OECD/ADBI 7th Round Table on Capital Market Reform in Asia

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SESSION 1: FINANCIAL POLICY LANDSCAPE

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Capital Market Development in Asia and Future Challenges

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Outline

- Structure of Asian Financial System
- Can Asia play a role in global capital markets on par with US and Europe?
- New Financial Structures and Investor Demands
- Recent Regulatory Trends
- Key Policy Challenges

Key Issues

- Globalization and demography is forcing pace of change
- Rise of China and India + recovery of Japan & ASEAN will mean Asia can play major role as net saver, but its capital markets are still weak relative to US and EU
- To avoid past Asian crisis, Asia financial market integration is inevitable
  - This requires further opening up and meeting efficiency and global standards of financial stability
- Reform of regulation and financial structure requires careful analysis of risks, rewards and resources, properly managed and sequenced.

Asia 55% of global population, one-third PPP GDP, 25% trade weight, but < 15% in capital markets

(% of world, 2001)

	PPP-GDP	Exports	Population	MSCI Weighting
Japan	***7.3***	***6.0***	***2.1***	***9.38***
4 Tigers	***3.3***	***9.4***	***1.3***	***1.82***
China	***12.1***	***4.0***	***21.0***	***0.26***
India	***4.7***	***0.9***	***16.7***	***0.12***
Other Asia*	***5.4***	***4.5***	***14.5***	***1.57***
Total ASIA*	**32.8**	**24.8**	**55.6**	**13.15**
US	**21.4**	**13.6**	**4.6**	**55.30**
EU	**19.9**	**37.7**	**6.2**	**17.14**
Others	**25.9**	**23.9**	**33.6**	**14.41**
TOTAL	**100.0**	**100.0**	**100.0**	**100.00**

***Excluding Australia and New Zealand**

Source: IMF, *World Economic Outlook*, April 2002

Historical Overview

- Post-war growth model was imbalanced, based on control of savings to fund exports and industrialization
- Banks were trade oriented, but evolved towards housing and infrastructure finance institutions
- Bond markets did not develop deeply because fiscal surpluses and low yields did not attract savings
- Retirement funds were mainly state-sponsored and devoted to mainly fiscal funding
- Insurance sector dominated by state and foreign firms
- Securities markets were dominated either by families or state-owned enterprises, and were more speculative than strong role in fund-raising and corporate governance

