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MATTER
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FOREWORD

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ANZ'S BANKS & DIVERSIFIED FINANCIALS TEAM COVER OVER 500 BANK CLIENTS IN ASIA PACIFIC. THIS UPDATE HIGHLIGHTS THEMES DISCUSSED OVER 1H2015 WITH OUR BANK CLIENTS.

Welcome to ANZ's 1H2015 Banks team update

This is the first time we've shared our on the ground Asian bank client themes with our Global FIG customer base. Today is also an especially auspicious day for the team as it marks our first day operating with a full Thai banking licence and almost a month of operations for our new Paris office.

ANZ now covers 34 countries globally and, of the nearly 1,000 bank clients covered by my team, over half are based in Asia Pacific. Inside this update you'll find a range of articles which have all started with our bank client conversations in Asia – a region with highly divergent financial developments across countries, but huge growth potential and growing world influence.

I sincerely hope you enjoy the read and welcome feedback or requests for further detail from our team of bank industry specialists.

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Thank you for reading

I think there are tremendous opportunities for being more collaborative in this industry, prompting this update - our first Banks team newsletter.

My role has afforded me the privilege of meeting many bank treasury teams across Asia Pacific and the Middle East. As someone who has sat on both sides of the table – formerly within ANZ's Group Treasury team in Australia, and now partnering with ANZ's FIG and Solutions teams in Asia – I feel safe saying that balancing internal business stakeholders, regulators, rating agencies and investors has become a tall order for bank treasury teams.

Yet most of our Asian bank clients have adapted to the changing regulatory environment with relative ease, notwithstanding the competing demands of developing capital markets, financial inclusiveness, regional integration and expansion of presence.

One area stands out for improvement. That, despite pockets of bilateral agreements and mutual desires for regional cooperation, it generally feels like Asia has less of a feedback loop with other banks, regulators and financial industry players vis à vis the European and US markets. This is where we can step up.

Enjoy the pack and please continue to loop me and the FIG team in on your interpretations, views, problems and questions relating to bank industry developments.

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TOTAL LOSS ABSORBING CAPACITY (TLAC)

On 10 November 2014, the Financial Stability Board **(FSB)** proposed a minimum TLAC requirement for 30 banks which had been deemed Global Systemically Important Banks **(G-SIBs)**.

While the proposed TLAC guidelines will initially apply only to G-SIBs in developed markets, many Asian Domestic Systemically Important Banks **(D-SIBs)** are considering what the potential i mpact to their business will be if their home regulators looked to adopt in some form.

What are the main TLAC requirements?

The FSB requires that designated G-SIBs hold a yet-to-be-determined percent (circa 16-20%) of Risk Weighted Assets **(RWAs)** in regulatory capital plus long term unsecured debt that can be bailed in. In addition, the aggregate of the regulatory capital and TLAC-eligible debt must be at least double the Basel III leverage ratio in the home country.

Of the aggregate TLAC-eligible instruments, which include common equity tier 1 **(CET1)** capital, additional tier 1 **(AT1)** capital, Tier 2 **(T2)** capital and bail-inable unsecured debt (typically in the form of structurally subordinated unsecured debt), CET1 capital can only comprise up to 67% as there is an explicit requirement that at least 33% is external debt – which must have over 12 months residual maturity. In addition to this quantitative 'Pillar 1' TLAC requirement, there is 'Pillar 2' component which is assessed at a firm level and subject to qualitative risks including footprint, risk profile etc.

Is it premature to be talking TLAC with Asia bank clients?

Asian D-SIBs are eager to understand TLAC requirements, although few expect TLAC to be a near-term requirement. Ultimately many Asian jurisdictions are members of the FSB and any introduction of a bail-in regime, in accordance with international agreement, will need to introduce a minimum bail-inable amount and criteria.

Japan is the first Asian country to be impacted with Mitsubishi UFJ, SMBC and Mizuho subject to TLAC requirements as designated G-SIBs. Chinese G-SIBs were carved out of the initial TLAC requirements, although the timeframe for their reprieve remains uncertain.

The key question for Asian D-SIBs is 'how much lead time' will regulators provide for meeting higher loss absorbency requirements via TLAC style requirements, considering:

MANY ASIAN BANK TREASURY TEAMS HAVE SEPARATE DECISIONING FOR CAPITAL ISSUANCE AND FUNDING ISSUANCE, HOWEVER TLAC BRINGS THE TWO TOGETHER.

1. **Investor education requirements for bail-inable debt.** TLAC-eligible debt will certainly have implications for many credit investors, but particularly insurers who may need to bucket the investment differently and hold greater capital amounts against the bail-in risks;
2. **The restructuring of issued debt securities,** preferably over a manageable timeframe as and when they fall due for refinance, to include a TLAC bail-in clause or alternatively statutory changes to reflect bail-in and resolution; and
3. **Most cross-border Asian D-SIBs are structured as a group of operating companies,** while TLAC requirements favour holding company structures which can issue structurally subordinated senior debt instruments. Organisational restructure is underway for some European G-SIBs who were structured as operating companies, but is a costly and time-consuming exercise.

