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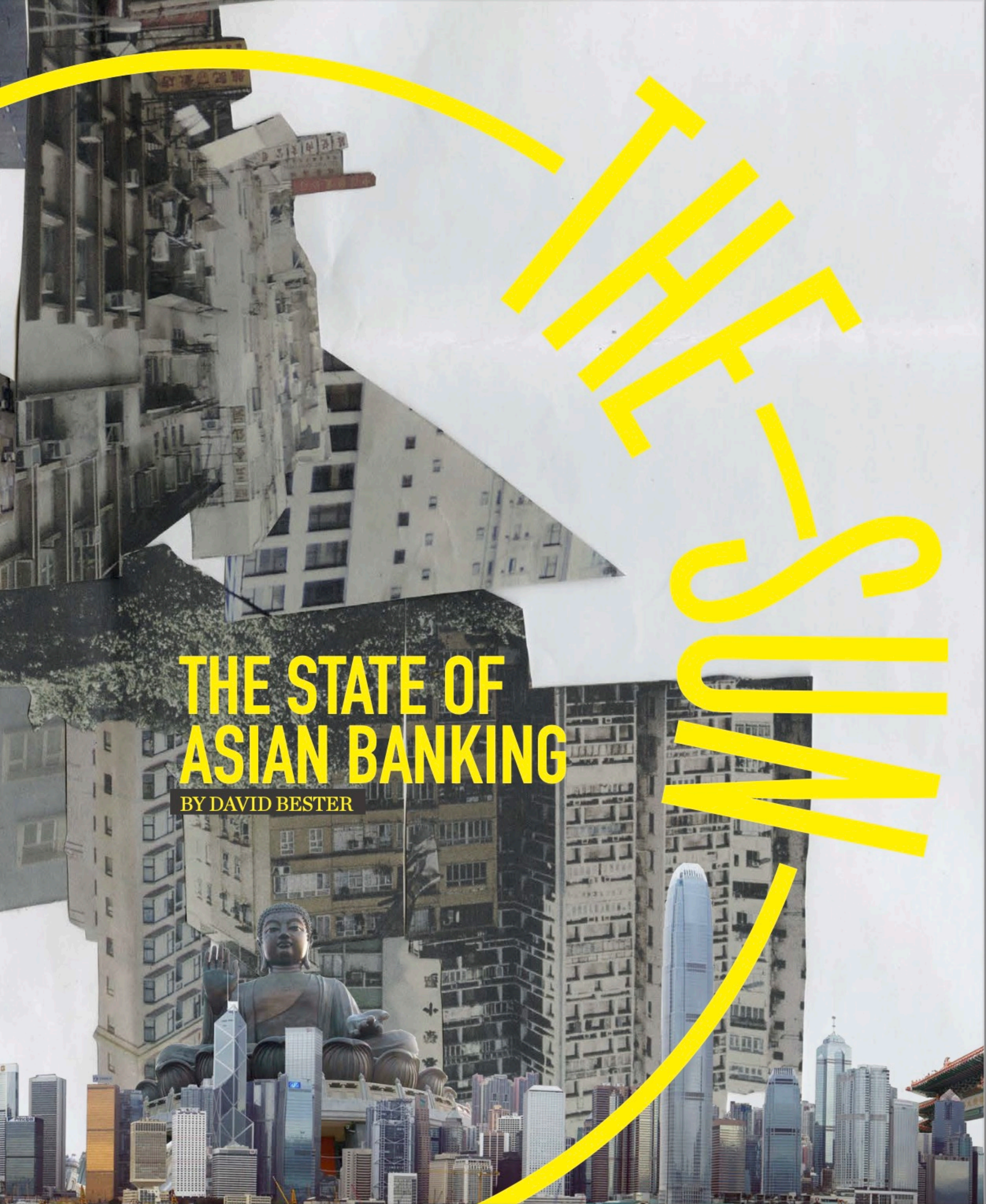

THE STATE OF ASIAN BANKING

BY DAVID BESTER

THE DISTANCE BETWEEN HONG KONG AND JAPAN IS GREATER

The devastating tsunami that hit Japan in March of this year left thousands dead, and thousands more injured or displaced. Frantic calls were made from abroad to find out if friends, colleagues, and loved ones in the country had been affected. Jaime Azcoiti Leyva, Director of Risks at CITIC Bank International, received many such inquiries from his native Spain. There was nothing to worry about in his case though, as Jaime lives and works in Hong Kong.

