Implications of the Crisis for East Asian Financial Sectors

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Financial and Private Sector Development Unit
East Asia and Pacific Region
The World Bank
Outline

I. Determining What We Know
II. How the Crisis is Hitting East Asia
III. Impact on Corporations
IV. Spillover to the Financial Sector
V. Policy Responses
VI. Next Steps
1. Determining What We Know
Do we know anything?

“There are things we know that we know. There are known unknowns. That is to say there are things that we now know we don't know. But there are also unknown unknowns. There are things we don't know we don't know. So when we do the best we can and we pull all this information together, and we then say well that's basically what we see as the situation, that is really only the known knowns and the known unknowns. And each year, we discover a few more of those unknown unknowns.”

What can we expect to know?

- The current global financial crisis started in the United States, which among the world arguably has:
  - One of the most regulated banking systems.
  - High levels of transparency and disclosure.
  - Expert supervisory capacities.
  - Strong legal system and enforcement systems.

- All relevant experts – Federal Reserve, Treasury, banking, securities, insurance, regulators, academics – failed to see the crisis coming and where it was going.

- So, we should have humble expectations...
Why is this so hard?

Doing financial and corporate sector analysis, particularly across countries, is difficult because of many reasons including differences in:

- Accounting standards
- Reporting and disclosure
- Availability of quality data
- Regulatory standards
  - (i.e., loan classification for banks)
- Supervision and enforcement practices
  - (i.e., forbearance to banks on loan restructuring)
So what do we do?

- Do the best we can with what we have.
- Utilize all sources possible, including data and analysis from:
  - Central banks
  - Investment banks
  - Ratings agencies
  - Databases (IMF, CEIC, Bankscope, etc.)
  - News sources
  - Interviews with relevant sources
  - Intuition and own experiences
11. How the Crisis is Hitting East Asia
What do we know?

• First, we can say with certainty that Asia was spared the direct costs of the financial crisis.

• The estimated total losses from sub-prime mortgage-backed securities (the “toxic assets”) across all of Asia is estimated to be only $20 billion, or 3% of the total globally.

• Losses related to failed U.S. institutions were also minimal.
  ○ Losses related to the collapse of Lehman Brothers were only $1 billion.

How is the Crisis Coming to Asia?

Basic transmission channel

- U.S. / EU Recession
- Drop-off of Demand for Asian Products
- Sharp Export Decline
- Decrease in Industrial Production
- Falling Corporate Profits
- Rising Bad Loans
How fast and hard is the hit?

Exports and industrial production fell off a cliff in Q4 2008...

Export Value Growth

Industrial Production Index
(\% Change year-on-year, Dec. 2008)

Source: CIEC and Bank Staff calculations.
Was Asia prepared for the hit?

- Although exports are over 40% of GDP in East Asia, most countries were better prepared for this crisis than prior to the 1997-98 Asian crisis:
  - Higher levels of foreign currency reserves
  - Larger fiscal balances
  - Better macroeconomic management
  - Improved monetary policy and responses
  - More stable and healthy banking systems
  - Long streak of profit growth
III. Impact on Corporations
Are corporations surviving?

- As compared to the Asian crisis, companies entered this crisis with:
  - Relatively healthy balance sheets
  - Higher profitability
  - Lower levels of debt
  - Larger cash reserves (i.e., retained earnings)

- No widespread evidence of corporate bankruptcies yet.
  - Rate of failures has remained relatively steady since 2007.

- But, signs of stress are emerging.
  - Manufacturing and export-oriented firms hit first.
  - Over 100,000 factories closed in China in 2008.
Are companies still profitable?

Level of profitability still remains positive...

**Profitability of Large Corporations** (for Q4 2008)

Source: Bloomberg and Bank Staff calculations. Based on data from top 100 listed companies by market capitalization.
… but, the pace of decline in profit growth is worrying.

**Profit Growth of Large Corporations** (Quarterly Change)

![Chart showing profit growth of large corporations with quarterly change for Q4 2007, Q1 2008, Q2 2008, Q3 2008, and Q4 2008.](chart)

Source: Bloomberg and Bank Staff calculations. Based on data from top 100 listed companies by market capitalization in seven key developing East Asian countries.
How are firms financed?

Corporate Financing Profile

This points to where corporate distress will spillover into the financial system...
1V. Spillover to the Financial Sector
How do corporate problems flow through to the financial sector?

**Micro-Level Impacts**
- Corporate Profits Fall
  - Unable to Pay Interest on Bonds
  - Investor Risk Aversion to Shares

**Impacts on Financial Sector**
- Unable to Repay Loans
  - Bank Loan goes Bad
  - High Spread on Bonds
  - Stock Price Decline

**Macro-Level Impacts**
- Companies Unable to get Credit
  - Companies Unable to Issue Bonds
  - Companies Unable to Issue Stock
How did stock markets perform?