Bringing capital and funding decisions together

"Many Asian bank treasury teams have separate decisioning for capital issuance and funding issuance, however TLAC brings the two together", says Kang Jae Kim, Global Head, Financial Institutions DCM. This could be especially true for Asian D-SIBs given their lower external funding requirement and high deposit base. If the TLAC requirement encourages D-SIBs to increase the issuance of subordinated debt, then they will have a lower requirement for senior term funding. This is likely to particularly impact TLAC ineligible debt securities, such as Covered Bonds and Structured Notes.

Considerations for TLAC-eligible instruments

At this stage, we cannot know what the final eligibility requirements will be for TLAC eligible debt, however TLAC liabilities must be able to be written-down or converted into equity during resolution. Further, this loss absorbency must be effected with minimal disruption to critical functions or material risk of legal challenge.

Investor appetite for TLAC eligible instruments raises more questions. Banks will likely be required to deduct TLAC eligible debt from own TLAC eligible debt holdings (as per rules applying Basel III instruments) which impedes their investment. Real money funds and insurers may need to consider how/if/where bail-inable securities fit in their own investment mandates and capital charges that may apply.

ANZ expects that considerable investor education will be required as the new class of TLAC debt is issued and will continue its investor work to gauge demand and considerations for issuers as the next iteration of TLAC proposals are released.

SHARING OUR INDUSTRY INTELLIGENCE WITH CLIENTS

ANZ's Financial Institutions DCM team have been proactively engaging with D-SIB clients across Asia, including China, Hong Kong, Malaysia, Philippines, Singapore and Thailand to discuss implications of a TLAC requirement in some form.

TLAC considerations form one part of DCM's suite of banks analysis which also includes a macro-economic update on capital markets and pricing; investor insights; peer benchmarking; Basel III capital adequacy and liquidity reforms; active liability management and funding portfolio considerations.

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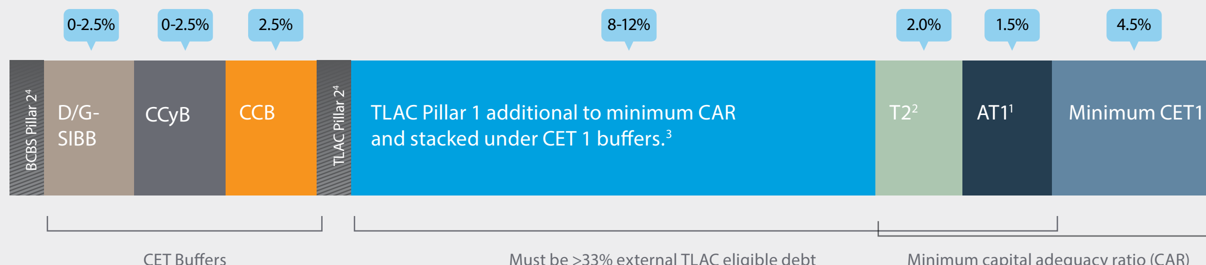
TLAC Requirements within bank capital composition (BCBS + FSB buffers)



Legend:
D/G-SIBB = Domestic/Global Systemically Important Bank Buffer;
CCyB = Countercyclical Capital Buffer;
CCB = Capital Conservation Buffer

Footnotes:
1) Minimum Tier 1 (6%);
2) Minimum CAR (8%);
3) Minimum TLAC Pillar 1 (16-20%);
4) Pillar 2 positioning varies. BCBS Pillar 2 may be grouped with TLAC Pillar 2 in some jurisdictions;
5) G-SIBB may be up to 3.5%, however this bucket is currently empty

GCC REGION IMPLEMENTATION OF BCBS CAPITAL REFORMS

February proved a particularly active month for bank client engagements in the UAE, Kuwait, Oman and Qatar. In late January, ANZ had our first active discussions with bank capital teams and regulators about the implementation of BCBS Basel III capital reforms in the Gulf Cooperation Council **(GCC)** region. This was followed by ANZ's early February clearing roadshow across Saudi Arabia, Qatar and UAE. Later in the month, ANZ also participated in a client event discussing the implications of Basel III reforms on non- financial corporate treasurers.

Will GCC banks need to raise capital levels?

ANZ observed that many GCC banks will need to raise capital levels to meet new BCBS Basel III hurdles, although there are several outliers in the region. These outliers are typically domestically focused institutions with significant family or government ownership and they have very high capital levels.

Each country has a different approach, but 'gold-plating' a common theme

Implementation of Basel III varies greatly across the globe. Even among banks operating in the same jurisdiction, there are examples of heterogeneous regulatory capital instruments issued and different interpretations of the final rules. Likewise, the implementation of Basel III across countries within the Middle East is divergent, although predominantly the rules relating to capital are more stringent than the minimum standards proposed by the BCBS. Interestingly, UAE has yet to release its Basel III capital rules although Basel III compliant issuance has already been raised by several banks. "*Basel III instrument loss absorption was in large part designed to protect taxpayers from bank bail-outs, however citizens in the GCC region do not pay individual income tax so it is less clear who the rules are designed to protect*", says Bhavik Pandya, Director, DCM Asia.

