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**Working Paper**

## Asian Financial System: Development and Challenges

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## ADB Economics Working Paper Series



### Asian Financial System: Development and Challenges

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Cyn-Young Park

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# **Asian Financial System: Development and Challenges**

**Cyn-Young Park**

November 2011

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**Asian Development Bank**

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## **Abstract**

Postcrisis policy responses tilted in favor of strengthening the global regulatory system and financial stability have limited the attention paid to the role of finance in supporting sustained economic growth and development. This has special implications for Asia which, despite being the new engine of growth to the world economy, continues to be challenged by the persistent gap between developments in its financial and real sectors. This paper examines how Asia's financial and economic landscapes have improved under the wave of regional macroeconomic and financial management reform, yet continue to be beset by highly bank-dominated local financial systems, financial infrastructures anemic in proper legal and regulatory frameworks, and shallow regional financial markets. The situation compromises Asia's ability to respond to the financial needs of its vast small and medium enterprise sector, infrastructure deficits, and poor households, constraining prospects for sustained high growth, development, and poverty reduction. The paper concludes that the financial development policy agenda in developing Asia should be focused on: (i) supporting economic growth and development, (ii) promoting financial inclusion, (iii) balancing regulation and innovation, and (iv) strengthening crisis prevention and management mechanisms.





# I. Introduction

Surviving the Lehman collapse in September 2008 and the postcrisis recession, the global economy struggles to regain strength. In response to the crisis, the G-20 leaders made firm commitments to “build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector, which will support sustainable global growth” (Group of Twenty 2009a, 3). Yet, the G-20 reforms have thus far focused more on strengthening the global regulatory system and restoring financial stability rather than on financial sector development, paying limited attention to the role of finance in supporting sustainable global growth.

Despite the often devastating effects of the crisis, finance remains central to economic growth and poverty reduction.<sup>1</sup> Theoretically, a well-functioning financial system has an important role to play in promoting economic growth and reducing poverty. Levine (2005) identified the functions of the financial sector under five broad categories, namely (i) producing information about potential investment opportunities; (ii) mobilizing savings to the most productive investment; (iii) monitoring firms and exerting corporate governance; (iv) promoting risk diversification and sharing across individuals, firms, and countries; and (v) facilitating the exchange of goods and services. Development of the financial sector reduces the cost of information collection, contract enforcement, and transaction, thereby increasing allocative efficiency and promoting economic growth.

Although not without contention, a large empirical literature has established a positive relationship between financial sector development and economic growth.<sup>2</sup> Past studies demonstrated that financial sector development influences real economic activity by altering saving and investment decisions, capital accumulation, technological innovation, and hence income growth. Essentially, the financial sector pools and mobilizes savings to the most productive investment. Development of the financial sector can also ease constraints on credit to improve the efficiency of resource allocation, hence promoting productivity growth. Here, the quality as well as the quantity of investment is also an important factor for determining the productive capacity of an economy. An important function of financial services is therefore to produce information about potential investment.

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<sup>1</sup> Zhuang et al. (2009) review the theoretical and empirical literature on the role of financial sector development in promoting economic growth and hence achieving poverty reduction.

<sup>2</sup> See Levine (2005) for a literature survey.

The role of finance in achieving strong, sustainable, and balanced global growth seems crucial more than ever as persistent weakness in advanced economies threatens the postcrisis global economic and financial stability. Risks remain large with increased budget deficits, sovereign debt burdens, and incomplete household and banking sector restructuring in Europe and the United States (US). With the expectation of prolonged weakness in advanced economies, it is essential that emerging and developing economies in Asia strengthen their own domestic demand for the sources of growth. G20 members with sustained, significant external surpluses also pledged to strengthen domestic sources of growth, including (depending on circumstances) increasing investment and/or consumption, reducing financial market distortions, boosting productivity in service sectors, improving social safety nets, and lifting constraints on demand growth.

In Asia, the crisis effects differed across borders depending on the degree of economic and financial openness, as well as on dependency on external demand and credit. Although most Asian financial systems exhibited remarkable resilience to the crisis, inevitable changes in the postcrisis global economic and financial landscape require a revisit to the reform of national financial sectors.

Across Asia, financial sector development remains an important development agenda. In fact, in the wake of the global financial crisis and the consensus to support more balanced and sustainable global growth, further domestic and regional financial development in Asia is now imperative. Experience and research demonstrate that an appropriately designed institutional framework for finance is crucial to achieve the twin objectives of supporting economic growth and financial stability. First, effective regulation and supervision is the basic foundation for financial sector development and sophistication. Second, a reliable institutional framework is essential to provide the rules of the game for financial transactions and to support financial sector development. Without an appropriate legal and institutional framework, effective finance will not develop. Third, previous episodes of financial crises, including the Asian financial crisis and the global financial crisis, underscore the importance of ensuring financial stability yet being prepared for times of financial distress and crisis. In times of financial distress or crisis, an effective resolution framework supports prompt responses to troubled institutions and helps contain the spread of financial troubles and minimize the impact of the crisis.

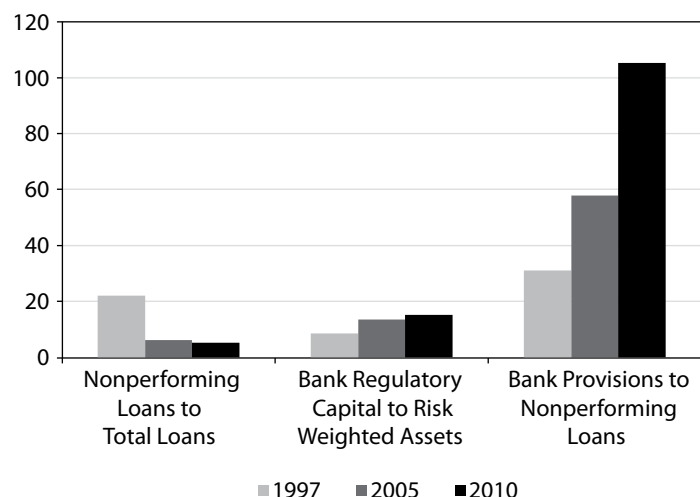
This paper will examine key development agenda of the Asian financial systems in the face of rapidly changing global financial landscape to shed light on challenges facing the region's policy makers. Section II explains salient features of the region's financial sector developments. Section III discusses challenges of financial sector development for balanced and inclusive growth in Asia. Section IV examines approaches to financial sector development for diversity and stability. Section V concludes with some policy implications.

## II. Financial Sector Developments in Asia

Developing Asia has emerged as a new growth pole of the world economy. With its robust growth, developing Asia has provided another “engine of growth” to the world economy when the traditional markets faltered. The region’s economic rise in the past few decades has been spectacular. Rapid growth in the region has been bolstered by policies to promote export-oriented industrialization while mobilizing a high level of savings. As the world’s fastest-growing region, developing Asia has not only outperformed industrialized economies, but also other parts of the developing world. During 1980–2010, developing Asia’s real gross domestic product (GDP) grew 7.3% annually on average, compared to the world average of 2.9%. The region’s real GDP in purchasing power parity (PPP) terms climbed from about \$2.2 trillion in 1980 to \$18.5 trillion in 2010. That is an increase of more than eight times, compared with about three times for the world economy during the same period. By 2010, the region accounted for 32.3% of world GDP; including Japan, the share reached 42.1%.

