



# Capital Market Development in Emerging East Asia: Issues and Challenges

**Srinivasa Madhur**

Director, Office of Regional Economic Integration (OREI)  
Asian Development Bank

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\* The views expressed here are those of the author and do not necessarily reflect the views of the Asian Development Bank (ADB) or ADB's Board of Governors or the countries they represent.

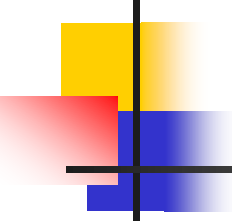




# Outline

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- Lessons from the 1997-98 crisis
- Banking systems and capital market developments since the crisis
- Securitization in the Region and Lessons from the current global financial market turmoil.
- Policy challenges



# Key financial sector imbalances precipitated the 1997-98 Asian Financial Crisis

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- Financial sector development lagged behind the miraculous performance of the real economy
- Financial sectors dominated by banks and capital markets less developed
- Within the capital market, bond markets were far less developed than equity markets

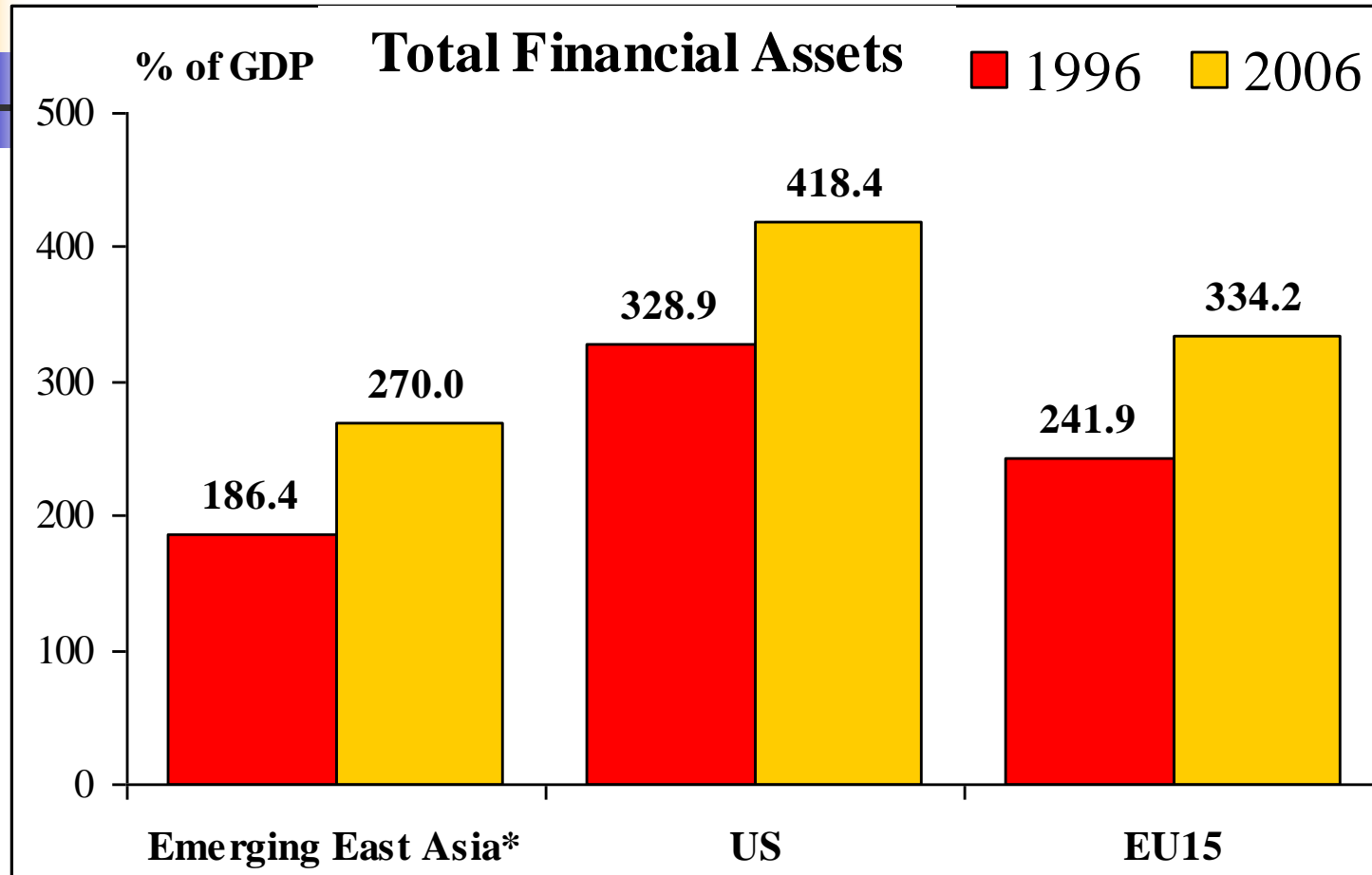


# Some of these imbalances have been corrected to varying degrees since the crisis

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- Financial and corporate sectors restructured to reduce their vulnerability to financial crisis
- Banking systems consolidated, reformed and restructured, and capital markets strengthened
  - Capital markets are difficult to develop in small economies, hence a regional approach (such as ABMI, and an ASEAN Exchange Alliance being proposed)
- Significant efforts at developing local currency bond markets have been made

