Financial Services Agency

FUNG GLOBAL INSTITUTE

FSA 'Asian Market Integration and Financial Innovation' International Conference

Session 2: Towards a Better Framework for Supply of Funds in Asian Financial Markets

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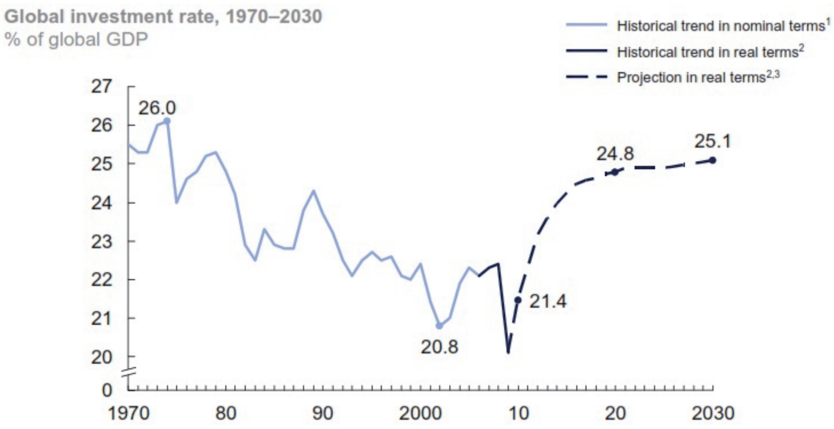
Why are there shortage of funds when there are surplus savings in Asia?

- Globally, Asia is net saver, but Asia still places considerable funding in advanced financial markets, especially official reserves.
- There is outcry for more credit to small and medium-sized enterprises (SMEs), long-term infrastructure projects, and venture capital.
- What are key factors constraining the development of more responsive financial markets in Asia – structural, technical or regulatory?

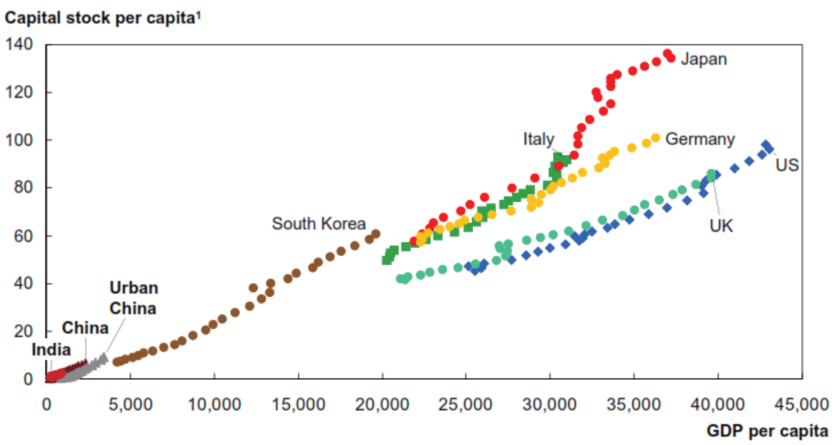
Global investment boom will increase demand for funds (McKinsey Global Institute study, 2011)



1 Based on actual prices and exchange rates of each year.
2 Shown in 2005 prices and exchange rates.
3 Forecast assumes the price of capital goods increases at the same rate as other goods and assumes no change in inventory.
SOURCE: Economist Intelligence Unit; Global Insight; McKinsey Global Economic Growth Database; Oxford Economics; MGI Capital Supply & Demand Model; World Bank's World Development Indicators; McKinsey Global Institute

- In one possible global growth scenario, global investment demand will hit 25% of global GDP by 2030, near its level at the beginning of 1970s

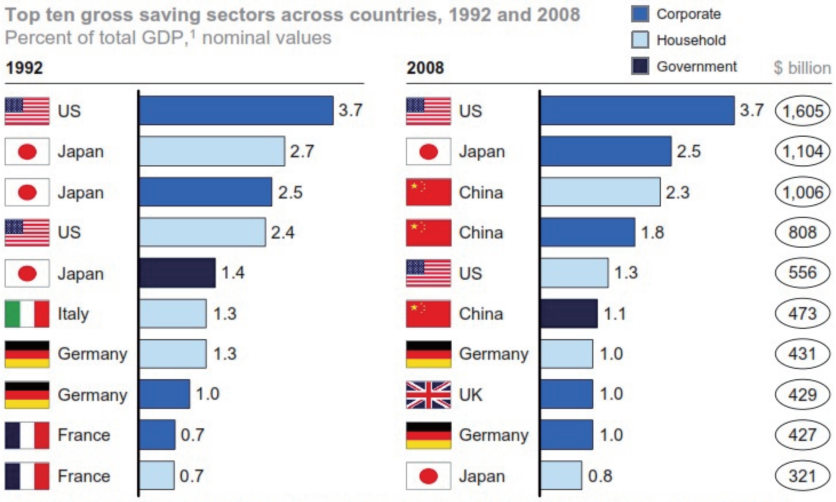
China and India will account for most of emerging markets' investments