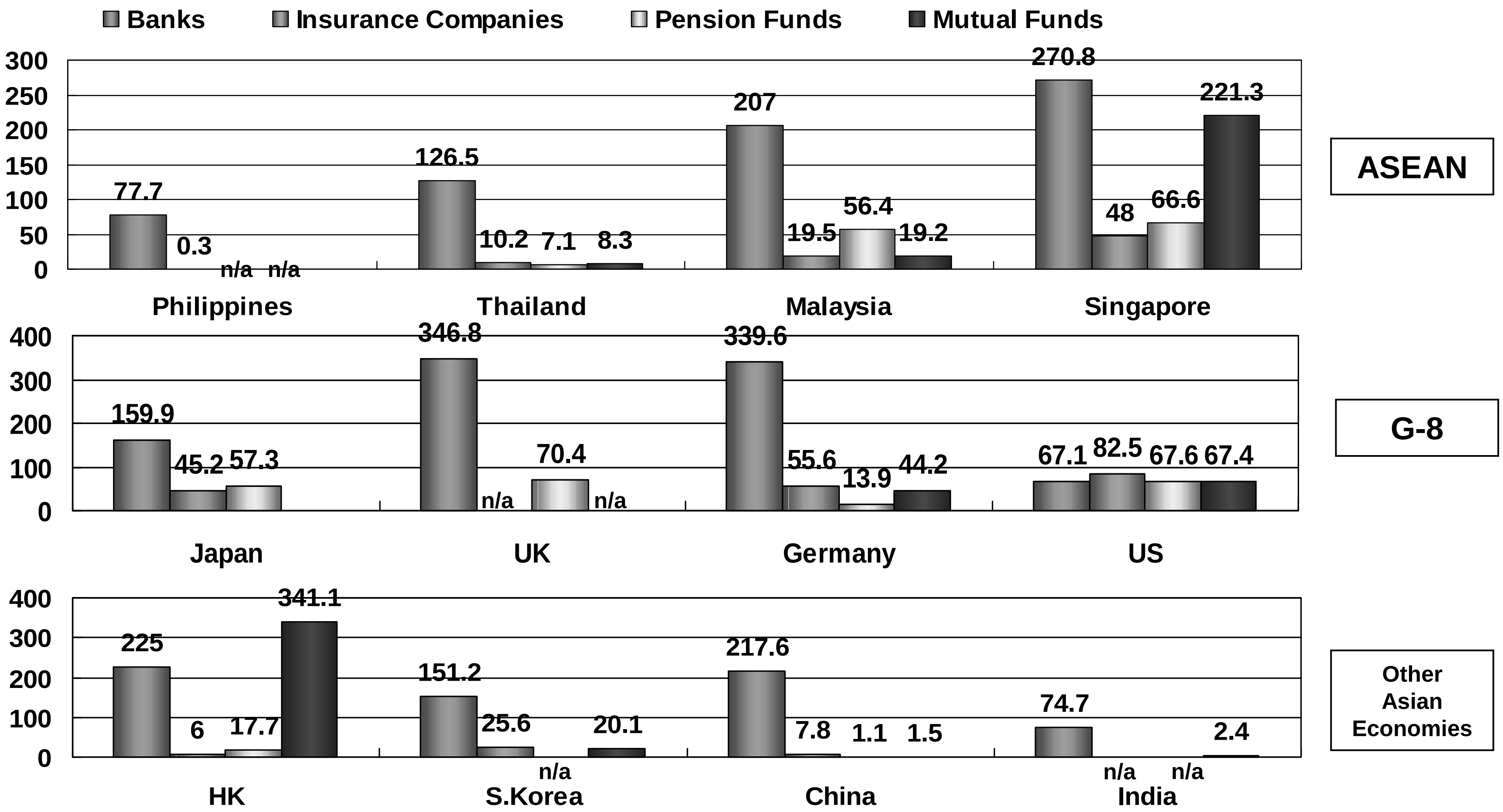
Asia Still Dependent on Bank Financing
(% of GDP, 2002)

	Bank Loans	Equity Market	Bond Mkt
Singapore	109	117	63
Malaysia	107	130	88
Thailand	81	36	42
Philippines	32	23	28
Indonesia	22	17	1
China	136	37	37
Hong Kong	150	287	42
India	36	42*	33
Japan	107	51	169
UK	154	182	68
US	78	114	156

* Figures as of 2003

Sources: Table 2.7, Table 3.1, GFSR April 2004, World Bank, IMF, WFE, CEIC, Bloomberg, BIS, various central banks and government websites

Assets of Banks vs. Insurance companies, Mutual and Pension Funds (% of GDP)



Asian Capital Markets – Where are We Now?