BASEL III INSTRUMENT LOSS ABSORPTION WAS IN LARGE PART DESIGNED TO PROTECT TAXPAYERS FROM BANK BAIL-OUTS, HOWEVER CITIZENS IN THE GCC REGION DO NOT PAY INDIVIDUAL INCOME TAX SO IT IS LESS CLEAR WHO THE RULES ARE DESIGNED TO PROTECT.

Basel III sukuk a popular structure from GCC banks

When ANZ met with GCC banks in late January, there had been limited precedents for the loss absorption language and only Kuwait, Qatar and UAE banks had tested demand with AT1 instruments in the mudarabah perpetual sukuk structure.

The first public issuance of Basel III-compliant AT1 perpetual mudharabah sukuk came from Abu Dhabi Islamic Bank in November 2012 and has since been followed by several UAE bank issues as well as from Kuwait via Burgan Bank and the subsequent NBK issue.

As the UAE had, and continues to have, no formal capital eligibility requirements, the UAE bank issues have contained variation language which points to both contractual and potential statutory loss absorption of the instrument. The UAE issues to date have a full write-off on the trigger event, whereas the Kuwaiti Burgan bank issue allowed for partial to full write-down sufficient to restore the bank's viability. Qatar's only precedent issue was a local currency private Basel III AT1 deal by the Commercial Bank of Qatar, although there are now several proposed public issues in the pipeline under the proposed sukuk AT1 structure, including from Qatar Islamic Bank.

Unlike the Emirati, Kuwaiti and Qatari banks, the Saudi banks have issued the sukuk structure to increase their tier 2 capital. Saudi Hollandi Bank was the first in late 2013, with other issues including Saudi British Bank and National Commercial Bank in early 2014.

Post ANZ's GCC bank meets, Oman's preferred AT1 structure has surfaced via Dhofar bank's inaugural bond issue which was not sukuk structure. Going to the US Reg S markets, Bank Dhofar's structure represented a contractual writedown with variation language to reflect potential statutory enforcement. The terms of the equity-accounted perpetual bond provided for partial to full write off at the point of non-viability with a clear sequential resolution.

Considerations for GCC Bank issuers

ANZ is expecting strong demand to continue for GCC bank credit with investor feedback reflecting their view of implicit support from GCC sovereigns for the major banks in the region.

SHARING OUR INDUSTRY INTELLIGENCE WITH CLIENTS

Timing of ANZ's bank client discussions on BCBS capital reforms coincided with record low oil prices and succession in Saudi Arabia with the passing of King Abdullah bin Abdulaziz.

ANZ's final report post trip, covered some 37 pages and provided a roadmap on the relative status of UAE, Kuwait, Oman and Qatar capital rules in the context of European and Asia Pacific Basel III implementation. For a copy of the report, please contact your local ANZ banker.

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Regulatory Minimums

		KUWAIT	QATAR	SAUDI ARABIA	OMAN
MINI CAR	CET1	7.0%	6.0%	4.5%	7.0%
	T1	8.5%	8.0%	6.0%	9.0%
	CAR	10.5%	10.0%	12.0%	12.0%
	Date	Jan-14	Jan-14	Jan-15	Jan-14
CET1 BUFFERS	CCB	2.5%[1]	2.5%	2.5%	2.5%
	D-SIB	0.5-2.0%	0-1.5%	TBD	1.0%[3]
	Date	Jan-14[2]	Jan-14	Jan-19	Jan-17

Source: Moody's Rating Agency; Country Regulators; SNL; ANZ Analysis

Footnotes:
1) Incorporated in minimum CAR;
2) Phase-in approach Jan-14-Jan-16;
3) 1.0% currently, but up to 2.5% is possible under the framework.

BASEL 'IV'

In December 2014, the BCBS released two consultations, "Capital floors: the design of a framework based on standardised approaches" and "Revisions to the Standardised Approach for credit risk". These consultations are designed to address some of the shortfalls of Basel II, including (a) mitigating model risk for IRB accredited banks; and (b) improving the granularity and risk sensitivity of standardised approach banks. Together, these consultations are being dubbed in the industry as Basel 'IV' and represent a new challenge for banks globally to adopt.

What are the main aspects of Basel IV?

The aim is to harmonise definitions and capital outcomes between the standardised and IRB approaches.
Key aspects include:

- A **capital floor for IRB banks** based on the new standardised approach. As yet, the BCBS has not calibrated the level of the floor.
- **Reduced reliance on external ratings** with a focus on key risk drivers. For example, bank exposures will be graded by Non-Performing Assets (**NPA**) ratio and CET1 ratio, for corporates it will be leverage ratio and revenue, and for residential mortgages it will be Loan to Value (**LTV**) and Debt Service Coverage **(DSC)** ratios.
- A **general increase in risk sensitivity and risk weight ranges.** Where previously corporate exposure risk weights varied from 20% to 150% for both banks and corporates, now the risk weights vary from 30% for banks and 60% for corporates up to 300% across both categories.

Will the capital floor level the playing field for Asian banks?

