitude of effort is impressive in case of crisis-affected economies as evident from:

- Banking sector consolidation that has resulted in closure of about 100 banks and merger of several banks.
- NPL transfer to Asset Management Companies (AMCs) in the range of \$370 billion.
- Over the period, as per an occasional paper of FSI reported NPLs in the banking system--as a % of GDP declined in China from peak levels of 35% to about 20% by end 2002, in Korea from 10% to 5.3%, in Malaysia from 25.5% to 18.5%, Thailand from 54% to 8.4%, and Indonesia 26.8% to 2.1% etc.
- Officially reported levels of NPLs have come down to below 10%, except in Philippines, Thailand and PRC. However, the real level of NPLs are estimated by many observers to be higher, as NPLs have not been effectively recognized and often restructured through rescheduling. The resolution of NPLs has been a complex process but facilitated by substantial changes in legal and regulatory frameworks.
- Removal of NPLs and recapitalization has helped improve the capital adequacy of the banks; though in some individual banks cases capital adequacy is overestimated.
- Excluding liquidity support and guarantees offered to depositors, Government capital injection for banks, on a cumulative basis, is close to \$500 billion in aggregate terms.

- Eased foreign restrictions significantly: 100% ownership is allowed in the Philippines, Korea, and Indonesia and Thailand at least temporarily allows 100% foreign ownership for 10 years. Others including Malaysia and PRC have substantial limits on foreign ownership. There, however, remain in most countries restriction on foreign bank activities.
- Progress in privatization varied across Asia. Korea was able to sell most of the acquired banks relatively quicker to foreign investors and Thailand to foreign banks. Indonesia's bank privatization lagged, however, now all taken over banks have been sold and state-owned banks have resorted to 10-30% of Initial Public Offering to divest Government shareholding.
- Management is now increasingly being based on fit and proper criteria.

It is further encouraging that across Asia supervisory authorities (including in PRC and Korea) are now more independent and have strengthened the market regulation and supervision. Most countries have significantly strengthened prudential standards and exit mechanisms for insolvent banks not only to prevent systemic crises, but to provide banks and their manager and owners with strong disincentives for failure. Supervisors have received substantial training to help implement more risk-focused supervision approaches. Regulations are also receiving more public scrutiny post-crisis, which will help ensure that improved regulatory requirements are actually enforced.

The pace of NPL resolution and banking sector reforms and restructuring has varied. For instance: In Korea, the reported NPLs as a % of GDP declined to 6.2% compared to 20% in PRC. This is partly on account of the differences in stages of development of financial sector, degree of distress and vulnerability of banks and partly because of differences in the underlying economic and political environment. It is hence no surprise that Asia's process of bank resolution and restructuring has been marked by different approaches and modalities depending on country and banking system circumstances. This has helped Asia accumulate its own rich and diverse experience. It is this rich experience that we hope to share this afternoon.

Of most interest to industry has been the experience of NPL resolution and the varying role and mandates of Asian AMCs. For instance, we have case of Korea and Malaysia, who moved quickly and have managed to dispose bulk of the NPLs they acquired. This has been principally facilitated by (i) strong mandates of AMCs backed by legal and regulatory framework; and (ii) setting up institutional arrangements for corporate restructuring which offered out-of court settlement opportunities. Indonesia-IBRA had a painful start. Besides issues surrounding central bank liquidity support, IBRA had an unprecedented large task of not only NPL resolution but also of selling off taken over banks and assets acquired from bank owners. With IBRA now officially closed, arrangements are underway to transfer the remaining assets into a separate vehicle.

Aside from the teething problems of these AMC's, the performance and recovery of bad asset varied across countries depending on the quality of assets AMC's inherited. NPLs in these countries varied in terms of the size, delinquency period, sector concentration and currency and the extent to which they were backed by security.