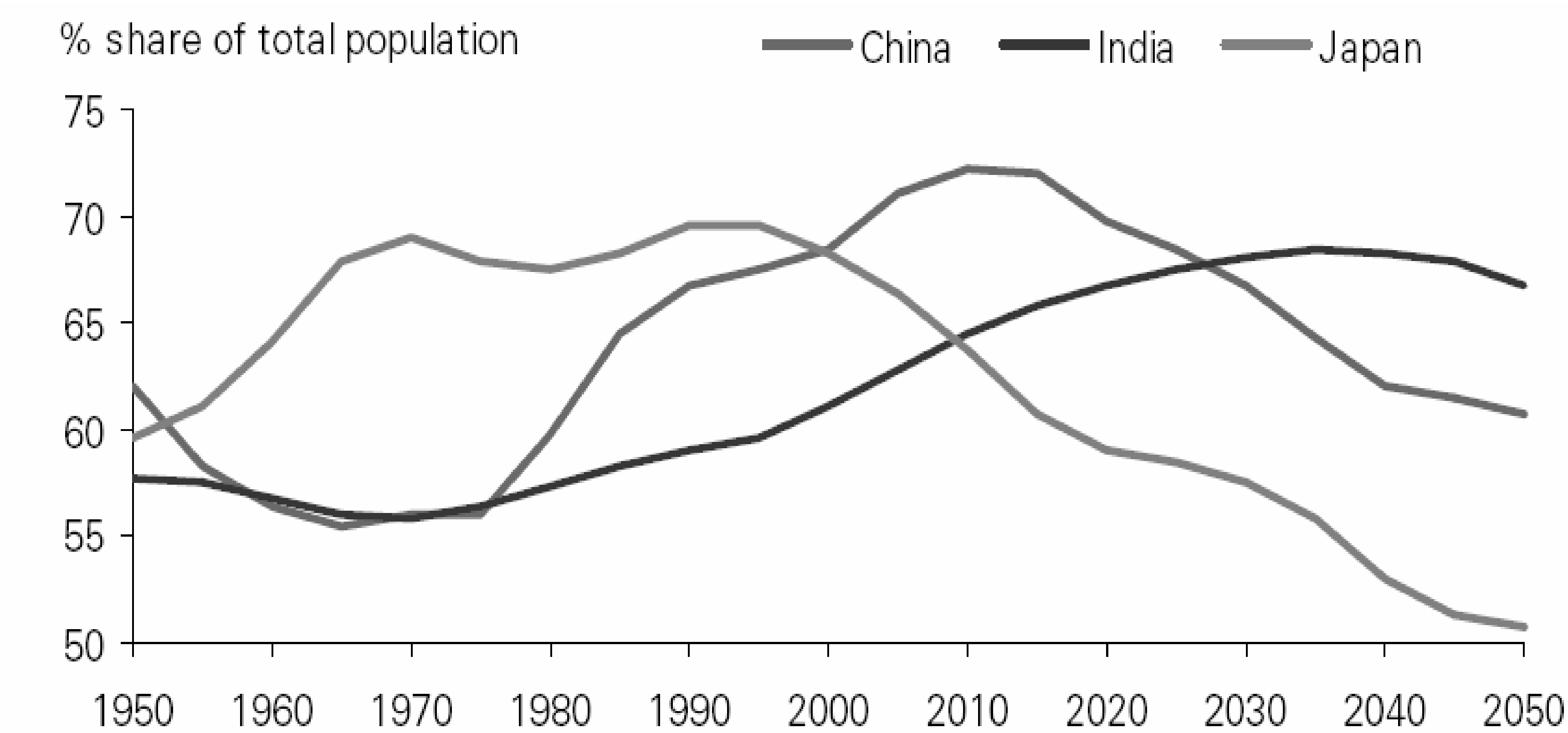
- **Finance system helps to delineate, transfer and protect property rights over the whole demographic cycle**
- **Historical total equity return swap with London and New York – Asia runs current account surplus with West, places US$2 trillion official reserves (of which US$1 trillion in US Treasuries at 4% pa), and flows return in FDI and FPI, leveraged to earn 10-15% pa.**
- **Asian capital markets remain bank-dominated, with limited growth in institutionalization of funds and capital market skills**

Reasons why West overtook Asia during the Industrial Revolution

- **Four fundamental reasons:**
  - **Demographics**
  - **Governance**
  - **Institutions**
  - **Property Rights Infrastructure**
- **Contemporary Anglo-Saxon economic analysis treats these factors as given assumptions**

- **These are valid issues facing Asia today**

Asian Demographics: Growth co-related with rise in Working Age Group



Source: UN Population Statistics

Demographics and Asian Capital Markets

- **Asian Miracle was Demographic Endowment of young work force entering into free trade age**
- **North Asia is aging with slowing growth, requiring real returns for retirees**
  - **But Asian retirement funds are either PAYG and tax burden on future generation**
  - **Given highly priced bonds and equity, tendency to use US and EU markets as long-term savings than regional markets**
- **Rest of Asia still young, and can build strong institutional retirement funds**
  - **Must develop independent and professional funds**
  - **Institutional savings will improve liquidity of bond and equity markets and play role in risk management and corporate governance**

Re-thinking Cost/Benefits of "Finance for Development"