Many banks in Asia use a standardised approach to quantify their market and credit risk exposures. Even Singaporean banks, all very sophisticated international players, still use the standardised approach for market risks, while adopting IRB for credit risk. Therefore, a capital floor on IRB models' deviation from standardised outcomes could be seen as a step towards a more even playing field between IRB and standardised banking multinationals in the region. For IRB banks, a high floor could dis-incentivise the internal model used, as compliance and maintenance costs could weigh against lower potential capital savings.

What are some of the challenges being discussed?

One of the biggest challenges being discussed by banks is the operational aspects of implementing the regime. Many banks still rely heavily on credit agencies to grade corporate exposures. One ANZ bank client went so far as to suggest that the BCBS should be changing the rating agencies' criteria

SHARING OUR INDUSTRY INTELLIGENCE WITH CLIENTS

Over March 2015, ANZ Financial Institutions Group gathered anecdotes and feedback from bank risk managers and treasurers across Asia Pacific, including ANZ's own treasury. Remarks were far ranging and varied by jurisdiction, although much concern was expressed about the bucketing of mortgages, the duplication of risk measurements for IRB banks and the operational requirements of moving away from rating agency based probability of default standard.

rather than the banks'. For bank treasurers, an effective working relationship with the risk managers implementing the changes will be crucial as many of the new risk drivers add data points that may not have been collected previously.

Another challenge raised by IRB banks, is how the floor may reduce risk granularity and bunch risk weight outcomes closer therein incentivising a shift to higher risk corporates with higher margin potential. Naturally, this ties in with the issue closest to heart, whether a 'safer bank' is factored into bank shareholder return expectations or whether costs can be passed onto customers to maintain existing shareholder value.

Some considerations for Asian banks

There has been some suggestion that BCBS may limit the application of floors to certain portfolios. Residential mortgage portfolios have been highlighted as most likely affected.

Many banks on IRB approach risk weight mortgages at <20% and sometimes as low as ~4%. If a floor shifts that up to ~40% then banks are looking at over 100% increase of capital on their mortgage portfolio alone. On a mortgage portfolio of US$100bn in a bank with a 12% capital adequacy ratio target, that is an additional US$2.4bn.

Banks using the standardised approach are not unscathed in the Basel IV approach to residential mortgages. LTVs are capped in the region between 70% and 80%[2]. DSC ratios are often difficult to obtain with only China, Hong Kong and South Korea routinely using. The existing risk-weight for qualifying mortgages is 35% under standardised, but assuming DSC>40% and LTV ratios of 40% and higher, expect risk weights of 40% - 100%, a minimum 14% increase.

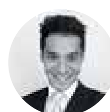
Basel IV is also generally negative for short term bank exposures, common in the Asia. *"Banks with an investment grade rating have at least a 50% increase in risk weights under the proposed standardised model"*, says Robert Tsang, Solution Design. Coupled with Liquidity Coverage Ratio and Asset Value Correlation Multiplier this will likely add imposts for bank trade and lower returns on bank debt securities within par portfolios.

RWA/Total Assets varies substantially across Basel III banks. This largely reflects the deviation in leverage of IRB banks vs. standardised banks, although portfolio composition may also vary.

Snapshot of Basel III compliant Asian banks
RWA/Assets ratio 1Q2015

Mandiri	69.3%	DBS	59.0%
Citi	68.8%	Maybank	54.6%
BDO[1]	68.3%	StanChart[1]	47.1%
Kasikorn	65.8%	HSBC	45.4%
ICBC	59.8%	ANZ	45.0%
Kookmin	59.2%	MUFG	39.1%

Source: SNL; ANZ Analysis



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Footnotes:
1) As of FY14.
2) ADB, May 2015 – www.adb.org/sites/default/files/publication/160057/adbi-wp528.pdf, (70% for Hong Kong, South Korea, Philippines and 80% for Indonesia, Japan, Malaysia, China, Singapore & Thailand)

LIQUIDITY REFORMS IN ASIA

Back in 2010, the BCBS unveiled the Basel III liquidity and stable funding rules for internationally active banks. Five years on, and a number of iterations later, several Asian countries, including Singapore, Hong Kong, South Korea, Japan, Thailand and China have now implemented the first of two quantitative measures, the Liquidity Coverage Ratio **(LCR)**. Other countries including the Philippines are now consulting with a view to also implement, possibly from next year.

A deposit is no longer just a deposit[1]

The LCR framework is highly prescriptive in terms of the run- off assumed for various categories of depositors and funding instruments, the purpose being to prioritise deposits less likely to be withdrawn at short notice during bank stress situations. Deposits from the retail market and small to medium-sized enterprises are considered very 'sticky' relative to wholesale client deposits. Within wholesale banking, a distinction is made between financial institution and non-financial institution monies, where the former are generally considered to be fully at risk of run-off in the stress test period.

Within Asia, many of the existing Government guarantee schemes on retail depositors do not qualify for the concessional 3% run-off under BCBS and so the minimum run off is typically 5%. However the maximum run-off for less stable retail deposits is approached very differently in each jurisdiction, with 10% for Singapore, 20% for Hong Kong, 15% for Philippines and 25% for Australia. Wholesale run- off is broadly in line, with only Philippines applying a slightly higher run-off to operational accounts of 30%, where all other jurisdictions apply 25%.

