Sustainability

Sustainability is a systemic concept, relating to the continuity of economic, social, institutional and environmental aspects of development. In the terms of the 1987 Brundtland Report of the UN's World Commission on Environment and Development, sustainability is: "Meeting the needs of the present generation without compromising the ability of future generations to meet their needs." The key concept for investors is the need to address a range of environmental, social, and governance (ESG) factors which will inevitably shape long-term returns as markets respond to changing resource requirements and public priorities.
INTRODUCTION

"Managing other people's money entails a fiduciary responsibility that calls for higher ethical standards than in the average business"

David Lascelles, "Other People's Money: The Revolution in High Street Banking"

"Although the direct environmental impacts of financial companies such as banks, asset managers and insurance companies are limited to universal business environmental issues such as resource use, procurement in offices and business/staff travel, there is a general consensus that they have significant indirect impacts through their lending and investment activities."

The Asian banking sector, like its counterparts globally, does not have high direct sustainability impacts. Nonetheless, the banking sector plays a crucial role in directing capital in one of the highest impact regions for environment, social and governance (ESG) risks. The ESG cost of bad credit decisions casts a long and, in some instances, irreversible shadow over development options. For example, the ability of Asian banks to respond to the current funding needs of Asia's fast-growing energy and high tech manufacturing sectors will inevitably shape Asia's long-term ESG profile. This interplay between lending decisions and Asian ESG management is amplified by the dominance of bank lending in the funding equation in Asia, making the health of the region's banks integral to Asia's ability to move toward a more sustainable development path.

While the financial authorities have made significant headway since the Asian crisis (1997-98) in developing local capital markets, most countries are still struggling with inefficient financial systems, outdated infrastructure and maturing legal systems. Most local banks are still controlled by the government or by families, raising a significant issue of corporate control as well as corporate governance.

Reflecting this diversity, management understanding of sustainability issues in Asian-based banking institutions ranges from top-of-the-agenda for the global financial institutions operating in the region such as HSBC, Standard Chartered, and Citigroup to significantly below the radar screen for most of the locally listed players. For example, HSBC moved from 45th in 2004 to 4th in 2005 in the Accountability Rating ranking of the Fortune Global 100. The large global financial institutions, particularly in Europe, have already evolved from a reactive stance to a proactive stance on sustainability and some are already moving to a comprehensive sustainable banking mode.

By contrast, financial institutions in Asia are by-and-large still in reactive mode, even when sustainability issues register on management's agenda. As a result, we see a scenario where ESG risks have the potential to accelerate the growing divide between leaders and laggards in Asian banking. As leading banks become more adept at identifying problematic ESG issues, they will be motivated to improve corporate governance, reduce credit exposure to affected...
sectors, or seize opportunities to develop new risk management tools. As a result, ESG risks could easily become concentrated in the corporate loan books of less capable banks, adding to their fundamental operational challenges.

ESG risks will place new pressures on Asia's banking sector and will highlight, once again, the importance of the most basic bank disciplines, especially those linked to governance. The key ESG risks affecting the financial sector in Asia today are inextricably linked to the most fundamental trends that shape the sector. And while ESG risks have the potential to further burden banks with troubled legacy assets, there will be scope for a new generation of banks with forward-looking ESG strategies which will have the potential to tap into new consumer and product-driven market niches.

In this report, we assess these issues in the context of Asia’s most broadly held large- and mid-capitalization listed banking companies. We believe that the most important sustainability themes for investors in the Asian banking sector will be:

- **Corporate control & governance** Efforts to improve bank governance will hinge on issues of corporate control
- **The technology bet** This will be crucial to establishing good governance, assessing sustainability risks, and seizing new product opportunities
- **Asset quality and sustainable risk assessment** The asset quality of Asian banks has suffered from a history of poor risk management; ESG risk assessment could provide a powerful new tool
- **ESG management — long-term differentiator** Asia's top banks will embrace sustainability themes, especially as they migrate toward consumer banking opportunities. Specialty players, such as non-bank consumer finance companies, unburdened by balance sheet problems, may also prove competitive in offering new sustainable finance products and services, permitting them to take significant market share in profitable niches of the finance industry

**COUNTRY AND SECTOR DYNAMICS**

What the sector looks like today

The financial sector in Asia is highly fragmented, reflecting the diversity of a region which encompasses the two most populous countries in the world, China and India, as well as some of the smallest. There is also a wide diversity of development, ranging from OECD countries such as South Korea, developed countries such as Hong Kong and Singapore, and some of the world’s poorest such as
Bangladesh, North Korea and Myanmar. Banks operating in Asia cover a wide spectrum from the world’s top global financial institutions to small local players.

**Figure 1 Larger Regional Listed Banks**

<table>
<thead>
<tr>
<th>Market</th>
<th>Company</th>
<th>Market Cap* (US$mm)</th>
<th>Market</th>
<th>Company</th>
<th>Market Cap* (US$mm)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>HSBC Holdings</td>
<td>182,937</td>
<td>Korea</td>
<td>Kookmin Bank</td>
<td>24,726</td>
</tr>
<tr>
<td></td>
<td>China Construction Bank</td>
<td>77,777</td>
<td>Woori Finance</td>
<td>Shinhan</td>
<td>16,182</td>
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<tr>
<td></td>
<td>Standard Chartered</td>
<td>29,494</td>
<td>Shinhan</td>
<td>Korea Exchange Bank</td>
<td>9,082</td>
</tr>
<tr>
<td></td>
<td>Hang Seng</td>
<td>24,955</td>
<td>Ind Bank of Korea</td>
<td>Daegu Bank</td>
<td>7,102</td>
</tr>
<tr>
<td></td>
<td>Bank of Communications</td>
<td>20,700</td>
<td>Daegu Bank</td>
<td>2,019</td>
<td></td>
</tr>
<tr>
<td></td>
<td>BOC Hong Kong Holdings</td>
<td>20,592</td>
<td>Malaysian Banking</td>
<td>4,894</td>
<td>11,096</td>
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<tr>
<td></td>
<td>Shanghai Pudong Dev Bank</td>
<td>4,894</td>
<td>Public Bank</td>
<td>5,918</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bank of East Asia</td>
<td>4,567</td>
<td>Commerce Asset</td>
<td>4,150</td>
<td></td>
</tr>
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<td></td>
<td>China Minsheng Banking</td>
<td>3,778</td>
<td>Hong Leong Bank</td>
<td>2,130</td>
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<td></td>
<td>Guoco Group</td>
<td>3,620</td>
<td>AMMB Holding</td>
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<tr>
<td></td>
<td>Hua Xia Bank</td>
<td>2,552</td>
<td>RHB Capital</td>
<td>1,065</td>
<td></td>
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<td></td>
<td>Wing Hang</td>
<td>2,116</td>
<td>Singapore</td>
<td>DBS</td>
<td>14,832</td>
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<tr>
<td></td>
<td>Dah Sing Financial Hldg</td>
<td>1,728</td>
<td>UOB</td>
<td>13,474</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dah Sing Bank</td>
<td>1,706</td>
<td>OCBC</td>
<td>12,534</td>
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<tr>
<td></td>
<td>Shenzhen Dev Bank</td>
<td>1,532</td>
<td>Hong Leong Finance</td>
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<td></td>
<td>Industrial &amp; Commercial Bank of China</td>
<td>1,366</td>
<td>Cathay Financial</td>
<td>15,361</td>
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<tr>
<td>India</td>
<td>First Pacific Co Ltd</td>
<td>1,226</td>
<td>Mega Financial</td>
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<td></td>
<td>CITIC Int'l Financial Hldgs</td>
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<td>Fubon Financial</td>
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<td></td>
<td>ICICI Bank</td>
<td>11,149</td>
<td>China Development</td>
<td>4,048</td>
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<td></td>
<td>Sate Bank of India</td>
<td>10,603</td>
<td>China Development</td>
<td>4,048</td>
<td></td>
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<tr>
<td></td>
<td>HDFC Bank</td>
<td>4,903</td>
<td>Taiwan Business Bank</td>
<td>1,093</td>
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<tr>
<td></td>
<td>HDFC Bank</td>
<td>4,887</td>
<td>Chinnatrust Financial</td>
<td>5,612</td>
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<td>Punjab National Bank</td>
<td>3,264</td>
<td>China Development</td>
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<td></td>
<td>Bank of India</td>
<td>1,380</td>
<td>Krung Thai</td>
<td>3,007</td>
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<tr>
<td></td>
<td>Union Bank of India</td>
<td>1,247</td>
<td>Siam Commercial</td>
<td>2,301</td>
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<tr>
<td></td>
<td>YES Bank</td>
<td>410</td>
<td>TMB Bank</td>
<td>1,400</td>
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</tr>
<tr>
<td>Indonesia</td>
<td>Bank Central Asia</td>
<td>4,266</td>
<td>Siam City Bank</td>
<td>1,255</td>
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<td></td>
<td>Bank Mandiri</td>
<td>3,380</td>
<td>Bank of Asia</td>
<td>1,075</td>
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<tr>
<td></td>
<td>Bank Danamon</td>
<td>2,379</td>
<td>Source: Bloomberg, December 2005</td>
<td></td>
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</tbody>
</table>

* As at 30 December 2005, or last official day of trading
While most of the leading banks are listed on local markets, it is significant that some of the major players in critical markets, such as the Bank of China, are not listed, or with very limited float, restricting the ability of investors to invest in some key segments of the sector. Indeed, the phased listing of China's Big Four government-owned banks which started in 2005 represents a multi-billion dollar step toward equitization of the China's banking sector. Foreign banks are active players to various degrees in most markets, depending on the market's openness to foreign investment and the particular bank's strategy. Most of the global financial institutions, such as Citigroup, Bank of America, JP Morgan Chase, HSBC, Deutsche Bank, BNP Paribas, Calyon and others are to various degrees involved in most Asian markets, as are the global investments banks such as Credit Suisse, Morgan Stanley, Goldman Sachs, Merrill Lynch, and UBS. And although the Asian insurance sector is developing rapidly, with significant participation from global companies, it is not yet a significant sector for Asian equity investors.