# Financial deepening has increased

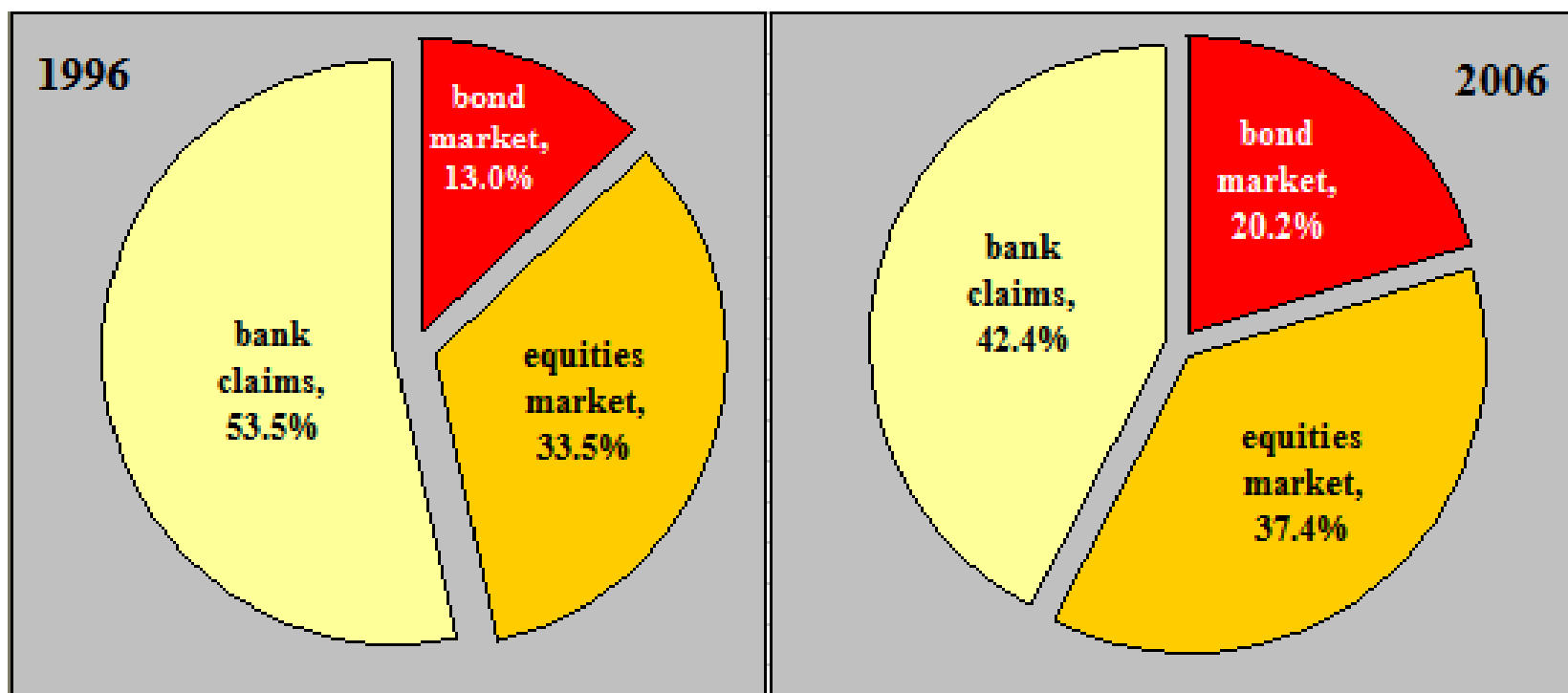


Note: Include the following: People's Republic of China; India; Republic of Korea; Hong Kong, China, Taipei, China; Singapore; Malaysia; Indonesia; Philippines; and Thailand.

Sources: Asian Bonds Online; IMF International Financial Statistics Online; Bank for International Settlements; World Federation of Exchanges and IMF World Development Indicators Online.

# Bank dependence has declined somewhat

Share of bank claims, bonds and equities in total financial assets



See footnote on the previous page.

# 10 years on, banking systems have become more resilient yet vulnerabilities linger

- **Banking systems showing resilience**
  - Nonperforming loan (NPL) ratios have declined
  - Capital adequacy ratios are robust
  - Banking sector efficiency and profitability have improved
- **Yet vulnerabilities linger**
  - More exposures of banking systems to real estate and stock markets
    - Elevated asset prices in a number of regional economies at risk of correction
  - Banks are believed to have limited exposure to US sub-primes, yet recent announcements by major banks (eg Bank of China) in the region cast some doubts



Countries have made significant progress in developing capital markets since the crisis...

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- Capital markets are deepening, broadening and become more open
- Investors and minority shareholder rights are better protected
- Corporate governance and transparency have improved
- Regulatory and supervisory frameworks have been strengthened