Exercising national discretion in LCR

There are differentiated treatments by regulators across Asia reflecting the varied issues faced in each individual country. Key points of deviation include:

(a) the definition of HQLA;

(b) the timing and phasing in of the requirement

(c) the approach to different currency liquidity matching, especially USD given the region's high usage; and

(d) the threshold for LCR application to banks.

Alternative liquidity approaches (ALA) and structural challenges in Asia

The LCR is best suited for the large liquid debt markets of Europe and North America, not the developing capital markets of Asia. The Australian and Hong Kong regulators were among the first in Asia to publicly acknowledge insufficient volume of HQLA in their domestic systems and have both employed Basel III alternative liquidity approaches. For Hong Kong, this is via limited acceptance of foreign currency HQLA, subject to haircuts.

Singapore and Philippines have not employed ALA, however Philippines have taken a phased-in approach to implementation while Singapore's regulator has softened its approach significantly after initial quantitative impact studies and industry feedback. Singapore has also applied a phase-in to their all-currency LCR, while requiring 100% LCR for local currency this year.

The BCBS LCR Requirement

$$\frac{\text{High quality liquidity assets (HQLA)}}{\text{Net cash outflows (30 days)}} \geq 100\%$$

Key aspects of the LCR are the narrow definition of HQLA and requirement for 'proven liquidity'. Net cash outflows is equal to the total expected cash outflows minus the lower of (a) total cash inflows; or (b) 75% of total expected cash outflows.

Footnotes:

1) Read more at ANZ Blue Notes – http://bluenotes.anz.com/posts/2015/05/a-deposit-is-no-longer-just-a-deposit/

Threshold for LCR application

Smaller banks and foreign banks subsidiaries are likely to face the most difficulty in meeting LCR due to a lesser ability to attract domestic sticky deposits and the highly complex operational side to managing a granular liquidity test like LCR. In Australia, Singapore and Hong Kong, regulators have recognised these concerns and created separate categories of banks which may comply with a less risk-sensitive liquid assets framework.

Fixing the liability mix to minimise net cash outflows

Even in jurisdictions where banks can source adequate HQLA, there is a considerable carry cost associated with holding these low yielding assets to cover maturing liabilities or high run-off funding. Many banks ANZ talks to are looking at strategies to reduce funding 'decay' over the last 30 days to maturity by:

1. lengthening the tenor of their short-dated debt;
2. replacing Financial Institution deposits with lower cost debt securities;
3. cementing their transactional banking relationships to drive up operational deposits; and
4. actively buying back debt securities prior to maturity and reissuing.

Some on the strategies to lengthen the tenor of short-dated debt are as simple as asking customers to extend deposit maturity dates by a few extra days, or weeks. Where LCR would usually erode any incentive for banks to pay a premium over interbank rates for wholesale deposits, depending on the shape of the interest rates curve, the interpolated base rate can top up the outright yield and maintain investor pricing expectations in some situations. Other banks, including ANZ, have looked at deposit product innovation and/or more active liability management to reduce net cash outflows.

From a cost-to-income ratio and margin perspective debt securities are commercially more attractive than deposits from financial institutions under LCR. Both categories have the same run-off assumption of 100%, unless the deposits qualify as 'operational' under strict BCBS criteria. Many Asian banks during recent discussions with our Debt Capital Markets and Loan Syndications teams have indicated that more active liability management is intended as LCR, but also importantly, the Net Stable Funding Ratio (NSFR) comes online. *"Banks are looking at spacing out maturities and reducing refinancing concentrations. They are also actively thinking about buying back or prepaying both short and long term debt before it enters the 30-day decay window"*, says John Corrin, Global Head of Loan Syndications. Apart from Australia, LCR implementation across Asia does not require banks to apply a buy-back assumption on run-off of debt securities.

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SHARING OUR INDUSTRY INTELLIGENCE WITH CLIENTS

As an Australian domiciled bank with regional reach across Asia, ANZ is well placed to discuss with Asian peers and bank clients the many considerations that come with the LCR now in play.

Over 1H2015, ANZ has reached out to our bank clients in Singapore, Hong Kong, Thailand and Philippines as they work through the implications of LCR on their liability profile. In general, the major Asian banks are favourably positioned for LCR as predominantly retail deposit funded.

However, structural issues in Asia, such as adequacy and sufficiency of secondary markets for debt do impact banks with a lower retail deposit base. This typically hits the non-major domestic banks and foreign subsidiaries hardest. Aligning liability profiles to reduce net cash outflows and has been a key focus for ANZ in client discussions, with active liability management a recurring theme.