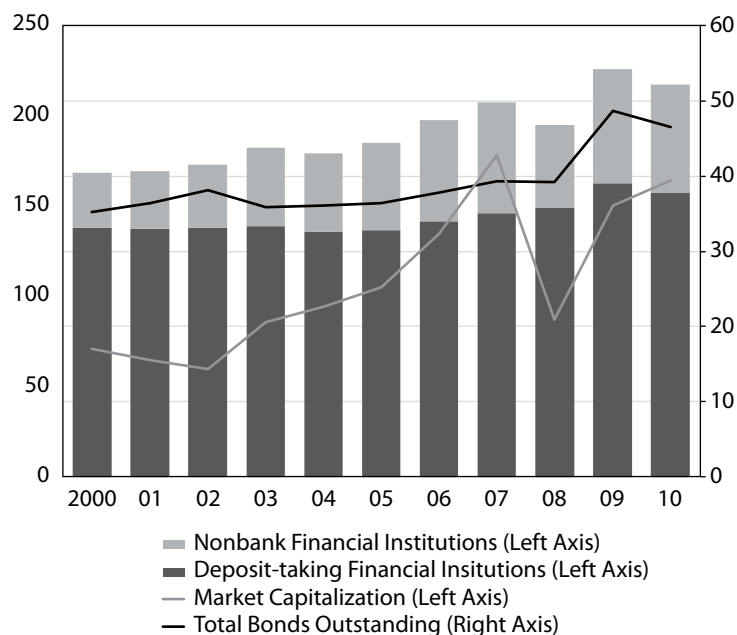
Developing Asia’s economic and financial systems showed remarkable resilience to the global financial crisis, largely owing to their limited exposure to toxic assets that sparked the crisis. In some part, however, it also reflects the successful reforms and restructuring undertaken in the aftermath of the region’s own crisis of 1997–1998. The Asian crisis prompted a comprehensive reform of the macroeconomic policy framework and financial sector regulation. Reform of macroeconomic and financial management had improved fiscal and external positions. The regulatory system was revamped, ensuring that financial institutions remain sound with capital adequacy ratios well above international norms. In the aftermath of the Asian crisis, massive external deleveraging was undertaken by the private sector, including bank and nonbank financial institutions. As a result, the region’s external vulnerability was reduced substantially. With current account surpluses from years of export-driven growth, the region had also accumulated international reserves, accounting for 45.0% of the world’s total foreign exchange reserves as of 2010.

Financial sector reforms following the Asian financial crisis centered on bank rehabilitation and recapitalization while upgrading in the prudential norms. Strong economic growth and profits strengthened banks’ balance sheets (Figure 1), reduced nonperforming loans, and improved their resiliency against external shocks as proven in the wake of the global financial crisis. Across the region, the crisis also prompted the development of financial systems beyond bank financing into, for example, government and corporate bonds, which improves financial resilience. The region’s financial sectors and markets have broadened and deepened in the past decade. The size of financial assets has increased significantly, with greater participation of nonbank financial institutions and capital markets, especially stock and government bond markets (Figure 2).

**Figure 1: Banking Sector Soundness Indicators—Developing Asia (percent)**

Note: Unless otherwise indicated, Developing Asia refers to Bangladesh; the People's Republic of China; Hong Kong, China; India; Indonesia; Kazakhstan; the Republic of Korea; the Lao People's Democratic Republic (PDR); Malaysia; Nepal, Pakistan; the Philippines; Singapore; Sri Lanka; Thailand; and Uzbekistan. Data for Bangladesh, the Lao PDR, Nepal, Sri Lanka, and Uzbekistan are not available.

Sources: *Financial Soundness Indicators* (International Monetary Fund 2011), national sources.

**Figure 2: Size of Financial Assets—Developing Asia (percent of GDP)**

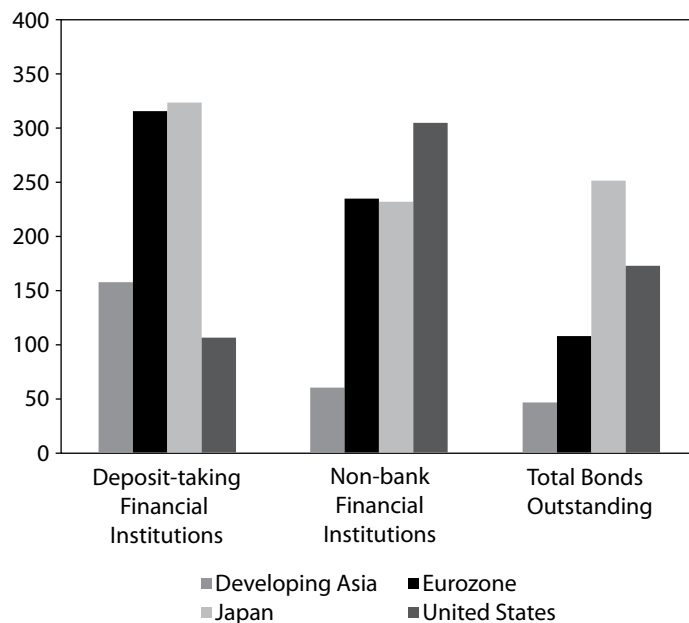
GDP = gross domestic product.

Note: Market capitalization data not available for the Lao PDR and Uzbekistan. Total bonds outstanding data not available for Sri Lanka and Uzbekistan.

Sources: ADB Office of Regional Economic Integration using data from national sources; *AsianBondsOnline*, ADB; Bank for International Settlements; CEIC database; World Federation of Exchanges; and World Economic Outlook Database April 2011, International Monetary Fund.

Despite the progress made so far, the region's financial sectors and markets continue to face major developmental challenges, which vary greatly in scope depending on country-specific development stages. First, development of the region's financial sectors and markets lags behind the progress of real sector economy, unable to provide necessary funding and financial services for the private sector. Weak financial sectors and markets present a significant constraint on economic growth and development. The region's financial sectors remain much smaller in size compared to those of advanced economies (Figure 3). Although wide variation exists across borders, there is room for further expansion even in the region's middle-income economies. The situation is much worse in a large number of low-income and conflict-affected economies, where the size of financial assets is much smaller even with a higher concentration in the banking sector (Figure 4). In addition, their banking systems have very limited physical presence in the number of branches and automated teller machines (Figure 5), failing to provide adequate access for the public (CGAP and World Bank 2010).

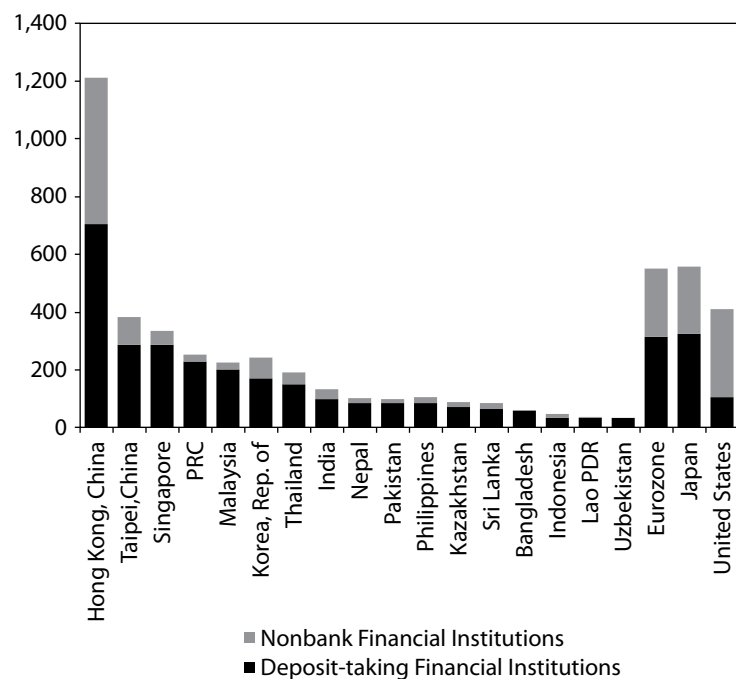
**Figure 3: Comparison of Financial Asset Sizes, 2010 (percent of GDP)**



GDP = gross domestic product

Note: Market capitalization data not available for the Lao PDR and Uzbekistan. Total bonds outstanding data not available for Sri Lanka and Uzbekistan. Deposit-taking financial institutions data refer to 2009 for the People's Republic of China (PRC), India, Kazakhstan, the Lao PDR, Nepal, Pakistan, Sri Lanka, and Uzbekistan, and to 2008 for Bangladesh. Nonbank financial institutions data refer to 2009 for the PRC; Hong Kong, China; India; Kazakhstan; the Lao PDR; Nepal; Pakistan; Sri Lanka; and Uzbekistan, and to 2008 for Bangladesh.

