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From "Global Finance" to "Local Finance"

—A New Form of Financial Globalization through Local Currency Markets—

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I Expansion of Local Currency Markets after the Global Financial Crisis
II Current Status of Asian Local Currency Markets
III Aiming at the "Localization" of Japanese Financial Institutions

The financial crisis starting in 2007 saw an increasing trend toward financing in local currencies in the Asian financial markets. Factors that drove this increase included: (1) dysfunction of international financial markets (such as the euro market) due to rapid credit crunch and (2) activation of "synthetic US dollar financing," whereby borrowers finance in local currencies and convert the proceeds to US dollars via swap markets to realize lower financing costs. Additionally, (3) growing needs for financing in Asian local currencies arising from economic stimulus measures (public expenditures) have also contributed to the increase.

Such financing in local currencies was supported by the growth of financial and capital markets in Asian countries, reflecting the financial sector reforms after the Asian financial crisis. The growth was also facilitated by the stabilization of local currencies through policy initiatives such as bilateral currency swap agreements, and expected market deepening through initiatives such as the "Credit Guarantee and Investment Facility" of the Asian Development Bank.

Japanese companies are also likely to shift the focus of financing to Asian local markets, reflecting the growth of local financial markets and the increasing needs to strengthen sales in emerging markets. Under such conditions, Japanese financial institutions are required to reorganize business structures by adopting the following approaches: (1) defining business areas as a financial group and building a business network in each local market; (2) optimizing global risk allocation; (3) globally optimizing the measures and currencies of financing and (4) developing financial infrastructure for cross-border transactions.

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I Expansion of Local Currency Markets after the Global Financial Crisis

1 Downturn in International Financial Markets

Along with the financial technology innovations in the 1980s and 1990s, financial transactions arranged in international financial centers such as London have increased, and gigantic financial conglomerates that operate across borders and business sectors have emerged.

One of the major factors behind the financial internationalization is that a huge amount of transactions can be freely arranged in international financial centers. In particular, the role of the euro market (Eurocurrency market)[1] has been critical, in which financial professionals enter into transactions based on non-regulated bilateral contracts. The markets equipped with relevant laws and regulations as well as financial experts to enable such transactions have come to flourish.

However, the subprime mortgage crisis after August 2007 and the collapse of Lehman Brothers in September 2008 were the turning points of international financial markets, during which the market functions temporarily came to a halt, making it difficult for many companies to raise funds. Figure 1 shows the annual amount of international debt securities issues and signed international syndicated credit facilities. We can observe a sharp fall toward the latter half of 2008, indicating that international financial transactions had become paralyzed.

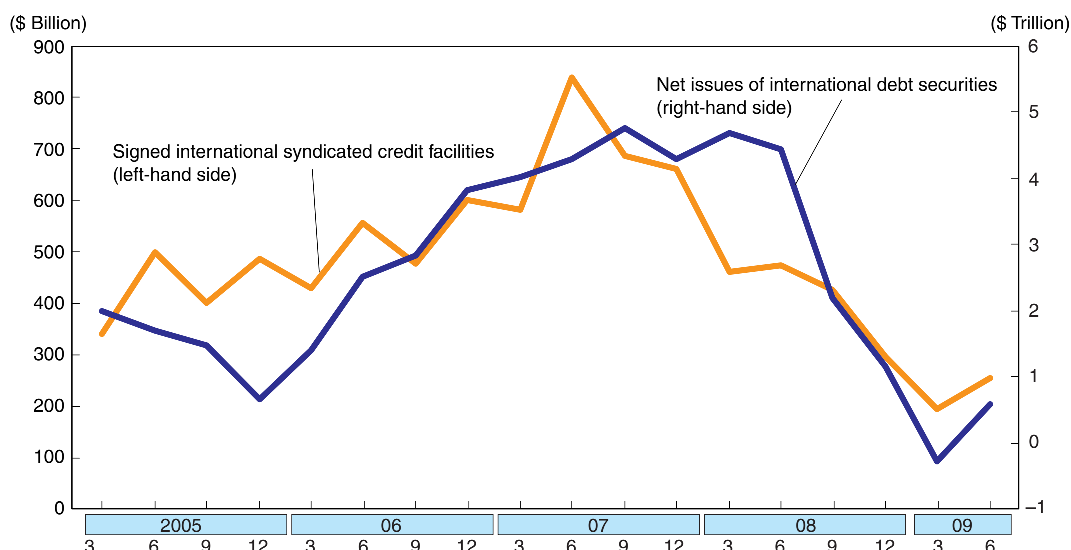
What led up to this situation is that since the latter half of 2007, financial institutions in the US and Europe faced severe shortages of liquidity, resulting in the tightening of supply and demand of liquidity in the major funding currency, US dollars (hereinafter referred to as "dollars"). The liquidity crunch in the dollar market led borrowers and issuers to finance in other hard currencies such as euro, Japanese yen and British pounds, and this has caused liquidity crises in the euro and yen markets on top of the dollar market. Additionally, increasing awareness of counterparty risk rendered credit spreads (difference of yields between the benchmark government bond and the corporate bonds of same or comparable maturity) significantly wider, which gave another setback to international financial transactions.