1 Stock of net fixed assets at the end of the year, assuming 5 percent depreciation rate for all the assets.
SOURCE: McKinsey Insights China; McKinsey Global Economic Growth Database; McKinsey Global Institute

- China and India still have a much lower capital stock per capita compared with the developed world, despite their high investment rates over the last two decades

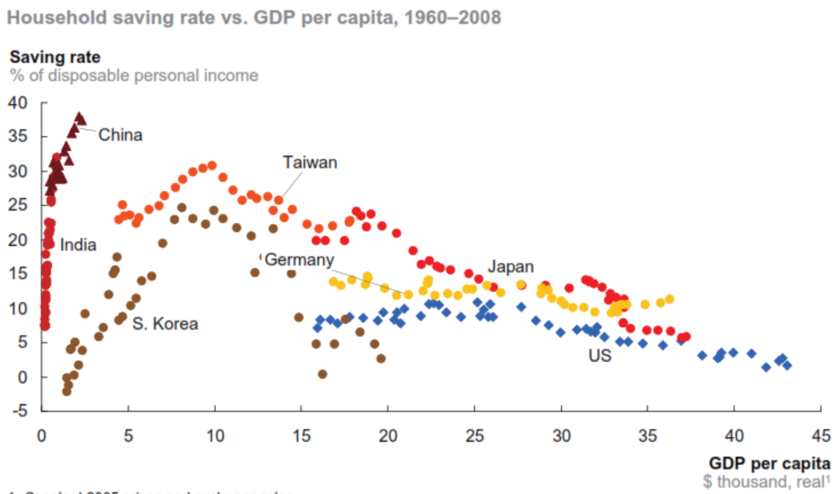
Increased demand will occur at a time of decreasing supply of funds



1 Australia, Brazil, Canada, China, France, Germany, India, Italy, Japan, Mexico, South Korea, Spain, the UK, and the US.
SOURCE: McKinsey Global Economic Growth Database; National sources; United Nations System of National Accounts; McKinsey Global Institute

- In 2008, China overtook the US as the largest saver (corporate, household and government savings combined) in the world

China's savings will decline when economy shifts to more domestic consumption



1 Constant 2005 prices and exchange rates.
SOURCE: Bank of Japan, Bank of Korea; Directorate-General Budget Accounting and Statistics, Republic of China; Global Insight; McKinsey Insights China; McKinsey Global Economic Growth Database; Reserve Bank of India; US Bureau of Economic Analysis; World Development Indicators of the World Bank; McKinsey Global Institute

- Japan and South Korea experience shows that savings will decline as economy matures
- China's 12th Five-Year Plan is already looking at increasing household consumption (as a share of GDP)

Structural Issues why SME and Infrastructure levels face shortages in Asia

- East and South Asian financial systems are still dominated by banks (especially maturity mismatches)
- Despite big push, bond markets are still relatively shallow and infrastructure bond markets have not been developed
- Equity markets do raise funds for large corporations, but in Asia, second boards have not been very successful to raise capital for SMEs
- Product and Institutional innovation still limited in Asia, partly due to pre-2008 concentration on mortgages and consumer financing by banks.
- Despite interest rate liberalization, lending rates may not totally reflect risks of lending to SMEs and long-term infrastructure financing.

Technical Reasons for Funding Shortages

- Property rights not clear for SMEs and complex infrastructure projects (e.g. collateral, legal framework, rules of the game)
- Transparency/Information quality poor, especially for SMEs and long-term lending where risks are unclear
- Lending to sovereign (including SOEs) and consumer financing (mortgages) seen as lower risks than SMEs and infrastructure
- Governance of SMEs and Infrastructure borrowers not up to standard
- Infrastructure projects cannot take off because of lack of project design and management skills at local government levels

Basel III impacts on SME and long-term funding

Increased capital requirements under Basel III

Increased Loss Given Default Requirements under Basel II and III

Elimination of beneficial Credit Conversion Factor for L/cs under Basel III

Capital requirements for short term trade – may be much higher for EME and smaller banks

Banks are likely to be cautious in funding perceived high risk areas under new regulatory regimes.

Conclusions

- There are major challenges ahead due to advanced country de-leveraging, tighter regulatory environment, changing market architecture, enhanced competition and new technology.
- National regulators will have to work closely with market participants to identify how funding to SMEs and long-term infrastructure projects can be improved (and regulation-wise equal treatment between large and small borrowers), without increasing systemic risks
- These are new challenges for all national regulators, and better understanding is needed over implementation of global rules.

THANK YOU

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