# Areas of Reforms in Supervisory Practices in selected countries since 1997

	Indonesia	Malaysia	Philippines	Singapore	Thailand
Risk based supervision	x	x	x	x	x
Consolidated supervision	x	x	x	x	
More effective organization, risk-focus			x	x	x
Risk focus in allocation of staff resources	x	x	x	x	x
Specialized staff and supervisory units	x	x	x	x	x
Risk-focused, targeted on-site examinations	x	x	x	x	x
Strengthened off-site micro and macro monitoring	x	x	x	x	x
Early Warning Systems (EWS)	x	x	x	x	x
Improved databases	x	x	x	x	x
New examination manuals	x		x	x	x
Major training efforts	x	x	x	x	x
Accreditation of bank examiners					x
Accreditation of banks' credit and risk managers		x			
Incremental enforcement actions		x	x		
Prompt Corrective Action (PCA) framework		x	x	n/a	
Encourage mergers and consolidation	x	x	x	x	x
Mandate all banks to be externally rated		x			
Mandate all banks to be listed			x		
Deregulate pricing and fees		x	x	n/a	x
Consumer protection and education		x	x	x	
Corporate governance	x	x	x	x	x
Require board committees	x	x	x	x	x
Encourage outsourcing		x	x		
Encourage institutional investors		x	x		
Remove expatriate restrictions		x			
Remove restrictions on salaries and mobility		x			
External auditor accreditation and rotation		x	x	x	x
Coordination with other dom. supervisors	x	x	x	n/a	x
Coordination with for. Supervisors	x	x	x	x	x

Source: Lindgren, Carl-Johan (May 2006), 'Banking Integration in the ASEAN- Region: An Overview', ADB Manila Philippines. Table based on questionnaires and central bank websites and annual reports.



# Areas of Regulatory Reforms in selected countries since 1997

	<b>Indonesia</b>	<b>Malaysia</b>	<b>Philippines</b>	<b>Singapore</b>	<b>Thailand</b>
Strengthen competition		x	X	x	
Limit new entry after crisis	X	x	x		x
Liberalize entry		x	x	x	x
Anti-commingling policy				x	
Strengthen bank governance	X	x	x	x	x
Loan classification and provisioning	X	x	x	x	x
Accrual of interest					x
Collateral valuation	X	x	x	x	x
Debt restructuring	X	x	x		x
Loan portfolio review			x		x
Related lending limit(s)	X	x	x	x	x
Loan concentration limit(s)			x	x	
Composition of capital funds			x		x
Computation of risk weighted assets		x	x		x
10% rule for financial investments	X	x			
CAR for market risk	X	x	x	x	x
Management of interest rate risk					x
Open forex position limit(s)			x		x
Auditing and disclosure standards			x		x
Accreditation and rules for external auditors			x	x	x
Improved regulatory reporting		x	x	x	
Mandate banks to be listed			x		
Mandate banks to be externally rated					
Adoption of IAS 39	x	x	x	x	x
Will adopt Basel II	x	x	x	x	x
Will adopt IAS 39				x	x
Code on Corporate Governance	x	x	x	x	x
AML/CTF frameworks and KYC rules	x	x	x	x	x

Source: Lindgren, Carl-Johan (May 2006), 'Banking Integration in the ASEAN- Region: An Overview', ADB Manila Philippines. Table based on questionnaires and central bank websites and annual reports.





## ... But the region's capital markets have several weaknesses

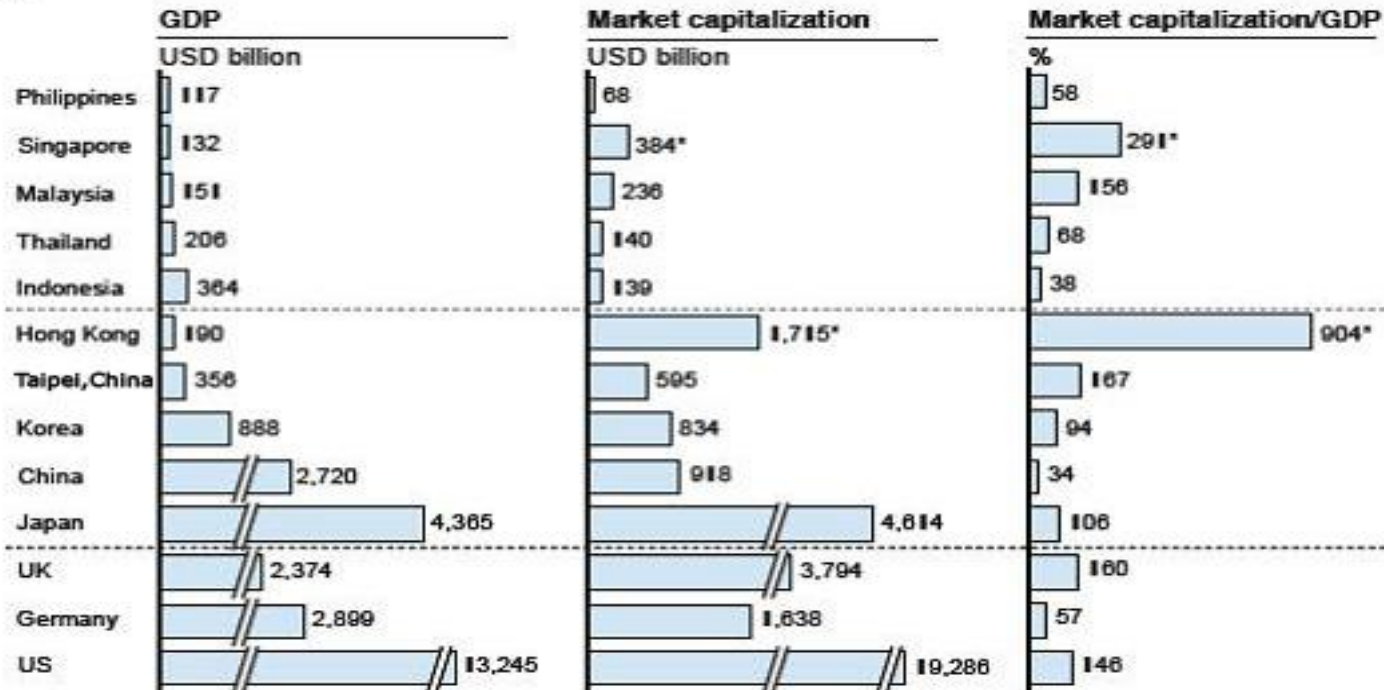
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- Markets are still small
- Relatively less liquid, in particular bond markets
- High transaction costs
- Narrow investor base – lacking institutional investors
- Weak risk management practice
- Inadequate information disclosure

# Many countries still have relatively small capital markets

- ❖ While Singapore, Hong Kong, Malaysia and Taipei,China have relatively deep capital markets, Thailand, Indonesia, and the Philippines lag behind.