This unexpected vulnerability of the global market, which had previously been considered stable, has highlighted the presence of "local" markets that have overcome a series of financial shocks.[2] The word "local" market, in a narrow definition, refers to a market in which local entities (domiciled in certain jurisdiction) raise funds in local currency under that jurisdiction. The Bank for International Settlements (BIS) employs a similar definition under the term "domestic" issues, which includes all domestic currency issues by residents of a given country. In addition, however, we also consider domestic currency issues by non-residents as "local" (although classified as "international" in the BIS statistics), and this type of funding also increased during the financial crisis, as explained later.

Figure 2 shows BIS data on debt securities. The percentage of domestic debt securities (domestic currency issues by residents of a given country) to all debt securities issues (the total issue amount of domestic and international debt securities) rose considerably from the fourth quarter of 2007 to the fourth quarter of 2008.

While the global financial crisis caused credit crunch in most countries to a greater or lesser extent, the

Figure 1. Transactions in International Financial Markets



Note: Net issues refer to outstanding year-on-year increase/decrease.
Source: Compiled based on statistics published by the Bank for International Settlements (BIS).

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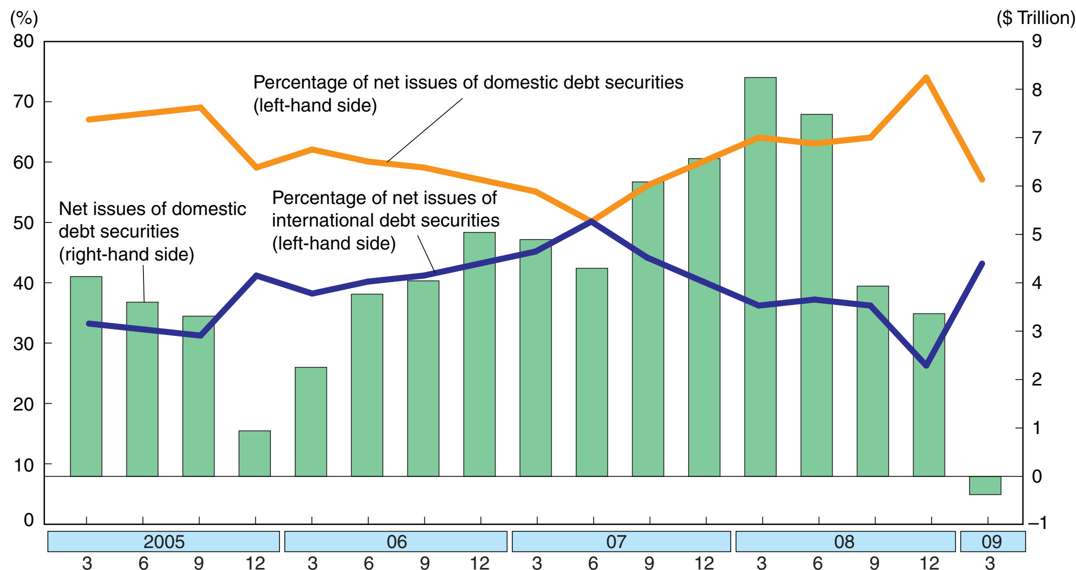
Figure 2. Changes in Net Issues of Domestic Debt Securities and Percentage of These Issues to All Debt Securities Issues



Notes: (1) International issues comprise all foreign currency issues by residents and non-residents of a given country and all domestic currency issues launched in the domestic market by non-residents. In addition, domestic currency issues launched in the domestic market by residents are also considered international issues if they are specifically targeted at non-resident investors. Domestic issues consist of all domestic currency issues by residents of a given country. (2) Net issues refer to year-on-year increase/decrease of outstanding.
Source: Compiled based on statistics published by the Bank for International Settlements (BIS).

liquidity of many currencies was not as tight as that of the dollar. Accordingly, market participants that had previously relied on international (mostly dollar-denominated) financial markets are considered to have returned to their home (currency) markets. This is one of the reasons for the increase of domestic debt securities.

Figures for the fourth quarter of 2008 show that, although the issue amount of domestic debt securities decreased, the proportion of domestic issues accounted for as much as 75 percent. This means that although local market financing decreased after the Lehman Brothers collapse, the function of international financial markets was even more affected.

In terms of the composition of domestic debt securities by country, Japan and the US account for more than half (in Japan, substantial amounts are government bonds; the US has traditionally been functioning as the world's largest local market, rather than as an international market). However, it is important to note that the issuance of debt securities in Asian countries other than Japan has also increased considerably. In terms of changes in amount outstanding, the share of the five Asian emerging economies (China, Indonesia, Malaysia, the Philippines and Thailand) among domestic securities markets doubled from 2.2 percent in March 2005 to 4.5 percent in March 2009, and this increase has remained stable even during the financial crisis.

Such an increasing trend of financing in domestic debt securities markets is likely to be a structural change rather than a temporary phenomenon in which financial globalization has accidentally halted. It is reasonable to assume that some of the roles that had been played by the international financial markets have been shifted to local currency financial markets.

