Banking in Asia-Pacific

Size matters and digital drives competition
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Foreword

Banks in Asia-Pacific (APAC) are under pressure. But with pressure comes opportunity.

Global megatrends, stakeholder pressure and sluggish economic growth are forcing local and international banks in the region to re-examine their business, while regulators, investors, customers and employees want banks to change their ways.

Despite some international banks withdrawing from APAC markets, competition remains fierce – from domestic banks, from banks with renewed regional ambition, and from a host of disruptive new players. Meanwhile customers (both consumer and corporate) are expecting more, and are very open to innovation.

Fortunately, the leaders of most APAC banks are used to dealing with change. But the speed and scale of transformation is likely to put a strain on even the best-run banks.

Following from EY’s Global Banking Outlook, this discussion paper looks at the growth opportunities in the region, particularly for the emerging markets – and identifies the likely players capable of seizing them. It then examines what these banks will need to do to succeed, including evolving their business models and leveraging digital technology.

Realizing the exciting potential of the region is challenging, and in the interest of debate, we also present a number of “big questions” with no easy answers:

- Will we see a pure pan-Asian online bank?
- What share of the market will fintech take?
- Will the learnings from crypto currencies transform the payments landscape?

Those banks that can reshape their strategies and operating models to capitalize on the region’s macro trends, leverage their investment in technology and respond to the increased sophistication of clients will be in a prime position to reap the benefits from APAC’s growth.

Jan Bellens
Global Banking & Capital Markets Emerging Markets and Asia-Pacific Leader

Gary Hwa
Managing Partner
Financial Services – Asia-Pacific
Executive summary

Since the global financial crisis (GFC), leading APAC-based banks have outperformed the global banking sector. Forecasts point to the region continuing to offer important growth opportunities, particularly in the emerging markets. Although at a more moderate rate, growth will be driven by rising middle class wealth and supported by governments around the region implementing structural reforms and strengthening macro policy frameworks. However, with an increasingly challenging trading environment — including new competitors — taking advantage of these opportunities will require a more strategic approach. Those remaining in the game will need to choose their strategic focus, revisit their business models and develop new sources of competitive advantage by harnessing digital technologies.

Who will be the key players?

As international banks downsize or withdraw from APAC, domestic and regional banks are stepping in — with a wave of new competitors hot on their heels. The region is already seeing new types of competitors from the rapidly-developing fintech sector, offering new banking, payment and financing options.

However, we are not expecting these new entrants to cause major disruption in core banking services — at least in the short term. In fact, their presence may be beneficial to incumbents, giving banks the opportunity to partner with these players.

“National champions” are on the rise across the region, hastened by the market integration promised by the upcoming ASEAN Economic Community, which will enable banks to operate more easily across borders. In many countries, smaller players will need to consolidate if they are to compete against banks from other markets. Governments are introducing carrot and stick regulation to encourage the emergence of national champions that can compete more effectively domestically and across borders.

Regional banks from Japan, Australia and ASEAN are also building their presence. These strong, well-capitalized institutions have spent the last five years expanding their regional footprints, following intra-region trade flows and the geographic expansion of their customers.
How will business models need to adapt?

New regulatory conditions, dynamic trading environments and changing customer preferences are shifting business models across all banking segments. To seize the opportunities in APAC, banks need to:

- **Invest in digital channels to meet customer needs** — but not at the expense of personal interaction with customers. Banks must find the right balance between self service and providing the “human touch” to sell higher value products and services.
- **Invest in technology-driven models** — not only to reduce costs and drive efficiencies but also to respond to new entrants from the fintech sector using technology to provide faster and cheaper solutions for customers.
- **Focus on areas of strength and specialist areas of expertise** — and withdraw from business lines and markets where scale or competitive advantage is lacking. International banks, in particular, are re-assessing what is core versus non-core for their business in the region.

Where will digital investment yield the greatest gains?

Banks will also need to harness technology-driven innovation to both differentiate themselves and operate their business more efficiently. In fact, the role of technology is so significant that we are seeing the lines starting to blur between technology companies and banks. Institutions are investing in technology to:

- **Innovate the customer experience in retail banking** — using data analytics to provide personalized, proactive services.
- **Innovate with direct models** — with many governments keen to open up financial services and encourage innovation, we expect more online-only banks to emerge — such as WeBank and Alibaba-affiliated MYbank. However, these will be national rather than regional. A pan-APAC online bank is still some way away.
- **Simplify and standardize operating models** — to transform cost structures and equip banks with a single customer view and detailed profile of accounts and interactions that are vital to delivering an engaging customer experience. Those reforms will also be vital to the effective implementation of capital, liquidity and leverage requirements from regulators, enabling banks to allocate capital and manage balance sheets more efficiently.
- **Use mobile to achieve a breakthrough in financial inclusion** — mobile solutions offer the potential to reduce the cost of obtaining banking services in emerging markets and increase penetration rates. But banks must also maintain some form of physical presence, to meet customer needs (and in some instances, regulatory requirements).