2006

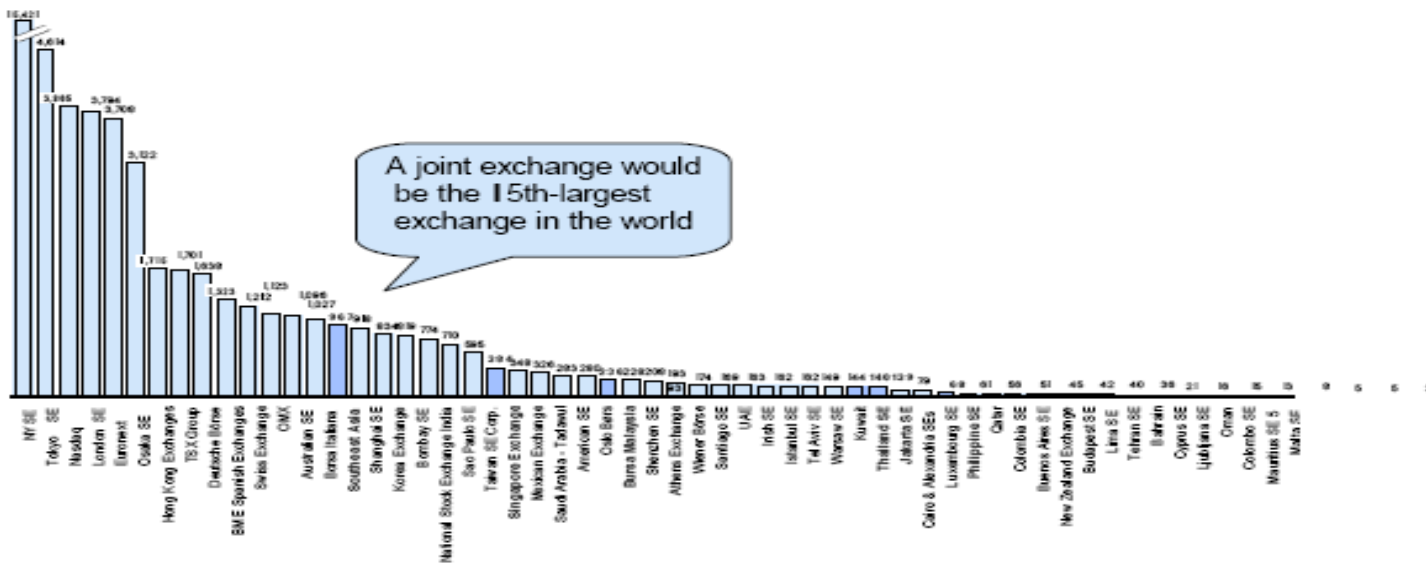


\* Source: McKinsey, IMF, World Federation of Exchanges

# Smaller markets in East Asia

- ❖ In 2006, the combination of the five main ASEAN exchanges would have been the 15th-largest exchange in the world, ahead of the Shanghai stock exchange and behind the Italian and Australian stock exchanges.