Many countries in Asia are significantly over-banked. For example, China's commercial bank deposits account for nearly 200% of GDP and loans in the banking system currently stand at 130% of GDP. This is also true for some of the most developed markets; Taiwan and Hong Kong have even higher banking ratios. Corporate control issues affect the ability of players to execute M&A strategies in countries like Indonesia and South Korea and restrict the ability of the government to encourage much-needed consolidation in markets like Taiwan and Thailand. In many countries, the financial authorities simply lack the power to move the agenda forward, with weak regulators and central banks controlled by the government. As recently highlighted by People's Bank of China (PBOC) chief Zhou Xiaochuan, "scandals are one of the four major incentives driving reform of the mainland's banking system" as they provide the stakeholder pressure necessary to push for reform.

**Cross-cutting issues**

**Inefficient financial systems** The Asian crisis of 1997-1998 painfully highlighted the inefficiencies of the region's financial markets and its over-reliance on bank lending as the primary source of financing. While governments have made significant headway in setting up local capital markets, most countries' financial systems still suffer from structural and efficiency problems. Regional cooperation between financial authorities has contributed to significant changes and local capital markets, particularly local currency debt capital markets, have since taken off. One example of such cooperation is the signing of swap agreements between the region's central banks to help fend off sporadic speculative attacks on their currency. Another example is the Asian Infrastructure Bond Fund, which was developed by the region's financial authorities to foster the development of the domestic bond markets.

Nevertheless, many financial systems remain under-developed and inefficient, with payment system infrastructure lagging behind. At the same time, the overwhelming reliance on bank lending as the primary source of capital for the region's enterprises continues to affect the financial system as a whole, with under-developed financial markets restricting the corporate sector's access to alternative sources of financing. Indeed this is one of the drivers behind decisions
by multilateral funding institutions to invest in China's banking sector. As stated by the IFC, "if you invest $10 in a bank and that bank becomes an effective financial intermediary by mobilizing savings and directing it toward borrowers that can use it most effectively, you can end up funding 150 shoemakers. The developmental impact of a good financial intermediary on an economy is huge."6.

The concentration of banking activities on corporate banking is also both a drag on banking revenues and a potential source of defaults affecting the sector's viability and exacerbating non-performing loan (NPL) problems. The problem is especially acute in China, where bank lending accounted for between 76 and 99% of all business financing in 2001-20057. Indeed, the prevailing mindset in local banks across the region has traditionally been a focus on size (total assets) before profits.

**Lack of system infrastructure** The lack of basic infrastructure, defined by manual local processes versus centralized automated processes and by low penetration of telephone, computer, and internet services in many countries, impedes the development of efficient financial systems. These gaps make it difficult to set up efficient clearing systems and settlements systems and are a roadblock to improved corporate governance. Under-investment in technology by most of the local players significantly impairs bank managements’ ability to provide basic services and to implement strategy and control execution. For example, sweeping bank regulations such as Basel II8—a global capital adequacy standard—and bank reforms are extremely difficult to implement across the banking sector in Asia where local players lack the basic infrastructure necessary to set up the relevant management information systems for internal reporting.

**Lack of legal infrastructure** In many countries, the legal system is still underdeveloped, with many lacking fundamental legal structures such as basic property rights, copyright protection, and banking laws. For a sector that is heavily reliant upon a well functioning system of secured transactions, this is a significant gap. Where there exists such legislation, enforcement is often inconsistent at best. Even in countries where the rule of law stands firm, there can be uncertainty in the interpretation and enforcement of basic laws. It is not enough to simply operate within the law, the moral obligation of banks implicit in corporate social responsibility, or good citizenship, is hard to establish when the law itself is a moving target.

**Long-term sector outlook**

Many forces, strongly reinforced by global and Asian sustainability trends, are at work that will substantially alter the financial landscape in Asia in the longer term. Technology will significantly amplify the tiering effect already visible in all markets. Players with the capacity to invest in technology will be better positioned to penetrate the promising new markets of consumer finance and wealth management, while at the same time reaping the rewards, in terms of increased profitability, of increased internal processing efficiency. Moreover, as sector leaders shift from corporate banking to consumer and retail banking, major revenue and profit generators will accelerate on the back of two major forces: the ageing of the population and the increasing disintermediation of the financial market.
Consolidation will accelerate, driven by the blurring of boundaries within the financial sector and the need for scale to absorb the required technology investments. Globalisation will continue, as markets grow more integrated, with the possibility of closer co-operation between the different markets. Asian capital markets will continue to deepen, driven by the urgent need for both corporate financing alternatives to banking and for pension fund investment alternatives as ageing populations increase the demand for pension fund development. "Best-in-class" practices will be adopted often reflecting a better understanding of sustainability risk factors and an effort to provide new risk management and investment products. This dynamic will accelerate as foreign global institutions continue their penetration of local markets and as the region’s dominant players become more actively involved in foreign markets.

The net effect of these trends for investors focused on sustainability issues should be greater emphasis on specific tools for effective implementation of improved corporate governance strategies. Investors will want to remain extremely attentive to operational and organizational metrics which signal progress on improved corporate governance and control at the board level, and crucially, in credit decisions. While this is a recognized priority with Asian bank regulators, the actual pace and quality of implementation will shape performance over the longer term as sector leaders and new entrants place competitive pressure on laggards. This trend will be accentuated as greater recognition of sustainable finance practices and products creates opportunities for the more nimble Asian banks.

**CORPORATE CONTROL & GOVERNANCE**

Perhaps the most strategic issue for investors in the Asian banking sector will be the ability of Asian banks to define and implement more effective standards of governance. Post-Enron and post-Asian crisis, it is hardly surprising that corporate governance is identified as one of the leading preoccupations of the banking sector in various industry and international surveys. With new studies increasingly correlating good corporate governance with good company performance, corporate governance becomes a differentiating factor between leaders and laggards in the industry. In Asia, polarization is accentuated by the heterogeneity of the sector, compared to more homogeneous developed markets such as the US.
In Asia, this particular issue takes on added significance as a result of the predominance of state-controlled and family-controlled companies in the financial sector, and as such, corporate governance is closely linked to corporate control. Foreign ownership of financial institutions remains tightly controlled in most markets, restricting the ability of better-capitalized local and foreign institutions to develop aggressive M&A strategies. Many initiatives are under way including the slow opening of China's market and the recent abolition by Taiwan authorities of the cap on foreign investment in domestic banks. In some countries the opening of the market to foreign investors has been an intricate dance, with two steps backwards for each step forward as regulators and politicians struggle to balance the promise of better sector fundamentals with domestic political pressures.

### Government and family ownership shape the sector's risk profile

State ownership still dominates the financial sector in many countries in Asia. This raises a very important corporate governance issue, partly due to the particular role of banks in the economy. According to the Asian Development Bank Institute: "Greater state ownership of banks is associated with less financial development, and lower growth and productivity. [It is] associated with the level of non-performing loans and policies that restrict bank activities, reduce bank competition and stymie private sector control of banks. [It] increases the probability of banking crisis." 9

#### Figure 2 Corporate Governance and Key Asian Markets

<table>
<thead>
<tr>
<th>Key Markets</th>
<th>Govt Ownership Dominance</th>
<th>Family Ownership Dominance</th>
<th>Tech Advance</th>
<th>NPLs</th>
<th>Corruption &amp; Control</th>
<th>Penetration of Foreign Investors</th>
<th>Probability of Technology Leapfrogging</th>
<th>Capital System Efficiency</th>
<th>Legal System Efficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>Medium</td>
<td>Low</td>
<td>High</td>
<td>Medium ↓</td>
<td>Medium</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>India</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
<td>Medium ↓</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>Low</td>
<td>Medium</td>
</tr>
<tr>
<td>China</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
<td>High ↑</td>
<td>High</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Taiwan</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>Medium</td>
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<td>Hong Kong</td>
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<td>Medium</td>
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<td>Low</td>
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<tr>
<td>Singapore</td>
<td>Low</td>
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<td>Medium</td>
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<td>Medium</td>
<td>Low</td>
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<td>High</td>
</tr>
<tr>
<td>Indonesia</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>High ↓</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
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<td>Malaysia</td>
<td>High</td>
<td>Medium</td>
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<tr>
<td>Philippines</td>
<td>Low</td>
<td>High</td>
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<td>High ↑</td>
<td>High</td>
<td>Low</td>
<td>Medium</td>
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<tr>
<td>Thailand</td>
<td>Low</td>
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<td>High ↑</td>
<td>Medium</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

Source: ASrIA, 2005
In some cases, government ownership is partly a result of nationalization of troubled financial institutions in the aftermath of the Asian crisis and the government's key role in driving a consolidation of the financial sector and a closing down of non-viable institutions. For example, in Indonesia significant banking reform has been accomplished under the government’s leadership: 70 banks were closed, 13 were nationalized, and the number of licensed banks was reduced from 240 at the time of the Asian crisis to 138 at the end of 2003. Bank Indonesia has announced plans to encourage further consolidation between the smaller banks, but the top banks in terms of assets are still government controlled. For example Bank Mandiri, the largest bank, is 70% government-owned while Bank Negara Indonesia (BNI), the third largest bank, is also state-owned.

The policy consequences of government ownership vary widely across Asia however. In Malaysia, the government forced through a consolidation of the banking sector reducing the number of banks from 55 to 10 in 1998-2003. More recently, a second wave of consolidation has started with the consolidation of the Commerce Asset Holdings Berhad (CAHB) banking group, the second largest bank group in Malaysia by asset size. The group’s investment banking arm, CIMB, announced on June 6, 2005 the takeover of its affiliate Bumiputera Commerce Bank (BCB). This deal creates a universal bank type entity capable of offering a full range of commercial and investment banking products, as well as a more sizeable entity able to reap economies of scale and position itself as an acquirer rather than a target in the next wave of national and regional

**Figure 3 Banking Assets under Government Control, 2002**

The policy consequences of government ownership vary widely across Asia
It is worth noting that CAHB's major shareholder is state investment agency Khazanah; the Malaysian government has made it clear that it wants to see a further round of market-led bank mergers in Malaysia and also seeks to improve corporate governance. Rather than forcing the mergers through, as was the case post-crisis, the government is taking steps to encourage banks to merge.