2 Dollar Financing through Local Currency Markets

Increased issuance of domestic debt securities is not simply supported by the demand for local currencies alone. What is also noteworthy is the increase of local currency financing in which the proceeds are subsequently converted to dollars via swap markets (we call this "synthetic dollar financing").

Traditionally, local financial markets had been utilized for the companies, governments and government agencies of each country to raise funds for domestic operations (or to complementarily raise funds for foreign operations if financing is difficult in foreign markets). Furthermore, there were not many cases where foreign companies with local operations had utilized the local financial market of that country. Rather, they most likely used the international financial markets and/or their home market to raise funds, with swap transactions to exchange for local currencies as necessary. This is because it was difficult to raise and manage funds in local markets due to exchange and capital account regulations. On the other hand, it has been more flexible to raise large amounts of funds in international financial markets and/or home markets. For Japanese companies in particular, the frequency of business transactions between foreign subsidiaries and the parent company, or among foreign subsidiaries of Japanese companies, was often greater than those with local entities (targeting sales in the local market).

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Accordingly, foreign subsidiaries and the parent company often entered into arrangements whereby the subsidiaries could finance capital expenditure from the parent company and minimize working capital among local subsidiaries of Japanese companies.

However, the recent global financial crisis has caused multinational companies and financial institutions that had previously raised funds in international financial markets to turn to local financial markets. What is important is that major companies of advanced economies have started to issue debt securities not only in the established local markets (such as Japan's Samurai bond (yen-denominated foreign bond) market) but also in local markets of emerging economies.[3]

Table 1 lists the local currency issuance by non-residents in Malaysia and Thailand (these data start in 2007; there were very few issues until 2006 in either country). These data reveal that multinational companies and financial institutions, especially those from Korea, India and the Middle East, are actively issuing debt securities in these two markets. The reality is that their home countries (especially Korea) had been affected by the global financial crisis with greater significance than the US and Europe, and these issuers had to turn to foreign markets for financing. Nevertheless, these moves activated discussions on non-residents' issuance in Malaysia and Thailand, and the discussions resulted in the development or revision of regulatory frameworks in the two countries. The most active Korean issuer is the Export-Import Bank of Korea, which has issued debt securities in Mexican pesos and Brazilian reals in addition to Asian currencies.

Almost all of these non-resident issuers immediately converted the local currency proceeds (in Malaysian ringgit and Thai baht) to dollars via swap markets. This means that these issuers tapped the local currency markets to finance dollars because, even during the recent global financial crisis, liquidity was sufficient in both the Malaysian and Thai markets and it was possible to raise funds with relatively better conditions.

Turning to the cost of financing in local currency markets, we see two major components that make up overall cost: swap cost and credit spread.

First, the swap component involves the following two transactions in the case of Thai baht: (1) "interest rate swap" in which fixed interest rate in baht (in most cases, fixed interest rate is applied for corporate bonds) is exchanged for floating interest rate; and (2) "currency swap (or basis swap)" in which principal and floating interest rate in baht are exchanged for principal and floating interest rate in dollars such as dollar LIBOR (London Inter-Bank Offered Rate). A combined transaction consisting of interest rate swap and basis swap is called cross-currency swap. Since the spread of basis swap could be either positive or negative, the cost of dollar financing via local currencies could also be

Table 1. Local Currency Issuance by Non-Residents in Malaysia and Thailand

Issue date		Maturity date	Issuer	Country	Total issue amount ($ million)
Malaysia					
2007	1/26	2017/02/08	Asian Development Bank	The Philippines	143.013
2008	1/24	23/02/03	Gulf Investment	Kuwait	306.176
	1/24	13/02/05	Gulf Investment	Kuwait	306.176
	2/29	13/03/12	The Export-Import Bank of Korea	Korea	312.969
	2/29	18/03/12	The Export-Import Bank of Korea	Korea	312.969
	3/10	09/04/07	GE Money India	India	6.202
	3/10	09/04/07	GE Money India	India	2.481
	3/18	13/03/29	State Bank of India	India	156.226
	3/19	18/03/27	Overseas Chinese Banking Corporation	Singapore	314.673
	4/2	18/04/11	Industrial Bank of Korea	Korea	189.119
	4/2	13/04/11	Industrial Bank of Korea	Korea	189.199
	4/4	11/04/15	Industrial Bank of Korea	Korea	62.647
	4/7	11/04/15	Industrial Bank of Korea	Korea	62.745
	5/8	11/05/16	Hyundai Capital Services	Korea	202.008
	5/28	10/06/11	Woori Bank	Korea	163.909
	5/28	11/06/10	Woori Bank	Korea	163.909
	5/28	15/06/11	Woori Bank	Korea	163.909
	6/6	18/06/06	Overseas Chinese Banking Corporation	Singapore	184.849
	6/18	13/07/01	National Agricultural Cooperative Federation	Korea	92.353
	6/18	11/07/01	National Agricultural Cooperative Federation	Korea	92.353
Thailand					
2007	4/4	14/04/05	Emirates NDB PJSC	United Arab Emirates	61.932
	11/30	17/12/11	Central American Bank for Economic Integration	Honduras	77.343
2008	6/24	11/07/04	Citigroup	USA	73.175
	6/25	11/06/30	French Development Agency	France	45.014
	7/30	18/08/07	The Export-Import Bank of Korea	Korea	105.235
	7/30	11/08/07	The Export-Import Bank of Korea	Korea	105.235

Source: Compiled based on Thomson Reuters database. (Thomson Reuters database does not cover the issuance of all securities.)