Market cap, US\$ billion; Dec, 2006

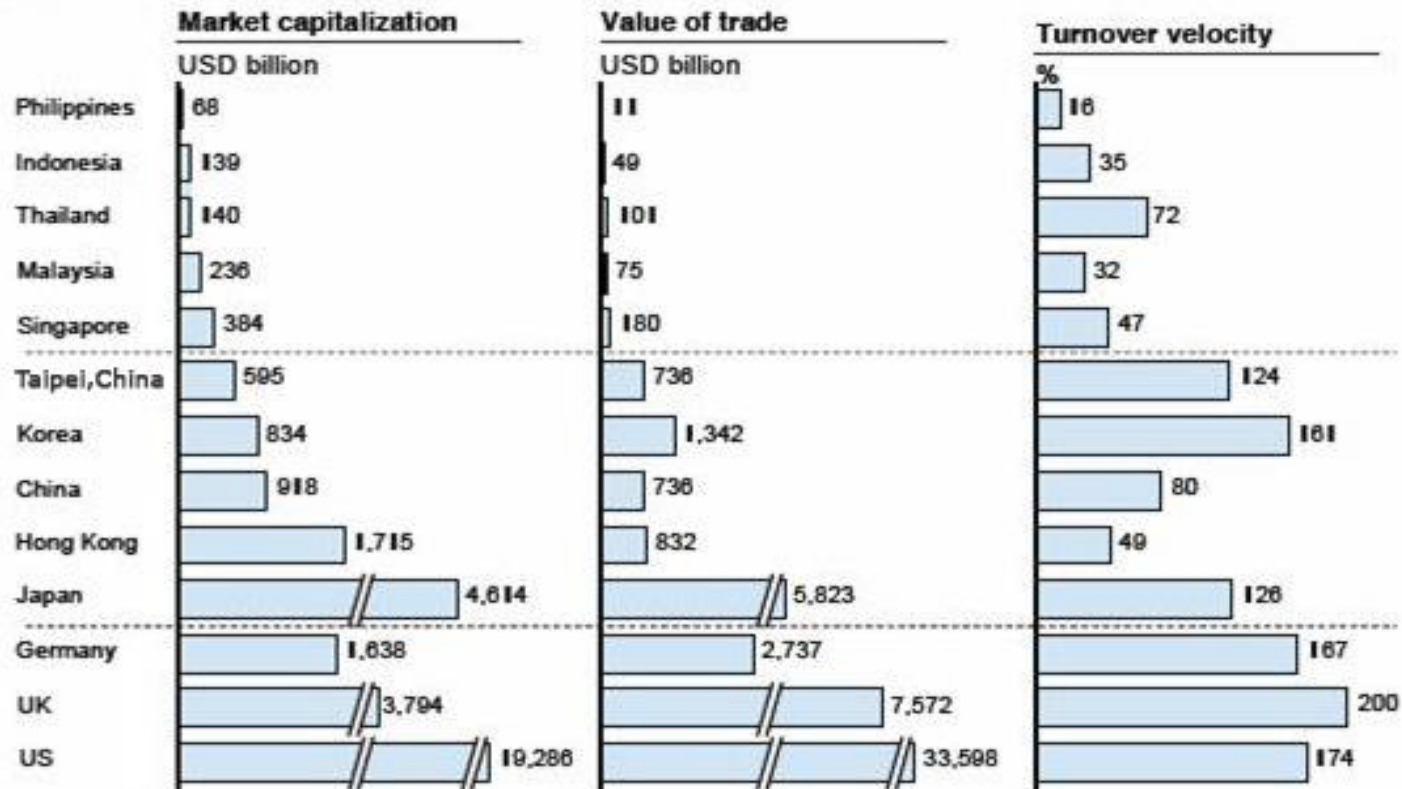


\* OMX includes Copenhagen, Helsinki, Stockholm, Tallinn, Riga and Vilnius Stock Exchanges

\* Source: McKinsey, World Federation of Exchanges, Stock Exchanges, Global Investment House

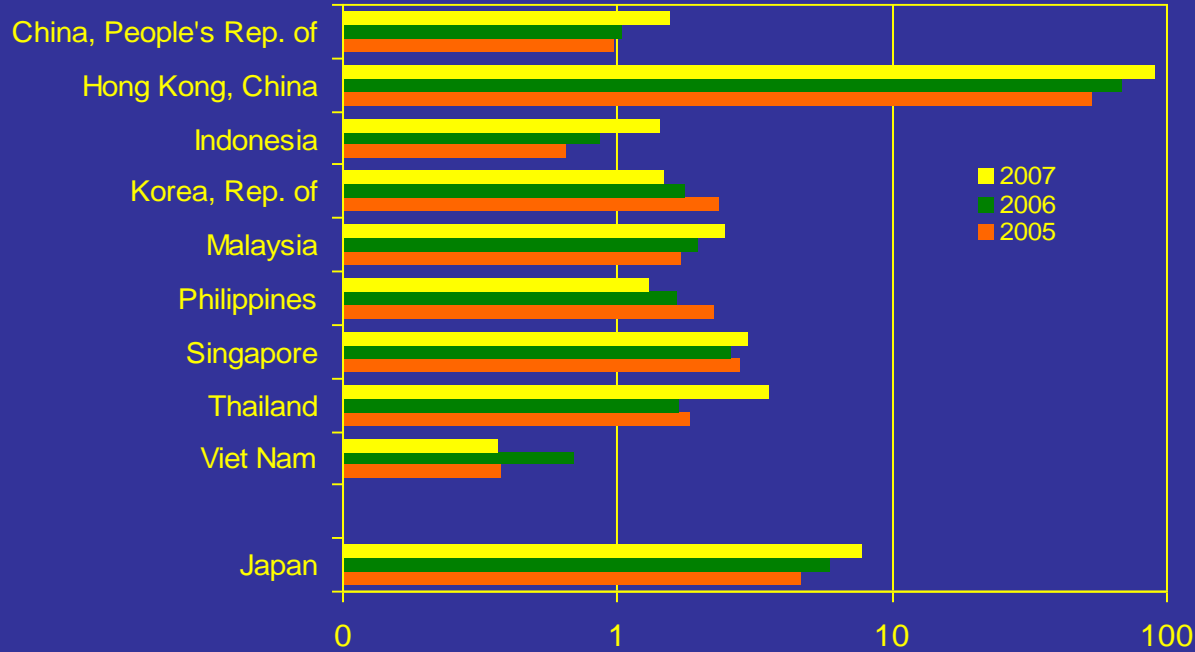
# Region's capital markets are less liquid than developed markets