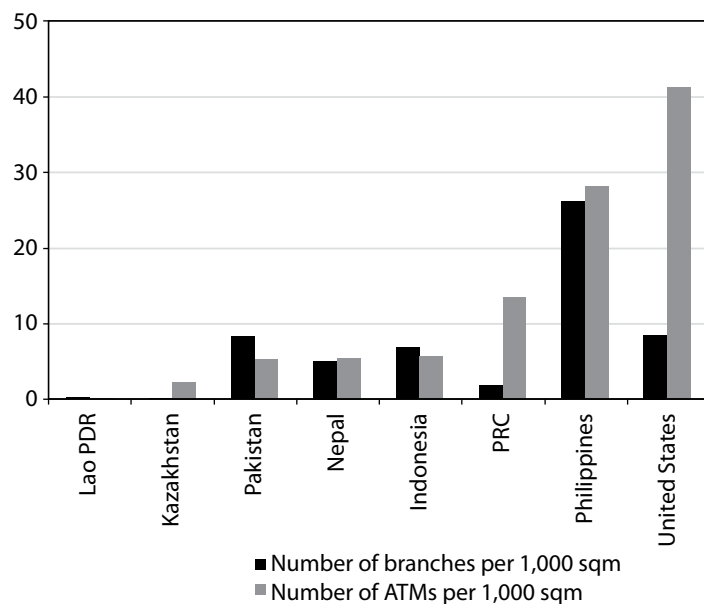
Sources: ADB Office of Regional Economic Integration using data from national sources; *AsianBondsOnline*, ADB; Bank for International Settlements; CEIC database; and World Economic Outlook Database April 2011, International Monetary Fund.

**Figure 4: Financial Sector Assets—Developing Asia, 2010 (percent of GDP)**

PRC = People's Republic of China, GDP = gross domestic product, Lao PDR = Lao People's Democratic Republic.

Note: Deposit-taking financial institutions data refer to 2009 for the PRC, India, Kazakhstan, the Lao PDR, Nepal, Pakistan, Sri Lanka, and Uzbekistan; and to 2008 for Bangladesh. Nonbank financial institutions data refer to 2009 for the PRC; Hong Kong, China; India; Kazakhstan; the Lao PDR; Nepal; Pakistan; Sri Lanka; and Uzbekistan; and to 2008 for Bangladesh.

Sources: ADB Office of Regional Economic Integration using data from national sources; CEIC database; and World Economic Outlook Database April 2011, International Monetary Fund.

**Figure 5: Access to Banking System—Selected Developing Asian Economies, 2009**

ATM = automated teller machine, PRC = People's Republic of China, Lao PDR = Lao People's Democratic Republic, sqm = square kilometer.

Note: Lao PDR for 2007; Indonesia ATM for 2007; Hong Kong, China for 2008; and Malaysia for 2008.

Source: ADB (2011b).

Second, the region's financial systems remain structurally unbalanced with high concentration in the banking system, which can undermine their structural resilience and systemic stability. The 1997–1998 crisis highlighted the risk of heavy reliance on bank lending, which limited financial diversity and hence threatened financial stability. The absence of well-developed domestic capital markets constrains the availability of alternative sources for stable long-term corporate financing and thereby increases the risks to the overburdened banking system from maturity and currency mismatches. The lack of diversification in firms' capital structure and investors' portfolios can also aggravate the financial position of the corporate balance sheets, should an adverse economic condition dampen investment demand, triggering a sudden withdrawal of capital and a rush for credit crunch.

Third, underdeveloped financial infrastructure combined with lack of proper legal and regulatory framework hinders efficient functioning of the financial sectors and markets. Basic financial infrastructure is lacking in many developing economies in the region. Rapidly growing middle-income economies—for example, India, Indonesia, the Philippines, Thailand—have strengthened financial infrastructure such as electronic payment systems, credit information bureaus, and collateral registries in the past decade. That helped significantly enhance the efficiency of banking operations and public confidence in the banking and financial systems. However, basic financial infrastructure, including necessary legal and institutional framework and governance systems, remain inadequate in most low-income developing economies.

Finally, the region's financial sectors and markets remain largely fragmented, hindering the deepening and broadening of the regional financial markets and services and thus effectively constraining the mobilization of the region's savings for its vast investment needs. Asia as a whole is a net saver and exports a large amount of capital to advanced economies<sup>3</sup> (Table 1). This already presents an irony—that capital flows from low-income to high-income economies. What is more ironical, however, is that a number of regional economies in need of external funding for their investment import these necessary funds from outside the region. This reflects the inability of the region's financial systems to effectively channel the surplus funds within the region, leaving the region vulnerable to swings in external credit and financial conditions.

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<sup>3</sup> Petri (2008) reports that the advanced economies (especially the US) imported about \$0.7 trillion in capital, out of which \$0.4 trillion came from Asia in 2005.



**Table 1: Savings and Investment, 2010 (US\$ billion)**

<b>Economy</b>	<b>GDP</b>	<b>Savings</b>	<b>GDCF</b>	<b>Net Savings</b>	<b>Savings (% of GDP)</b>	<b>GDCF (% of GDP)</b>	<b>Net Savings (% of GDP)</b>
Asia	16,564	5,691	5,058	633	34	31	3.8
Japan*	5,498	1,173	1,032	141	21.3	18.8	2.6
Emerging Asia	7,608	3,491	3,216	275	46	42	3.6
China, People's Rep. of	5,879	2,999	2,654	345	51.0	45.2	5.9
India	1,729	492	561	(70)	28.4	32.5	(4.0)
NIEs	1,892	559	389	171	30	21	9.0
Hong Kong, China	224	67	53	14	29.9	23.7	6.2
Korea, Rep. of*	1,014	251	216	36	24.8	21.3	3.5
Singapore	223	103	53	49	46.0	23.8	22.2
Taipei, China**	430	138	67	72	32.2	15.5	16.7
ASEAN-5	1,566	467	421	46	30	27	3.0
Indonesia	707	226	230	(4)	32.0	32.5	(0.5)
Malaysia*	238	60	28	32	25.2	11.8	13.4
Philippines	200	54	41	13	27.2	20.5	6.7
Thailand	319	98	83	15	30.6	26.0	4.6
Viet Nam	104	29	39	(10)	28.4	37.9	(9.5)

ASEAN = Association of Southeast Asian Nations, GDCF = gross domestic capital formation, GDP = gross domestic product, NIEs = newly industrialized economies.

\*Savings and GDCF values are for 2009.

\*\*GDCF value is for 2009.

Sources: *World Development Indicators and Global Development Finance*, World Bank. Values for Taipei, China are from [eng.stat.gov.tw/mp.asp?mp=5](http://eng.stat.gov.tw/mp.asp?mp=5).

Reforming the banking and financial sector should start with the development of a central bank. Weak central banks often compound the problems of weak financial sectors and markets as well as inadequate financial supervision in many low-income and crisis-affected developing economies. In particular, the inability of central banks to properly monitor the economy, formulate and conduct appropriate monetary policy, and effectively supervise banks is a major hurdle to development of the financial system in many developing economies in the region. Particularly in low-income and/or crisis-affected countries, public confidence in the monetary and financial systems is very low. Another important complication is prevailing dollarization in a number of low-income developing economies such as Cambodia, the Lao People's Democratic Republic (PDR), Kazakhstan, the Kyrgyz Republic, Tajikistan, and Viet Nam. While the impact of dollarization on financial sector development is still debated, it is clear that dollarization is a serious threat to fiscal and monetary policy effectiveness. Past studies also find that high dollarization of banks' assets may increase the banks' solvency and liquidity risks.<sup>4</sup>

Broadening financial sectors and deepening markets is also an important long-term agenda for creating more efficient and resilient domestic financial systems. Across the region, banks play a dominant role in the financial system (Table 2). However, the scope of banking businesses and services are limited in many developing economies—

<sup>4</sup> See Asel (2010), Duma (2011), and Menon (2007) for dollarization experiences in developing Asia.

authorities need to promote greater public access to banking; encourage banks and other financial institutions to diversify savings instruments and provide credits to traditionally underserved sectors such as households and small and medium enterprises (SMEs); and allow diverse products to develop for better risk management. Development of the nonbanking financial sector is also largely limited while the progress of capital market development is often biased toward equities. The region's equity markets have grown robustly and have emerged as an important source of corporate funding in a few large developing economies such as the PRC and India on the back of strong foreign capital inflows. However, the development of local currency bond markets has lagged. Government debt markets are yet to be fully functioning in many emerging and developing economies in the region.