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either positive or negative. If the cost is negative, it is more advantageous to raise funds in local currency and convert to dollars, rather than raising funds directly in dollars.

Figure 3 shows the relative cost advantage when funds are raised in local currency and converted to dollars in comparison with direct dollar financing. If the figures in the graph are positive, the cost of financing in local currency in exchange for dollars is higher than direct dollar financing. If the figures are negative, the cost of financing in local currency in exchange for dollars is lower than direct dollar financing. These data indicate that this cost has generally been lower in Malaysia and Thailand in addition to Japan, Singapore and Hong Kong. This fact explains the sharp increase in non-residents' debt securities issuance in the Malaysia and Thai markets.[4]

The second component of financing cost concerns the difference of credit spread. The credit spreads of different countries are difficult to compare because the rating scale used by international credit rating agencies and national credit rating agencies are different. However, in many cases where the same issuer is rated by both international and national rating agencies, credit spreads are lower in local currency markets such as those in Malaysia and Thailand.

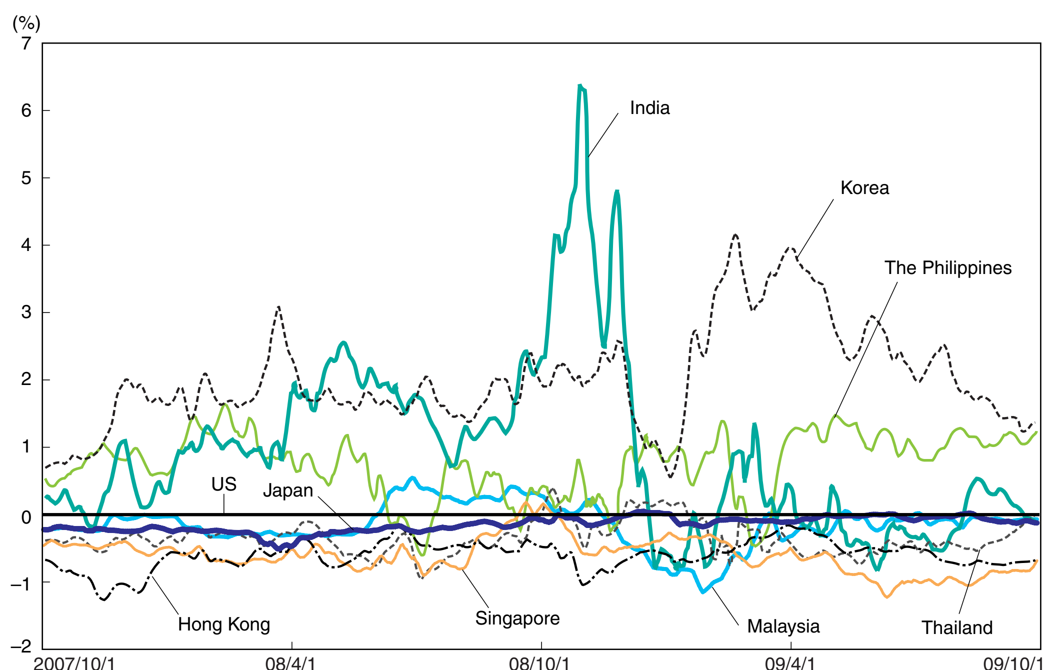
One of the reasons for these lower credit spreads is the lower default probability of Asian issuers. For example, if there is a company that has received an international rating of BB and a national rating of AA, then the international rating of BB is considered equivalent to the national rating of AA in terms of credit risk. However, when we compare ratings of Asian issuers (and issues), the default probability of issuers (issues) with national ratings of AA (for example) is considerably lower than that of issuers (issues) with an international rating of BB (for example). This is true for national ratings by R&I (Rating and Investment Information, Inc.) in Japan, RAM (Rating Agency Malaysia) in Malaysia, TRIS (Thai Rating and Information Services Co.) in Thailand and CRISIL (Credit Rating Information Services of India Limited) in India. While it is unknown whether investors are pricing credit risk based on such differences in default probability,[5] it is true that there is some possibility of cost reduction from the narrower credit spread due to the differences in rating scales when non-residents issue bonds.[6]

3 Increasing Needs for Financial Transactions in Local Currencies

It is inevitable that local financial markets will be further utilized by various entities to access local currency funds (whether or not converting to dollars through swap transactions). In particular, as the world economy recovers, the effects of the phased correction of current-account imbalances (so-called global imbalances[7]) will gradually become apparent.