2008

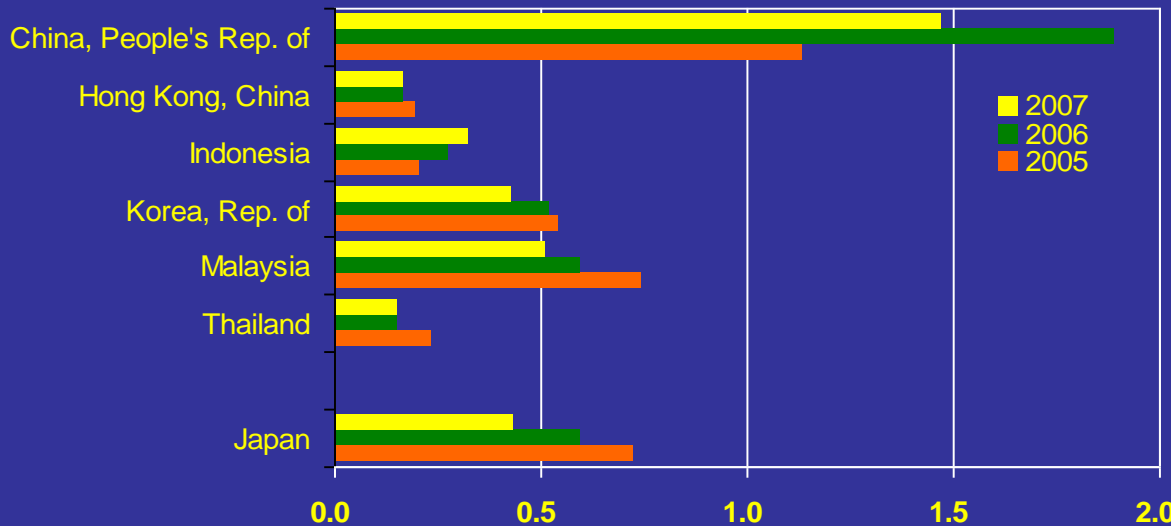


\* Source: McKinsey, World Federation of Exchanges

# Bond markets are also less liquid



**Government Bond Turnover Ratio**

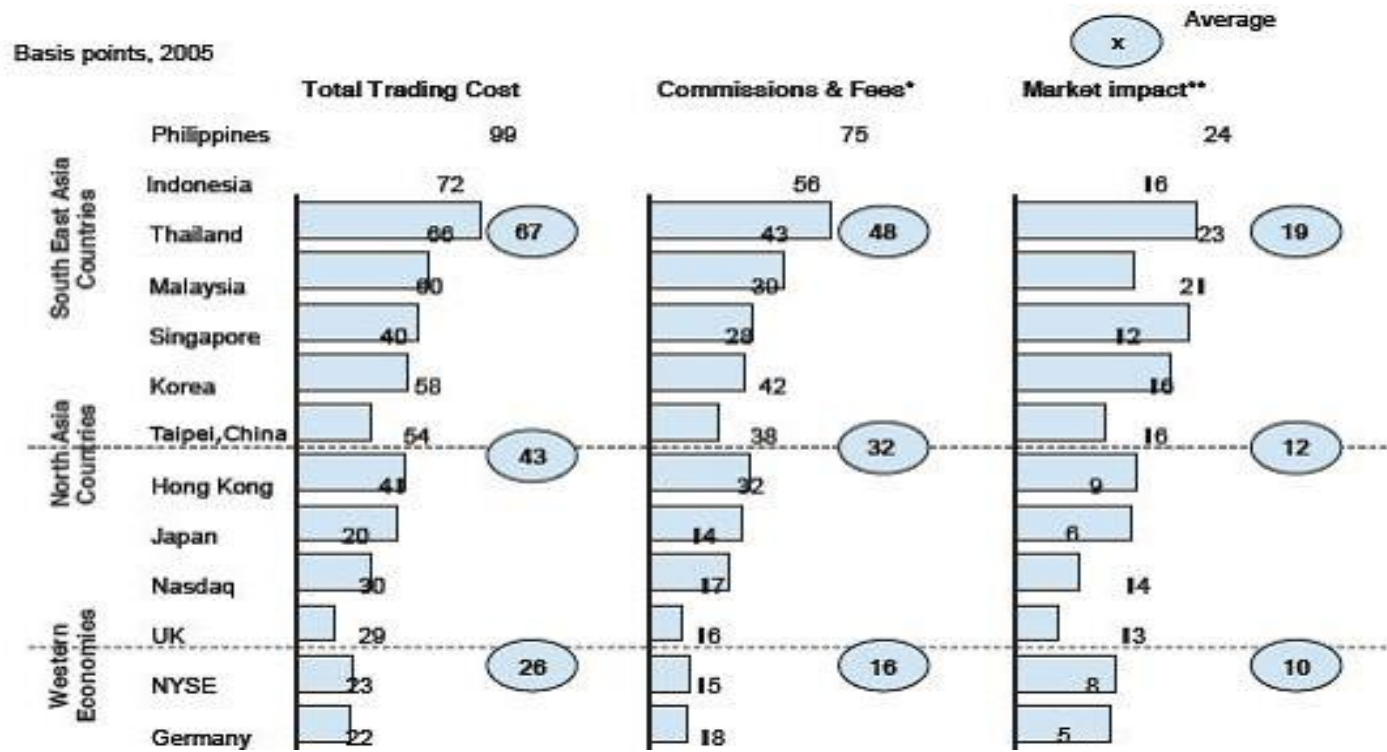


**Corporate Bond Turnover Ratio**



# High transaction Costs

- ❖ As a result of small markets with low velocity, trading costs in Southeast Asian markets are significantly higher than in many other regions.