- **The Asian financial crisis and losses are the inevitable costs of "imbalanced growth strategy"**
  - **Extracting resources from savers to subsidize growth and infrastructure may be appropriate for "catching-up" growth phase of emerging markets**
  - **But globalisation has exposed the protected and inefficient sectors and marked them to the global competitive market**
  - **NPLs and quasi-fiscal deficits are symptoms of sunken costs of the marking to global markets**
- **The roots of NPL and financial crisis lie in:**
  - **Failure to restructure financial system during high growth period – use resources from growth to write off inherent losses, i.e. re-write national balance sheet to more balanced growth strategy**
  - **Sudden slowdown of real growth due to rising wages, aging population, and inflated financial wealth**

Institutions of Capital Market

- Accurate, timely and accessible information
- Properly aligned incentives
- Educated investor
- Efficient intermediaries
- Strong issuer
- Efficient and robust infrastructure
- Strong prudential framework with enforcement

- **The issue is really about designing and implementing a system that protects property rights over the whole demographic cycle.**

Four Functions of Capital Market

1. **Resource Allocation**
   - Allocate resources efficiently to maximize welfare
2. **Price Discovery**
   - Generate transparent price signals consistent with efficient use of resources
3. **Risk Management**
   - Encourage good risk management that diversifies losses and profits
4. **Corporate Governance**
   - Promote sound corporate governance that provides proper incentives.

Financial system is a system to transact and protect property rights of all participants over the whole demographic cycle!!!

Asian Capital Markets Remain Problematic

Price discovery – high liquidity and low risk spreads not reflecting underlying risks

Resource allocation – why is Asia still bank dominated?

Risk management – has risk management really improved? Why do we still have substantial NPLs?

Corporate governance – are the banks and capital markets sufficient checks and balances on borrowers and corporate sector?

Efficient Markets require:

- **Free Entry of Participants and Products**
- **High degree of transparency/low information asymmetry**
- **Efficient Operations by *solvent* participants under international rules of the game *at low transaction costs***
- **Absence of incentive distortions or bias that moves markets in unhealthy direction e.g. moral hazard or subsidies**
- **Efficient regulation at low regulatory costs;**
- **Orderly exit of *insolvent* participants [obsolete products and insolvent operators create huge dead costs on market]**
- **⇨ Accountability [feedback and exit for bad players]**

Recent Key Market Trends in Asia

Deposit-taking Institutions – demographics changing customer pattern – growth of consumer banking, credit cards, demand for structured products

Risk-pooling Institutions - still foreign dominated, but demand growing

Contractual Savings Institutions - huge liquidity pools, but shortage of professional fund management skills

Market Makers - key investment banking skills still dominated by large foreign players, with foreign fund managers as key clients

Specialized Sectoral Financiers - policy-based banks shrinking in market size; venture capital and private equity becoming more important

Financial Service Providers – exchanges demutualizing

Key Capital Market Trends

Demographics – around 300 million Asians earn US$5,000 or more annually; by 2020, discretionary spenders will grow to 1.4 billion. Huge demand for asset management and consumer banking needs

Wealth management - private banking spreading from those with US$1 million or more to middle income professionals

Mutual Funds - in US already US$7.5 trillion market, but becoming more leveraged – no longer just long-only funds; line between mutual funds and hedge funds blurred

Market makers - Asian investment banks still small by any standard

Outsourcing - over 100,000 jobs moved to India from US, worth US$136 bn in wages – trends will continue

Hedge Funds are driving the business

8,000 hedge funds with US$1 trillion in assets under management – leveraged around 2-3 times

Trading velocity much higher than mutual funds - currently account for 40-50% of turnover in US and EU

Fees around 1-2% of AUM + 20% of profits

Larger funds around US$10-15 bn in AUM

Depend upon prime brokerage for transactions and funding - if we do not allow in prime brokers, how can emerging markets benefit from hedge fund activities?