FOREIGN CURRENCY DENOMINATED CAPITAL AND NON-TRADED FX RISK

As banks adopt regional strategies and accumulate risk weighted assets **(RWAs)** in multiple currencies, overarching controls on intragroup liquidity and capital management become a consideration. For liquidity, regulators have been forthright in their supervision of currency risks, with the Monetary Authority of Singapore **(MAS)** the most vocal *"Should there be prudential concerns at a particular institution, MAS may impose currency- specific liquidity requirements on an institution-specific basis"*. However, for capital, regulators have been less prescriptive with non- traded FX risks managed as part of business as usual to an all-currency level 1 (parent + branches) and level 2 (parent + branches + subsidiaries + affiliates) capital adequacy.

Banks are increasingly issuing local currency regulatory capital

In Asia, banks are strongly encouraged to support local capital markets development. Additionally, in most instances can achieve tighter pricing for regulatory capital instruments in domestic markets than offshore. This is primarily due to local investor familiarity with the name, sovereign risk and prudential regulator rather than deep understanding of the structural features of the Basel III loss-absorbing regulatory capital bonds.

As such, ANZ is increasingly seeing replacement of USD denominated legacy hybrids and subordinated debt instruments with local currency Basel III compliant Additional Tier 1 and Tier 2 issues. However, in many cases this has been done without consideration as to the USD denominated assets and potential capital FX risk and prudential ratio FX risk.

To hedge or not hedge capital FX risks

In discussion with ANZ's Asian bank clients, there are typically two considerations as to whether the bank should consider capital FX hedging. Firstly, the geographic diversity interests of shareholders and secondly, the level of currency risk the bank is comfortable with in keeping capital denominated in higher-interest currencies.

Many banks remain unhedged on the basis that their shareholders invest for the geographic diversity and manage their own FX risks as part of their overall portfolio approach to investments. This may be the case for banks with a stated regional strategy, but often in Asia, even domestically focused financial institutions can end up with a substantial portion of their risk weighted assets denominated in USD or other currencies due to the high prevalence of foreign funding, payments and trade in this region.

For these domestically focused banks, they have three options:

1) Stabilise the value of their reported capital base by immunising it against the effect of any devaluation in the relevant foreign currencies with forward contracts or options;
2) Match capital issuance currencies to RWA currencies and maintain a target CAR to match bank level CAR across all currency exposures; or
3) Hold a sufficient capital buffer in their functional currency to cover their FX risks up to a perceived threshold (i.e. a 5% currency movement, or the VaR over a 60 day period during which time the bank can raise enough capital).

Market Liquidity in Asia is still a headwind

Stabilising the value of banks' reported capital base can be difficult or costly given the limited market liquidity in Asia. Most Asia Pacific banks use spot exchange or more actively manage FX risks using forwards, but these instruments deny the benefits of a favourable move in the foreign currencies.

Options can be much more attractive as they allow for the upside if movements in the foreign currencies are favourable, while protecting downside risk from unfavourable movement. However, ANZ has found that options contracts in Asia are not as liquid as forward contracts and carry high initial premiums, especially when the underlying currency is volatile.

For regional exposures across multiple currencies, basket options could be considered to reduce the costs, however we have yet to see banks in the region taking this action.

Regulatory Capital Instruments – overissue to create a buffer for FX risk over life, or actively manage prudential ratio FX risk via hedges?

An alternative to financial hedging instruments is the overissuance of regulatory capital in local currency to build up an FX capital buffer within the Pillar 2 capital buffer. This FX capital buffer should be set to reflect the bank's expectation of the time it would take to raise more capital and the greatest expected currency movement over this period. Often banks set this as a proportion of movement i.e. 5% movement in USD / local currency pair.

This strategy can make a lot of sense for Asian banks which can typically enjoy higher returns on the capital set aside in local currency vs. USD or other offshore markets. It does however require that any decline in the CAR caused by the negative impact of FX rate movements is managed by issuing more regulatory capital. For many regional players, with currency exposure that cannot be hedged due to Government regulations, low levels of liquidity or high transaction costs this may be the singular choice at the moment.

SHARING OUR INDUSTRY INTELLIGENCE WITH CLIENTS

As a regional bank, ANZ is well placed to share insights with bank clients on the management of non-traded FX risk. At ANZ, this risk is considered from four angles:

1. Asset / Liability FX Risk from a net asset or liability position being denominated in a non-functional currency
2. Revenue / Expense FX Risk from future revenues and expenses being denominated in non-functional currency;
3. Capital FX Risk arising from investing stockholders' funds (Common Equity Tier 1) into offshore branches, subsidiaries and associates; and
4. Prudential ratio FX risk that generates volatility in capital adequacy ratios due to asymmetries in accounting and prudential standards on Additional Tier 1 and Tier 2 instruments.

Typically ANZ's bank clients manage items (1) to (2) actively, (3) to a lesser extent with no management of (4). However, ANZ is observing increasing questions from clients on non-traded FX risks in light of the potential US rate hikes and the perceived impact on FX crosses.