In other cases, government control of the financial sector is a legacy issue from the past. For example Taiwan has 14 financial holding companies and 47 banks, of which 12 are state-owned, and the three largest banks (Bank of Taiwan, Taiwan Cooperative Bank and Land Bank of Taiwan) are all wholly owned by the government.

Since the Asian crisis, it is estimated that Asian governments have invested over US$500 billion to help their domestic banks, highlighting the critical role of banks in financing the economy and as a repository of deposits. Banks are used by governments as a device for economic development and to an extent this hobbles Asia’s banking systems. On the other hand, "governments have to take responsibility when the banks get in trouble" says Terry Chan, Standard & Poors director.

**Figure 4** Chinese banking sector: market share by assets, 2002

In China, as a result of the legacy of socialism, wholly state-owned banks dominate the market and control over 60% of the sector's total assets. Most major mainland Chinese banks are still under government control. Further to China’s entrance in the WTO, the government has embarked on an ambitious program of banking sector reform, including opening the sector to foreign investors, consolidation, and privatization through overseas listing of the state-owned and state-controlled banks. Starting with the joint-stock companies — Bank of Communications and China Minsheng — the sector is slowly opening up to foreign investors. Overseas listing of the Big Four is also in process, with CCB completing an US$8 bn IPO in Hong Kong October 2005 and the other listings expected in the next 12 to 18 months. UBS estimates that overseas investors have committed US$18 billion to the Chinese banking system from Sept 2004 to Sept 2005 and that by the close of 2007 foreign banks and other
investors could conceivably control more than one-sixth of the entire Chinese banking system.

**Figure 5** Overview of the Chinese banking sector

<table>
<thead>
<tr>
<th>Big Four State-owned Banks</th>
<th>11 Joint Equity Commercial Banks</th>
<th>Three Policy Banks</th>
<th>Small and Mid-Sized Banking Institutions</th>
<th>Four Asset Management Companies</th>
<th>191 China branches of Foreign Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>China Construction Bank</td>
<td>China Minsheng Banking Corp. Ltd.</td>
<td>The Export-Import Bank of China</td>
<td>City Commercial Banks (112)</td>
<td>China Huarong Asset Management Corp.</td>
<td>• HSBC</td>
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<tr>
<td>Agriculture Bank of China</td>
<td>Bank of Communications</td>
<td>Agriculture Development Bank of China</td>
<td>Credit Cooperatives (39,100)</td>
<td></td>
<td>• Citibank</td>
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<tr>
<td>Industrial and Commercial Bank of China</td>
<td>Citic Industrial Bank</td>
<td>China Development Bank</td>
<td>Trust &amp; Investment Companies (136)</td>
<td></td>
<td>• JP Morgan Chase</td>
</tr>
<tr>
<td>Bank of China</td>
<td>Shanghai Pudong Development Bank</td>
<td>Leasing Companies (12)</td>
<td></td>
<td></td>
<td>• Bank of East Asia</td>
</tr>
<tr>
<td></td>
<td>China Merchants Bank</td>
<td></td>
<td></td>
<td></td>
<td>• Standard Chartered</td>
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<tr>
<td></td>
<td>Guangdong Development Bank</td>
<td></td>
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<td></td>
<td>• ABN Amro</td>
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<td></td>
<td>Huaxia Bank</td>
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<td></td>
<td>Shenzhen Development Bank Co. Ltd.</td>
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<td></td>
<td>Evergrowing Bank</td>
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<td>Fujian Industrial Bank</td>
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<td>China Everbright Bank</td>
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The link between government ownership and governance risks is unfortunately quite strong. Government-directed and policy lending designed to favour specific industry sectors has been a consistent trait of the banking landscape in Asia, especially in China with lending to state-owned enterprises (SOEs) and in South Korea with lending to the chaebols. This in turn has resulted, in many cases, in significant lessening of asset quality in the banking sector and, in the worst cases, in high NPL ratios. This has negative affects on the growth prospects of the financial institutions, the efficiency of the financial system and the growth prospects of the economy as a whole.
Unwinding long-established lending abuses is not easy however. In some cases, government initiatives to reform the banking sector and push through better corporate governance have clashed with other government macro-economic initiatives.

For example, in Thailand, over the past year the finance minister and the central bank governor clashed over lending at state-owned Krung Thai Bank, which had rapidly expanded its loan portfolio as part of the government's policy to stimulate growth.

Many initiatives are under way to privatize government-owned financial institutions and in some cases the process is nearing completion. For example, in South Korea, “the government continues to direct the sector's evolution and intends to divest itself of stakes in local banks and re-capitalize distressed financial institutions”\textsuperscript{13}. However, in other countries progress has been impaired by vested interests, in particular labour unions concerned about the loss of jobs as a result of consolidation, as in Taiwan, as well as significant pressure from politicians seeking to protect established areas of influence, as in South-East Asia and India.

Another difficulty impairing the progress in privatization is the lack of efficiency of the financial system which restricts the sources of available financing. Despite significant progress accomplished post-Asian crisis to develop local domestic capital markets, most markets still lack the depth necessary to recapitalize ailing domestic financial institutions. Opening the market to foreign capital enables a much needed injection of funds into the sector, and also brings about the technology and know-how necessary to improve governance and efficiency, which explains why governments in markets like South Korea, Thailand and recently China have been encouraging international buy-ins. In fact, Chinese government and banking officials alike emphasize that the main driver for opening the banking sector to foreign investors is the ability to tap foreign institutions' know-how in terms of corporate governance, risk management and technology. According to UBS chief Asian economist, the Chinese authorities are following the "PetroChina model" whereby the purpose of selling to foreigners is never to get money, as most large state firms are already awash with liquidity. In fact, the government found that overseas investors provided a "one-stop shop" for enterprise reform. In most cases, the result has been better-managed, more profitable and transparent companies\textsuperscript{14}. Javed Hamid, IFC's East Asia chief, believes that the IFC's main contribution to Chinese bank reform will come from the impact its investments and knowledge sharing have had on China's regulators\textsuperscript{15}. The Asian Development Bank announced on 10 October 2005 that it would invest US$75 million in Bank of China to "help the lender enhance corporate governance and control systems ahead of its IPO"\textsuperscript{16}.

In many countries, particularly in South-East Asian countries such as Thailand, as well as in more mature banking markets like South Korea, family groups control a significant number of local financial institutions. This is not simply a characteristic of the banking sector, but a general characteristic of the Asia Pacific economies, which are still to a large degree dominated by family or government controlled businesses. Academic studies show that founding families play a dominant role in corporate Asia\textsuperscript{17}. According to research done by the
World Bank, approximately two-thirds of the listed companies in Asia, and substantially all private companies, are family-run. Some commentators put family control of companies at 90% in India with tax avoidance facilitated by intra-corporate loans, misappropriation of funds, and cover-ups the result. A recent survey of 455 companies listed in Singapore and Malaysia stock exchanges found that 52% of the sample was family controlled¹⁸. Most companies in Asia are organized into family-controlled business groups via pyramids and cross-shareholdings¹⁹. In Hong Kong, analysts see a similar pattern, with owners of as little as 20% of a company’s outstanding shares exercising effective control over the company in an estimated 90% of listed companies.

The ADBI 2005 comprehensive survey of banks in four Asian economies (Indonesia, South Korea, Malaysia and Thailand) and an academic report from the Chinese University of Hong Kong based on the ADBI data show that:

- 70% of the banks in the survey have concentrated ownership and are controlled by families (12%), governments (30%) or foreigners (30%)

- There exists significant political involvement in the management and governance of the banks

- The banks’ governance structures are significantly related to the banks ownership and control structures, in particular family or state controlled banks tend to adopt governance structures that cater to the controlling owners

- Significant positive relationships between governance quality and performance exist in sub-samples of countries and/or control types. In particular, the non-performing loan ratio is positively related to state control while negatively related to widely held banks²⁰

Governments in the region have begun to address these issues. In some cases, for example in Thailand, measures have been taken to limit single party ownership in banks to a maximum of 5%. In Singapore, the MAS forced banks to break up ties with non-banking businesses and to sell down their non-banking assets. In South Korea, after banks were forced to cut links to group companies, accounts improved significantly. As a result, the leverage ratio of listed South Korean companies was dramatically reduced from 339% of total equity in 1999 to 101% in 2004. This spectacular achievement was made possible in large part because the stock market in South Korea was already much more efficient than in most Asian countries, allowing the companies to turn to the equity markets for alternative sources of capital. This, in turn, forced companies to adopt higher corporate governance standards.

Governance basics still a challenge

While there is no definitive checklist of bank-related governance standards, the following areas set the tone for company-level governance challenges.
Board independence and roles The issue of the independence of board directors and auditors is only beginning to emerge in Asia. What constitutes a truly independent director remains the subject of much debate. In some Asian countries, the problem is compounded by the scarcity of eligible candidates and the necessity of limiting the number of directorships to a manageable figure. Strengthening the core functions of the board is also a key issue, in particular, with respect to audits. For example, when IFC invested in the Bank of Shanghai, "restructuring the board was key" to the reform process. Bank of China's Annual Report 2004 highlights the changes the bank made to its corporate governance structure in order to align the bank to corporate governance practices at large international banks. This included establishing a system consisting of a general meeting of shareholders, a board of directors with three independent directors, a board of supervisors and senior management. China Construction Bank (CCB), in its 2004 Annual Report, defines corporate governance as "the system by which business organizations are directed and controlled. The corporate governance structure specifies the rights and responsibilities of the different participants in the corporation, such as the executive management, operational managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions in corporate affairs".

