

## Banking on ASEAN

### AT A GLANCE

- Many investment banking business in developed markets like the US and UK have suffered declines in business revenues following the global financial crisis. Declining demand for capital raising services together with tighter regulatory restrictions has impacted their ability to return earnings back to their pre-crisis levels.
- The experience of Southeast Asia's banking sector is in stark contrast to its developed market counterparts. Stronger economic fundamentals, coupled with growing requirements for funding business expansion and national infrastructure projects has created a favourable operating environment for the region's major banks.
- Government initiatives, together with strategic planning by the ASEAN sub-regional collective are working in combination to strengthen capital markets and expand Southeast Asia's appeal as a single investment destination.
- Banking sector reforms are heading in the right direction, but existing restrictions on capital flows and policy actions by central banks to manage economic expansion at a sustainable pace present risks to earnings growth.

**Investment banking in the US and UK may have passed its glory days, but banks in Southeast Asia may be on the cusp of a new era in capital cultivation. The key economies are expanding and companies are looking at growth opportunities outside their home markets. The demand for a broader range of services is growing, presenting unrivalled opportunities for the region's key players. Where are the opportunities for investors?**

### TROUBLED TIMES IN BANKING

The business of investment banking in major centres like New York, London and Frankfurt has fallen under challenging times in the post-financial crisis era. Deal flow has declined, fees earned through the construction of new investment vehicles have diminished, mortgage delinquencies have surged and increasingly restrictive regulatory conditions have impacted earnings growth.

Bank of America, the second-largest US bank, showed evidence of the constraining conditions early in April when it reported a 39% fall in first quarter profits compared with the same period last year. Net income has fallen into negative territory, down from its 2006 peak of US\$21 billion before the crisis took hold. Bank of America prided itself on paying consistently higher dividends each year to shareholders since 1995. However, the crisis meant the company had to nearly eliminate dividends to conserve capital. Bailout conditions imposed by the US government means paying a return to investors remains a difficult proposition. In its most recent earnings announcement, the company said it had failed to obtain US regulatory approval to increase its dividend from the paltry one cent per share return to investors last quarter.

### THE ASEAN DIFFERENCE

A different set of operating conditions prevail in Southeast Asia. The major banks, which include Malaysia's Maybank, Thailand's Siam Commercial and Indonesia's Bank Mandiri, have benefitted from relatively stronger economic conditions and the multi-year expansion phase that characterises this part of the world. Growing business financing requirements and government privatisations have driven development of the Southeast Asian banking sector. By 2009, Southeast Asia accounted for 9% of Asian wholesale banking revenues and 13% of capital market and investment banking revenues.<sup>1</sup>

The region's major banks have expanded their businesses from offering a narrow suite of consumer and business-lending products to introduce capital-market financing and advisory services to companies, multi-nationals and government agencies. Malaysia's Maybank is a prime example. Its staff numbers have doubled from around 20,000 in 2004 to over 40,000 today and its assets have grown from US\$46 billion to over US\$103 billion over the same period.

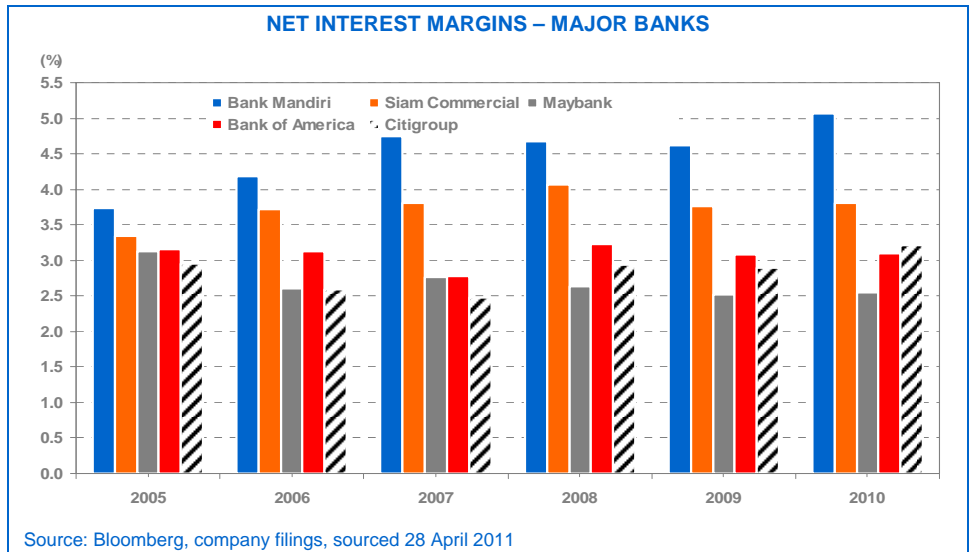
### THE EMERGENCE OF ASEAN REGIONAL SUPERPOWERS

Banks like Maybank are looking beyond their home markets to participate in regional opportunities. Maybank now has offices in eight out of the 10 countries represented by the Association of Southeast Asian Nations (ASEAN)<sup>2</sup> as well as a presence in the US and UK. Maybank's corporate vision is "to be a regional financial services leader" and expects 40% of its earnings to come from outside Malaysia by 2015. The recently proposed acquisition of Singapore's Kim Eng Holdings, a highly-rated brokerage firm, is an example of its expanding investment banking franchise. Establishing a presence in India, China and the Middle East also forms part of its strategic objectives.

