

REJUVENATING BANK FINANCE FOR DEVELOPMENT
IN ASIA AND THE PACIFIC

Issue Note

The Asian Banking Sector

The Asia region has predominantly bank-centered financial systems with a long history of government intervention in the operation and management of banks, allocation of credit, direct fiscal support and implicit guarantees for the special purpose banks and sectors. Although this framework has helped the regional economies' financial systems to grow, their sustainability has come to be questioned in recent years. The following basic elements need to be considered regarding rejuvenating bank finance for development:

1. The banking sector continues to be the primary form of financial intermediation in the Asian and the Pacific region, and as such is the largest conduit for the mobilization of domestic savings, the main source of external capital to firms, and the key player in the payments system.¹

2. The health of the banking sector is central to the ability of countries to mobilize their domestic finance for development. Even five years after the onset of the Asian financial crisis, the Asian banking sector has not fully recovered, struggling in providing long-term funding.

3. The operation of the banking system in many countries in the region is fragile due to a variety of factors such as low capital base, poor regulations, excessive government intervention, and ineffective supervision and, at times, inordinate risk-taking behavior involving maturity and currency mismatch in their portfolio. Fragile banking systems not only misallocate resources but also are prone to crisis, putting the savers' funds at risk,

with serious consequences for economic growth.

4. The banks' balance-sheet recovery has been constrained by lingering non-performing loan (NPL) overhang, petty performance of loan growth, and increased competition for a limited pool of good credit.

5. Growth and innovation in the region are constrained by banks whose capital has been eroded by the accumulation of non-performing loans.

6. Although the NPL ratios in some of the crisis-hit countries have fallen recently, the reductions in NPL ratios for a considerable number of banks were largely brought about by the transfer of NPLs from banks to the public asset management companies (AMCs). Significant efforts continue to be required to restructure and dispose of the past stock of NPLs and to strengthen credit culture to limit new NPLs.

7. The progress of banking sector restructuring depends on the performance of asset disposal by AMCs. The NPL ratios including net transfer to AMCs are as high as 48.6% in Indonesia, almost 19.3% in Thailand, 10.3% in Malaysia and 8.5% in the Republic of Korea, as of June 2002.

8. The capital adequacy ratios (CARs) of the crisis-hit countries have shown some improvement recently mainly due to the injection of the government's public funding, except the Philippines where there were no publicly funded recapitalization.

9. On the supply side, loans of the Asian banks have become much more conservative than before the crisis, and have shifted towards much low risk consumer banking from corporate lending which is vital for nation's development.

¹ Except for Hong Kong, China and Singapore, the equity markets in the more advanced economies of the region are no more than one quarter of the size of the banking sector and the bond markets in all of them are no more than 10 to 15 per cent of bank assets, with the exception of the Republic of Korea.

10. On the demand side, borrowers with good credit records have held themselves back from taking out bank loans, while those with less favorable credit records have been blocked by the banks.

11. Banks appear to have become risk averse to such a degree that the needs of the less creditworthy are being ignored. More innovative mechanisms, perhaps involving public guarantees, need to be examined to overcome the current impediments in lending to such categories of borrowers.

12. The Asian banking sector is still vulnerable and could deteriorate if the economy slows down and/or interest rates go up.

13. The governments need speed up their banking sector restructuring process before the situations get worse by encouraging and helping their banks to increase capital and reserve, improve disclosure and governance structure, and develop risk management.

14. Banks in the regions need to implement the Core Principles for Effective Banking Supervision developed by the Basle Committee on Banking Supervision, so as to include the prescribed capital adequacy ratio and loan loss provision.

15. The division of responsibility between various supervisory and regulatory agencies on the banking sector needs to be clarified. Further, the strengthening of accounting and auditing standards is required.

16. It is desirable to reduce the direct use of banks by the government as a source of funds and put public sector and government-specialized banks progressively on the same footing as private banks, as the government-led restructuring process is completed.

17. In order to ensure healthy competition within the banking sector, entry of non-bank financial institutions with appropriate regulation, and also including further cautious liberalization of entry of foreign banks or foreign financial firms into domestic banking

sector need to be allowed. For the medium and long term domestic bond markets in some countries require further nurturing.

18. The microfinance(MF) institutions play an important role in financial resource mobilization as well as poverty reduction strategy. Improved access to MF services such as credit and insurance can enable the poor households to develop their micro enterprises, enhance their income earning capacity, and achieve an improved quality of life.

19. The emergence of MF services has also triggered a process toward broadening and deepening of the rural financial markets, by inculcating the saving habit among those who have limited or no access to the formal banking system.

20. SMEs are considered as the driving force behind the economic development of almost all countries in the region, due to their important role in employment creation and achievement of socio-economic objectives, including poverty reduction.

21. Available evidence reveals that despite financing schemes specifically designed for the SMEs, they continue to have restricted access to formal system of finance. Factors such as the relatively high transaction cost of loan processing, the perceived risk associated with small loans, the need for high collateral and the historical orientation of banks towards larger enterprises, continue to restrict SMEs' access to formal financial institution.

22. Steps need to be initiated to expand the reach of banks to broader segments of the population including particularly the SMEs and enterprises in the rural areas i.e. the less creditworthy, such as the poor and women who have no collateral to offer.