Previously, accelerated borrowing from the US government, companies and households virtually functioned as the engine of the world economy. However, the US is considered to be shifting its direction to reducing debt. On the other hand, many countries will increase debt to finance stimulus packages (fiscal expenditures) in order to maintain economic growth without relying excessively on US demand. In addition,

Figure 3. Relative Cost Advantages of Raising Funds in Local Currency in Exchange for Dollars (in comparison with direct dollar financing)



Source: Compiled based on the Bloomberg data.

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for household consumption in emerging economies in particular, consumer credit services (credit cards, loans, etc.) have been spreading rapidly. Accordingly, it is likely that the weight of local currency markets against the international market will further increase.

In line with such change, Asian emerging countries have been steadily developing their local currency markets. The development of local currency markets may resolve the longtime challenge of channeling domestic savings to domestic investment opportunities.

II Current Status of Asian Local Currency Markets

1 Reduction of External Debt and Development of Local Financial Markets

This chapter examines the current status of the local currency markets in rapidly growing Asian countries. Here, the word "Asia" refers to emerging China and ASEAN (Association of Southeast Asian Nations) countries.[8]

The Asian financial crisis of 1997 and 1998 dealt a devastating blow to the financial markets and overall economies of many Asian countries. In terms of per-capita income, it was not until 2004 that the income level recovered to the pre-crisis level in Malaysia; it was 2006 in Thailand.

The principal factor that precipitated the Asian financial crisis was the dependence of banks and/or other businesses (sectors differ by country) on short-term external borrowing. This is because instruments for financing and the amount of funds available were limited in local currencies.[9] Accordingly, a sudden devaluation of currency immediately revoked concerns on the repayment of these short-term external loans, leading to a downward spiral that pulled currency values down even further. This phenomenon is known as "double mismatches" in terms of maturity and currency. In some countries, the double mismatches concentrated on the banking sector, leading to banking crises that greatly affected the overall economy.

Based on this experience, many Asian countries have become cautious of foreign debt and have put increased importance on the deepening of local financial markets rather than relying on external borrowings. For example, Indonesia, which was one of the countries that suffered most from the Asian financial crisis, commenced drastic reforms of its financial sector after the crisis. In the 1990s, the reforms centered on post-crisis fix measures. However, after 2000, measures to stabilize and deepen its financial sector have increasingly been adopted, including the introduction of a legal framework for Islamic financial sector and real estate investment trust (REIT), introduction of deposit insurance scheme and the enactment of the new central bank law. Furthermore, 2010 will see the launch of the Financial Services Agency (OJK), a consolidated regulatory and supervisory framework for the financial sector.

Vietnam is another notable example. Neither stock market nor bond market existed in the country until the beginning of the 2000s. Now, however, there are 420 companies listed on the country's two exchanges (238 companies in Hanoi and 181 in Ho Chi Minh City, as of November 2009). Furthermore, in Cambodia, which was still at war in the 1990s, and in Laos, preparations are being made to establish stock markets in 2010.

The development of the Islamic financial market in Malaysia is also important. The headquarters of the Islamic Financial Services Board (IFSB), an international organization for international standards on Islamic financial services, is located in Kuala Lumpur. The ratio of Islamic financial assets to total assets under management by Malaysian financial institutions has been increasing year by year (to about 13% as of September 2009).

A major change that has also occurred in most Asian countries is the increasing confidence towards local currencies. Based on the lessons of the Asian financial crisis, Asian central banks have put more emphasis on exchange policies and have accumulated huge foreign currency reserves.[10] In addition, the Chiang Mai Initiative (CMI), a framework to mutually supplement short-term foreign currency liquidity, has also contributed to stabilizing exchange rates. The CMI consists of "bilateral swap arrangements" among ASEAN + 3 (Japan, China and Korea) countries and "regional (multilateral) swap arrangements" among ASEAN countries. Japan has entered into agreements with Korea, Thailand, the Philippines, Malaysia, China, Indonesia and Singapore. (There are also multilateral and bilateral arrangements in which Japan is not involved. In particular, China is active in establishing arrangements for renminbi swap transactions). It has already been agreed that the current bilateral arrangements will be reorganized into multilateral arrangements in the future, and studies are now underway for implementation.

In many Asian countries, there has been a lingering challenge that domestic financial resources or human/institutional resources are not well channeled to domestic economies due to the outflow of wealth or cross-border arrangement of financial transactions by foreign players. This is because high net worth individuals have not given much trust to their home markets, and corporations are provided with few choices of financial products and schemes available in each local market. Thus, strengthening of local currency markets is also important in restoring domestic business opportunities and fulfilling economic potentials.