"Geographically, people tend to think of Asia in an unrealistic manner," he explains. "The distance between Hong Kong and Japan is greater than the distance between Madrid and Chernobyl for example. But when the nuclear disaster took place in Russia, everyone understood it was happening in a country far, far away."

If your only exposure to Asia has been through textbooks and generic maps, this confusion is understandable. In these formats Asia is represented as a unified block,

THAN THE DISTANCE BETWEEN MADRID AND CHERNOBYL

painted with a common color. In reality, Asia is more of a concept than a unified region.

"Asia is not very homogenous," explains Elbert Pattijn, CRO of Singapore-based DBS Bank. "You may find certain similarities between how banks operate in specific countries, Hong Kong and Singapore for example, but treating Asia in a holistic manner can lead to misconceptions and frustrated expectations."

From Malaysia, AmBank Group's CRO Andrew Kerr has a similar view, particularly from a business perspective. "You can't just take a western model and apply it across Asia. You need to customize it to the specific circumstance. There isn't one Asian culture. Each country has its own."

The story of Asian banking is the future of banking itself. But is it the tale supported by conventional wisdom, that since the financial crisis of 1997 Asian banks have become more cautious, better capitalized, and are prepared for an incredibly bright future? Or did Asian banks benefit from a perfect storm of microeconomic reforms as well as a favorable combination of macroeconomic circumstances, which may be subject to sudden reversals and endanger the progress made, as the BIS suggested in a recent working paper?

"GEOGRAPHICALLY PEOPLE TEND TO THINK OF ASIA IN AN UNREALISTIC MANNER."

THINK asked Jaime, Elbert, and Andrew to share their own insights on liquidity, banking, and the role of risk management in relation to current prospects and future challenges in Asian banking.

MALAYSIA | ANDREW KERR, CRO | AMBANK GROUP

With a focus on discipline and governance, AmBank has enjoyed four consecutive years of record returns. Profits have exceeded market consensus estimates even as risk-adjusted returns have taken a priority over growth. For Andrew, these results are a reflection of risk management's growing role within AmBank.

"In terms of governance, the risk function began receiving more prominence in Asian banks over the last five years. Previously, risk was considered more of a back office function. Now, and certainly in Malaysia, this has changed to the point where risk is becoming an equal partner at the table."

Even as risk recognition techniques have improved greatly over the past 20 years, many institutions within Asia still look to older principles and rely on relationships as a basis for decision-making. "The challenge with older techniques is that they cannot be applied effectively to portfolios, especially given the volume of coverage we see today, and make it difficult to accurately price for risk being incurred." Asian banks are therefore looking to acquire new techniques and post-crisis insights, and their Western counterparts are the natural guides to turn to. "It's valuable to learn from your mistakes," says Andrew. "But it's cheaper and smarter to learn from someone else's."

UNDERLYING INVESTMENTS

"It's a sobering thought that banks cause recessions. Once firms take their eye off the portfolio and drop standards in order to maintain growth, it's inevitable that you will begin to take on products that aren't fully understood and priced appropriately. Should portfolio concentrations in such circumstances occur, Basel II, even Basel III requirements aren't helpful: the banks can become too sick to get into any more trouble."

To build a secure foundation for the future, AmBank has taken bold strides towards a new risk infrastructure. The strategy is twofold: seek incremental improvements in areas which were satisfactory but could be enhanced, such as governance, and implement more advanced solutions for the bank's key areas of focus.