Highly skilled business - talents drawn from fund managers and investment banks (ie difficult to home grow)

Private Equity Funds are reborn merchant banks sans regulation

- 3,000 private equity funds with unknown total assets under management – leveraged levels also unknown
  - More involved in direct equity investments rather than trading
- Fees around 1-2% of AUM + 20% of profits
  - Longer lock-ups
  - Larger funds of around US$5-10 bn in AUM
- In 1H2004, Asia raised US$5 bn, compared with US$3.3 for 2003 and US$3 bn for 2002 (compared with US$17.9 bn in 2000 and US$9 bn in 2001) – overall private equity investments in Asia estimated at US$8.6 bn
- Roughly 10% of UK pension funds invested in private equity - still early days for Asian pension funds

Hedge Fund Issues to Consider

- The impact of hedge funds on the markets in time of stress has not been tested in the major markets.
- The combination of low risk premiums (for inflation and credit risks), complacency (in good times) and untested elements of risk management systems dealing with complex financial instruments could ultimately become hazardous to financial markets (IMF Global Financial Stability Report April 2005).
- Regulators need to be mindful of the instability which hedge funds and hybrid financial products could suddenly bring to the markets in time of crisis.

Recent Regulatory Trends

Greatest change in global standards and regulation since 1930s -

- Convergence in IAS and US GAAP
- Oversight of auditors, analysts, CRAs

Massive changes in corporate governance standards and disclosure -

- Sarbanes-Oxley
- European Directives, Higgs etc

International rules -

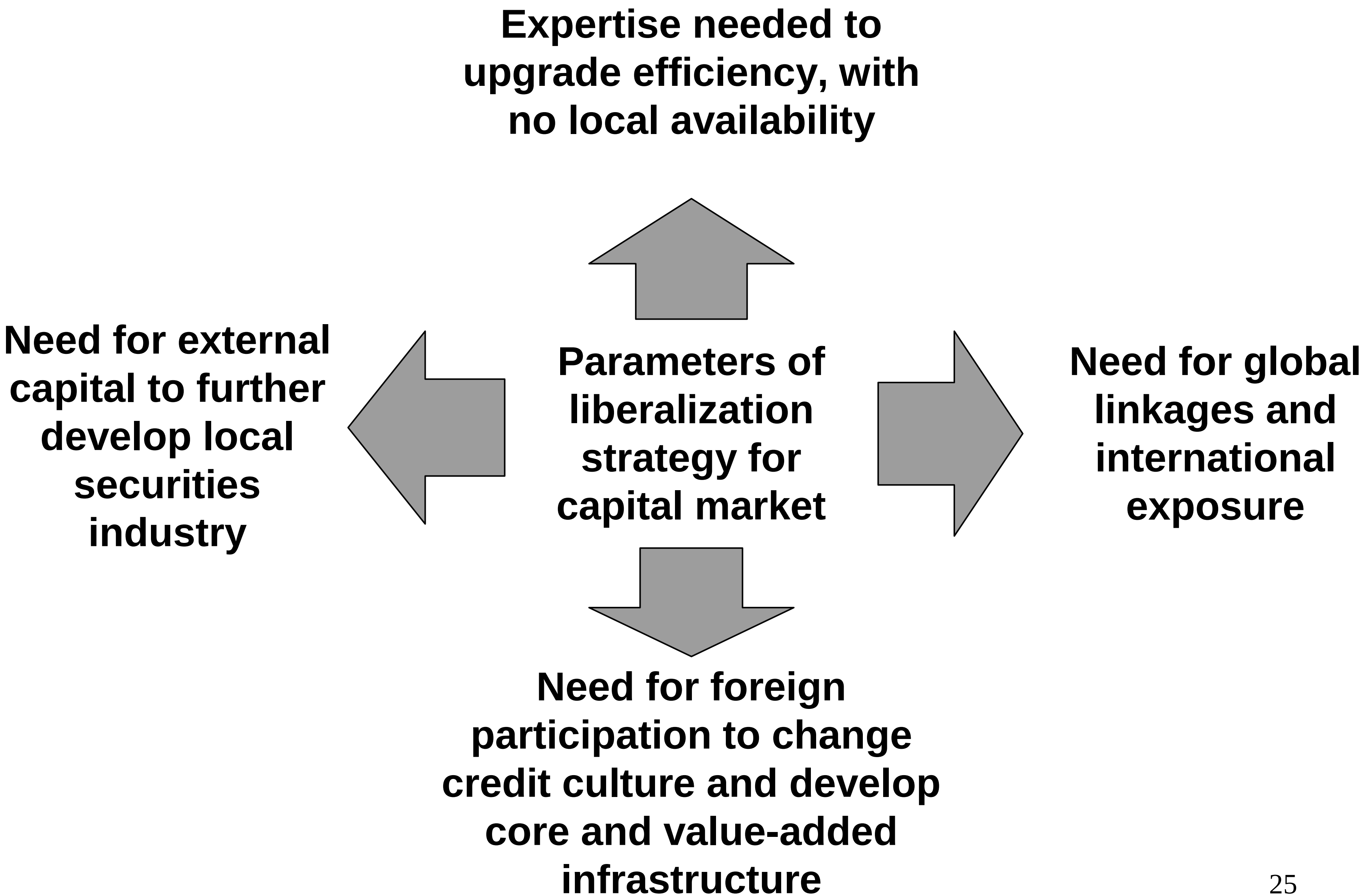
- Basle Capital II
- IOSCO standards, especially MMOU