- Due to investor fears of firm performance (among other factors) –
- Initial public offerings (IPOs) in emerging Asia totaled only $67 billion in 2008.
  - This was a 71% decline from the $233 billion raised in 2007.
  - This is the lowest volume since 2003.
  - Chinese firms represented 61% of the total value of equity raised in Asia in 2008, primarily in the domestic A-Share markets.

- Equity market indices in the major emerging East Asian countries decreased by about 52% in 2008.
- This effectively wiped out $2.94 trillion in market capitalization.
What about the bond market?

- Combination of risk aversion by investors and a thinly traded, volatile market resulted in much higher spreads...

### Corporate Bond Spreads Over Government Bonds

<table>
<thead>
<tr>
<th>Country / Issuer Quality and Tenor</th>
<th>07-Dec</th>
<th>Mar-08</th>
<th>Jun-08</th>
<th>Sep-08</th>
<th>Dec-08</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Korea</strong></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>AAA 3 Year</td>
<td>90</td>
<td>63</td>
<td>71</td>
<td>172</td>
<td>264</td>
</tr>
<tr>
<td>BBB+ 3 Year</td>
<td>184</td>
<td>166</td>
<td>191</td>
<td>315</td>
<td>631</td>
</tr>
<tr>
<td><strong>Malaysia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AAA 3 Year</td>
<td>54</td>
<td>68</td>
<td>54</td>
<td>72</td>
<td>125</td>
</tr>
<tr>
<td>BBB+ 3 Year</td>
<td>618</td>
<td>631</td>
<td>582</td>
<td>646</td>
<td>740</td>
</tr>
<tr>
<td><strong>Thailand</strong></td>
<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>AAA 3 Year</td>
<td>50</td>
<td>71</td>
<td>67</td>
<td>79</td>
<td>192</td>
</tr>
<tr>
<td>BBB+ 1 Year</td>
<td>112</td>
<td>115</td>
<td>114</td>
<td>123</td>
<td>270</td>
</tr>
</tbody>
</table>

What about the rest of the sector?

- Capital markets effectively closed for firms in 2008, but there were some signs of recovery.
  - Stock markets are up about 21% year-to-date.
  - Corporate credit spreads have narrowed.
- But, banks continue to be the key providers of financing for firms.
  - Over 40% of all corporate financing is from banks, and in many instances it is much higher.
  - Banking sector assets now account for approximately 102% of GDP in the region.
What is the impact on banks?

- As with companies in the region, banks also entered this crisis well prepared:

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Interest Margin</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Performing Loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Adequacy Ratio</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

But, profitability seems to be poised for a substantial decline this year…

Will this create a wave of NPLs?

It is hard to say, but…

- Ratings agencies are projecting an increase in NPLs in the region of about 29% in 2009.
  - Although the overall level would remain at about 8%.
- Korea is an interesting example because it was a “first mover” in Asia during this crisis because it has an open and export-oriented economy.
  - Overall NPL ratio for banks in Korea was among the lowest in the EAP region at 1.1% in 2008.
  - However, NPLs rose by 46% since 2007.
  - Defaults among SMEs surged by 57% in the first two months of this year.
  - Expected NPL level by end-2009 is 3.6%
When will we know the effects?

- It’s hard to know.
- There is generally a long lag between the time of real sector distress and when it shows up on bank balance sheets [see next slides].
- Regulators also often exercise forbearance to banks, which further delays the day of reckoning.
  - For example, the China Banking Regulatory Commission in Jan. 2009 issued a policy that “if some enterprises are facing temporary challenges due to financial crisis, banks could think of rescheduling the loans for them.”
  - Banks tell us that they can restructure a loan for a year, so NPLs won’t show up until at least 2010.
- Finally, once loans are recognized as bad, they are hard to collect.
  - Recovery rate is only about 33 cents on the dollar, or half the amount seen in OECD countries.
What happened in the U.S.?

Among the federally insured U.S. banks, in the fourth quarter of 2007 we saw the following worrying signs:

- Loans for residential mortgages, commercial real estate, and construction were 48% of the total.
- On average, relatively low levels of non-performing loans (over 90 days past due) at only 1.4%.
- But, bad loans rose by 33% overall (with mortgages and real estate development registering 32% and 73% increases respectively.
- The write-offs related to mortgages rose 144%.
- Earnings fell sharply too, with the return on assets falling 7% and return on equity declining by 29%.

When were problems realized?

It took about a year for the full results to be seen in the banking system...