Staff compensation Bank compensation systems are largely responsible for most of the more blatant forms of corruption. The problem reflects the fact that in many Asian markets there are large branch networks with remote operations giving under-compensated managers almost complete lending authority. Often branch managers in state-owned institutions receive relatively low fixed wages geared toward civil servants. When compensation is performance-based, it is often linked to loan volume or asset size, rather than profitability. Not surprisingly, salary and compensation reforms are therefore crucial in stamping out corruption at the most basic level. Thus, financial institutions that implement performance-based compensation systems and effective corporate control over remote branches often outperform rivals as corruption cases drop. In its investments, the IFC emphasizes the importance of compensation systems linked to performance. The compensation committee at the Bank of Shanghai, for example, sets annual targets for management based not just on growth, but also on capital adequacy, non-performing loans and profits. It is conceivable that, as the commitment to sustainability and corporate social responsibility increases, the compensation system will evolve to incorporate links between compensation and "sustainable performance".

Legal systems Although there have been major reform efforts undertaken in banking regulation and corporate law in Asia over the past seven years, many countries in Asia still suffer from immature legal structures. In some countries, property rights and bankruptcy laws are either non-existent or difficult to enforce, making it tricky for banks to recover debts and implement new financial techniques such as securitization. As a result, investors will continue to regard rule of law as a crucial country-level competitive variable until reforms currently under way in many countries achieve maturity.

Accounting standards One of the major pillars of governance — accounting standards — varies widely across Asia, making it more difficult to accurately assess risk in certain markets. One particularly crucial area for banks is asset valuation since many banks in Asia still routinely practice asset-based lending.
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and take assets as collateral. When the accounting standards call valuation into question, problem loans may arise. For example, IFRS standards are now forcing banks to reflect in their accounts the true value of bad loans, while Basel II forces them to set aside more capital for non-performing loans, resulting in significant impact on financial statements. Additionally, lack of disclosure and discrepancies in the definition of NPLs undermine the credibility of valuations. This has become a key differentiator for Asian banks. Indeed, those financial institutions with the resources to adopt international accounting standards should benefit from the adoption of best practices.

Taxation Another key element for accountability and good corporate governance lies in a credible tax system that is functioning, fair and progressive. Many countries in Asia still lack the tools needed to implement transparent taxation systems. Recently surfacing as a corporate governance issue, tax avoidance has started appearing on the radar screen in Asia's financial sector. The widespread use of offshore vehicles for many financial transactions in Asia, from securitizations to project finance and direct investment, has sheltered many transactions from taxation in the country of origin of the transaction. In addition, banks in some countries offer products to high net worth customers which are explicitly geared to evasion of local tax regimes. Whilst most of these are legal structures, governments and taxpayers have begun to raise questions about prevailing policies. As a result, stakeholder pressure may increase in this relatively new area of corporate governance as more publicly disclosed transactions surface.

Comprehensive governance surveys at the sector level in Asia are rare and not yet systematic. Nonetheless, one commonly cited survey, published by the Asian Corporate Governance Association and CLSA, the specialty Asian broker, provides a useful reference point for the governance performance of Asia's leading banks compared to the performance of other listed companies.

Figure 6 Asian Banks in the Top Two Quartiles of the ACGA/CLSA 2004 Survey

<table>
<thead>
<tr>
<th>Hong Kong</th>
<th>India</th>
<th>Indonesia</th>
<th>South Korea</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Singapore</th>
<th>Taiwan</th>
<th>Thailand</th>
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<tbody>
<tr>
<td>HK Exchange</td>
<td>HDFC Bank</td>
<td>Bank Central Asia</td>
<td>Hana Bank</td>
<td>Public Bank</td>
<td>Equitable PCI Bank</td>
<td>Singapore Exchange</td>
<td>SinoPac FHC</td>
<td>Siam Commercial Bank</td>
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<tr>
<td>HSBC</td>
<td>HDFC</td>
<td>Bank NISP</td>
<td>Kookmin Bank</td>
<td>Maybank</td>
<td>Bank of the Philippine Islands</td>
<td>OCBC</td>
<td>Chinatrust FHC</td>
<td>KasikornBank</td>
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<td>StanChart</td>
<td>UTI Bank</td>
<td>Bank Danamon</td>
<td>Shinhan Financial Group</td>
<td>RBH</td>
<td>Banco de Oro</td>
<td>DBS Group Holdings</td>
<td>Fubon FHC</td>
<td>Kiatnakin Finance</td>
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<td>Wing Hang Bank</td>
<td>Bank Rakyat</td>
<td>Indonesia</td>
<td>Woori Financial Group</td>
<td>CIMB</td>
<td></td>
<td>Taishin FHC</td>
<td></td>
<td>Bangkok Bank</td>
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<td>Wing Lung Bank</td>
<td></td>
<td></td>
<td>Commerce Asset</td>
<td></td>
<td></td>
<td>E Sun FHC</td>
<td></td>
<td>Tisco Finance</td>
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<td>Bank of East Asia</td>
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<td>National Finance</td>
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<td>Dah Sing Financial</td>
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<td>Hang Seng Bank</td>
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Source: ACGA/CLSA "CG Watch 2004"
UNDERSTANDING THE TECHNOLOGY BET

To a greater extent than many investors realize, an investment in a bank is a bet on technology and a company’s ability to manage it. As a result, whether investors are assessing the management of sustainability risks or the development of new sustainable finance products, we are implicitly discussing a bank’s technology strategy. Indeed, progress on critical banking disciplines is tightly linked to technology, because so many aspects of operations rely on functioning risk management systems and management information systems. Beyond regulation, technology impacts every aspect of the banking and finance sector from processes to human resources management and new business development — making it a tangible proxy for sustainable management practices.

While much of the focus is on technology gaps in Asia, one of the most fascinating aspects of technology development has been the ability of Asian economies to leapfrog several stages of technology evolution to adopt cutting edge technologies. This was the case in the telecom industry where mobile phone penetration has exceeded levels found in many developed markets. The extent and ability of banking and financial institutions to capture the benefits of technological innovation to develop new businesses and enhance efficiency and profitability is a key element of risk, not only in developed countries but also in the fast growing markets of Asia. As such, technology is not only a key element of banking business sustainability per se, but also one of the three key sustainability issues in the financial sector in Asia.

The main aspects of technology as a key sustainability variable in the financial sector in Asia are all linked to corporate governance and new product development. Technology plays a key role in the areas of:

- Efficient control and risk management
- Improved processes
- Reporting and regulatory compliance
- Development of new businesses and markets

Technology: the backbone for efficient control and risk management

The banking and financial sector is heavily and increasingly reliant on technology for efficient control and risk management processes. Technological capabilities are a key for financial markets like foreign exchange, treasury including money markets, capital markets and derivatives. As countries increasingly move to adopt real time gross settlement (RTGS) payment systems, as is already the case in Hong Kong, Singapore and recently India, seamless integration of back offices into clearing and settlement systems becomes a critical differentiating factor for financial institutions.

As Asian capital markets develop, banks increasingly require online trading systems as firms evolve from proprietary closed platform trading systems to
open platforms involving multiple participants. These are complex systems which require the segregation of duties if the systems are to avoid "rogue trader" problems. Improving price transparency through the adoption of independent data provider systems such as Reuters or Bloomberg is also crucial to more efficient markets. For instance, China announced that Reuters would become the first foreign provider of comprehensive reference rates for the state-backed bond markets.

Efficient control and risk management is therefore simply impossible in today's global, real-time financial markets without the necessary, and increasingly costly, investment in technology and systems. In other segments of the banking and financial markets, the role of technology in control and risk management may be less apparent, but no less important. Effective credit risk management is the essence of the business of banking, be it corporate banking or consumer/retail banking. In recognition of the key role that efficient risk management plays, the People's Bank of China asked the IFC to help establish an institute to train the country's bankers in such neglected skills as risk assessment. As a direct result the Shanghai International Banking and Finance Institute opened its doors in April 2005.

Key elements for an efficient credit risk management system include:

- Significant senior management involvement
- Independent risk function
- Effective internal rating/credit scoring systems
- Effective measurement, monitoring and reporting processes
- Accurate, reliable and accessible data
- Implementation, evaluation and control

For instance, in terms of control of credit risk and exposure in financial institutions with far-flung locations, only efficient computerized systems allow for accurate determination of aggregate exposure and early identification of potential problems. This can be a particular challenge in countries with poor telecommunication infrastructure because it is almost impossible to implement effective risk management outside of urban centers due to a lack of local oversight. For example, in India the tele-density is one of the lowest in the region with 4.3 lines per 100 people.

Security issues, which are rising in prominence around the world as a result of identity theft, credit card and check fraud, also present a new technology challenge, which necessitates additional investments to protect system integrity. For example, in Hong Kong the HKMA recently mandated the adoption of additional layers of security for online banking services. Only those institutions able to make the necessary investment in the relevant technology will be able to protect their customer franchise and avoid losses related to fraud and security issues.

Increasingly, efficient internal processes in banking and finance rely on automated, centralized processes. Most major international financial institutions have either outsourced or de-localized to offshore processing centers the
The vast majority of their back-office processes. For example, both HSBC and Standard Chartered Bank have offshored their back office processes to centers based in India and China. Some international banks have outsourced the back-office processes for FX to banks specializing in such services. Nonetheless, elsewhere in Asia, many local banks, particularly legacy retail banking institutions, tend to rely on manual processes, which are highly decentralized at the local branch level, resulting in over-staffing and inefficient processing.

Traditionally, banks have trailed other industries in terms of customer profitability measurement. Until very recently even major international institutions were notoriously poor at analyzing customer profitability. In part this was a result of the focus on asset size and loan volume as opposed to profitability, and partly it was because the systems needed to aggregate the data from all sectors of the bank and implement effective cost accounting were not available. At the time of the Asian financial crisis, only a handful of the most sophisticated global financial institutions were implementing ROE based measurements, let alone risk-adjusted return on capital (RAROC). Until very recently, most banking institutions in Asia, including some of the international players, were still measuring performance in terms of loan volume and size of balance sheet.

To investors, the technology issue is crucial in terms of analyzing bank fundamentals. As the banking sector moves from simple volume and asset metrics to risk-based profitability and performance measurement, it becomes possible to move towards risk-based pricing. This is a crucial advance for Asian banks, which cannot be achieved without heavy investments in hardware, software, and control systems, which enable accurate measurement and efficient processing.