Conclusion

Over the next five years, the banks that grow beyond their domestic markets to become strong pan-regional champions will be those that embrace technology innovation. They may not have global aspirations but they will need to respond to a wave of emerging non-bank competitors, inspired by new technology but also believing they can offer a more compelling proposition to customers. Digital developments will also accelerate growth through increased banking penetration levels and improve profitability by lowering costs. Regulatory reforms will facilitate the development of digital and branchless banking.

In this fast-changing environment, there will be plenty of opportunities for bold, innovative banks. Winners will be those who play to their strengths, harness digital technology and who not only understand their customers, but also move forward with them.

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Note: In this publication, APAC includes Australia, China, Hong Kong SAR, India, Indonesia, Malaysia, New Zealand, Philippines, Singapore, South Korea, Taiwan, Thailand and Vietnam.
Where are the growth opportunities?

Since the GFC, leading APAC-based banks have outperformed the global banking sector. Forecasts indicate the region will continue to offer important growth opportunities, especially in emerging economies with growing middle class wealth.
Strong historical performance
From 2007 to 2014, while the global average banking ROE was stuck in single digits, APAC banks averaged 13%. Other growth indicators, including asset and revenue growth, told a similar story. Prior to the crisis, no APAC banks (ex. Japan) ranked in the top 10 banks globally. By 2013, four Chinese banks were in the top 10 banks, including the number one ranking.

This is not to suggest that performance was consistent across markets. Over 2010 to 2014, the best returns for investors came from the Philippines, Thailand and Indonesia.

Average ROE

Source: SNL Financial, EY analysis

Total asset and revenue growth CAGR, 2009–2014

Source: SNL Financial, EY analysis

Growth opportunities ahead
Today, despite the challenges of market volatility, recent capital outflows and slowing growth in China, APAC is likely to remain a leading growth region for banking – though at a more moderate rate. Banks in the emerging APAC markets are forecast to maintain asset growth of 11% CAGR for the period 2014–19, while GDP per capita is forecast to grow at a CAGR of 4.6% – albeit off a low base. This growth will continue to be driven by rising wealth and supported by governments implementing structural reforms and strengthening macro policy frameworks.
Foreign banks have made great efforts to build their presence in China, hoping to benefit from new opportunities as a result of domestic financial reforms and as Chinese corporates expand internationally. However, progress has been limited. At the end of 2013, foreign banks had a combined market share of less than 2% of the Chinese banking market and will face major challenges in growing their presence. Opportunities are scarce unless players are already established in the market. The limited physical distribution channels of the international banks put them at a distinct disadvantage to local incumbents. We don’t expect many new foreign banking entities from outside APAC to seek to enter the mainland China market over the next five years. The greater opportunity lies with Chinese banking customers expanding cross-border, where they can be served by foreign banks with global networks.

However, the trading environment will be increasingly challenging. New global and domestic compliance and capital requirements, and rising funding and labor costs have increased the cost of doing business. At the same time, competition from local players that dominate most of the APAC markets, combined with low interest rates, have put downward pressure on fees and margins.

Will foreign banks capture a greater share of China’s banking market?

Foreign banks have made great efforts to build their presence in China, hoping to benefit from new opportunities as a result of domestic financial reforms and as Chinese corporates expand internationally. However, progress has been limited. At the end of 2013, foreign banks had a combined market share of less than 2% of the Chinese banking market and will face major challenges in growing their presence. Opportunities are scarce unless players are already established in the market. The limited physical distribution channels of the international banks put them at a distinct disadvantage to local incumbents. We don’t expect many new foreign banking entities from outside APAC to seek to enter the mainland China market over the next five years. The greater opportunity lies with Chinese banking customers expanding cross-border, where they can be served by foreign banks with global networks.

In this environment, what type of bank is likely to take advantage of the region’s growth opportunities?