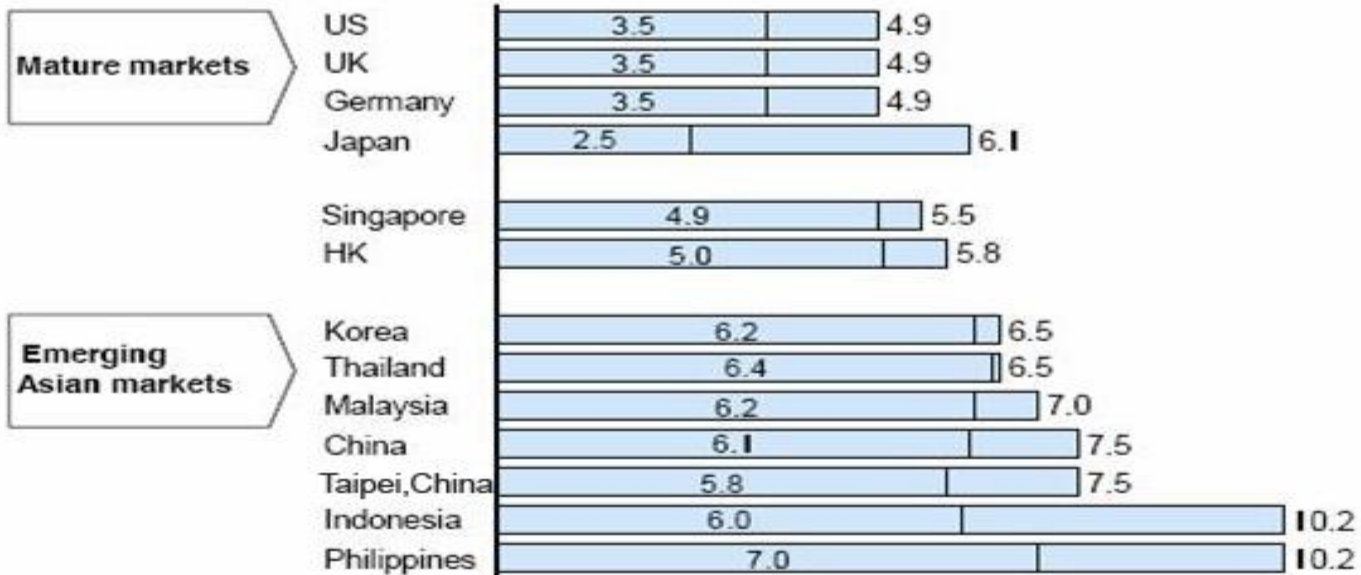
\* Source: McKinsey, Elkins McSherry Survey



# Higher equity risk premiums

- ❖ In 2006, the average equity premium was significantly higher in Southeast Asia and a little higher in PRC and Taipei,China than in Western markets.

Equity risk premium low/high from different sources; percent



\* Source: McKinsey, NYU Stern School, Goldman Sachs



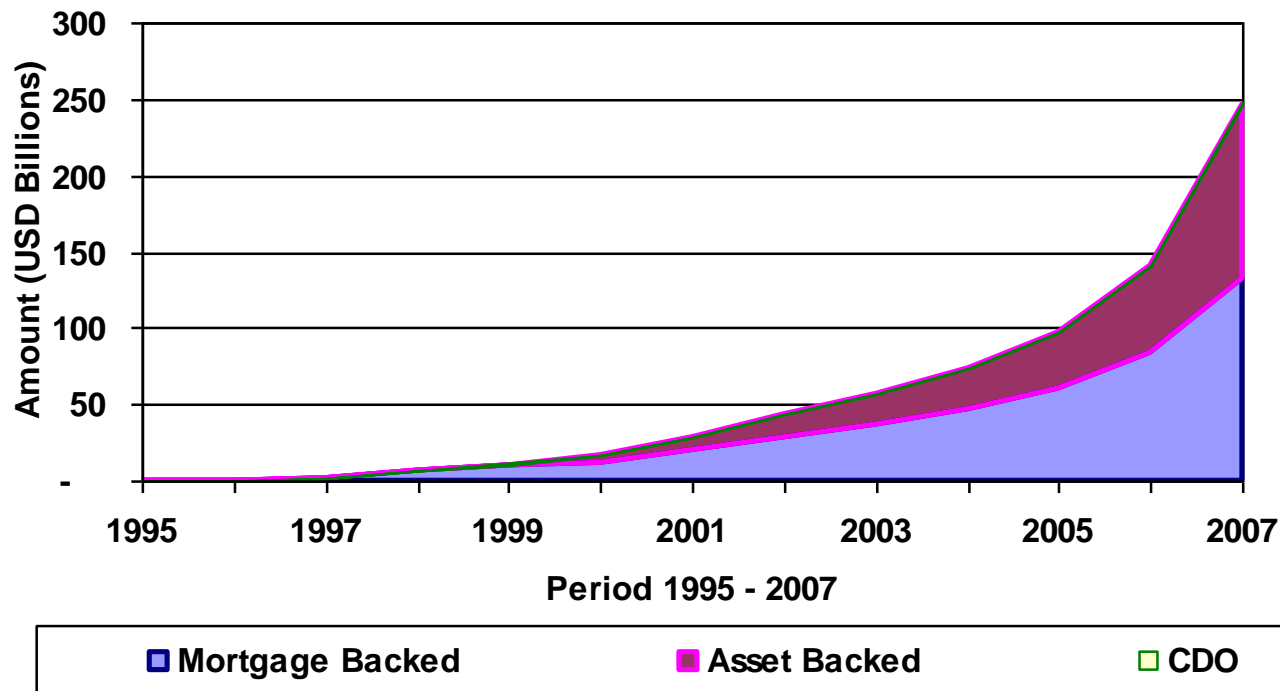
# Securitization in emerging East Asia: is it a risk?