In the aftermath of the 1997/1998 financial crisis, East Asian economies in particular took various steps to improve the domestic financial system and promote regional financial integration. They took the crisis as an opportunity to deepen financial cooperation and integration—both as a safeguard against the spillovers of global market instability and to provide a platform for regional financial market development. Some regional initiatives are noteworthy, such as the ASEAN+3 Economic Review and Policy Dialogue, the Chiang Mai Initiative, the Asian Bond Market Initiative, and the Asian Bond Fund Initiative.<sup>5</sup>

However, there is much room for improvement in the region's financial integration. A number of studies find that the region's financial markets remain largely fragmented and provide evidence that the region's financial markets are integrated more with the global markets rather than with each other in the region (see Kim, Lee, and Shin 2008; Hinojales and Park 2011; and Park and Lee 2011). The region's financial markets also lack depth and liquidity due to fragmentation and limited availability of regional financial products. Further financial integration would require liberalization of capital accounts, promotion of common standards for financial transactions, and establishment of financial infrastructure that can support cross-border transactions.

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<sup>5</sup> See ADB (2008) for details.



### **III. Financial Sector Development for Balanced and Inclusive Growth**

The global financial crisis highlighted the risk of substantial global savings and investment imbalances at its root. Working out these imbalances is paramount to sustaining the postcrisis recovery momentum and safeguarding financial stability. The crisis has made it clear that the world economy also needs multiple sources of growth. Asia has pulled the global economy out of recession and its strong growth is expected to contribute to a more balanced and resilient global economic expansion. Given the expectations of prolonged weaknesses in external demand, accelerating the shift in the sources of demand toward domestic and regional demand would be also largely in the region's self-interest.

Financial sector development is essential to increasing private investment and consumption, hence contributing to the rebalancing process. Across Asia, there is a clear need to focus efforts on financial sector development to support inclusive and balanced growth. The region's predominantly bank-based financial systems have made considerable progress broadening, enhancing the reach, and improving the efficiency and stability of financial services since the 1997–1998 Asian financial crisis (Ghosh 2006). In many developing economies, however, the limited access of the poor and SMEs to formal credit remains an important constraint on achieving sustained high growth, development, and poverty reduction.

The promotion of financial access for the traditionally underserved sectors, such as the poor and SMEs, is a high priority. Banks need to extend their reach to the broader public, including through continued development of microfinance markets. Middle-income economies need to continue their effort to diversify the financial systems by developing the nonbanking sector and capital markets while at the same time improving access to banking services. For low-income developing economies, however, the focus should be on strengthening the banking systems and broadening public access to basic financial services, with particular attention paid to increasing microcredit facilities.

Poor households typically have uncertain income sources with limited savings in perishable assets. They also face substantial difficulty in managing their financial risks due to limited access to any formal financial sector including insurance while relying heavily on social networks and their offspring. It is often very expensive for banks to reach out to the poor. Lack of pledgeable assets or collateral and credit information also compounds the adverse condition for the poor households' credit access. Promoting housing finance and mortgage markets would be helpful to strengthen households' financial position. Very little efforts have been made in the region, except for a few

economies, to introduce mortgage schemes and systemically assist housing finance development.<sup>6</sup>

Many emerging and developing economies in the region also continue to face the challenge of developing financial sectors and markets to efficiently channel domestic savings into productive investment. The region's bank-dominated and underdeveloped capital markets present an important hurdle to funding long-term development needs and thus achieving sustained high growth. Funding needs for infrastructure and SMEs are particularly significant in this respect.

An important issue in bank financing of infrastructure is the asset–liability mismatches. While infrastructure is typically a long-term project, banks' main funding sources are short-term deposits. Therefore, funding infrastructure investment will naturally create significant asset–liability mismatches in bank balance sheets. This asset–liability mismatch problem is particularly acute in emerging Asia, where banks remain a major source of corporate funding.

SME financing is another important issue. In many emerging and developing economies, SMEs are the main pillars of production and job creation. Despite SMEs' economic importance, however, banks are reluctant to lend to them because of their generally high business risks, lack of reputation, inadequate credit information and history, and collateral. Relatively high nonperforming loans by SMEs and higher costs associated with managing a large number of small accounts also discourage banks from lending to them.

The progress of SME finance varies widely across the region. The most visible progress has been made in the region's middle-income economies, where secured and nonsecured lending regimes have been established with collateral management systems, credit information bureau, etc. But in low-income developing economies, lack of legal and regulatory framework, inadequate information and market transparency, weak corporate governance, and underdeveloped financial infrastructure continue to hamper effective SME finance.

In order to enhance financial access by the poor and SMEs as well as meet the region's huge infrastructure financing needs, strong policy intervention and support is necessary. First, legal and regulatory reforms as well as capacity building can support financial institutions to provide more efficient microfinance services. In many developing economies in the region, state-owned financial institutions offer commercial microfinancial services. However, their limited ability of credit assessment and risk management as well as weak

<sup>6</sup> Malaysia established Cagamas, the National Mortgage Corporation, in 1986 to serve as a special vehicle to mobilize low-cost funds to support the national home ownership policy and to spearhead the development of the private debt securities market. In Thailand, there was a specific-purpose financial institution, the Government Housing Bank, to provide a source of finance with lower interest rates for people seeking to purchase their own homes, especially those of low- and middle-income groups. In 1997, the Secondary Mortgage Corporation was established to promote and develop the secondary mortgage market.

corporate governance hamper efficient services and leave them prone to financial losses and bankruptcy. Inadequate monitoring and supervision of these institutions add another layer of complication.

It is imperative to strengthen the legal and regulatory system including clear and transparent property rights, proper insolvency arrangements, and bankruptcy procedure while enhancing credit assessment, risk management, and corporate governance. At the same time, however, it is important to create an enabling environment where private microfinance institutions can thrive by removing unnecessary legal and regulatory hurdles to market entry and undue administrative burdens on their operations.

Second, building critical financial infrastructure such as web-based collateral registers or credit information systems is essential to ensuring the efficient functions of microfinance markets. It is particularly important to build institutional and systemic support toward effective risk management. Credit risk managers in emerging markets have a difficult task, as necessary information on credit ratings and traded security prices, for example, can be hard to come by. Many microfinance institutions have very limited data on credit information and default histories of their clients. There is also little infrastructure support such as credit information bureaus. Even where there is some data availability, drastic changes in the economic environment in which banks and financial institutions operate since the mid-1990s across Asia would make it difficult to gauge default probabilities or exposures to defaults in the current situation.

Third, it is important to encourage innovative ways to provide a better array of financial services and products that cater to the needs of small entrepreneurs and investors while effectively reducing banks' operational costs. The use of innovative technology needs to be positively considered and pursued. In many developing economies with low population density or disconnected geography, internet or mobile banking may help extend banks' reach to their remote clients. This will also help reduce the cost of setting up bank branch networks.

Securitization is another important financial innovation that is potentially very useful to pool assets or future incomes for necessary funding for investment. In Asia, securitization was used increasingly in the wake of the Asian financial crisis as a means to address loan losses by financial intermediaries or as a device to help bring about market-based financial sector restructuring. However, the global financial crisis of 2008–2009 put a rather abrupt stop to the growth of securitization markets worldwide. Given its great potential in facilitating mobilization of savings for investment by increasing the degree of freedom for both savers and investors to customize their financial positions that can fit their risk profiles and preferences, the use of securitization needs to be positively reviewed with a proper regulatory and monitoring framework.