Industry estimates point to worldwide IT investments by banks of US$174bn for 2005 with a projected growth rate of 4.9% per annum from 2005 to 2008 and with Asia showing the fastest growth rate of 7.3% per annum. For the whole financial sector, estimates point to a worldwide IT spending of US$362 Billion in 2005 with the strongest growth coming from the banking industry.

For example, projected 2004 IT spending by Chinese banks was estimated at RMB 18 Billion (US$2.17 billion) and estimates point to a technology spending of US$6 billion for 2003-2005. This compares to total IT spending by the Big Four of only US$4.34 billion for the period 1995-2000. A recent report highlighted the big increases in bank IT spending in Indonesia and estimated that Indonesian banks would spend approximately US$450 million on IT by the end of 2005.

In addition, only those institutions able to invest in the necessary systems will be able to effectively comply in full with the newest regulations, and therefore adopt best practices in terms of risk management. This will further accentuate the already gaping divide between the technology have and have-nots. For example, the Bank of Communication established its risk management and control structure based on an international advanced model introduced by HSBC when it acquired a minority stake in the bank. The reengineering of the information infrastructure of the group, including a data centralization project, management accounting system, consolidated financial reporting system and pricing management system, is under way. Indeed, one of the most prominent
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debates in the banking sector currently is the discussion of regulatory burden. Prominent banking executives have called attention to the increased cost of new global and local banking regulations and reporting requirements in terms of technology investments required as well as management and staff involvement needed. For example, industry estimates point to IT investments in risk and compliance solutions topping US$ 51bn in 2004. A recent survey emphasized privacy regulations and compliance challenges as a main driver of IT spending for banks. As an illustration, IT investments to comply with the MiFID (Markets in Financial Instruments Directive) in the EU are estimated at GBP 8 to 12 million for a UK investment bank with annual costs estimated at GBP 1.5 million.

The most significant new regulations include:

- **Basel II** which affects the banking sector globally. Over 100 financial regulators worldwide have agreed to implement the Basel II principles with implementation targeted from 2006 to 2009.

- **Sarbanes-Oxley** in the US which affects all US-listed companies as well as any company with over 300 US shareholders.

- **Patriot Act** in the US, and the institution of the **Financial Action Task Force**, for prevention of money laundering worldwide which have wide-ranging implications in terms of "Know Thy Customer" rules for banking institutions.

- **EU Financial Services Action Plan** with over 42 new pieces of legislation in process and **Markets in Financial Instruments Directive (MiFID)**.

- **UK Reporting** rules affecting all UK listed companies.

- **International Financial Reporting Standards (IFRS)** in the EU and **International Accounting Standards (IAS)** in the US.

In addition, many global banks as well as some forward-looking emerging markets banks are moving to apply new standards of reporting for crucial sustainability matters, in particular environmental impacts and corporate social responsibility factors. Banks must also develop systems to monitor compliance with international compacts including:

- **Equator Principles** (in project finance)
- **UN Global Compact** and **UNEP FI statements**
- **Global Reporting Initiative (GRI) principles**
- **CERES principles**
- **World Bank and IFC guidelines**
- **EU directives and guidelines**
- **ICC Business Charter for Sustainable Development**
For example, a number of leading global institutions such as HSBC are at the forefront of technology investment in terms of Basel II compliance and also invest heavily in terms of corporate social responsibility (CSR) and environmental reporting. By contrast, few country-level Asian players have the systems in place or the management expertise required to implement such regulatory requirements. This is evidenced by the Hong Kong Monetary Authority (HKMA)’s phased implementation plan for Basel II, which divides the banks into three tiers according to technological capabilities.

**A requirement for more technical sophistication**

In the new markets of consumer finance, as well as retail banking, technology drives profitability by enabling economies of scale and freeing of resources to focus on customer service and product development. The development of new businesses and innovative products therefore requires more technical sophistication. In Asia, where retail banking and consumer finance together with wealth management are deemed by all finance industry experts to be the key markets for growth in financial services, technology will increasingly be a key differentiating factor for financial institutions.

The rise of retail banking and consumer finance in Asia is the result of changing demographics, high economic growth, and the rise of modern consumer economies. Asia is home to some of the most populated countries in the world such as China, India, and Indonesia, as well as the world’s fastest growing economies. As a result, the bankable population is expanding rapidly and with it the need for basic banking products on a mass-product scale. McKinsey estimates that the bankable population in Asia, defined as individuals with incomes approaching $1,000 p.a., will double from 2000 to 2010 with a concentration in Asia’s 50 biggest cities — and that China and India together will account for over 70% of all new accounts.

Wealth accumulation and concentration is fast increasing. Demographic changes such as rapidly ageing populations mean that the financial needs of the bankable population will shift within one or two generations from savings to capital preservation and retirement products, particularly pensions. Governments have already started pushing through mandatory defined contribution retirement plans. For example, while Singapore had long had such a system in place, Hong Kong only enacted the MPFSO (Mandatory Provident Fund Schemes Ordinance) in 1995.

At the same time, Asian consumers are fast adopting Western standards of consumption over traditional Asian values of saving. For example, South Korean households saved a quarter of their incomes in 1988 but by 2003 banked just 6.1%.

In China, consumer spending is rising fast, reaching double-digit year-over-year levels in early 2005. Key target areas for banking growth across Asia include mortgages, credit cards and consumer finance. For example, mortgage penetration is still low in key growth markets such as China and India where 1.8% of households own mortgages, compared to saturated markets like Australia with 68%.
In China, research by McKinsey clearly points to the emergence of consumer banking and consumer finance as a key driver of growth for the financial sector:

**Figure 7** Home Ownership Versus Mortgage/Households

Source: Analysis of Mortgage Market Trends, UBS Research, 24 March 2005

**Figure 8** Retail Rising: Forecast Earnings by Source for China's Banking Sector, in %

Source: McKinsey Quarterly, Retail Banking in China, 2004
Increasingly, the industry leaders will be those capable of capturing on the one hand the potential of growth markets such as consumer finance whilst on the other hand improving their efficiency and performance in more traditional areas such as corporate banking. Technology will play a critical role as a differentiating factor. Moreover, it serves as an important proxy for identifying which Asian banks have the resources necessary to implement the types of risk management and product development strategies of interest to sustainability investors.

**Figure 9** An Industry’s Future: Forecast Banking Revenues in China by Type of Product

<table>
<thead>
<tr>
<th>Revenues, $ million</th>
<th>Compound annual growth rate, 2003-13, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer credit</td>
<td></td>
</tr>
<tr>
<td>Mortgages</td>
<td>8,336</td>
</tr>
<tr>
<td>Auto loans</td>
<td>5,372</td>
</tr>
<tr>
<td>Credit cards</td>
<td>5,090</td>
</tr>
<tr>
<td>Other personal lending</td>
<td>6,961</td>
</tr>
<tr>
<td>Personal financial assets</td>
<td>12,031</td>
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<tr>
<td>Deposit taking</td>
<td>14,733</td>
</tr>
<tr>
<td>Bancassurance</td>
<td>2,663</td>
</tr>
<tr>
<td>Mutual-fund distribution</td>
<td>2,169</td>
</tr>
</tbody>
</table>

*Use of bank’s distribution channels to sell insurance products

Source: McKinsey Quarterly, Retail Banking in China, 2004

**ASSET QUALITY & SUSTAINABLE RISK ASSESSMENT**

The hottest, most debated issue related to the banking and finance sector in Asia is without contest asset quality. In other words, to what extent will a bank’s assets, namely its earning assets of loans and securities, be repaid in accordance with their agreed terms? How does the asset quality of banks relate to sustainable development and corporate responsibility? Deloitte succinctly states the case, "The prevalence of NPLs in Asia can be traced to corporate governance and credit risk management weaknesses in the financial sector." As a result, the status of NPLs in the Asian banking sector serves as the fundamental backdrop to the management of ESG risks in credit portfolios. Indeed, as Asian banks begin price ESG risks into their credit portfolios, we...
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expect to see higher NPLs on legacy loan portfolios and more resilient credits where banks respond to emerging challenges.

**Figure 10 Asset Quality Basics**

**Key components of asset quality measures include:**

- Total Loans — metrics evaluating loan portfolio composition and vulnerability of loan book to macroeconomic upheavals
- Non Performing Loans — NPLs are generally defined as loans in which the borrower is not making the required payments of interest and/or principal
- Loan Loss Reserves
- Loan Loss Provisions
- Loan Write-Offs

**Why is asset quality so important? There are three main reasons:**

- Accounting systems report interest income when it is earned (accrual accounting) not when it is collected => net income and profit overstated if asset quality is not taken into account
- NPLs if not repaid represent impaired assets = irretrievable losses to the bank and these losses translate into a reduction of the bank's capital
- Any capital lost must be replaced. Unless new capital is injected, it must come from profits

**What are the key considerations when examining the asset quality of banks?**

- The definition of key terms. For example, the exact definition of NPL can vary by country
- Does the definition take into account collateral or not?
- Degree of management discretion in identification and definition
- Treatment of accrued income from loans later deemed NPLs. Net income is distorted if accrued interest income is not collected

**Building sustainable balance sheets**

In Asia, many investors are concerned in particular about the high level of NPLs in the sector. According to the 2004 Deloitte NPL survey, the most likely leading cause of the high level of NPLs — both official and estimated — lies in poor corporate governance and weak credit risk management.

What are the main reasons for the deficiency in credit risk management in Asia? According to Deloitte, management of a bank's credit portfolio requires a culture focused on credit risk, robust policies and procedures, well-trained
staff, and constant management and oversight. On all four counts, there are severe deficiencies in Asian banks, particularly the legacy local players. Most local players have not evolved much beyond asset-based lending which relies upon collateral and have little to no expertise in cash-flow analysis, not to mention cash-flow forecasting. With much of the decision-making in effect decentralized at the branch manager level, the approval process is fraught with lack of controls. Basic separation of functions, crucially including the separation of risk management from lending function, may be lacking, as is corporate control. Even when forward-thinking management has adopted credit policies, the lack of implementation at local level is a key issue.