### Regulatory agenda for banks in Asia-Pacific

**Financial crime**
- AML/KYC
- Beneficial ownership dialogue starting globally
- FATF standards adopted to varying degrees by governments & regulators — increasing scrutiny/strengthening
  (e.g., SG, HK)

**Financial reporting**
- IFRS 9 – ECL models
- IFRS 17
- BCBS 239
- Basel III Pillar 3
- FATCA
- CRS
- FATCA: IGAs for most jurisdictions

**Capital markets reform**
- OTC Derivative Reform
- G20 Roadmap on Shadow Banking
- Shadow banking: changes to banks’ wealth operations (CN)
- Market integrity (e.g., SG – financial benchmarks regulation)
- OTC derivatives reforms: potential standardization issues
- Capital markets integration

**Consumer protection**
- Conduct: mis-selling (e.g., AU, KR)
- Data security/protection (e.g., CN, HK, SG, KR, ID)
- Financial advice reforms (AU, SG)
- Deposit insurance (e.g., AU – single customer view, CN)
- Revised Code of Banking Practice (HK)

**Resolution planning**
- New Large Exposures Framework
- GSIBS, D-SIBs
- NBNI rules on GSIs
- FSB – Key Attributes of Effective Resolution Regimes

**Risk transformation**
- BCBS: Corporate Governance Consultative Guidelines
- Corporate governance/risk management strengthening (e.g., AU, IN, MY, PH, KR, SG)
- Distressed assets guidelines/early identification (IN)
- Strengthening controls on outsourcing (SG)
- Lending scrutiny (e.g., AU, MY, TH)
- Bank technology rules (CN – on hold; ID)

**Prudential**
- Basel III - capital, liquidity
- Stress testing (AU, HK)
- Higher leverage ratio (e.g., CN, IN)
- Stricter LCR rules or faster phase-in (e.g., CN, AU, HK)
- Higher minimum capital requirements (super and accelerated adoption e.g., TW, SG, PH, IN)
- Accelerated capital deduction phase-in and/or full deduction for many markets

**Structural reform**
- Priority sector lending targets (ID, IN)
- Standardization requirements (e.g., SG, HK, ID, IN – incentives)
- Tier 1 capital determines permitted scope of business/expansion (ID)
- Consolidation measures (e.g., PH, VN)

Source: IMF, EY analysis
Key players
Who’s in, who’s out?

Domestic and regional banks are stepping in as international, investment and private banks withdraw from the region. But a wave of new competitors are hot on their heels.
Push for national champions

Across the region, “national champions” are on the rise. The pace of domestic market consolidation is being hastened by the market integration promised by the upcoming ASEAN Economic Community. The ASEAN Banking Integration Framework will introduce greater competition by enabling easier access to markets within the region. Being able to operate across borders should enable banks to take advantage of economies of scale to increase efficiency and reduce costs.

In many countries, smaller players will need to consolidate if they are to compete against banks from other markets. In the Philippines, for example, the four largest domestic banks combined are still smaller than any of the major domestic banks in Singapore.

In their push to create national champions that can compete with banks in other countries, regulators are using both carrots and sticks. Taiwan, whose banks have struggled to grow abroad, has recently eased offshore investment limits for banks to facilitate their overseas expansion. Some markets are also liberalizing foreign bank ownership restrictions to encourage investment. For example, the Philippines has increased foreign ownership limits in local banks from 60% to 100% and allowed more foreign banks to establish operations in the country (previously capped at 10). At the same time, regulators in the Philippines and Vietnam have increased minimum capital requirements, putting pressure on the smaller banks in the market to consolidate.

In this environment, we expect M&A activity to remain concentrated on domestic and regional cross-border transactions. Institutions with small business lines and regional franchises are likely to seek stronger owners who can scale up. This is especially the case for investment banking and private banking. Investment banking requires scale and a global platform to be profitable, as demonstrated by a number of banks withdrawing from certain business lines in APAC. Private banks with sub-scale operations and low returns are also reassessing their strategy in Asia.

Rise of the regionals

As international players downsize and withdraw from the region, regional banks from Japan, Australia and ASEAN are building their presence. These strong, well-capitalized local institutions have spent the last five years expanding their regional footprints, following intra-region trade flows and the geographic expansion of their customers. Smaller banks in particular have been following customers moving into, for example, Thailand’s manufacturing hub. Meanwhile, the majors have built up their operations in areas such syndicated lending and project finance.

To find sustainable growth outside their sluggish domestic market, Japanese institutions have been building their regional presence via local branches and subsidiaries, and investments in other financial institutions. Similarly, some Australian banks have targeted Asia in response to a low growth domestic environment.