Similarly, developing diverse market segments such as venture capital, factoring, and lease markets would be a good way to improve SMEs' access to finance. The Republic of Korea successfully developed a well-functioning stock market for start-up SMEs to raise capital through publicly traded shares. Singapore established an impact investment exchange—a social stock exchange that provides a trading platform and an efficient capital-raising mechanism for social enterprises (which includes microfinance entities). With a substantial portion of Asian SMEs in export industries, providing effective financial assistance in hedging against foreign exchange volatility and trade financing is also valuable.

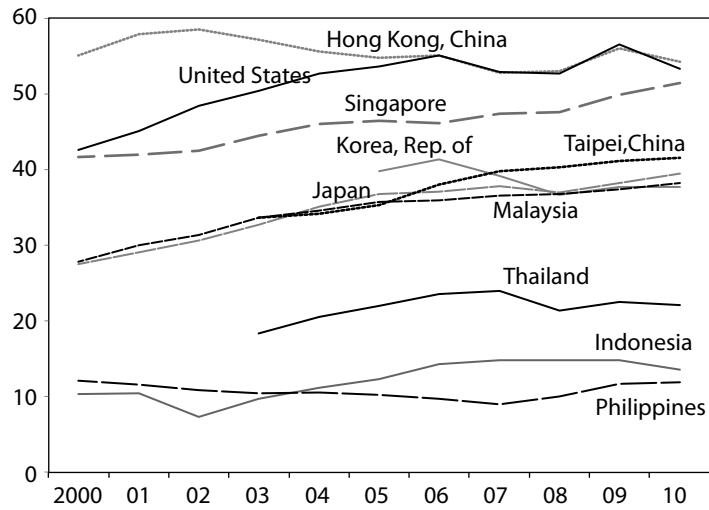
Finally, developing domestic capital markets and contractual savings is important to finance long-term investments. A transition from short- to medium- and long-term funding, however, requires certain policy initiatives with a long-term view, such as gradually extending tenors of government and corporate bonds and accelerating the process of pension reforms. Development of pension and insurance sectors has an added value of strengthening the nation's social security system.

The development of liquid and well-functioning local currency bond markets provides a venue for long-term finance for infrastructure investment. An important element to this development is a strong presence of domestic institutional investors with long-term horizons—such as funded national pension schemes, mutual funds, and domestic insurance companies. Institutional investors not only mobilize long-term savings for long-term investment, but also reinforce market disciplines as they exercise the right of creditors in oversight of the firm performance.

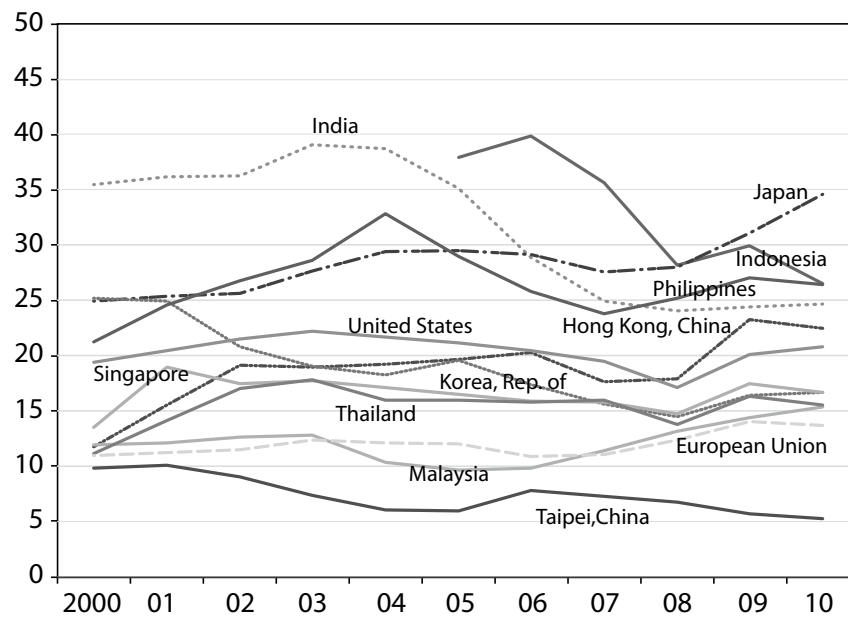
## **IV. Financial Sector Developments for Diversity and Stability**

The recent strength of Asian financial systems reflects the success of the financial sector and regulatory reforms undertaken in the aftermath of the 1997–1998 crisis. The region's banking systems—which play a dominant role in financial intermediation—are stronger than before: their balance sheets are healthy; risk management practices have generally improved; and prudential oversight has strengthened. Even so, there is a large scope of improvement in terms of their efficiency, inclusivity, and stability. Lack of diversity in the region's financial systems is another structural weakness that may undermine systemic resilience and hence jeopardize financial stability.

For Asia, where banks remain the main channel for financial intermediation, building a strong banking system remains a priority. Although the region's banking systems exhibited remarkable resilience during the latest crisis, recent developments in global financial markets and some notable changes in the region's banking business such as increasing household lending and securities transactions require special attention (Figures 6a-b).

**Figure 6a: Real Estate Loans (percent of total loans)**

Sources: CEIC database; Hong Kong Monetary Authority; Bank of Indonesia; Bank of Japan; Bank Negara Malaysia; US Federal Reserve Board; Taipei, China's central bank.

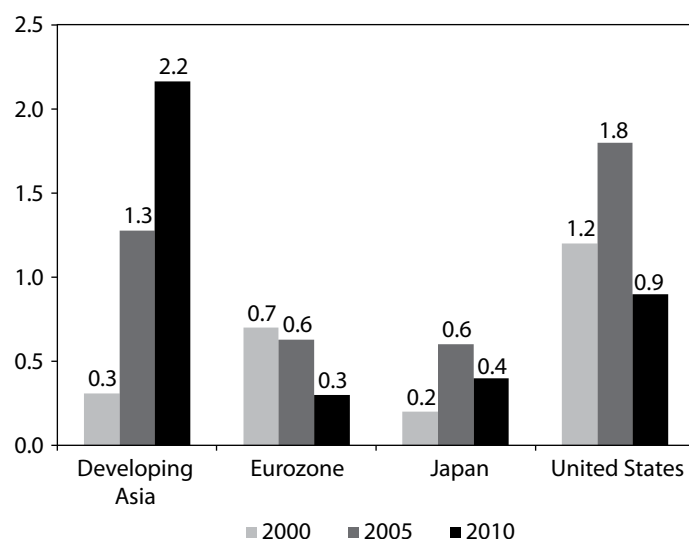
**Figure 6b: Securities Investment of Commercial Banks (percent of total bank assets)**

Sources: CEIC database; Hong Kong Monetary Authority; Bank of Indonesia; Bank of Japan; Bank Negara Malaysia; US Federal Reserve Board; Taipei, China's central bank.



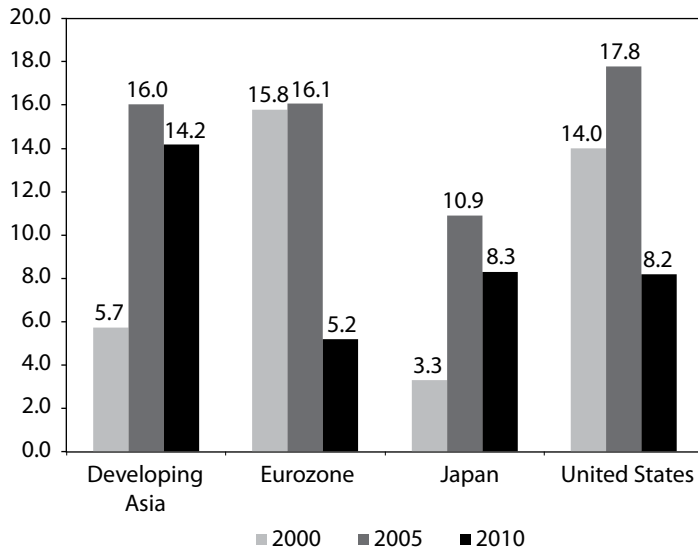
Asian banking systems returned to profit and strengthened their operational efficiency following the reforms after the 1997–1998 crisis (Figures 7a-e). Earnings have improved, with commercial banks venturing into new areas such as credit cards, mortgages, insurance, and other retail financing. Profit performance generally improved on strong growth in noninterest income as banks strengthened their fee businesses. Net interest income also improved as banks reduced operational expenses and funding costs declined to historically low levels, reflecting the extended period of low interest rates and strong liquidity conditions. However, rapid expansion of banks into unfamiliar areas may entail new types of risks. As the banking system extends its reach beyond the traditional customer base and takes on new risks, it is essential to strengthen prudential regulation and supervision to ensure the stability of the system.