2 Local Currency Financial Assets

Local currency financial assets have become attractive not only to domestic investors but also to foreign

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Table 2. Coverage of Local Currency Index

	iBoxx ABF	JP Morgan GBI-EM	JP Morgan ELMI+	HSBC ALBI
China	✔	—	✔	✔
Hong Kong	✔	—	✔	✔
Indonesia	✔	✔	✔	✔
Korea	✔	—	✔	✔
Malaysia	✔	✔	✔	✔
The Philippines	✔	—	✔	✔
Singapore	✔	—	✔	✔
Thailand	✔	✔	✔	✔

Notes: ALBI = Asian Local Bond Index, ELMI+ = Emerging Local Markets Index Plus (forward exchange contracts, deposits, short-term government securities, etc.), GBI-EM = Government Bond Index-Emerging Markets (government bonds); iBoxx ABF = an index that covers government and public sector bonds in local currencies in the economies listed in the left column.

investors. In addition to equities, which are denominated in local currencies and for which there has been certain cross-border investment, investment into foreign exchange and bonds is also likely to have increased. Widespread recognition of indices such as Emerging Local Markets Index Plus (ELMI+; forward exchange contracts, deposits, short-term government securities, etc.) and Government Bond Index-Emerging Markets (GBI-EM; government bonds) developed by JP Morgan has also contributed to the increase in investments in local currencies. In addition, the World Bank Group has developed Global Emerging Markets Local Currency Bond (Gemloc) in cooperation with the Pacific Investment Management Company (PIMCO) and Markit, a global financial information services company for indices. This program is expected to contribute to further growth of investments in local currencies.

While the overall size of cross-border investment in local currency bond markets is not available, there are many internationally accepted indices that cover major Asian countries, as shown in Table 2.

III Aiming at the "Localization" of Japanese Financial Institutions

1 Overseas Business Operations and Financial Activities of Japanese Financial Institutions

Among Japanese financial institutions, banks, securities firms, insurance companies, non-banks (credit cards, sales credit and consumer credit) and leasing companies are actively engaged in overseas business operations. To date, the major overseas activities of Japanese financial institutions have centered on Japanese-related transactions (such as loans, insurance and leasing for Japanese companies and asset management in Japanese markets). Transactions that are not Japanese-related, such as retail financial services for local consumers and financial transactions with local companies, have just begun to appear in recent years; several non-banks and insurance companies have established subsidiaries and joint ventures or purchased local companies in Asia. (It should be noted that Japanese financial institutions have long been providing automobile-related services such as autofinancing, dealer financing and local supplier financing; these services are considered to be close to Japanese-related transactions.)

In the case of Japanese-related transactions of banks, it was not necessary for Japanese banks to actively finance in local markets because the Japanese companies deposited money with them. Similarly, Japanese companies operating abroad tended to minimize financing in local markets because they often brought in funds for capital expenditure (or even facilities themselves) from Japan and, in some industries, aligned the terms of accounts receivable and payable among Japanese companies to reduce working capital needs. When they access loans in local markets, the cost is usually lower if they borrow from Japanese banks with guarantees from parent companies. Accordingly, Japanese companies have had little need to borrow from local banks and/or access local capital markets.

2 Suggested Approaches for Japanese Financial Institutions to Achieve "Localization"

However, with the rise of local currency financial markets as discussed in Chapters I and II, it will no longer become possible to meet the needs of Japanese companies trying to operate in foreign local markets if Japanese financial institutions limit their activities to conventional businesses. In addition, considering the expansion of local currency markets (and the shrinkage

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of Japanese, US and European markets), the priority of expanding networks into local financial markets in emerging economies has become higher as one of the few opportunities for growth. Given such changes of environment, we would like to summarize the following four points as important challenges for Japanese financial institutions.

(1) Responding to the "financial localization" of Japanese companies operating abroad

The first point concerns the fact that Japanese companies have started to conduct financing activities more globally and efficiently in order to pursue business penetration in the local markets of emerging economies.

Traditionally, large companies have established subsidiary finance companies within their own groups and had them engage in global financing such as financing in the euro market, while at the same time adopted global cash management system in each region whereby they can optimize financing efficiency within the group. In addition to these activities, especially since the early 2000s, Japanese companies have accelerated their financial activities in local markets such as issuing corporate bonds in local currencies. Currently, such issuances are mostly done by large, well-known companies. In the near future, more companies with increased localized businesses will begin to utilize local financial markets. If Japanese financial institutions are unable to provide necessary local-currency financial services to the Japanese companies that are pursuing localization, they might lose opportunities for additional businesses.

Given the increasing availability of financing choices in local currency markets and diversification of financing needs by Japanese companies abroad, financial institutions are also required to localize themselves. Specifically, they are expected to provide a wider selection of services (transactions in local currencies) to Japanese companies and, with such service selections, serve the needs of non-Japanese companies as well.

(2) Entry into retail business

Second, entry into retail business (handling of personal deposits and sales of products for consumers) is a promising choice, especially for banks in order to finance themselves. Retail business generally provides a source of steady earnings and is also effective in achieving higher publicity. Therefore, entry into retal business is worth considering as one of the options to expand businesses beyond Japanese-related ones. For non-banks, insurance and asset management companies, the growing markets of the middle-class and wealthy segments in Asia would provide good opportunities. For securities companies, retail business would contribute to strengthened global competitiveness because a strong retail network (particularly towards the wealthy segment) would enable more effective financial proposals backed by sales capabilities.

Currently, among Japanese financial institutions, non-banks (credit cards and consumer credit) and insurance companies are going ahead in entering retail businesses. In contrast, there are still only a limited number of such cases among banks and securities firms. In order to fully expand into local markets, it may be necessary to consider measures such as mergers and acquisitions of local companies.