Banks in the smaller and more mature markets of Singapore and Malaysia are seizing their only real growth opportunity to develop into major pan-ASEAN regional players. According to Bloomberg data, Maybank, DBS and CIMB were among the top five arrangers of Southeast Asian equity sales in 2014. To a lesser extent, Thai banks are also looking to develop an ASEAN presence. In China, banks have established operations across the wider APAC region to serve the needs of the Chinese diaspora.


Market concentration: market share of top five banks

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<th>Country</th>
<th>Market Share</th>
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<td>New Zealand</td>
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<tr>
<td>Australia</td>
<td></td>
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<tr>
<td>Malaysia</td>
<td></td>
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<tr>
<td>Hong Kong</td>
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<td>Singapore</td>
<td></td>
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<tr>
<td>Philippines</td>
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<tr>
<td>India</td>
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<tr>
<td>Indonesia</td>
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<td>South Korea</td>
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<tr>
<td>China</td>
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<tr>
<td>Vietnam</td>
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<td>Taiwan</td>
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<td>Thailand</td>
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Indonesia, Philippines and Vietnam are among the markets undergoing consolidation.

Source: SNL Financial, regulator statistics, EY analysis

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As these trends continue, smaller banks in emerging markets may make attractive targets for larger institutions with regional aspirations, depending on the target market's openness to foreign investment. For example, Taiwanese banks have recently acquired smaller institutions in China, Cambodia, the Philippines and Indonesia.

However, such acquisitions will be complicated by regulators' moves to control banks' franchises and align them with domestic banks to protect their home markets. Foreign banks may be required to establish separately capitalized local subsidiaries and local management teams. Regulators are also setting lending quotas that require institutions to direct lending to certain segments such as SMEs. Such requirements increase the cost of acquisition and may curb some regional expansion plans.

**International banks redefine what's core**

Major banks in Europe and the US are withdrawing from certain geographies and whole lines of business in their Asian operations. Those facing capital and profitability pressures in their home markets are seeking to unwind investments, re-assessing what is core versus non-core for their future business in Asia. Anti Money Laundering/Know Your Customer (AML/KYC) requirements are also pushing banks to consider reputational issues and "customer fit" when evaluating which business lines and markets are deemed non-core. Even profitable non-core businesses are being divested.

Add to this the fact that many international network hubs and small franchise businesses have failed to achieve acceptable rates of return. No wonder few banks are aspiring to be truly global and most are questioning where to continue to operate internationally and why.

Given the capital constraints for European and US banks, any deal activity from international banks is likely to employ greater use of "capital light" deal structures, such as alliances and partnerships. We are already seeing specialist financial services firms teaming up with deep-pocketed capital providers from outside the sector. These deals show that small acquirers can play for big deals if they have the right platform and management team together with a well-capitalized partner.

**New competitors enter the fray**

Without the legacy infrastructure of traditional banks, new entrants from the fintech sector are using technology to provide faster and cheaper solutions for customers. Governments and regulators are actively encouraging fintech development to increase competition, bring innovation into financial services and/or provide sources of funding for SMEs. South Korea, for example, has made fintech innovation a priority as part of plans to strengthen its financial services industry.

However, such innovations have the potential to threaten traditional players with disruption and disintermediation as they target multiple parts of the banking value chain. APAC is already seeing new types of banking competitors offering digital banking, mobile banking – to address financial inclusion issues – and peer-to-peer (P2P) lending and crowdfunding – for customers who may not be able to access finance from banks.

Although currently accounting for only a very small share of the lending market, P2P lenders could potentially make inroads on banks' personal and business lending market share. Internet finance companies in China offer money market funds with higher returns than traditional banks, intensifying competition for deposits; some are now also establishing banking operations.

Banks have the opportunity to partner with these players and, in so doing, gain access to more sophisticated and detailed customer data. Already, some banks are moving in this direction, either partnering directly with new entrants or establishing fintech hubs and accelerator programs that incorporate collaboration with startups. Australian bank Westpac has established a venture capital fund to invest in fintech startups.

However, collaboration can be a challenge. Big banks don't always understand new technology and how to implement it; small fintech firms don't understand how banks make their investment decisions and find the organizational hierarchies confusing. Startups may also struggle to survive if they are only providing a service to a single institution. With the proliferation of opportunities on offer, banks need to decide where to focus their investment to deliver a stronger customer proposition and ensure sustainable ROI.

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**Will we see the emergence of a truly international bank headquartered in APAC?**

As the international banks retreat to their home markets, we see the possibility of an APAC bank emerging to take their place. Three scenarios are possible: a completely new entrant in the form of a domestic or regional champion from China, India or ASEAN; Japanese banks continuing the expansion beyond the region; or an international bank with a large APAC presence relocating its headquarters to the region.
What share of the financial wallet will the new fintech players take?