"We have various components of our new risk infrastructure program in various stages of development/completion. The program includes new Financial Spreading tools, new Probability of Default, Exposure at Default and Loss Given Default models for Retail and Non-Retail, new Funds Transfer Pricing system, new automated provisioning systems, automated stress testing, new foreign exchange and derivatives system, new (markets) rates validation system, new Asset Liability Management system and new operational risk incident reporting system. Future projects include a new VaR engine, a new collateral management system and finally the development of economic capital models. In a 4-5 year timeframe, it's a significant overhaul while running 'business as usual'."

RISK-ADJUSTED RETURNS

A focus on risk-adjusted returns is fairly new to Asia, and particularly to Malaysia. "Hong Kong and Singapore are more advanced than say the Philippines, Vietnam and Thailand, with Malaysia and perhaps Indonesia being in the middle of the pack. To different extents, we all have work to do on understanding the importance of risk-adjusted returns and their effect on capital and sustainability of growth. We're putting our focus on risk-adjusted returns, and we don't mind shrinking before we grow to set solid foundations for future sustainable profitability."

Central Banks in Asia, including Malaysia, have been working to cool housing

"THE BROADER ASIAN COMMUNITY HAS LONG MEMORIES WITH REGARD TO THE ASIAN CRISIS, PARTICULARLY THE ADVICE TO RAISE INTEREST RATES AND LET COMPANIES FAIL."

MALAYSIA

markets in an attempt to avoid recent mistakes made in western markets. Despite these efforts, banks in Malaysia still seem to be behaving irrationally. As a result of extreme price competition, coupled with high loans provided relative to underlying house values, AmBank has restricted the growth of its residential mortgage book over the past two years. "When you're dealing with 20-25 year housing loans, you have to shape your portfolio carefully. We continue to dip our toes in these waters, we'd very much like to have higher growth, but in current market conditions we maintain a very disciplined stance on the risk/reward outcome."

With Asian markets maintaining their strong growth, the risk function is kept under constant pressure, particularly with the region's susceptibility to hot money. "As we have been reminded from the GFC (Global Financial Crisis), funding and liquidity are paramount to the stability of the financial system. AmBank has set up a Balance Sheet & Capital Management unit dedicated to managing funding, liquidity, as well as duration risk and its appropriate capital structure. AmBank has led the Malaysian market in tapping longer duration funding sources such as medium term notes and positioning the bank for future expected interest rate increases.

CULTURE AND CRISIS

In response to the GFC, central banks eased interest rates and governments provided extensive support to both the finance and corporate sectors. This course of action was almost the opposite of what was imposed on countries by the IMF and other agencies during the Asian crisis of the late 1990s. Interestingly, Malaysia, which promoted solutions similar to those used during the GFC, was looked on poorly at the time. Despite vocal opposition from international critics, the government resisted IMF aid. Instead it provided support to the financial and corporate sectors, imposed capital controls, and pegged the ringgit at a fixed exchange rate to the U.S. dollar to manage volatility of capital flows and exchange rates. Nearly 15 years later, Malaysia has rebounded strongly with a healthy, well-capitalized financial sector and generally sound economic fundamentals.

"The broader Asian community has long memories with regard to the Asian crisis, particularly the advice to raise interest rates and let companies fail. But even with the time passed since that crisis, the West generally does not appreciate the distinctions within Asian culture. Just because an approach has worked elsewhere does not mean it can work here, and just because an approach works in Hong Kong doesn't mean it would work the same way in Malaysia. Concepts need to be adapted to country-specific circumstances."

When Andrew arrived at AmBank, the non-performing loan ration was around 6%. It now sits around 1.5%. Risk Appetite Strategies have been strengthened and execution has materially improved, while funding, liquidity, and interest rate gap management have also shown material improvement. The AmBank risk team, which numbered roughly 100, has since doubled to support its expanded responsibilities. "We are keeping an open mind about applying best practices from around the world, adopting most and molding them to the Malaysian culture, while working as a collaborative team with our business colleagues. We have fashioned ourselves into a uniquely Malaysian group."