**Figure 11  Challenges for China’s Bank Regulators**

China Banking Regulatory Commission (CBRC) deputy chairman Shi Jiliang made a critique of the state banks just three days after the results were released on January 13, 2005. "The Bank of China [BOC] and China Construction Bank [CCB] have shown some preliminary progress, but their task ahead is very onerous ... the state banks have the same defects as state companies, with low efficiency, poor internal management and 'everyone eating out of the same pot'. They have an enormous amount [of work] to do to change their true nature, stop a worsening of their assets and change from being state banks into real commercial banks," he told an international seminar in Beijing. "If we analyze the figures coolly and include the assets from the two banks that were transferred and use the original specifications, then the NPL amounts rose to some extent. This is certainly a matter of great concern."

Source: SCMP "Regulator takes state lenders to task on bad-loan figures", 21 February 2005

Another critical component in the NPL problem is the fact that many banks in Asia derive the lion’s share of their revenues from corporate banking, which is the source of the majority of NPLs. Newer players, which have concentrated on consumer banking and consumer finance, have to a large extent avoided crushing NPLs. However, a lack of basic credit disciplines can prove problematic in fast-growing consumer credit markets as well. Banks in both South Korea and Taiwan, the unchecked exponential growth of credit cards has resulted in significant portfolio losses.

In the wake of the Asian financial crisis, many countries have made significant progress towards addressing the crucial issues of NPLs by implementing more stringent regulations. Indonesia, Malaysia, South Korea and soon Taiwan, are implementing an international style five-category loan classification system to bring about much needed transparency. However, implementation is rendered difficult by loan misclassification and debt payment rescheduling. The latter in particular is a common practice, in large part linked to the prevalence of relationship lending. By rescheduling over-due debt, the banks avoid classifying these assets as non-performing but also ignore the true nature of the risk. The bank therefore ends up rolling over non-performing assets on its books. As a result, many analysts estimate that the true level of NPLs in the banking sector in Asia is vastly under-reported, resulting in the application of ad hoc discounts to book-linked metrics when valuing Asian banks.
Following the Asian crisis, many governments have acted to reduce the crushing burden imposed on the financial system by the high level of NPLs. Many NPL resolution techniques have been used to varying degrees of success, including bank self-management, public auctions, private sales, securitization, limited auctions and joint ventures.

Chief among the strategies for NPL resolution has been the use of Asset Management Companies (AMCs) set up to help struggling banks dispose of the worst of their non-performing portfolio to specialized companies set up for that purpose. Some of the AMCs have been successful at dealing with the NPLs portfolios post-Asian crisis. However, in some cases it is difficult to ascertain the real efficiency of the asset disposal process. For example, recently a Chinese AMC was bidding to acquire the assets of another AMC. In some cases, AMCs are stretching the notion of disposing of bad loans. For example, recently Cinda Asset Management was discussing a fund management joint venture with Australia's First State Investments.

Figure 12 NPL Amounts and Reductions, in Billions US$

<table>
<thead>
<tr>
<th></th>
<th>NPLs in all Financial Institutions</th>
<th>NPLs in AMCs *</th>
<th>Gross Reductions of NPLs in Financial Systems since Asian Financial Crisis **</th>
<th>Special NPL Law/NPL body</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>330 (b)</td>
<td>112 (c)</td>
<td>600</td>
<td>RCC/IRCJ</td>
</tr>
<tr>
<td>China</td>
<td>307 (a)</td>
<td>107</td>
<td>200</td>
<td>4 AMCs</td>
</tr>
<tr>
<td>Taiwan</td>
<td>19.1</td>
<td>N/A</td>
<td>50</td>
<td>None</td>
</tr>
<tr>
<td>Thailand</td>
<td>18.8</td>
<td>5</td>
<td>95</td>
<td>5 AMCs</td>
</tr>
<tr>
<td>Philippines</td>
<td>9</td>
<td>N/A</td>
<td>N/A</td>
<td>Bangko Sentral, DoF</td>
</tr>
<tr>
<td>Indonesia</td>
<td>16.9</td>
<td>5</td>
<td>37</td>
<td>IBRA</td>
</tr>
<tr>
<td>India</td>
<td>29.9</td>
<td>N/A</td>
<td>N/A</td>
<td>SARFAESI</td>
</tr>
<tr>
<td>South Korea</td>
<td>15</td>
<td>45</td>
<td>125</td>
<td>KAMCO</td>
</tr>
<tr>
<td>Total</td>
<td>746</td>
<td>274</td>
<td>1,107</td>
<td></td>
</tr>
</tbody>
</table>

* Estimated unresolved NPLs still in government AMCs

** Estimated gross reduction in financial system NPLs due to restructuring, reclassification, repayment, transfer to AMCs/Bad Banks, or write-offs

(a) No official government statistics available. Calculated estimate includes the 5-tier classification for: 4 SOCBs, 11 stock banks, and 3 policy banks, as well as the 4-tier classification for the 112 city banks. Excludes financial institutions in rural areas.

(b) Based on 35.5 trillion yen as of March 2003 at foreign exchange rate of 107 yen = US $1

(c) Includes 4.6 trillion yen and 4.7 trillion yen in unpaid balance acquired by The Housing Loan & Credit Management Corporation (HLCMC) and the Resolution and Collection Bank (RCB), respectively, in addition to 2.5 trillion yen in unpaid balance acquired by the Resolution and Collection Corporation (RCC) and foreign exchange rate of 107 yen = US $1. HLCMC, which required loans from Housing Loan Finance Cooperatives: and the RCB, which acquired loans from the failed financial institutions, were merged and created the RCC in April 1999.

N/A - Not applicable

Source: Ernst & Young, Asia Pacific Financial Solutions, 2004
Winners and losers — how ESG risk assessment could make a difference

Against this backdrop of NPL pressure, we see the potential for various shifts in the asset quality of Asian banks as ESG risks are addressed more actively in the marketplace. Perhaps the most material would be added pressure on poor credit disciplines due to a rise in borrowers' and lenders' liability resulting from stricter ESG regulations. Indeed, as more forward-looking ESG regulations are adopted and enforced, weak companies may face increased difficulties in financing the investments necessary for compliance. This will result in a new layer of credit risk. Given the strong influence of state-directed policy lending, which typically favors heavy industry state-owned enterprises, a case can be made that banks with large exposure to high ESG risk sectors could be significantly more affected by increased NPLs than financial institutions which escape from such policy lending.

Examples of this trend are beginning to emerge within Asia. In China in particular, where state-owned enterprises control the bulk of the extractive and heavy industries, more rigorous enforcement of environmental regulations limiting emissions has the potential to push some of the ailing SOEs into bankruptcy, triggering a new wave of NPLs. A second aspect of this trend could be a concentration of growing ESG risks in banking markets with generally lower environmental standards. For example, there have been recent reports that Chinese FDI in Vietnam and Cambodia has been motivated by a desire to offshore production facilities to countries with less restrictive environmental and social protection standards.

This is particularly relevant at the level of credit risk management especially as it influences lending policies. Most global financial institutions have taken at least preliminary steps to address ESG risks in lending policies. Initially this was done in response to efforts to address large scale contaminated land liabilities through legislation. More recently, global banks have realized the need to develop industry-specific lending policies to guide credit policies in global markets which may not have well-established local policies for high impact industry sectors such as pulp and paper or extractives.

The local and global pressures for ESG risk assessment are becoming more relevant for Asian banks. Key drivers over the next several years could come from various directions, but two areas bear particular attention. Contaminated land remediation policies have proven crucial in forcing banks to price in risks to loans and collateral. Although few formal policies enforcing liability for land contamination have been tested in Asia, a legal framework is beginning to emerge as the public becomes more concerned about health impacts, especially in new urban centers. As Asian banks begin to fund their emerging multinationals, they are increasingly being exposed to regulatory and credit risks linked to overseas ESG risks. As a result, we expect Asia's leading banks to begin to seek the same risk management tools as their global counterparts.
Taking Stock: Adding Sustainability Variables to Asian Sectoral Analysis

According to the Environmental Bankers Association, common strategies for integrating environmental risk management "include the basic building blocks of risk management — identification, assessment, control, mitigation and monitoring. Each of these can be successively integrated with conventional credit risk underwriting using the 5 C's of credit: cash flow, collateral, character, capacity and conditions specific to considering environmental risk.” Key tools in the process may include loan documentation or covenants which obligate the borrower to monitor and mitigate specific environmental risks throughout the life of the loan.

Perhaps the leading example of a systematic effort to address ESG-linked credit risks is the Equator Principles for project finance, which are based on IFC guidelines. Project finance funding is most common for large-scale infrastructure or industrial development projects, many of which have high environmental impacts. In addition to the Equator Principles, there are a range of investor and banking sector led groups which focus on the ESG impacts of financial institutions such as the United Nations Environmental Program’s Finance Initiative (UNEP FI) and CERES. Asian participation in these groups is to-date somewhat limited with only three signatories from Japan and one from Australia to the Equator Principles. However, a more diverse group is participating in the UNEP FI initiative, with good representation from institutions in Australia, Japan, and the Philippines. Notable Asian signatories include Kookmin Bank, the Export Import Bank of Korea, Bank Negara Indonesia, Thai Investment and Securities Public Company, Bank of Shanghai, and a full complement of Philippine banks.
The Equator Principles are a voluntary set of guidelines for managing environmental and social issues in project finance lending, developed by leading financial institutions. They are based on the environmental and social standards of the IFC, and apply globally to development projects in all industry sectors with a capital cost of $50 million or more.