Regional growth combined with favourable economic conditions is supporting profitable business development. Many of the major Southeast Asian banking operators have been able to expand earnings margins on commercial lending activities, contrary to the experience of major US banks. Net interest margins, which represents the difference between the interest income generated by a bank and the amount of interest paid to its lenders, has expanded in many cases. Southeast Asian banks have also largely avoided the problems with non-performing loans that lead to significant losses in the US banking sector. Bank of America attributed much of its 39% earnings decline over the past year to higher costs associated with mortgage default-related expenses.

1. McKinsey, Capturing the investment-banking opportunity in ASEAN\*, March 2011.

2. ASEAN country members: Indonesia, Malaysia, Philippines, Singapore, Thailand, Brunei Darussalam, Vietnam, The Peoples Democratic Republic of Lao, Myanmar and Cambodia.

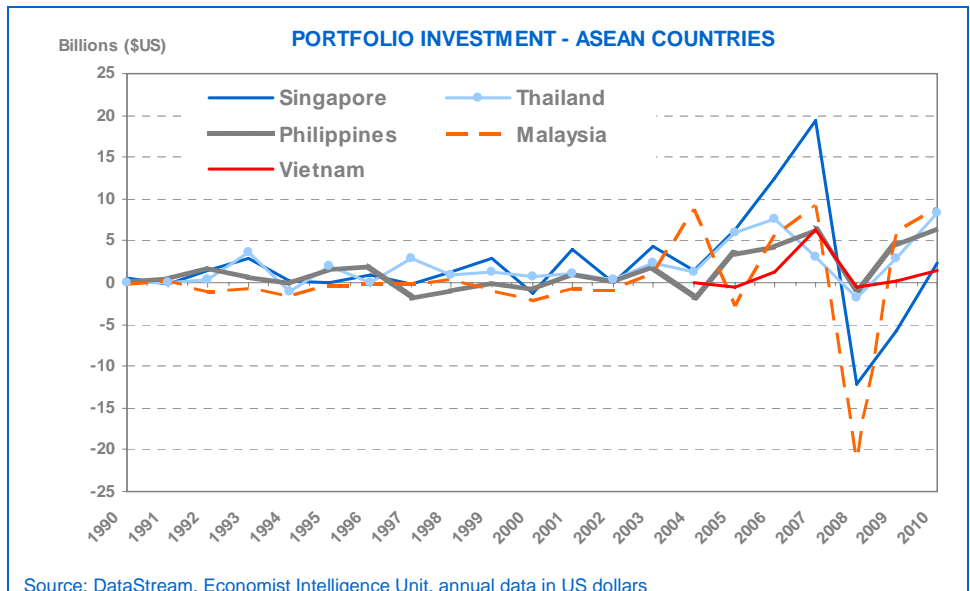


### CAPITAL MARKET DEVELOPMENT INITIATIVES ALREADY IN PROGRESS

Many national banks in Southeast Asia have benefitted from government efforts to develop capital markets, improve regulatory oversight and encourage foreign investment. The governments of Malaysia and Thailand, in particular, have recognised the imperative of developing capital markets if their respective countries are to successfully expand the private sector and attract foreign capital. The Securities Commission Malaysia launched phase II of its Capital Market Masterplan on 12 April, a blueprint for development plans over the next ten years. Naturally, tighter regulation forms part of the plan, but emphasis has been placed on facilitating product innovation in new areas like venture capital and unlisted investments. Measures to support smaller and mid-sized companies such as streamlining licensing and registration processes are also included. According to the Securities Commission, delivering on these initiatives will see the size of Malaysia's capital markets quadruple from 377 billion ringgit (US\$127 billion) to 1.6 trillion ringgit (US\$ 543 billion).<sup>3</sup>

Thailand's government launched its Capital Market Development Master Plan in 2009. The plan set out six key measures similarly aimed at expanding product offerings, improving accessibility, developing exchange infrastructure and reducing the cost of financing to companies seeking to issue stocks or bonds. It is little wonder Southeast Asian investment banks are rapidly gearing up for a capital-raising-fee bonanza.

Offshore investors have responded to the investment appeal of the region and initiatives towards capital market development and integration. This has been reflected in a noticeable increase in volumes of portfolio investment captured within national accounts.