**Figure 7a: Return on Assets—Emerging Asia and G3, Selected Years (percent)**



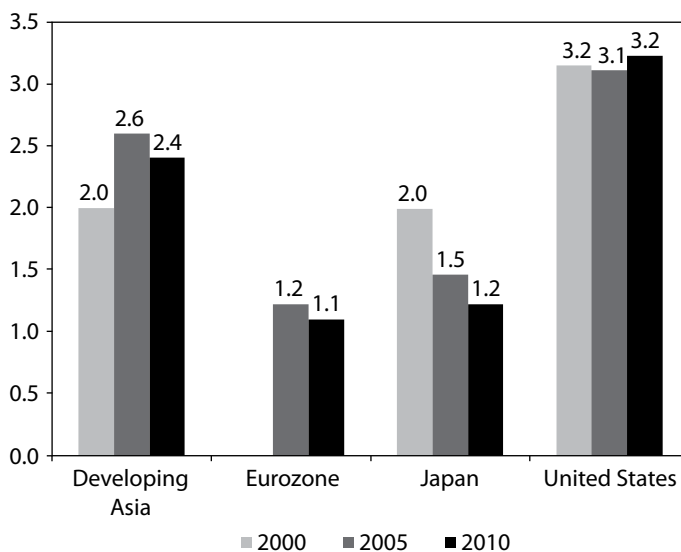
Note: Data definitions follow, to the extent possible, the methodology of the Financial Soundness Indicators Compilation Guide. For complete annotations, limitations and sources, see *Financial Soundness Indicators*, International Monetary Fund. Data for 2000 for eurozone refer to 50 largest banks. Data for Bangladesh, the Lao PDR, Nepal, Sri Lanka, and Uzbekistan are not available.

Sources: National sources; European Central Bank; and *Financial Soundness Indicators*, International Monetary Fund.

**Figure 7b: Return on Equity—Emerging Asia and G3, Selected Years (percent)**

Note: Data definitions follow, to the extent possible, the methodology of the Financial Soundness Indicators Compilation Guide. For complete annotations, limitations and sources, see *Financial Soundness Indicators*, International Monetary Fund. Data for 2000 for eurozone refer to 50 largest banks. Data for Bangladesh, the Lao PDR, Nepal, Sri Lanka, and Uzbekistan are not available.

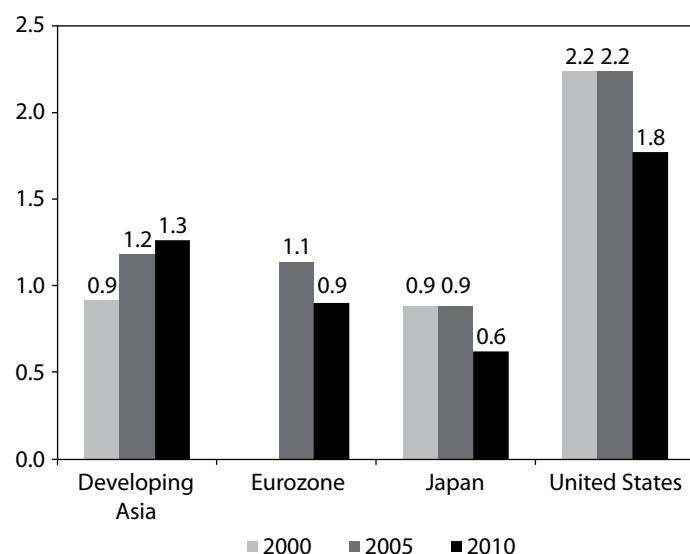
Sources: National sources; European Central Bank; and *Financial Soundness Indicators*, International Monetary Fund.

**Figure 7c: Share of Net Interest Income to Average Assets—Emerging Asia and G3, Selected Years (percent)**

Note: Data for Bangladesh; the People's Republic of China; Hong Kong, China; Kazakhstan; the Lao PDR; Pakistan; Nepal; Sri Lanka; and Uzbekistan are not available.

Sources: European Central Bank; ADB Office of Regional Economic Integration using data from CEIC database and national sources.

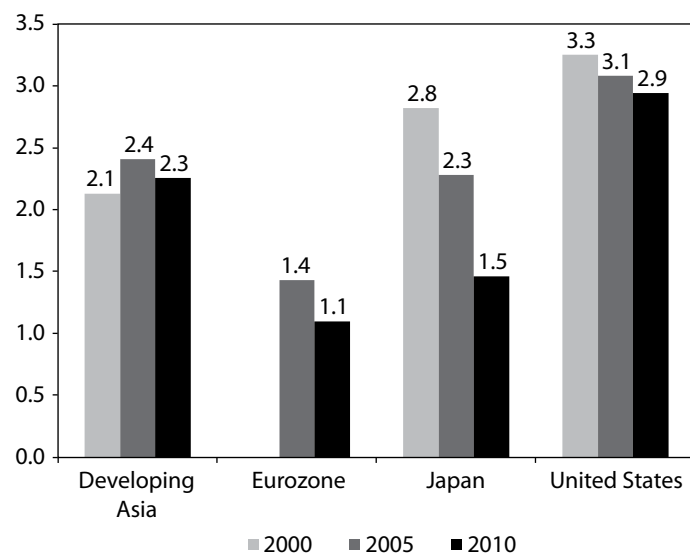
**Figure 7d: Share of Net Noninterest Income to Average Assets—Emerging Asia and G3, Selected Years (percent)**



Note: Data for Bangladesh; the People's Republic of China; Hong Kong, China; Kazakhstan; the Lao PDR; Pakistan; Nepal; Sri Lanka; and Uzbekistan are not available.

Sources: European Central Bank; ADB Office of Regional Economic Integration using data from CEIC database and national sources.

**Figure 7e: Share of Operating Expense to Average Assets—Emerging Asia and G3, Selected Years (percent)**



Note: Data for Bangladesh; the People's Republic of China; Hong Kong, China; Kazakhstan; the Lao PDR; Pakistan; Nepal; Sri Lanka; and Uzbekistan are not available.

Sources: European Central Bank; ADB Office of Regional Economic Integration using data from CEIC database and national sources.

The region's banking systems need to further enhance their systemic resilience and financial strength. Strengthening regulatory and supervisory framework is particularly important for developing economies with a relatively weak financial market infrastructure to support credit risk assessment and effective risk management. It is critical that the minimum capital requirements are met for regulated financial institutions. But more importantly, implementation of a rigorous supervisory review process needs to ensure that banks maintain sound balance sheets and exercise due vigilance in their risk management practice. Regulators also need to strengthen their capacity—and be fully empowered—to evaluate banking soundness against the rapidly evolving financial environment and assess the impact of new developments on the micro- and macro-prudential soundness of financial institutions, risk management, investor protection, and systemic financial stability.

Rapid penetration of financial innovation in some parts of the region's largely underdeveloped financial systems is a significant regulatory concern, while some of the more advanced regional economies also need to remain vigilant against their banking system's exposures to new financial products and services. The degree of financial innovation and globalization in the region's banking and financial systems may not be as high compared to their counterparts in industrial countries. Asia's banks held up well compared to their western counterparts in large part because of their relatively low degree of financial innovation and sophistication. But the region continues to embrace the wave of financial globalization and sophistication, brought by various factors, including the increasing participation of foreign investors, the tightening global network with the revolution in information and communications technology, and introduction of new financial products and services.