The approach used under the Equator Principles includes:

1. Categorization of a project according to its environmental and social impacts using IFC’s screening procedures

2. Based on the categorization process, borrowers may have to complete an Environmental Assessment addressing the environmental and social issues identified

3. The Environmental Assessment will take into account the Environmental, Health and Safety Guidelines for all countries. However, for projects in low-income, lower-middle income and upper-middle income countries (as defined by the World Bank), it will also take into account the Safeguard Policies

4. In high-impact projects, borrowers will undertake appropriate consultation with affected local stakeholders and develop an environmental management plan that addresses mitigation and monitoring of environmental and social risk

Banks active in Asia which are signatories: ABN Amro, Bank of America, Bank of Tokyo Mitsubishi, Barclays, Calyon, Citigroup, Credit Suisse, Dresdner, HSBC, ING, JP Morgan Chase, Manulife Financial, Mizuho Corporate Bank, Rabobank, Standard Chartered, Sumitomo Mitsui Bank, WestLB, Westpac

Source: IFC, 2005

Although global banks operating in Asia are increasingly alert to reputation-damaging ESG risks in their loan books, the awareness level for domestically oriented financial institutions generally remains very low. Sustainability issues thus become another differentiating factor between Asian banks through their credit policies: the more ESG-aware the lending policies, the lower the risk of non-performance in the asset mix. It is highly likely that the less sophisticated and capable banks in Asia will end up with a higher concentration of high ESG risk loans and NPLs than the more sophisticated and ESG aware institutions.
THE LONGER TERM: NEW OPPORTUNITIES FOR BEST-IN-CLASS PLAYERS

Over the longer term, we see potential for sustainability issues to create a new competitive dynamic which will offer clear competitive benefits to those Asian banks and financial services providers which are capable of providing best-in-class performance on sustainability variables and new sustainability products. A mix of internally oriented strategic moves and new product development will drive this process. The rationale is straightforward: it has the potential to sharpen banks’ risk management capabilities and, in combination with moves toward consumer banking, to add a new avenue for product differentiation.

Historically Asian bank valuations have been dominated by country-level variables, tracking local credit cycles with the overall quality of regulation to a large degree determining the quality of assets. We may be approaching an inflection point, however, with sustainability variables emerging as a differentiating factor with the potential to influence company-level valuations. This would reflect the different opportunity sets of Asian banks, which have the potential to benefit from globalization and technology leadership in their home markets. For these banks, sustainability variables offer a new tool for defining competitive advantage versus less capable local competitors.

New incentives for regional and country-level leaders

Initial signs of this competitive dynamic are already evident in Asia. For example, on a stock-specific level, large global financial institutions such as HSBC are already among the "best-in-class" in corporate governance, irrespective of which markets they operate in, driven by consumer and shareholder pressure in their markets of origin. In South Korea, market leaders such as Kookmin Bank and Shinhan Financial Holdings have begun to articulate their own governance and sustainability priorities. This is influenced by a desire to keep in step with global banks such as Citigroup and Standard Chartered, which have expanded their footprint in South Korea through sizeable local acquisitions.

In China a range of small and large banks has sought foreign investment largely to address governance and technology transfer issues.

This trend has also been reinforced in China as a range of small and large banks has sought foreign investment largely to address governance and technology transfer issues. Indeed, the effectiveness of this strategy will gain a high profile market test as China’s Big Four commercial banks complete their initial public offerings and begin trading over the next year. The importance of HSBC’s strategic investment in China’s Bank of Communications was prominently cited as a positive in the Bank’s June 2005 listing on the Hong Kong Stock Exchange. The key role that the IFC has played in fostering reform in the six small to midsize banks in which it invested in China has opened the way for other foreign investors. IFC’s efforts in fostering good governance practices have also led to changes in the banking legislation and regulation in China, which in turn is making it possible for top international banks to invest in the sector. 

www.asria.org
Meanwhile, selected new banks can also have a competitive advantage in embracing new practices because they lack many of the legacy issues of the older generally state-owned local banks. This can be seen with rising competitors such as HDFC Bank in India which, like its parent company the Housing Development Finance Corporation, specializes in consumer-related lending. YES Bank, a newly listed Indian bank, also offers Asian investors a timely opportunity to evaluate the prospects for a new financial institution which is seeking to bring global sustainability practices to a fast growing Asian market.

**Figure 15  YES Bank's Sustainable Business Model**

YES Bank's CEO Rana Kapoor states that "we seek to identify areas that have high growth potential. Tomorrow's winners will be those businesses that address and incorporate sustainable development in their business practices. We aim to lead by example and highlight innovative corporate sustainability benchmarks that demonstrate the increasing integration of sustainability with business approaches."

Financing projects under development include:

- A USAID backed loan program which will target small- and medium-sized industry investments in clean energy technology
- A US$30 mn private equity fund for cleantech projects and equipment manufacturers
- Providing strategic financial advice to back Global Education Management Systems' effort to establish a new system of 600 schools in India

*Source: Corporate Voice — Rana Kapoor, The Financial Express, October 30, 2005*

Other factors will contribute to the development of ESG-linked business strategies across the sector and across Asia, particularly the fast adoption of technology by Asian consumers. Mobile phone, TV/cable/satellite, and Internet penetration is already high and increasing rapidly in less developed Asian markets, bringing with it more channels for consumer awareness. This is creating better informed and more aware consumers, employees and shareholders with better access to new ways of disseminating information. Increased use of the internet and text messaging in Asia also has the potential to result in more stakeholder activism in areas such as environmental protection, corporate governance, social responsibility and related ESG issues as well as in politics. Indeed, some countries are already cracking down on such technology. For example, in August 2005, Malaysia ordered phone companies to register all holders of pre-paid services and in May, Thailand moved to register users of pre-paid phones54.

New consumer technologies will create markets for financial products and lead to disintermediation and fragmentation with the possibility that the best new
opportunities will migrate away from less agile traditional banks. As India's software and IT industry continues to expand, it may create new, off-the-shelf systems which will lower the cost of new technology implementation, benefiting the financial institutions capable of investing in such systems — both in terms of monetary and human investment. Indeed, the development of new delivery channels for accessing remote populations which are currently unconnected, and as such unbankable, is another important area of growth and possible profitability for financial institutions, particularly in the more populous countries like India, China and Indonesia. The use of new technologies to by-pass infrastructure gaps and address basic banking needs of hitherto underbanked populations can yield significant returns for banks that are able to invest in the relevant technology and systems, as well as promoting economic development.

For example, development of financial services delivered through mobile handsets to reach bankable populations in remote areas can pay off handsomely. A 2001 study by McKinsey, pointed out that "consumers and businesses in emerging markets were likely to find mobile financial services more attractive than do their counterparts in developed markets, because they have fewer alternatives." It is expected that some Asian countries will "move directly from a paper-based payment system to a mobile one without ever having to build an extensive wired POS or ATM network". Another application for mobile financial services is credit cards. In a new development illustrating the way Asian nations are leapfrogging technology phases, ICICI Bank and AirTel are now offering a product that offers VISA credit card services on a cellular customer's SIM card. Such a product is only available in a few countries around the world, including Malaysia, South Korea, Thailand and Finland.

Growing markets for sustainable financial products

Just as we expect strategic competition amongst Asia's banks on sustainability variables, there is also considerable potential for product competition as banks seek to adapt established sustainable finance tools for growing Asian markets. This effort will focus on products which span the consumer, investment, risk management, and service sectors of financial markets.

With the rise of environmental protection and issues relating to climate change, as well as Asia's vulnerability to weather-related catastrophes, it is expected that regulatory constraints related to such issues will increase across Asia and the world. The extent of regulation and the awareness of such issues vary from country to country. However, environmental issues are expected to progress rapidly to the front of the agenda for extractive and manufacturing industries, and followed by consumer-related industries. Significant investment will be needed to upgrade production facilities to state-of-the-art standards and to adopt new, cleaner and more efficient technology. Therein lays a great opportunity for banks to provide financing solutions to these needs, as eloquently put by James Cameron, founder of Climate Change Capital:

"We have a great mission, much as the 19th century merchant banks financed great technological innovation and massive social projects. The climate change
problem is inspiring for engineers. I have a deep conviction that there is a design and engineering response to climate change that is truly exciting to invest in.56"

Such loans might typically be providing project finance for construction of new facilities or for cleaning up and upgrading existing facilities and for introducing new technologies. Banks active in project and infrastructure financing and with sophisticated, ESG-aware credit risk management, should be the primary beneficiaries of such activity. They would undoubtedly also be linking up with supranationals and agencies such as IFC and the World Bank to devise innovative and ESG-compliant financing. One such example would be the initiatives developed under the auspices of the China-US Center for Sustainable Development, with pilot projects for ecologically balanced living communities in Huangbaiyu and six major cities. This project, which has won the support of China’s leaders, relies on funding being raised by local governments. Opportunities, therefore, arise for banks and financing institutions to participate in such sustainable initiatives through carefully engineered financing structures57. In areas such as real estate lending and property development, financing of ecologically sound structures would provide a new area of development, particularly as traditional buildings are often energy inefficient and major polluters, contributing to 40% of carbon emissions in the UK for example58.

Another area offering competitive advantage to banks with extensive risk-management capacity is the emerging market of carbon emission trading and its derivatives. This follows the coming into force of the Kyoto treaty, which has been signed and ratified by most countries in Asia with the notable exception of Australia59. In the space of a year, most big banks have developed a growing awareness of the market, trades have picked up, and interest is surging as a result of the banks’ existing exposure to energy markets60. That large global companies, which are the banks’ core corporate banking and investment banking customers, are actively lobbying for the implementation of a global system of emissions trading, has clearly played a leading role in spurring on the banks interest.