HONG KONG | JAIME AZCOITI LEYVA, DIRECTOR OF RISKS | CITIC BANK INTERNATIONAL

Jaime arrived at CITIC Bank International (CBI) following a long stint with BBVA and noticed the risk structure at both firms had a lot in common. Each organization had given the risk function a broad mandate to acquire a holistic approach of the bank's exposures and act in autonomy.

That is not to say CBI and BBVA ran identical operations. The overall culture of risk was stronger at BBVA, as was the development of its risk infrastructure. "Then again," Jaime observes, "it is those differences that brought me to Hong Kong."

"THINK OF THE UPCOMING PERIOD AS THE PYRENEES, OR THE HIGH MOUNTAIN STAGES OF THE TOUR. THIS IS THE STAGE WHERE THE WINNERS OF THE RACE ARE DETERMINED."

FILLING THE GAP

CBI is a Hong Kong-based commercial bank that aims to leverage the insights and reach of its parent bank, China CITIC Bank, to be the 'China Bank of Choice.' "When you talk about Asia, you're including countries as different as China, Australia and Malaysia, among others. There is a huge diversity. If you try to treat the region in a holistic manner, you will be missing out on huge cultural differences." The relationship with its parent bank provides CBI with the kind of ground level insights and introductions that are essential to play a role in the country's future growth.

To take advantage of these opportunities, the right infrastructure has to be in place. For technology insights and support, CBI turns to the experience of its other partner, BBVA. "If we are able to combine the prospect of a huge, emerging customer base with advanced products and technical capabilities, we have a great chance to find success and become one of the winners in what is a competitive and challenging environment." One of the key groups that can bridge the gaps between culture and infrastructure is the risk management function.

IN PARTNERSHIP

At CBI, risk analysts are referred to internally as credit partners. The analysts are viewed as being fully engaged in value creation and serving the financial strength of the bank. The risk area reports directly to the CEO and is independent from the business units.

"As partners, the risk function's role is to support value creation by keeping the right balance between four key factors: growth and control, risk and return, defining our risk appetite, and ensuring we make the right profitability within our risk appetite."

To support the bank's ambitious plans, CBI has been working a multi-year implementation to upgrade the bank's risk management platform. Work began in January 2009 and the first star project, a new ratings platform, came online in 2010. Forthcoming highlights of the project include ALM and ICAAP support, and a new risk-based pricing tool, all expected later in 2011. By 2012 CBI plans to have an asset management system in place to round out the bank's risk infrastructure.

"In the end banking has to do with running risks. We do feel the need to build up a strong risk management infrastructure, but on top of that, or more accurately at the same time, we are aiming to develop a strong risk culture. These two drivers go hand in hand. We invest in our risk infrastructure and culture because we feel both contribute value and strength to the institution."

FACING FORWARD

While Jaime sees positive opportunities ahead, there are specific challenges firms like CBI must address to take advantage of them.

"The biggest challenges ahead for Asian banks are uncertainty, competition, and tougher regulation. If you combine these three factors what you have is a more, or a much more difficult business environment." Jaime looks towards these challenges as an opportunity, not unlike the ones bikers face in the Tour de France.

"Think of the upcoming period as the Pyrenees, or the high mountain stages of the Tour. This is the stage where the winners of the race are determined. If you are strong and prepared for the difficulty, you see it as an opportunity rather than a danger. That's certainly how I see CBI's future. The road ahead is complex, and each new complexity comes with its own set of risks. But we view it in a positive way. It's an opportunity to differentiate ourselves relative to the competition. We're ready to position ourselves for victory."