Financial innovation and globalization complicates local authorities' tasks of effectively regulating and supervising financial institutions. Despite its potential to create more efficient and resilient financial markets, financial innovation entails significant risks and uncertainties by changing the ways of financial intermediation and market functioning. The past episodes of financial crises showcased the risk of innovation that challenged market participants and regulators' understanding of risk while generating overly optimistic views about its benefits. A lack of institutional capacity among both financial institutions and regulators is another factor that can hamper effective risk monitoring and control.

The crisis also highlighted the importance of adequate information on cross-border financial activities and effective knowledge sharing. The region's regulatory authorities need to have adequate information on cross-border financial activities and promote effective knowledge sharing perhaps through formal regional policy dialogues, which can also ensure adherence to international standards and minimum regulatory principles by adding peer pressure.

Lack of necessary infrastructure and institutional support continues to impair the development of the region's banking sector. Many low-income developing economies with less developed financial systems face longer-term development issues such as (i) establishing legal and institutional infrastructure for finance such as creditor rights, prudential regulations, and insolvency regimes; (ii) building information and governance infrastructure such as credit information systems, accounting and disclosure rules, and internal and external auditing systems; and (iii) strengthening the role of central banks to provide systemic liquidity support through effective monetary operations and efficient payments and settlement systems. Such institutional building is also an important prerequisite to financial liberalization without undermining financial stability.

Authorities must also foster a broader range of financial sectors and markets—including nonbank financial institutions, debt and equity capital markets, securitization, and derivatives—to enhance systemic resilience and promote financial stability. Diversity of financial systems—while meeting the demand from the society for diverse financial services by accommodating various risk preferences of savers and investors—helps reduce the risk of overreliance on banks and hence promotes financial stability.

Nonbank financial institutions such as private investment funds, mutual and pension funds, hedge funds, insurance and leasing companies, and venture capital firms, while growing rapidly in the region's relatively more advanced economies, remain largely underdeveloped (Lee and Park 2008). As shown in Table 3, in most Asian middle-income economies, pension systems are relatively new with limited coverage (Park 2009). In recent years, some larger middle-income countries, including the PRC, Indonesia, Thailand, and Viet Nam, established national pension systems or strengthened their existing schemes by extending coverage and improving benefits. Private pension funds are, however, still at an embryonic stage of development even in middle-income countries in Asia. With the concern of aging population growing in some large middle-income countries notably in the PRC and Thailand, the process of pension reform needs to accelerate.

**Table 3: Pensions in the Asia and Pacific Region**

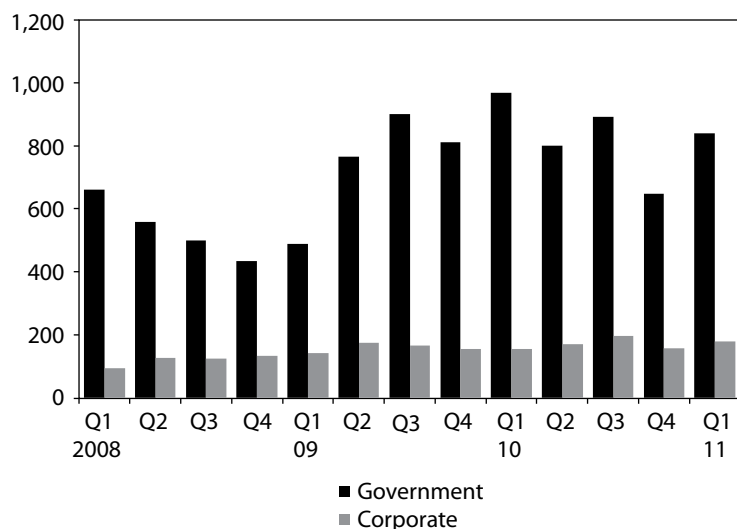
Economy	Type of Pension Scheme*		Replacement Rate, 2007 (in %)**	Labour Force Coverage Rate, 2007 (in %)**	Ratio of Total Pension Assets to GDP, 2006 (in %)**	Year Pension System was Introduced	
	Public						Private
	DB	DC					DC
Asia and Pacific							
High-Income							
Hong Kong, China			•			2000	
Japan	•					1942	
Korea, Rep. of	•		50	48.5	21.1	1988	
Singapore		•	21	58	62.9	1955	
Taipei,China	•					1950	
Upper Middle-Income							
China, People's Rep. of		•	48	20.5	1.3	1951	
Malaysia		•	37	50	48.7	1951	
Thailand	•		33	22.5	4.8	1990	
Lower Middle-Income							
India	•	•				1952	
Indonesia		•	19	15.5	0.1	1992	
Pakistan	•					1976	
Philippines	•		77	27.1	8	1957	
Sri Lanka		•				1958	
Viet Nam	•		55	13.2	3.3	1962	

DB = defined benefit, DC = defined contribution.

Sources: OECD (2008), Park (2009).

Broadening and deepening domestic financial markets remains an important long-term agenda for more efficient and resilient financial systems. Some of Asia's stock markets are now as large as—or even larger than—those of other regional emerging markets at similar income levels. However, growth is uneven across different segments of capital markets. Especially, short-term money and fixed income markets are often shallow and fragmented. Except in Japan and the Republic of Korea, local currency bond markets account for a smaller share of GDP than in the US or Europe. Although it is undeniable that growth has been phenomenal in terms of the size of local currency bond markets, this has been also driven primarily by the government bond markets. Development of the corporate bond markets has been considerably lagging behind that of government bond markets (Figure 8), suggesting much remains to be done.

Development of local currency bond markets improves resource allocation by allowing greater scope for market-determined interest rates to accommodate various risk profiles of the issuers; providing essential market indicators for credit and market risks, thus helping risk management of financial institution; and promoting risk sharing and debtor monitoring among a large number of creditors.

**Figure 8: Government and Corporate Bond Issuance (US\$ billion)**

Note: Government figures include central bank issuances. Data includes local currency bond issuance of the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.

Sources: *AsianBondsOnline*, ADB; *Asia Capital Markets Monitor 2011* (ADB 2011a); Bloomberg.

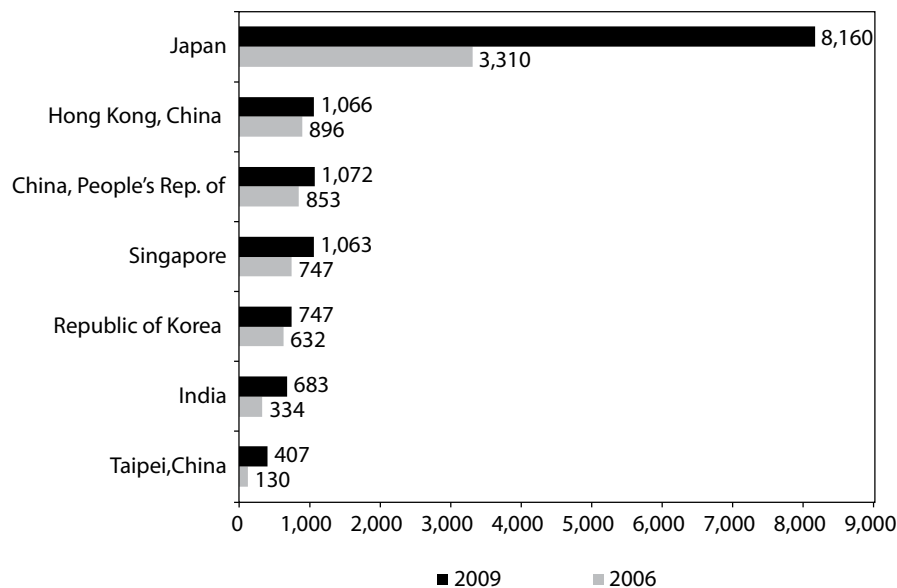
A liquid government bond market serves as an anchor to the development of domestic credit markets. By providing an essential benchmark yield curve, a government bond market facilitates the introduction of new financial products and services. More often than not in emerging markets, government securities also provide crucial market liquidity for the secondary market trading and lays a foundation for market infrastructure. The existence of primary issues on certain benchmark maturities, however, would not necessarily create benchmarks or a benchmark yield curve, while the quoted price remains only indicative.