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ASEAN LONG TERM TRENDS IMPACTING BANK STRATEGY

In late April, ANZ Economics launched the ASEAN: The Next Horizon report[1] which discussed the development of three sub-regions within the ASEAN region (1) the Mekong Frontier of Cambodia, Laos and Myanmar; (2) the Mid-Manufacturing Competitors of Indonesia, Philippines, Thailand and Vietnam; and (3) the High Income Economies of Brunei, Malaysia and Singapore. *"The ASEAN bloc has enormous potential, as both a manufacturing hub and a source of consumption for the world. A large, youthful workforce and strategic location are just some of ASEAN's many advantages, which should draw more companies to establish production bases in the region"* says Andrew Geczy, CEO International and Institutional Banking.

ASEAN Banking Integration Framework (ABIF) – Rise of the regional bank?

Notwithstanding these developments, ASEAN banking integration remains limited ahead of the ASEAN Economic Community **(AEC)** agreement due to be implemented in December 2015. There is no central bank authority for the whole of ASEAN, therefore the ABIF signed in March 2015 provides for member countries to sign reciprocal bilateral deals to operate in a partner country on the same terms as domestic financial institutions, via "Qualified ASEAN Banks" **(QABs)**. However, more clarity is needed on the definition of reciprocal terms because not all countries have applied the same minimum paid-up capital thresholds and banking rules.

The ABIF scope of bilateral agreements does not preclude other countries from negotiating similar terms, for example within ASEAN+3 (China, Japan and South Korea); the Regional Comprehensive Economic Partnership (ASEAN+3, India, Australia and New Zealand); or other free trade agreements including the Trans-Pacific Partnership (of which Singapore, Malaysia, Vietnam and Brunei are party).

SHARING OUR INDUSTRY INTELLIGENCE WITH CLIENTS

ASEAN's potential as the new factory of Asia has very large implications for ANZ bank clients globally. Ahead of SIBOS 2015, which will be based in Singapore, ANZ Financial Institutions Group together with Transaction Banking have taken time-out to consider some of the long term banking trends in this high-growth region.

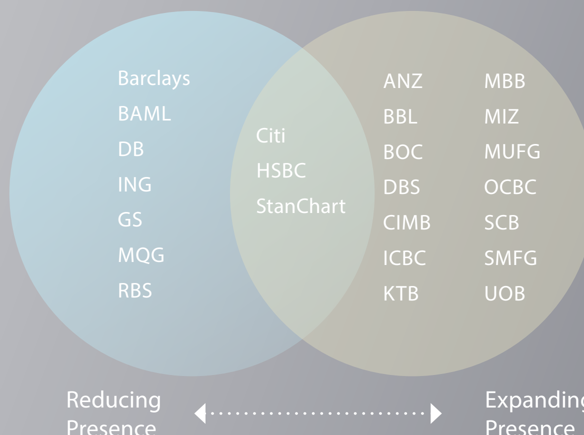
A copy of our thought leadership paper will be made available at the ANZ stall at SIBOS.

Singapore vs. Indonesia
Minimum Paid-in Capital

Source: Bank Indonesia citing ABIF taskforce, 2012

Retreating in Asia

Regional Asian banks



European and North American banks have long looked to Asia to boost growth, however post GFC, more and more Western banks have left or scaled down in ASEAN with Asia Pacific based regional banks stepping into their wake. This has included regional champions from Japan, China and Australia as well as ASEAN based Singaporean, Malaysian and Thai banks.

Direct ASEAN currency crosses – Long term expectations

ASEAN has come a long way in terms of trade integration with solid intra-ASEAN regional trade growth over the past decade reaching $608.6 bn[1] in 2013. While there are cyclical factors lowering the pace of trade growth, ANZ Economics still expect over USD1trn in intra ASEAN trade by 2025[2].

The vast majority of current trade, even intra-regional, is denominated in US dollars, however there have been a number of calls recently from central banks and supranationals for emerging Asia economies to actively engage in de-dollarisation[3] *"to mitigate against external shocks and constraining the central bank's ability as lender of last resort"* (IMF).

De-dollarisation has many implications for the regional banks operating in ASEAN and encourages the use of at least one trading partner's currency in a bilateral real trade of imports, exports and investments. Subject to market depth and liquidity as measured by bid-ask spreads and volatility, direct currency crosses can substantially reduce costs for participants by taking the USD leg out of the transaction. It removes the settlement risk with the USD correspondent bank, as well as the capital for the additional bank exposure. Additionally, many of the compliance burdens associated with US reporting regulations may be reduced.

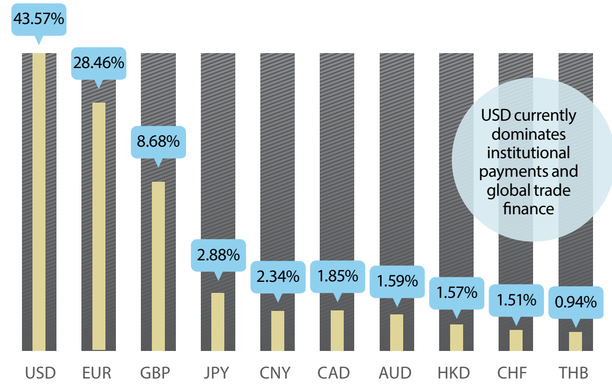
'Plus One' and the Flying Geese Paradigm (FGP)[4]

The flying geese paradigm represents an Asian model of development where labour-intensive manufacturers move from countries where wages and productivity are rising to lower income environments. The frontier economies in ASEAN represent the lowest cost wages in the Asia region and are increasingly represented in the economic expansion plans of Asia's economic giants, Japan and China via a 'Plus One' strategy.