(3) Competition among "financial conglomerates"

Such business expansions inevitably increase competition with international and local financial institutions. Under such competition, it is important to determine a stance against the universal banking model (whereby financial institutions handle multiple financial products). In many markets including Asia, the universal banking model has been adopted to enable banks to offer various financial services such as securities and insurance services. European financial institutions, which were the first to adopt this model, and US financial institutions, which were allowed to form financial conglomerates with the Gramm-Leach-Bliley Act of 1999, now offer a wide range of financial services to customers around the world.

With the advent of the financial crisis and resulting management difficulties facing many international financial institutions, the validity of this model is now subject to some doubt. Nevertheless, in order to maximize management resources, the scale and scope of businesses remain emphasized from both the regulatory and business perspectives, rather than just returning to the specialized financial institution model. In emerging Asian economies, in particular, banks play dominant roles in the financial sector and have a wider network connecting individuals and companies. Therefore, banks are well positioned to provide various financial services, while enjoying the lower cost of financing and stronger backup against liquidity risk.

In Japan, while the trend toward financial conglomerates is in progress, overseas business expansion and operation seem to be managed only by individual business units rather than on a group-wide basis. However, since further localization would assume competition with international and local financial conglomerates, Japanese financial groups would also need a strategy as a group.

(4) Arrangement of financial transactions in multiple local markets

Localization of financial business is also expected in view of meeting the needs of financial transactions across multiple countries and markets. In addition to the existing "global" transactions, there will be more businesses involving "multiple" local markets, such as simultaneous arrangement of local currency transactions

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in different local markets or M&As involving several local markets, on top of the conventional "global" market. Financial institutions not only need to optimize their local operations within each country, but also need to be able to arrange cross-border transactions with other local operations.

Major financial institutions that deploy multiple-local businesses in Asia include HSBC (the UK), Standard Chartered Bank (the UK), DBS Bank (Singapore) and CIMB Bank (Malaysia). (Prior to the financial crisis, the ING (the Netherlands) and AIG (the US) groups, whose businesses are centered on insurance, were also among such financial institutions). These financial institutions are well positioned to introduce their international customers to various financial products of and investors in Asian countries and will continue to be highly competitive in multiple local businesses.

3 Future Global Business Models for Japanese Financial Institutions

Based on what was discussed so far, this section proposes future global business models for Japanese financial institutions from the aspects of profit and balance sheet, as well as from the viewpoint of underlying infrastructure.

(1) Profit: Defining business areas as a financial group and building business network in each local market

Although many Japanese financial institutions have formed financial conglomerates consisting of banking, securities, non-bank (and insurance) operations in Japan, it is often only individual business units that actually determine overseas business operations. This stance should be reconsidered. In addition to meeting the needs of existing Japanese customers through each business unit, it should be necessary for the entire group to examine what other business opportunities are available in foreign markets for which they could utilize their business resources. While this strategy is difficult to adopt for a company that has not formed a financial group, M&As in local markets could be useful to compensate for a lack of resources.

Looking at profit structure, it is necessary to consider a long-term perspective on a group-wide basis, rather than requiring each business unit to be profitable in the short term. For example, if a business unit is not making a profit, the other units in a group can cover the costs incurred by that unit. It is assumed that ING group had adopted this approach in the Asian market, and was successful in improving its profitability from the early stages of its market entry, although the group has been suffering management difficulties as of 2009. The principal business field of ING is insurance (especially, variable rate insurance and individual annuity insurance), and it generally takes some time for these businesses to be profitable. This is because, at the early stages, costs (including payment of insurance claims) tend to be larger than insurance premiums, and it also takes time to attain recognition and popularity of the products. With ING's business model, however, its investment advisory and asset management arms could support the life insurance business until it became profitable. Japanese financial institutions are now well positioned to adopt this kind of business model, given the impact of the financial crisis that put many international financial institutions in difficult straits in terms of global expansion.

(2) Balance sheet (1): Optimizing global risk allocation

From the perspective of the balance sheet as well, efficiency of operations must be improved to accommodate global expansion. With the Basel Capital Accord, it has become a significant issue for banks and banking groups to efficiently allocate capital according to risk; this issue will become even more important with overseas business development. If a bank attempts to expand its customer base and/or business areas overseas, it is necessary to standardize global risk assessment to include foreign subsidiaries and joint ventures, and to optimize risk asset allocation.

The next step is to examine the stance for taking credit risks in Asia, and this is where the accumulation of information becomes crucial. What tends to be lacking in Asian markets in comparison with global markets such as the euro market is the tolerance of credit risk rather than the amount of capital (liquidity). Similar to investors in the US and Europe, investors based in Hong Kong and Singapore (which function as euro markets in Asia) are trading in the high-yield bond market, which continues to play an important role even after the financial crisis. However, in other Asian countries, the high-yield bond market barely exists, especially for foreign credits. Under such conditions, some of the Japanese investors with high risk tolerance have to turn to financial institutions in Singapore, for example, to manage their funds. In the future, Japanese financial institutions are expected to create a demand in Japan for Asian credits, and at the same time, to accumulate information on credit risks.