As fintech innovators become more mainstream, their share of financial services will almost certainly go up. However, we believe that these new competitors are highly unlikely to be able to – or want to – completely disintermediate traditional banks. Fintech payment players are looking to capture part of the value chain by providing alternative ways of enabling payments – they are not seeking to bypass banks. We have yet to see how far these new business models can be expanded and how these organizations would deal with the inherent (and often little understood) risks in new intermediary models that have not withstood a crisis of their own. Nor are they likely to want the onerous compliance requirements that may follow from attracting increased regulatory scrutiny.

Will blockchain technology transform the payments landscape in the APAC region?

We believe that cryptocurrencies, and the underlying blockchain technology, have great potential to transform the APAC payments landscape in the longer term. Offering low cost and near instant transfers over mobile and the internet, cryptocurrencies are a particularly exciting innovation for emerging markets where payments and banking infrastructure is less developed. But security risks associated with the use of cryptocurrencies and regulatory uncertainty challenge their take up. The anonymity of cryptocurrencies makes them vulnerable to criminal activity. As a starting point, robust KYC regulation will be essential to build the trust and confidence needed to establish a viable currency for consumers and merchants. The greater disrupter is likely to be blockchain technology, which we believe will deliver powerful learnings for the APAC payments landscape. Offering the potential to streamline and reduce the cost of cross border transactions, banks in APAC are investigating the use of blockchain technology in areas such as intrabank transfers, international payments and trade finance. The technology will also drive further innovation in mobile wallet and stored value solutions for consumers.
“Financial intermediaries or activities involved in credit intermediation outside the regular banking system”

With its relatively less developed financial markets, less complex financial products and smaller non-bank sector, APAC’s shadow banking system is very different from those of the US and Europe. In Asia, bank loans have traditionally been the source of funding for business. But not all businesses have access to bank lending, leading to the emergence of ‘shadow’ markets. Assets held by non-bank financial intermediaries in Asia, excluding insurance companies, pension funds and public financial institutions, account for less than 15% of the total financial system. This is significantly below the global average of 25%.

Even so, shadow banking in the APAC region is receiving increased attention from regulators and policy makers over the potential for systemic risk. The main focus has been on China, where banks have used off balance sheet lending and the interbank lending market to circumvent financial system regulatory controls. The rapid growth in the sale of wealth management products has seen large amounts of money entering the financial system. This has been used to invest in real estate and local government infrastructure projects, building up risks in the banking system.

Global shadow banking assets in selected APAC markets 2013

Source: Financial Stability Board

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<thead>
<tr>
<th>Country</th>
<th>Assets (US$ billion)</th>
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<tbody>
<tr>
<td>China</td>
<td>2,738</td>
</tr>
<tr>
<td>Australia</td>
<td>229.6</td>
</tr>
<tr>
<td>India</td>
<td>190.0</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>102.8</td>
</tr>
<tr>
<td>Indonesia</td>
<td>40.5</td>
</tr>
<tr>
<td>Singapore</td>
<td>33.2</td>
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The IMF has highlighted the size and rapid growth of shadow banking in China as warranting close monitoring. As at March 2014, shadow banking accounted for an estimated 35–50% of GDP, was growing at over 20% per year and expanding at twice the rate of bank credit.6

In the future, we expect additional regulation for shadow banking activities to address concerns not only of systemic risk but also consumer exposures. Large investment management companies that could pose potential systemic risk may be required to provide greater transparency and more market disclosure, and to tighten controls and due diligence around investments.

However, rather than seeing shadow banking players as a threat, smarter banks will look at ways to team profitably with these entities. Examples could include providing funding for alternative business finance providers or referral arrangements, whereby small business customers who don’t qualify for a loan can be referred to the bank’s associated P2P lender. This is already occurring in the UK, with encouragement from the government. Despite the somewhat negative image conjured up by the term, shadow banking can play an important role in emerging markets, financing businesses and deepening financial markets. In China, shadow banks have provided access to credit for SMEs who struggled to access finance through traditional banking channels, and offered investors higher rates of return than bank deposits.

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7. Financial Stability Board, *Global Shadow Banking Monitoring Report 2014*, 30 October 2014. Statistics based on the FSB’s narrower measure of shadow banking cited in the report, which filters out non-bank financial activities that have no direct relation to credit intermediation or that are already prudentially consolidated into banking groups. This more accurately reflects the size and composition of the shadow banking sector.
Growth play
What are the success factors?