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- Securitization has gained pace recently in East Asia as a means to:
  - address loan losses by financial intermediaries
  - fund the region's massive infrastructure needs,
  - support microfinance and HR development (eg. student loan securitization)

# Securitization markets have grown in East Asia, partly because of the enabling environment created by the governments

Securitization Assets Outstanding in East Asia



Source: AsianBondsOnline, National sources



# Assessment of Prevailing Securitization Conditions (from 0 to 5)

	Sale, assignment or other conveyance of assets to securitization vehicles			Creation and operation of SPV		Other	
	Legal framework for creating, transferring and perfecting ownership interests	Restrictions on types or terms of financial assets that may be transferred	Taxation and capital gain recognition issues by the SPV	Default, foreclosure, repossession at the level of source individual assets	Legal and regulatory impediments (e.g.: bankruptcy remoteness)	Taxation or licensing requirements	Restrictions on securitization vehicles issuing multiple tranches
Hong Kong, China	5	5	4	5	5	5	5
Indonesia	2	2	2	2	1	2	2
Korea, Rep. of	5	4	3/4	4	5	5	5
Malaysia	5	4	4	3/4	4	4	5
Philippines	2/3	2/3	1/2	2/3	2/3	1/2	2/3
Singapore	5	5	5	4	5	5	5
Thailand	3/4	3	3/4	3/4	2/3	4/5	2/3

# National Enabling Legislation and Regulation

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People's Rep. of China	Major bank sector securitization legislation under preparation 2007-08. Limited trial deals permitted by banking and securities regulators in 2006–07
Hong Kong, China	Permissive legal framework, except for conflicts with bankruptcy laws arising in certain future flow transactions
Indonesia	Pre-1997 securitization decrees 2002–03 securities regulator guidelines
Japan	Perfection Law 1998 Asset Liquidation Law 1998/2000 Trust Business Law (Amendment) 2004
Rep. of Korea	1998 Asset-backed Securities Law 1999 Mortgage-backed Securities Law 2003 Korea Housing Finance Corporation Law
Malaysia	Generally permissive common law legal framework, except for future flow transactions. Well-established legal framework for Islamic securitized issues.
Philippines	2002 Special Purpose Vehicle Act, Republic Act No. 9182, enacted 2003 2004 Securitization Act, Republic Act No. 9567 (largely untested) Implementing Rules and Regulations (2005) over credit rating requirements and the use of SPVs.
Singapore	Permissive legal framework, except for conflicts with bankruptcy laws arising in certain future flow transactions Highly supportive REIT regulatory code 2001–05, Business Trust Act 2004
Thailand	1997 securitization decree 2003 Asset-backed Securitization Act 2004 Special Purpose Vehicle Act
Viet Nam	None

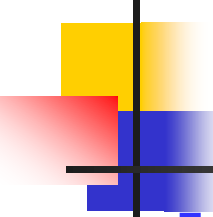
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# What have we learned from the subprime crisis

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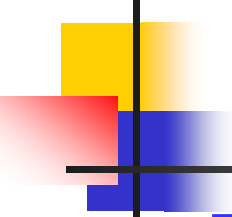
- There is no such thing as a low-risk, high-return investment
- Financial institutions' and markets' global reach has not dispersed risk more widely
- A strong economy and rising house prices can help buffer risky business—but only for so long
- Understanding underlying risk and having adequate risk management strategies and systems pays off
- As the shock wanes, investors in search for yield will seek new ways to price risk and package securities



# Policy challenges to further develop capital markets (1)

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- Improve transparency by better valuation and accounting of off-balance sheet instruments
- Strengthen risk assessment and risk management among financial institutions, regulators and credit rating agencies
  - Setting incentives right: encourage issuers, investors and rating agencies to share responsibilities
  - Create incentives for investors to do more due diligence
  - Better balance between investor due diligence and agency ratings

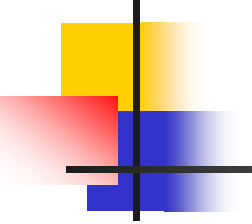


# Policy challenges to further develop capital markets (2)

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- Increase regional cooperation and coordination
  - Increase information sharing in monitoring and regulating financial institutions
  - strengthen the capacity of central banks and regulatory authorities in addressing near-term stresses and longer-term financial stability
  - strengthen the capacity to react rapidly to changes





# Policy challenges to further develop capital market (3) –Managing Risk in the Securitization Process

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- Keep the originating banks accountable
  - Retaining part of “1<sup>st</sup> loss” = Limiting moral hazard
- Basel II—improve regulatory incentives for credit risk transfer
  - Require capital to reflect actual economic risk
- Trace subsequent ownership of original assets
  - Risk management for financial stability by central banks
- Improve disclosure to investors
  - Details of underlying asset risk, plus amount of leverage



# Thank You

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**Srinivasa Madhur**

Director, Office of Regional Economic Integration (OREI)

Asian Development Bank

6 ADB Avenue, Mandaluyong City

1550 Metro Manila, Philippines

(Tel) 632-632-6239

(Fax) 632-636-2183