In these endeavors, the Credit Guarantee and Investment Facility (CGIF) that will be established as the trust fund of the Asian Development Bank under the ASEAN + 3 framework, will provide major support for the enhancement of bond investment toward this region. In view of the fact that many Asian companies with investment-grade ratings by national rating agencies are often assigned non-investment grade by international rating agencies, this facility provides credit guarantees to corporate bonds of well-performing companies in Asia. It is hoped that these measures will contribute to the familiarization of Asian local currency markets among financial institutions and investors as well as all others involved in

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the financial sector, and will facilitate a variety of activities among them.

(3) Balance sheet (2): Globally optimizing the measures and currencies of financing

Optimization of the measures of financing and the combination of currencies also constitutes an important future strategy. With a view to financing optimal currencies globally while reducing liquidity risk, it is necessary for financial institutions to have access to sources of financing in local markets. As explained in Chapter I, during the period of difficulty in raising funds in the international financial markets, Korean financial institutions were able to secure funds in Asian and Latin American markets.

In the past, it was often a major challenge or a common goal to "sophisticate" the measures of financing successfully. When conducting financial businesses in emerging local markets, however, financial institutions face a different type of challenge to effectively fulfill necessary financial needs in immature markets while reducing risks.

For example, it is still difficult to raise long-term funds in emerging Asian markets. Similarly, it is not easy to hedge against interest rate risks, etc. when holding long-term assets. Accordingly, financial institutions must match assets and liabilities as rudimentarily as possible. For this purpose, measures such as acquiring various customers with different financial needs and achieving the targeted asset liability management (ALM) would be necessary.

(4) Developing financial infrastructure for multinational transactions

To date, the major beneficiaries of international financial infrastructure have been assumed to be players in advanced economies such as the US and Europe. For example, companies from advanced economies account for most of the issuers with investment-grade ratings by international rating agencies, and many companies in Asian countries, with the exception of Japan, are classified in the high-yield segment (with non-investment-grade ratings). Another example is that two international clearinghouses, Euroclear and Clearstream, which are headquartered in Europe, form a dominant presence in securities settlement in the euro market and, under this structure, it is not possible to settle Asian transactions in Asian time.

Nevertheless, gradual improvements are seen in the infrastructure area as well. Standard & Poor's, a rating agency, announced the launch of the ASEAN Regional Rating Scale in May 2009, which offers a more detailed rating scale to evaluate the credit risk of companies in the ASEAN region. While it is still unknown if this new rating scale will be accepted by global investors, the ASEAN regional rating scale does address the long-standing issues of national vs. global scale ratings by enabling comparison of the credit risk of companies (and issues) from different ASEAN countries under the same scale, and by assigning investment grade ratings to leading companies in ASEAN.

In addition, in October 2009, Clearstream announced that it plans to set up a clearing subsidiary in Singapore. This will enable the settlement of Asian transactions in Asian time.

To date, these initiatives have been taken by American and European players in international markets by way of localization. Japanese financial institutions are also expected to play important roles in pursuing the future growth of Asian local markets. Starting with the development of financial infrastructure, there are various agendas under international discussion, to which Japanese financial institutions could contribute.[11]

Notes:

1 Euro market refers to financial market outside of the financial jurisdiction of a certain country.

2 However, for several months after the Lehman Brothers collapse, it had become difficult to enter into term transactions in many local market as well.

3 In the ASEAN + 3 region, countries where non-residents are allowed to issue bonds include Korea (Arirang bond), Hong Kong, Indonesia, Malaysia, Singapore, Thailand and the Philippines (however, there have been no actual issues so far in Indonesia and the Philippines). In China, studies are underway to apply Panda bond, which is a framework for non-residents' issuance, to private companies in the future.

4 However, except for Japan, the US, Hong Kong and Singapore, liquidity in the swap markets is not high; these data shall be considered only as reference.

5 Practically, capital account is not fully liberalized in many Asian countries, making it difficult to pursue arbitrage opportunities based on credit risk pricing. This is assumed to be one of the reasons for the difference in credit spread.

6 However, there have been several cases where spreads are wider for non-resident issuers than for resident issuers with the same ratings. This is assumed to be attributable to the fact that investors had priced-in the costs related to difficulty in accessing information on non-resident issuers and complicated procedures in case of default.

7 A phenomenon whereby export countries in Asia and the Middle East accumulate a current-account (trade) surplus with the US while the US increases its current-account (trade) deficit.

8 Korea and Taiwan are not included in emerging economies. While India is an emerging economy, it is not included here because the history and characteristics of market development differ from those of other countries.

9 Prior to the Asian financial crisis, many Asian countries suffered from current account deficits and the liquidity in the local market was not sufficient to support domestic funding needs.

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10 While the Ministry of Finance oversees foreign exchange intervention and manages foreign currency reserves in Japan, in many Asian countries, the central banks play these roles.

11 Infrastructure-related agendas include the development of local currency payment networks and the introduction of cross-border collateral arrangements by central banks. Various views and opinions are being presented for these agendas.

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