FIGURE 11:

Customer Initiated and Institutional Payments. Inbound + Outbound traffic. Based on Value (Jul-15)

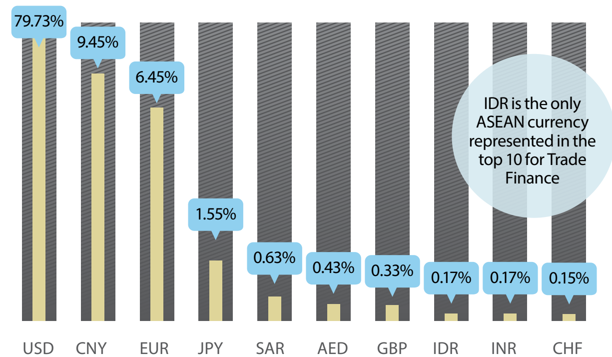
Percentage (%)



Source: SWIFT Watch

Letters of Credit and Collections.
Inbound + Outbound traffic. Based on Value (Jan-15)

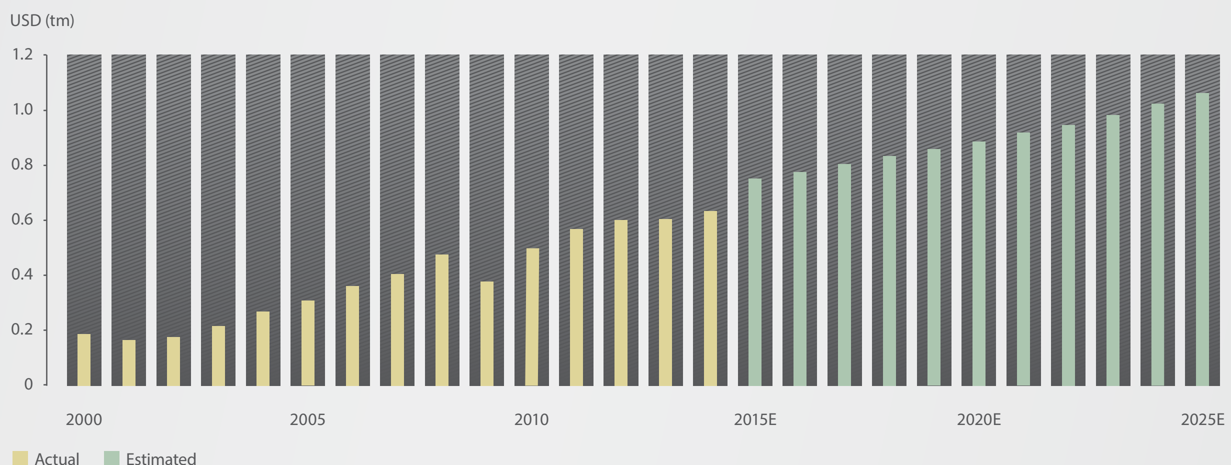
Percentage (%)



Source: SWIFT Watch

Intra ASEAN Trade

USD (tm)



Source: UNCTAD, WITS, ADB, CEIC, ANZ Research

Footnotes:

1) ASEAN Statistics, Intra-ASEAN Trade 2013;

2) ASEAN: The Next horizon, ANZ Economics, 2015 - Read more from ANZ Economics at ANZLive.com;

3) Including from Naoyuki Shinohara, IMF, as well as the Bank Negara Malaysia;

4) Read more at ANZ Blue Notes – https://bluenotes.anz.com/posts/2015/06/unravelling-the-asian-textile-supply-chain/

THESE DEVELOPMENTS EMPHASISE THE STRONG GROWTH OF INTRA-ASIA TRADE CORRIDORS, WHICH HAVE ACCORDINGLY BEEN DRIVING THE CROSS-BORDER NEEDS OF ASIAN BANK CLIENTS.

China accounts for more than 40% of global textile and garment exports, however due to increasing costs, low value textile and garment manufacturing has been progressively moving away from China to other markets such as Bangladesh, Vietnam and Cambodia since 2007.

The China Plus One strategy represents Chinese manufacturers' ambition to improve margins in a growing wage environment, by outsourcing some of their lower value manufacturing to another country – the 'Plus One'.

Meanwhile in Japan, Prime Minister Abe has emphasised the strategic importance of ASEAN, adopting a "Thailand Plus One" business model in which Japanese companies operate from the Thai logistic hub, transferring the labour-intensive parts of their production processes to special economic zones (SEZs) in Cambodia, Laos and Myanmar near their borders with Thailand.

"These developments emphasise the strong growth of intra-Asia trade corridors, which have accordingly been driving the cross-border needs of Asian Bank clients", says Deepan Dagur, Head of Financial Institutions Sales, South East Asia and Pacific. It also explains the strong interest of the Japanese and Chinese banks in the region, which have made significant investments in ASEAN presence.

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