In areas such as investment banking, heightened international scrutiny over the end use of funds raised through equity or debt, capital markets transaction will increasingly affect leading investment banks participation in large public offerings. For example, the public outcry over the end use of proceeds from a US$1 billion bond issue by Chexim has affected the reputation of the US investment banks that lead-managed the issue61. Similarly, public reaction to evidence that prison labor was used by listed company Henan Rebecca Hair Products, China’s largest wig maker, has negatively affected the reputation of six of the world’s largest financial institutions which had purchased minority stakes in the firm under the QFII scheme62. Managing reputational risk will increasingly steer financial institutions clear of participating in transactions where the fall-out from failure to meet good governance and CSR standards can reach the point of threatening the viability of the institution itself. Such was the case with Banco Delta Asia in Macau, which had to be taken over by the government in the face of a run, started after the US Treasury department made public allegations of money laundering practices related to North Korean transactions.
The potential for offering investment products in Asia is expanding rapidly, as individuals and firms look to diversify their savings away from plain bank deposits. With a rapidly aging population, the demand for retirement oriented products will also increase. In tandem with increasing awareness of ESG issues, this opens the door to the development of sustainable and responsible investment (SRI) funds, which have already made significant headway in Europe and the US. As more research corroborates the link between good governance and good performance, the appeal of SRI funds will broaden to the general public and should tap broader demand. Banks that are well positioned to structure and/or deliver investment products efficiently should be the biggest beneficiaries of this new product opportunity. Increasingly the distribution of funds is being decoupled from product design and management. For SRI funds, this could mean that local players with a distribution network and a consumer franchise might become beneficiaries of the growing interest in such funds among their customer base. Local players that invest in the technology necessary to leverage their distribution and customer base assets will clearly be well positioned to benefit from this development.

Micro-finance also promises to emerge as a growth area that can help banks reach under-served communities. The Grameen Bank, one of the most frequently cited successful examples of micro-finance, originated in Asia and has inspired a growing number of microfinance initiatives around the world. Many microfinance initiatives are under way in various Asian markets, particularly in the most populated nations such as China, Indonesia and India. Micro-finance is now reaching 80 million people in about 70 countries. Banks are increasingly getting into the act. Citigroup has provided US$17 million in grants to 178 partners involved in microfinance during the past 5 years. The Deutsche Bank Microcredit Development Fund, initiated by Deutsche Bank, provides loans to non-profit microcredit lenders. ABN AMRO Bank runs programs in Brazil and India.63

Possibilities for banks include bringing investment banking skills to bear in the area, for example arranging capital raising and venture capital to assist in the expansion of existing successful micro-finance initiatives.

Other areas of investment banking ESG-related opportunities include equity capital markets (ECM) and debt capital markets (DCM) transactions related to sustainable project finance. Examples would be the financing of renewable energy projects or environmental preservation and water treatment projects. Another example would be corporate advisory in the area of M&A between Asian and foreign companies. For example, Veolia Environment has invested US$800 million in China in 10 water treatment projects and two facilities that generate power with methane gas released from solid waste. Veolia raised debt financing for the projects from financial institutions.64

As technology now makes it possible to efficiently process small transactions and provide mobile banking (including POS technology), the need for local branches is reduced. Commercial banks are increasingly focusing on the potential from this segment of the market, where demand is estimated at more than US$300 billion versus a current supply of US$4 billion.65 For example, prepaid cards are increasingly being touted as a way to develop new markets hitherto considered unbankable or financially excluded, because such prepaid cards do
not require card holders to undergo a credit check or have a bank account to get a card\(^6\). Another application, luncheon or service vouchers, is being evaluated for implementation in Asia by non-bank service providers such as Accor\(^67\).

Other opportunities include developing the sub-prime consumer finance market. For example, HSBC is planning to adapt sub-prime consumer financing technology from its US affiliate in Asian markets for introduction into Asia. In this, as in many other cases, technology is a key differentiator. Institutions that can invest in the relevant technology, and/or have efficient processes, will be able to profit significantly from the opening of these new markets.

Another promising growth area is sustainable private equity. The fast growth of private equity in the region offers the opportunity for financial institutions to invest in SRI initiatives in areas such as renewable energy, new sustainable businesses, and environmental strategies such as contaminated land clean up. Indeed, the cleantech investment arena holds particular promise in Asia due to both the emerging demand for cleantech products and processes as well as the attractive economics associated with low cost Asian manufacture of new technologies which have mass market potential. Leading players in this segment differentiate themselves with management skills in specific technologies, ESG project due diligence, and value enhancement through ongoing management inputs.

Many opportunities exist, given the inefficiency of existing systems to provide much needed services, across the range of hardware and software services. Clearing and settlement systems, trading platforms and ratings agencies are all in need of investment and partnership. The IFC, for example, has been leading the way by investing in firms providing key elements of financial system infrastructure, such as ratings agencies, credit-scoring firms, and by introducing ESG-aware policies to its investees. Leading foreign providers such as Experian\(^68\), the world’s biggest credit scoring company, and Lexis-Nexis Group\(^69\), a leading database information provider, are investing in China as the government increasingly opens the market to best practices. Technology and efficiency again provide important differentiators as to who is in a position to capitalize on such opportunities.
INVESTOR QUESTIONS FOR COMPANIES

Lending policies

• What is the exact definition of non-performing loans?
• What proportion of revenues and net income come from corporate lending today and 5 years ago?
• What type of credit screening processes do you have in place, particularly in corporate banking?
• Do you take ESG variables such as environmental risks into account in the credit screening and credit evaluation process?
• Is there any area of exclusion in your lending policy such as high risk ESG sectors?
• Have you prepared detailed policy papers on any sectors or issues, such as climate change?

Compliance and standards

• Have you, or do you plan to, sign any environmental principles or guidelines such as UNEP FI, EU Guidelines, World Bank/IFC guidelines, Equator Principles?
• Do you have, or plan to apply for, environmental certification such as ISO 14001?
• Who are your regulators? What are the latest developments in terms of regulation of the banking industry in your market? How is your bank coping with the changes and what steps have you taken to improve compliance?
• Is your bank planning to comply with Basel II requirements? What is your time-frame in terms of implementation?

Management & internal investment

• What is the amount of investment in technology today and over the next three years and what is the breakdown between maintenance and new technology?
• Do you use performance-based compensation systems? How do you motivate branch managers? Describe your performance measurement systems.
• Please detail your internal or external training policies for staff on ESG related issues.

Opportunities

• What opportunities do you see in terms of sustainable finance products for your bank?
RESOURCES

Company websites

- Bangkok Bank Public Co. www.bbl.co.th
- Commerce Asset-Holdings Bhd www.commerz.com.my
- DBS www.dbs.com/home
- Hana Bank www.hanabank.com/info_new/eng/eng_main.jsp
- HDFC Bank Ltd www.hdfcbank.com/nri/others.htm
- Hong Leong Bank Bhd www.hlb.com.my
- HSBC www.hsbc.com
- ICICI Bank Ltd www.icicibank.com
- Kasikornbank Public Co. kasikornbank.com/GlobalHome/EN/homepage.html
- Korea Exchange Bank www.koexbank.co.kr/english
- Krung Thai Bank Public Co. www.ktb.co.th/cgi-bin/frontweb/eng/index.pl
- Lippo Bank www.lippobank.co.id/english

Examples of sustainability reporting

- Bank of China, 2004 Annual Report Corporate Governance section page 27 & 28
- Bank of Communication Interim Report 2005, page 8
- China Construction Bank, 2004 Annual Report Corporate Governance section page 14
- HSBC CSR reports and updates www.hsbc.com/hsbc/csr
- PBOC report Cited in FT, 27th May 2005
- Standard Chartered Bank www.standardchartered.com/corporateresponsibility
Useful web-based resources

- Asian Bonds Markets information www.asianbondsonline.adb.org/regional/market_infrastructure/key_market_participants.php
- CERES Principles www.ceres.org
- Equator Principles www.equator-principles.com
- Financial Insights Indonesian Banking www.financial-insights.com
- Global Reporting www.globalreporting.org
- ICC Charter www.iccwbo.org/home/environment_and_energy/charter.asp
- International Finance Corporation www.ifc.org/sustainability
- India: statistic from "Doing business in India" www.ebusinessforum.com/index.asp?layout=newdebi&country_id=IN&country=India&channelid=6&title=Doing+e-business+in+India
- Kyoto Protocol www.unfccc.int/resource/docs/convkp/kpeng.html
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Laws and regulatory information

- Financial Action Task Force website www.fatf-gafi.org/pages/0,2987,en_32250379_32235720_1_1_1_1,00.html
- Summary information on Sarbanes-Oxley Act of 2002 www.aicpa.org/info/sarbanes_oxley_summary.htm

Basel II information

- Detailed information on Basel II is available on the BIS website www.bis.org/publ/bcbsca.htm
- View the presentation to LEGCO on the HKMA website www.info.gov.hk/hkma/eng/legislative/index.htm
- For a view on state of preparedness of banks in Asia for Basel II implementation, see Ernst & Young "Asia Pacific Basel II Survey presentation at www.ey.com/global/download.nsf/China_E/050124_Presentation_English/$file/050124_Presentation_English.pdf
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- SCMP, 7 September 2005. "Phone technology a ringing headache for Asian nations"
- SCMP, 17 August 2005. "Banks buy into jail-labour firm"
- SCMP, 21 February 2005. "Regulator takes state lenders to task on bad-loan figures"

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- Deloitte 2004 Report on Asian banking consolidation
- Deloitte Asia Pacific Banking Structures, March 2005
- Deutsche Bank, China Special, 2004
- Ernst & Young 2004 Asia Pacific Financial Solutions
- McKinsey "Banking in Asia", ADBI
- McKinsey Quarterly, Retail Banking in China
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2. cf. “Sustainability in Finance” Marcel Jeucken
4. SCMP, 25 May 2005
5. asianbondsonline.adb.org/regional/market_infrastructure/key_market_participants.php
8. Detailed information on Basel II is available on the BIS website: www.bis.org/publ/bcbsca.htm
10. “Universal” banks are financial institutions offering a full range of financial services from traditional to investment banking including insurance and fund management, under one roof
17. Claessens et al, 2000 and others
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19. Academic study, La Porta et al, 1999
20. CUHK, June 2005
25. Financial Times Special Report, 10 October 2005. “When staff get paid more for hitting green targets”
26. The most notorious illustration of the "rogue trader" is Nick Leeson who ultimately caused the failure of Barings
27. Financial Times, 6 October 2005. "Reuters to analyse Chinese bonds"
35. For a view on state of preparedness of banks in Asia for Basel II implementation, see Ernst & Young "Asia Pacific Basel II Survey presentation" at: www.ey.com/global/download.nsf/China_E/050124_Presentation_English/$file/050124_Presentation_English.pdf
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