3. Securities Commission Malaysia, "Capital Market Masterplan 2", 12 April 2011.

## WILL CAPITAL CONTINUE FLOWING TO ASIA?

A weaker US dollar and exceptionally low yields on US treasuries are factors likely to sustain demand for higher yielding stocks and bonds in emerging Asia. The Malaysian Ringgit, Thai baht and Singapore dollar have risen 21% over the past two years against the US dollar, in part reflecting strong capital inflows to these countries. The outlook for Asia remains favourable which should sustain the momentum of funds entering the region.

## THE ASEAN ASSET CLASS

ASEAN has identified development of regional capital markets as a core initiative. The ASEAN Investment Area (AIA) Council, a committee charged with this assignment, is aware of the need to develop capital markets so that investable funds can be allocated to their most efficient use. Greater efficiency in capital allocation ultimately contributes to economic growth. With the right support, Southeast Asian economies have the potential to grow faster than the rest of Asia. Independent forecasts support this notion. Over the next five years, gross domestic product growth in Vietnam (7%), Indonesia (6%) and Malaysia (5%) is expected to surpass developed markets like Japan (2%) and Australia (3%).<sup>4</sup>

ASEAN finance ministers convened for their 15<sup>th</sup> annual meeting on 8 April to progress regional cooperation efforts. One outcome from the meeting was a pledge to promote ASEAN as an asset class in its own right. This proposition underlies the committee's plan to develop an integrated ASEAN capital market, where domestic and offshore investors will be able to invest in stocks through an integrated platform of country-based exchanges by 2015. Under this plan it is envisaged that capital will move freely between countries, variances in taxation regimes will be neutralised and investors can buy assets through multiple countries. Key initiatives include integration of settlement systems and the creation of regionally-focused investment products. Malaysia, Singapore, The Philippines and Thailand securities exchanges expect to have a common technology framework by the end of this year.

## ASEAN'S INITIAL PUBLIC OFFERINGS PIPELINE...

Country	No. of IPOs scheduled over next 12 months
Vietnam	82
Thailand	17
Indonesia	9
Bangladesh	3
Philippines	1

Source: Bloomberg. Data sourced 27 April 2011.

## THE OUTLOOK FOR SUKUK

Governments in Southeast Asia have pioneered the establishment of Sukuk – an investment instrument which is acceptable to Islamic investors. These instruments replicate the cash flows of conventional bonds without interest payments, which are forbidden under Shari'ah law. Malaysia issued the first Sukuk in 2001, which proved attractive to the Islamic investment community. Favourable taxation treatment over traditional bonds in Malaysia has been an additional driver.

Many Malaysian banks have taken advantage of new rules designed to support development of the Sukuk market. RHB Islamic Bank was one of the first, with the successful issuance in 2006 of a uniquely-structured Islamic bond to finance the Mukah power plant project. Indonesia followed in August 2008 with its issue of the nation's first sovereign Sukuk, following the passage of taxation and legal reforms in the world's largest Islamic nation. The opportunity to attract Islamic finance to fund key national projects, particularly from oil-rich nations in the Middle East, offers an enormous potential for Southeast Asian banks. The Islamic investment sector is estimated to be US\$1 trillion in size, or about 5% of the worldwide investment industry.<sup>5</sup>

## TODAY'S CHALLENGES AND TOMORROW'S OPPORTUNITY

The current threat of inflation is pushing many governments to hike official interest rates and reserve requirements for banks. Last month, Malaysia's Bank Negara, the nation's monetary authority, raised the statutory reserve requirement by 1%. According to Citigroup, a 1% hike in the reserve requirement would remove 7.6 billion ringgit (US\$2.6 billion) from the system. The Bank of Thailand levied a 30% reserve requirement on banks in 2006 to stem the inflows of short-term capital and manage its currency appreciation – a restriction which remains in place today. Forcing banks to lock away large amounts of capital restricts the flow of funds and bank earnings capacity.

Research from Citigroup suggests banks in Asia are reaching critical points in their ability to lend capital. The ratio of loans to lendable deposits is at 94% for Thailand, 87% for Indonesia and 82% for Malaysia. Low available deposits on bank balance sheets means they are likely to incur incremental costs in sourcing funds through other wholesale channels.<sup>6</sup>

Still, Southeast Asia is moving through a period of rapid development. Governments are readying themselves to attract new investors through developing capital markets and upgrading regulation and legal structures to safeguard foreign-sourced capital. These measures are destined to encourage innovation in the banking sector and create a new force in Asian finance. Betting against success in these banks may be a bold decision.

4. Global Insight, GDP growth, compound annual growth estimate for 2009-2014.

5. Financial Standard, "Malaysia pioneers Islamic Finance framework", 15 February 2011

6. Citigroup, "Where is the Money, Honey?", 5 April 2011



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