Philippines opted to retain NPLs in the banks. Unlike others, reported NPLs in Philippines has grown to 14.7% end of 2003 given the lack of effective debt resolution mechanism, continued regulatory forbearance and weak economic conditions. The Philippines adopted a SPV Act and supportive regulations in 2003 but banks are reluctant to transfer NPLs at market prices because of its implications for balance sheets that unless accompanied by fresh capital infusion would deteriorate and lack of acceptance to the discounts being offered on the NPLs by market.

In contrast to East Asia, the PRC, other transitional economies and South Asia banking sectors are still state dominated. There continued to be issues of credit culture and government interventions which are adding to the bad debt problem although some of them started to deal with the stock problem of NPL. In these countries, the separation of "policy" from "commercial" lending, the greater use of market-based mechanism for allocating credit and determining interest rates, and the increased role of private sector in owning and operating banks, have started to reshape the nature of the banking sectors.

While banking systems have been cleaned up and few have been classified as Asia's best banks, regions banking system is not fully robust today and faces a set of internal and external challenges. Internal issues range from the delays in corporate restructuring which impinge on banks ability to resolve NPLs and the slow credit growth despite low interest environment. Subdued credit demand and low margins have squeezed profitability of banks. This and the carrying costs of non-earning assets together have impacted return on assets. Credit slowdown across wide range of countries is attributable to a series of economic shocks and inability of banks to lend because of its implications on balance sheets and insolvency of large traditional big companies. In addition to this, banks face increased competition from the debt and equity market as companies are able to raise capital competitively.

Aside from internal factors, WTO commitments, which will force open domestic banking markets to foreign competitors, who have developed their capabilities in some of the world's most competitive banking markets underscore need for effective positioning of the banks. Increasing competition from foreign banks should be beneficial for corporate and retail clients alike, improving the range and pricing of banking services. Large global banks also tend to transfer new skills to the markets they enter. Nevertheless, decision makers in regulatory bodies and domestic banks face considerable challenges in making sure that

their banking systems can reap the benefits of increased participation of foreign banks without destabilizing domestic institutions. Some regulators, including for example Malaysia, have been readying domestic banking systems for more foreign competition by inducing mergers and acquisitions through increases in minimum capital requirements. Others place more reliance on market forces within a tightened regulatory framework. In Korea, a number of large domestic banks were sold to foreign investors after the crisis. Last month it was announced that Citigroup would be the first foreign bank to acquire a Korean bank. This transaction will likely prompt a number of the larger domestic banks to seek global strategic alliances in order to compete.

Today, even the larger banks in Asia are smaller than the global banks with large international presence. In order to meet investment and other requirements for finances, Asia needs to continue to restructure and strength its banking system. For all countries, it will be important to introduce fundamental change in credit culture and enhance banks capacity for credit appraisal and risk management. NPL resolution requires an adequate legal environment to facilitate contract enforcement and debt recovery helps reduce and mitigate the risks inherent in financial transactions. Strengthened insolvency laws should not only be enacted but also enforced to provide strong disincentives for company default. Secured transaction regimes that facilitate collateral registration and enforcement need to be established, as do positive credit information bureaus. Banks need to further their corporate governance structure and increasingly move towards independent directors and strengthening of internal controls and audit system. Bank managers need to be provided with incentives that ensure that credit decisions are based on an analysis of risks and returns rather than on non-commercial considerations.

With this background I would like to inform you that as Governor Aziz has to leave early, he will make his presentation during the first session after Mr. Liu. Ms. Schuler will open the second session.

Dominic Barton will act as moderator for the seminar chairs McKinsey's Asia Pacific Practice. He is also a member of McKinsey's Shareholder Council and co-chair of the Partner Review Committee. Some of his recent assignments in Asia include:

- leading a strategy study for one of the four largest state-owned banks in PRC;
- advising the Financial Supervisory Commission in Korea on restructuring the banking system and changing its regulatory and supervisory approach;
- helping a leading Korean bank change its internal organization and management systems and build its marketing skills; and
- leading a strategy study for the Monetary Authority of Singapore on positioning the country as a world-class financial center.

Dominic will introduce our distinguished panel and act as moderator while I will close the session at the end.