Without active secondary trading, the price discovery process is largely stalled, unable to provide reliable prices. Especially in many emerging markets, liquidity is often concentrated on some of the benchmark issues, failing to create a continuous benchmark yield curve. In order to enhance market liquidity in the secondary market and induce firm prices for benchmark issues, authorities should establish a conducive environment for market making, such as providing hedging tools for primary dealers. To enhance liquidity in the secondary market, market infrastructure, including the trading, depository, clearing and settlement systems, need to be strengthened. Rationalizing tax impediments is also important, while streamlining regulation and accounting practices to ensure equal tax treatment among different savings vehicles.

Development of the asset management industry can help foster the retail investor segment of the market, enhancing demand and market liquidity (Figure 9). Mutual funds

and various investment funds can effectively channel retail demand to the short- and medium-term segment of the market. Well-developed pension and insurance sectors will also have the desirable demand impact on the long-term segment of local currency bond markets in the future as the maturity of instruments gradually extends. Some middle-income countries including India, Indonesia, Malaysia, the Philippines, and Thailand have promoted investment funds for the growth of the pension and insurance sector, but the size of assets managed by the region's institutional investors remains much lower than that of Europe and the US.

**Figure 9: Assets under Management, 2006 and 2009 (US\$ billion)**



Sources: 2006 figures are from Matrix Services Limited. 2009 figures are from CEIC Database; Census and Statistics Department (Hong Kong, China); *Central Provident Fund Annual Report 2010* (Central Provident Fund Board 2010); China Country Finance Report (Economist Intelligence Unit 2010a); India Country Finance Report (Economist Intelligence Unit 2010b); Singapore Country Finance Report (Economist Intelligence Unit 2010c); *Investment Company Fact Book 2011* (Investment Company Institute 2011); Monetary Authority of Singapore; OECD Institutional Investors Statistics; *China Financial Stability Report 2010* (The People's Bank of China 2010); and *World Insurance 2010* (Swiss Reinsurance Company Limited 2011).

Development of other related investment instruments, including repurchase agreements (repos), forwards, interest rate swaps, futures, and other derivatives should enhance risk management, contributing to financial stability. The development of a private repo market is crucial for improving market liquidity and thus facilitating price discovery. A well-established repo market also provides a link between collateral and money markets, thus strengthening the market infrastructure. Establishment of a futures market may present a great opportunity for enhancing market liquidity and transparency at an early stage of bond market development. By concentrating liquidity on certain generic products such as government bond futures, the reliable and centralized price information facilitates trading activities in the secondary market.



## V. Policy Implications

The experience of the global financial crisis underscores a new as well as unfinished reform agenda as the environment where financial institutions do business and markets function continue to transform with innovation and globalization. Following the crisis and the G20 responses to it, significant reforms have taken place to build a stronger, more globally consistent, supervisory and regulatory framework for the financial sector.<sup>7</sup> Despite the critical nature of these reforms for the future financial landscape worldwide, however, their focus has been rather exclusively on strengthening global regulatory guidelines such as the Basel III standards, filling the regulatory gaps, and broadening a swathe of the coverage.

There is an urgent need to establish effective and collaborative implementation mechanisms at the national levels, reinforcing global efforts at revamping the financial architecture to avoid a repeat of the crisis. However, such reform efforts should not overlook enormous development challenges faced by the region's low- and middle-income countries and the different conditions that they face in terms of financial sector and market development, regulatory capacity, availability and flow of information, and financial openness.

Across the region, there are two important reform priorities: first, there is an overriding interest of economic growth and development in the context of financial stability; and second, there is the drive to create inclusive growth to support social stability and equity. Therefore, when considering issues related to financial sector development and regulatory reform, these twin objectives must be central. For Asia's emerging and developed economies, special attention needs to be paid to the balance between growth and stability; and between financial innovation and regulation. In this respect, appropriate sequencing of reforms is important to support financial development and economic growth. Finally, issues that are pertinent for the region's financial sector development and regulatory reform may be summarized as follows.

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<sup>7</sup> In the wake of the unprecedented global financial crisis, the G20 Leaders gathered at the Washington Summit in November 2008. Under the premise of the G20's guiding principles, the Financial Stability Board and its constituents sculpted specific reform proposals to strengthen financial stability. The Basel III package of capital and liquidity reforms—the first concrete outcome of such reforms—was endorsed by the G20 Leaders at the November 2010 Seoul summit to be implemented from January 2013 and fully phased in by 1 January 2019. Further reform is ongoing in the areas of strengthening macroprudential policy frameworks; studying regulation and supervision of commodities and futures markets; improving market integrity and efficiency; enhancing consumer protection; strengthening regulation and supervision of shadow banking; and assessing regulatory reform issues, which are especially relevant to emerging markets and developing economies.

- (i) **Supporting economic growth and development:** Developing Asia's underdeveloped financial systems remain an important constraint on funding necessary development and ensuring sustained high growth. There is a clear need to focus efforts on financial sector development to support growth, in the context of establishing necessary foundations of finance and financial infrastructure, such as effective payment systems, clear and transparent property rights, information infrastructure, corporate governance structure, and strong legal and regulatory framework, including insolvency and dispute resolution systems. In the context of financial sector development, particular attention needs to be paid to the region's financial needs for infrastructure and for SMEs, and promoting financial inclusion of low-income households. In the context of banking, it is important to extend the banking service to a broader portion of the population, especially SMEs, including through continued development of microfinance markets. In the context of securities markets, infrastructure, transparency, and corporate governance are central to development (as well as stability), not only in equity markets but also in debt markets.
  
- (ii) **Promoting financial inclusion:** Financial inclusion empowers people, particularly the poor, women, and marginalized sectors of society to participate in business and economic activity. At the Pittsburgh Summit in 2009, the G20 leaders committed to improving access to financial services for the poor (Group of Twenty 2009b). It is agreed that the G20 supports the safe and sound spread of new modes of financial service delivery capable of reaching the poor and, building on the example of microfinance, will scale up the successful models of SME financing. Further efforts need to be made to increase public access to banking; promote financial literacy and consumer protection; provide adequate credit to promote entrepreneurship; diversify savings instruments; and develop appropriate products and markets for better risk management. It would be helpful to encourage a more innovative approach to doing them. Necessary legislative/regulatory reform can also ensure that financial institutions and markets provide affordable credits, savings accounts, and basic insurance to the financially excluded sectors.
  
- (iii) **Balancing regulation and innovation:** The key challenge for regulators in emerging and developing economies is how to encourage and manage financial market development without stifling innovation. Regulators should be wary of complex innovations that make the underlying risks of products or services more difficult to assess or trace—whether by bank management, regulators, or investors. However, an important distinction should be made between the basic elements for financial market development and risky financial innovation. For many developing

economies, simple innovation—creating and utilizing new financial instruments, technologies, and services such as securitization and derivatives—could be very useful to broaden access to finance and promote financial efficiency and resiliency.

**(iv) Strengthening crisis prevention and management mechanisms:**

The global financial crisis highlighted the need for an effective national, regional, and global framework to ensure financial stability. At the national level, it would imply that a comprehensive framework and contingency plan for financial institution failure is needed, including consumer protection measures such as deposit insurance. At the regional level, establishing regional and subregional fora would be of added value to support regional economic and financial cooperation, policy coordination, and crisis assistance, while complementing and augmenting the role of G20 and the Financial Stability Board. Asia also needs to actively participate in the reform of the international financial architecture and establishment of global financial safety nets to enhance crisis prevention and management.

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### **About the Paper**

A well-functioning financial system has an important role to play in promoting economic growth and reducing poverty. Cyn-Young Park explores the key development agenda of Asian financial systems that aims to promote economic growth and development through well-functioning financial markets and, in the process, bolster inclusive growth to support social stability and equity in the region. Pertinent issues in the region's financial sector development include: (i) supporting economic growth and development, (ii) promoting financial inclusion, (iii) balancing regulation and innovation, and (iv) strengthening crisis prevention and management mechanisms.

### **About the Asian Development Bank**

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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