To seize the growth opportunities in APAC, banks will need to choose their strategic focus, realign their business models and develop new sources of competitive advantage by harnessing digital technologies.
Evolving business models

New regulatory conditions, dynamic trading environments and changing customer preferences are shifting business models across retail, corporate, private and investment banking.

Adopting omni-channel distribution strategies in retail banking

Although changing customer preferences and the growth of self-service channels means customers are less likely to use branches for routine transactions, human interaction remains a vital sales channel – especially for complex financial products and services. Digital channels are important, but banks should not focus on them at the expense of their branch networks. Instead, they need a true “omni-channel” strategy that meets differing customer needs.

Digital channels have strong penetration in APAC, with both individual and corporate customers rapidly adopting digital and mobile banking. According to our latest Global Consumer Banking Survey, between half and three quarters of the customers from APAC markets use online/internet channels at least weekly, and a third use mobile channels. Customers from India are the world’s heaviest users of these digital channels. The widespread adoption of mobile technology in emerging markets offers banks a new way to reach the unbanked and underserved in remote areas. Banks are developing low-cost, basic services for these customers, using branchless banking enabled by point-of-sale and simple mobile payments technologies.

Percentage of customers who use channels at least weekly

<table>
<thead>
<tr>
<th></th>
<th>Australia</th>
<th>China</th>
<th>Hong Kong (SAR)</th>
<th>India</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Singapore</th>
<th>South Korea</th>
<th>Vietnam</th>
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<tbody>
<tr>
<td>Online/internet</td>
<td>76%</td>
<td>64%</td>
<td>59%</td>
<td>70%</td>
<td>51%</td>
<td>52%</td>
<td>56%</td>
<td>63%</td>
<td>50%</td>
</tr>
<tr>
<td>Mobile</td>
<td>29%</td>
<td>44%</td>
<td>38%</td>
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<td>34%</td>
<td>32%</td>
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<td>ATMs</td>
<td>55%</td>
<td>51%</td>
<td>66%</td>
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<td>61%</td>
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<td>Branch or office</td>
<td>13%</td>
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<td>25%</td>
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<tr>
<td>Call center</td>
<td>4%</td>
<td>17%</td>
<td>21%</td>
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<td>6%</td>
<td>36%</td>
<td>11%</td>
<td>13%</td>
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Source: EY, Winning through customer experience: EY Global Consumer Banking Survey, 2014
However, APAC customers have not abandoned branch usage. Our survey showed 65% of customers still prefer branches for sales-related enquiries and 54% want human interaction to receive advice. Challenges also remain around regulations that require certain banking activities to be conducted in person and mobile banking options that are limited to a few basic services.

Many banks are looking at alternative approaches to enlarge their footprint. In Indonesia, innovative banks have developed itinerant branches that travel to customers in remote locations. Others are partnering with third parties to expand their digital distribution reach—such as Malaysia’s CIMB, which has teamed up with convenience store retailers in Indonesia to offer mobile bank services.

Currently, branch networks across APAC markets are not shrinking significantly—indeed, they are continuing to expand in emerging markets thanks to urbanization and a growing middle class. But, as digital adoption increases, traditional branch usage will eventually decline. We expect branch footprints to contract, as regulatory restrictions around opening of accounts and provision of banking services relax and governments act to expand financial inclusion.

**Reinventing the private banking model**

The potential for private banking services in APAC seems evident: APAC is the world’s fastest growing wealth market and is expected to soon be the largest globally. But there are significant challenges with serving this customer base in APAC, which is unusually price sensitive. Many potential private bank customers do not see value in using a private bank over commercial banks and wealth managers, making customer acquisition challenging.

Private banks also face profitability challenges. Operating costs are high and increasing. Relationship managers and frontline staff are expensive, particularly where talent is scarce. Technology investment to meet evolving customer expectations is also driving up costs, as are regulatory compliance requirements. In particular, increasingly stringent AML/KYC regulation is making the cost of acquiring customers prohibitively high.

We believe that private banks need in excess of US$20 billion in assets under management before they can generate enough revenue to be profitable. Smaller banks will need to scale up, through M&A or partnerships. Survivors will need to transition from the traditional relationship manager centric model to one that leverages technology to meet customer expectations, improve efficiency and drive down costs.

Private banks also need to review the role of relationship managers. Currently, we estimate that relationship managers spend only 10%-20% of their time directly with customers, with the bulk of their time taken up with administrative and back office activities. If they are truly to add value, relationship managers must spend more time on building relationships and becoming a trusted advisor to their customers. Improved digital capability can help this process, automating the back office and supporting relationship managers with customized solutions based on analyzing integrated customer information.