— HONG KONG —

SINGAPORE

SINGAPORE | ELBERT PATTIJN, CRO | DBS BANK

At DBS Bank, Southeast Asia's largest lender by assets, Elbert is overseeing a multi-year, S$40 million ($31 million U.S.) technology project. The goal: to overhaul the bank's credit rating models and the IT architecture needed to support them. "It's an interesting time," says Elbert. "But it's a lot of hard work all the same. I'm sure most of my counterparts in various banks would give you a similar answer."

The project is designed to provide DBS with the tools to support the Advanced Internal Ratings-Based (AIRB) approach under Basel II. "We're on a journey towards AIRB so that if we decide to apply officially, we will have the framework in place to do so," explains Elbert. "But in terms of good risk management, we feel we need models in place for everything."

HURDLES AND BENEFITS

These models need to work together and flow through the organization quickly to support economic capital assessments for ICAAP (Internal Capital Adequacy Assessment Process).

"If the point of the exercise were only to clear a regulatory hurdle, then we would follow the standardized route. But we do believe that through ICAAP and economic capital models, more than through regulatory capital models, we will gain better insights into risks on a standalone, transactional basis as well as on a business unit or portfolio basis," Elbert explains.

Elbert also points to the business benefits that will be provided by the network. "We're investing a lot of money on I.T. to integrate all these pieces that can be connected through the desktop of the relationship manager," he describes. Through desktop applications, the relationship manager can input a credit application along with the client's financial details. Once the application is complete, the system will generate a new rating right away. "By integrating the financial data into systems, there will no longer be a need for separate inputs into the system. This in turn will provide us with greater efficiencies and reduce the administrative burden on our RMs."

COMPLIANCE AND CONCENTRATIONS

While compliance may be driving some banks to invest in new models and systems, for DBS it goes to how they view the risk function: a mechanism to acquire information from various aspects of the business to see how it affects the outlook on a holistic level.

"If you look at what brought certain banks down (during the financial crisis), it was their exposure to various instruments, but the interesting fact was, that most of these business units had individually approved limits. They stuck to those limits, but no one was aggregating the total exposures. And they turned out to be everywhere; in banking books, trading books, across disparate parts of the business.

Ultimately it's concentrations that kill you. So in that sense, risk management is concentration management. I'm not really sure how you could measure this without having an enterprise view of the business."

OPTIMISM: IN THE EYE OF THE BEHOLDER

2010 saw DBS bring in a record high revenue with core earnings up 28% year on year, and more than 100 awards from industry panels. Many of these recognitions honored the bank as best in its class in Singapore, and occasionally as best in class for all of Asia. The risk management project championed by Elbert is just one in a series of strategic initiatives that are designed to help DBS maintain strong capital and liquidity positions, and improve asset quality. So Elbert has some reason to be optimistic about the organization's future. But he is perplexed that Western banks seem to share his optimism.

"What I frankly don't understand is the outlook of the Western banks if they are cautiously optimistic, particularly with an eye on liquidity. I attended a presentation that put forward some numbers on what European banks need to raise to meet their liquidity requirements. These numbers were in the neighborhood of £300 billion for UK banks, and €4 trillion for continental banks. If these numbers are correct, or the correct numbers are anywhere near this range, I think the banks will have big problems raising these numbers. The question is, who will be the holders?" Elbert asks.

Historically banks have held a lot of each other's bonds. New liquidity rules as well as capital rules discriminate against these holdings, as recent history has demonstrated banks are more volatile and present a greater systemic threat than previously thought. While equity can be raised at a price, the liquidity issue the European banks face may be more severe than capital problems, if only because it is difficult to tempt people to hold that kind of volume.

"To me, that's where Asian banks are in an enviable position. We are very liquid, and benefit from being in a region that is expected to do better economically in the near to medium-term," observes Elbert. The issue banks like DBS do face is that the liquidity debt being carried is generally in a currency different from the liquidity borrowers want to have. So care must be taken to ensure that swaps books are run effectively, and that does carry liquidity implications.

"We may not share a homogeneous culture across borders, but Asian banks are generally better capitalized than European banks, and are much more liquid. We do have that in common."

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