Massive civil litigation if financial firms do not get it right

Nobel Laureate Joe Stiglitz: Roaring Nineties Allen Lane, 2003

- “The central lesson that emerges from this story of the boom and bust – that there needs to be a balance between the role of government and of markets – is one which evidently the world has to learn over and over again.”
- “When countries got that balance wrong, veering either towards too much or too little government, disaster happened.”
- “Today, the challenge is to get the balance right, between the state and the market, between collective action at the local, national, and global levels, and between government and non-governmental action.”

How to Open Up



Source: Singh, Emam, and Tang. 2001. “Foreign participation in emerging securities industries”

SWOT Analysis

Strengths: High growth and savings, key global time zone	**Opportunities: Third global time zone capital market - Asian currency zone**
Weaknesses: Fragmented markets, NPLs, lack of local skills, protectionist tendencies	**Threats: Continued local crises and destruction of retirement savings**

Reform is a Process - Need Process to Manage Successful Reform

- **Most reformers go where angels fear to tread - too much vested interests stall or even reverse reforms**
- **Pick Important Problems, Fix Them and Tell Everyone**
- **Strategic Calculation of Reform is to estimate 3 R’s:**
  - **Risks - what are the risks of failure or stalemate?**
  - **Rewards - do benefits clearly outweigh risks?**
  - **Resources - reform skills and political capital are scarce. Don’t throw them at low benefit reforms!**
- **Differentiate between TECHNICAL solutions versus POLITICAL solutions**
  - **Technical solutions are not necessarily the best political route**
  - **Consult widely, get feedback and move where and when opportunities arise**
- **Prioritize and Sequence Reforms - you may be able to achieve only 3 major breakthroughs in one term.**

Example: Super-regulators

- For most emerging markets, super-regulator debate is a diversion of energy and convenient excuse to delay work
- Requiring super-regulator would create huge bureaucratic infighting and divert key supervisory attention in most emerging markets
- Getting cooperation between existing regulators and forcing enforcement of existing laws and rules are probably more effective than massive revamp of regulations
- No one size fits all solution - look carefully into local conditions and:-
  - Diagnose - what is really hindering markets
  - Damage Control - get some quick fixes
  - Allocate the losses - do the political calculation
  - Change the incentives - often strict enforcement and empowerment of regulators would do the work

Fix the Important not just the Urgent

Not Urgent and Important: Get separate task force to think through	**Urgent and Important: Fix and top priority!**
Not Urgent and Not Important: may be fashion of the moment, ignore	**Urgent but not important: Where we spend most of our time**

Challenges for the Future

- **Asian capital markets are integrating, as Asian savings seek regional placement, but it will integrate according to global standards.**
- **In Asian time zone, stock markets have to change from "national" markets selling only national products to Pan-Asian product distributors**
- **Globalization has benchmarked all domestic financial systems. You need to compete according to global performance, otherwise you become marginalized.**
- **Getting foreign skills involved in building domestic strength is inevitable. Closed systems cannot compete against open systems.**
- **Corporate competitiveness cannot be built without strong financial services sector**
- **The future of capital markets is up to us to build!**

Thank You!