We see a new model of private banking emerging. The top tier will become digital banks, responding to their customers’ preference for access via an online platform. Relationship managers will be used strategically and only where they can demonstrably add client value. The middle layers will consolidate and look to develop into top tier players. Selected boutiques will continue via the strength of their personal relationships and a clearly differentiated offering.

**Reducing the cost to serve SMEs**

Across APAC, margins are under pressure in traditional SME banking, which relies on the resource-intensive relationship manager model. However, a new technology-driven model is now possible, based on an automated back office and self-service digital channels for routine transactions. The model will free up relationship managers to deliver value added services, speed up approval times and drive down operational and credit administration costs—offering significant growth opportunities.

We see a three-tiered model as optimal for this customer segment, incorporating technology and relationship managers in different ways:

- **Retail plus**—branch, digital and self-service only
- **SME core**—digital/self-service with support from a relationship manager pool
- **SME premium**—digital/self-service with a named relationship manager

Technology will also enable banks to gain a single customer view, supporting cross-selling and helping to complete KYC documentation efficiently. Certain APAC banks are also using behavioral analytics to target and select low-risk, high-value customers. Others are using digital to move beyond traditional banking services, such as harnessing social media to host SME communities and support networks. Through these networks, banks have access to a wealth of data that can be combined with customer transaction data to provide customized offerings, such as benchmarking a customer’s performance against their peers.

The service model for SME customers must be “fit for purpose” in the particular segments on which a bank is focusing. For example, banks that service the upper end of the middle market are increasingly positioning themselves as “transaction bankers”. These banks could leave credit provision to emerging providers—P2P, invoice auctioning—and instead focus on higher margin services that generate more fee income. With the emergence of these potentially disruptive alternative providers, there is increasing pressure on SME banking to transform from a credit driven relationship to a service provider relationship.

But while technology can offer efficiency and effectiveness dividends, challenges remain in SME banking. In APAC’s emerging

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The customer view
In our Global Commercial Banking Survey, bank customers told us that banks need to:

“Make it easier to access the information we need”
“Simplified approval procedures to speed things up”
“Make security tighter and more clear so that customers feel safe:”
“Good customer support, online security, fast clearance”

markets, distribution is the biggest constraint, simply because of the geographically dispersed markets. Although online options can address this to some extent, current regulation still requires face-to-face interactions for some activities – making acquisition costs high.

Re-evaluating corporate banking portfolios
Corporate lending in the region is dominated by APAC-based banks. However, although these banks have strong lending relationships, few have the size or product suite to serve the wider range of needs of corporate customers. As international banks reassess and redefine their Asia operations, including withdrawing to their home countries in some instances, regional APAC banks have an opportunity to fill the gaps and reposition their corporate relationships.

Rather than trying to be all things to all customers, APAC banks need to focus on developing their strengths and areas of expertise to develop best-in-class services in niche areas. Our corporate banking survey found that many major corporates use a two or three-tiered relationship hierarchy, with the top two tiers of banks committing the most money and performing the most services and the third tier typically including a broad pool of banks that provide local country support or specialized services. APAC-based banks need to re-evaluate their corporate portfolios, assessing risks and profitability by business, geography and product. It’s time for banks to exit lines of business and markets that are no longer profitable, or where regulation is impacting liquidity and capital use – and decide where, how and with whom they will do business in the future.

The cross border expansion of APAC corporates offers opportunities for regional and international banks. This is likely to prompt banks to focus on countries where more complex cash management and hedging products are needed or where larger corporates are seeking financing through debt and equity issuance. We also expect to see domestic banks in emerging markets partner with international banks with broader capabilities to support the

56%
Inconsistent service and pricing across geographies

35%
Outdated processes and systems

30%
Bureaucratic and inflexible

Source: EY, Successful corporate banking: focus on fundamentals, 2013

Will APAC banks fund global infrastructure needs?

Estimates suggest that about US$57 trillion will be required for global infrastructure investment by 2030. In APAC, Asian Development Bank research indicates a US$7.8 trillion funding need in the region’s emerging markets between 2010 and 2020. This is likely to be met by domestic and regional banks, which are increasingly supporting infrastructure projects in the region, following the retreat of international banks. In future, we may see APAC banks contributing to global infrastructure projects in the early stages, when funding needs are smaller. But we do not believe they will play a major role in the long-term funding of global infrastructure, given domestic and regional infrastructure needs and the constraining effect of Basel III on balance sheets. This role is more likely to be taken up by APAC sovereign wealth funds, insurers and pension funds. Also, if banks are funding infrastructure projects, they are less able to fund business growth as well.

corporate banking survey. Many respondents also said that value-added advice and insights are the top benefit of their relationship with their core bank.