<table>
<thead>
<tr>
<th>Performance Indicators</th>
<th>2008</th>
<th>2007</th>
<th>Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Problem Institutions</td>
<td>252</td>
<td>76</td>
<td>232</td>
</tr>
<tr>
<td>Failed and Assisted Institutions</td>
<td>30</td>
<td>3</td>
<td>900</td>
</tr>
<tr>
<td>Non-Performing Loans / Total Loans (%)</td>
<td>2.93</td>
<td>1.39</td>
<td>111</td>
</tr>
<tr>
<td>NPLs in Real Estate Loans (%)</td>
<td>3.80</td>
<td>1.71</td>
<td>122</td>
</tr>
<tr>
<td>NPLs in Construction (%)</td>
<td>8.55</td>
<td>3.15</td>
<td>171</td>
</tr>
<tr>
<td>Charge-Offs (in US$ billions)</td>
<td>99.5</td>
<td>44.1</td>
<td>126</td>
</tr>
<tr>
<td>Return on Assets (%)</td>
<td>0.08</td>
<td>0.81</td>
<td>(90)</td>
</tr>
<tr>
<td>Return on Equity (%)</td>
<td>0.79</td>
<td>7.75</td>
<td>(90)</td>
</tr>
<tr>
<td>Unprofitable Institutions (as % of Total)</td>
<td>23.59</td>
<td>11.56</td>
<td>104</td>
</tr>
</tbody>
</table>

Source: Federal Deposit Insurance Corporation, “Quarterly Banking Profile: First Quarter 2009,”
V. Policy Responses
Will history repeat itself in Asia?

Some bad practices from the past that generated bad loans seem to be re-emerging:

- Governments appear to be supporting subsidized lending and/or coercing financial institutions to do directed lending:
  - Vietnam’s central bank is subsidizing interest rates for banks.
  - Proposal in Thailand to provide low interest loans and guarantees to banks for small-business loans.
  - In China, state banks have expanded credit massively ($667 billion in Q1 of 2009 alone) as part of the Government’s stimulus plan.
How proactive have policies been?

- Most actions have been focused on: reducing interest rates and bank reserve requirements, increasing deposit insurance coverage, and guarantee schemes to keep credit flowing to certain sectors.

<table>
<thead>
<tr>
<th>Financial Crisis Policy Responses</th>
<th>Quantitative Easing / Liquidity Support</th>
<th>Increased Deposit Insurance Limits / Coverage</th>
<th>Capital Support for Banks</th>
<th>Trouble Assets Purchase / Guarantees</th>
<th>Measures to Kick-Start Lending</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>✔</td>
<td></td>
<td></td>
<td></td>
<td>✗</td>
</tr>
<tr>
<td>Indonesia</td>
<td>✔</td>
<td>✗</td>
<td></td>
<td></td>
<td>✗</td>
</tr>
<tr>
<td>Korea</td>
<td>✔</td>
<td></td>
<td>✗</td>
<td>✗</td>
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</tr>
<tr>
<td>Malaysia</td>
<td>✔</td>
<td>✗</td>
<td></td>
<td>✗</td>
<td>✗</td>
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<tr>
<td>Philippines</td>
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<tr>
<td>Thailand</td>
<td>✔</td>
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<td>Vietnam</td>
<td>✗</td>
<td></td>
<td></td>
<td></td>
<td>✗</td>
</tr>
</tbody>
</table>
What are the current debates?

1. Many East Asian countries still have substantial state ownership in the financial sector.
   • DEBATE: Does the current crisis vindicate this model? Does ownership really matter or is corporate governance more critical?

2. Many countries in the region were pursuing the consolidated regulatory structure modeled on the United Kingdom, but this system also failed in a number of ways in this crisis.
   • DEBATE: Is there an appropriate model after the crisis? A consolidated supervisory agency? A systemic regulator?

3. There has been limited coordination across the region in response to the crisis (with the exception of the $120 billion currency swap arrangements – Chiang Mai Initiative).
   • DEBATE: Is there a way to better coordinate policy responses? What about the idea of an “Asian Monetary Fund”?
What about the global agenda?

- China, Korea, and Indonesia are now part of the key decision-making body – the G20.

- Thus, these major emerging East Asian economies are now able to influence the direction of the global financial sector reform agenda.

- Although much of the reform agenda relates to the most highly developed financial markets...

- Why? Because financial systems in emerging Asia are still relatively basic, so many of the issues covered under the G20 “Washington Action Plan” (November 2008) are not that relevant, such as regulating:
  - Complex structured financial instruments, derivatives, off-balance sheet vehicles, hedge funds, sophisticated risk management techniques, and credit ratings agencies.
VI. Next Steps
What should be done next?

- Assessing the condition of financial system vulnerabilities to further economic deterioration would be a good next step.

- Only supervisory authorities can really gain a full understanding of the situation through their own review processes.
  - Outsiders will only have limited access.

- The process will take time and expertise.
  - For example, the stress tests of top 19 banks in the U.S. involved hundreds of supervisors 45 days to complete.
What can the World Bank do?

- Key activity in this area is the Financial Sector Assessment Program (FSAP).
  - Designed to identify vulnerabilities in financial systems and determine needed reforms.
  - Consists of a wide range of analysis, including stress testing, financial soundness indicators, and stability, financial sector structure and development, supervisory practices and standards.
  - FSAPs for FY2010 are: Cambodia, China, Indonesia, Philippines, and Papua New Guinea.
- Advisory work on a case-by-case basis on improving financial sector supervision, individual bank reviews, etc.
Questions?

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