**Forming regional franchises for investment banking**

Traditionally in APAC, global players have used their scale to capture a large share of the investment banking market. However, the investment banking landscape is changing. A host of regulations imposing structural reforms and higher capital and leverage ratios requires investment banks to re-evaluate their business models. Higher capital standards and ring fencing requirements are forcing investment banks to reduce their balance sheets and withdraw from higher margin, higher risk business.

With declining revenues across a range of businesses, some investment banks are struggling to be profitable. Improving operational efficiency and decreasing the cost to serve is proving extremely challenging, as the financial impact of regulatory compliance makes it harder to keep costs down – especially in areas where institutions lack sufficient scale. As a result, we have already seen a number of international banks shrinking their investment banking divisions.

Where these international banks have withdrawn, regional and major domestic banks see opportunities. These APAC banks are not seeking to become the new wave of global players but rather to focus on building out strong regional franchises that will allow them to acquire the more complex and higher-value business. Domestic players that do not invest in building out their presence and in developing more advanced products will find themselves left with lower margin business. We also expect boutique players to continue to play an advisory role in deals where scale isn’t important and doesn’t impact the balance sheet.

**Digital**

Technology-driven innovation is critical for banks in emerging markets to both differentiate themselves and operate their business more efficiently. The role of technology is so significant that we are seeing the lines starting to blur between technology companies and banks.

**Innovating the customer experience in retail banking**

Our consumer banking survey confirms that trust, convenience and personalization form the foundation of a customer’s relationship with their bank – and technology is the enabler. In mature markets, customers expect 24/7 real time and seamless banking across channels. In emerging markets, low-cost mobile banking technologies are enabling profitable engagement with new customers in markets with low banking penetration. Our survey highlights that customers in emerging markets value innovation more than in developed markets, so banks that can offer innovative customer solutions stand to gain a competitive advantage.

In all markets, data analytics can help banks transform the customer experience. Banks hold a wealth of data on their customers that can be used to provide more targeted segmentation and improve the customer experience at an individual level – such as personalizing products and services, and proactively alerting customers to relevant bank offerings. But to be able to do this effectively, banks need a single customer view, which most are yet to achieve.

With improved experience comes increased engagement. Engaged customers are more willing to invest with their bank (by paying a little more, adding more accounts and/or services). More than three

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**WeBank: the vanguard of China’s online banking revolution?**

China’s first online-only bank is a joint venture led by gaming and social network group Tencent Holdings. WeBank is one of five institutions to be granted a licence under a government pilot scheme to establish privately operated banks, as part of moves to open up China’s banking sector. Banks licensed under the scheme are expected to focus on expanding access to finance for small and micro businesses, and individuals.

Tencent operates the highly popular mobile messaging and social media app WeChat – one of China’s largest social networks, with 549 million monthly active users (as at first quarter 2015). WeChat already offers customers financial services in the form of a bank card linked to their WeChat account and Tencent’s wealth management platform, offering customers the opportunity to invest in third-party investment products via their smartphones.

The extent to which online players will be able to penetrate and disrupt China’s banking sector still depends to some extent on China’s regulators. WeBank may not be a competitive threat to China’s bank incumbents for now, but future developments may see the new players such as WeBank start to change China’s banking landscape.
Quarters of customers in China, India, Indonesia, and South Korea say they would invest more in return for personalized products and services, and for their bank helping them to find new ways to conduct their business. In Vietnam, more than 90% of customers would do so. Similarly, being alerted to relevant products, services and special offers is appealing to customers in China, Hong Kong, Indonesia and Vietnam.

Banks must be careful that their use of smart analytics doesn’t become overly intrusive. Customers must have confidence that their data is managed with integrity. Banks risk eroding customer trust if customers feel that their bank knows too much about them.

The challenge is to find a comfortable balance between the competing elements of trust, convenience, data security and innovation.

For now, established, traditional banks have a trust advantage over new, technology-based entrants, who have yet to establish longstanding customer relationships. However, our survey indicates that in online and mobile banking, established banks in APAC have only a small competitive advantage over new entrants. To compete with new types of financial services providers, win more business and retain their customers, banks must work hard to maintain the highest levels of trust.

**Percentage of customers who would pay a little more, add more accounts/services or increase their balances in exchange for:**

- **Customized products and services to fit their needs**
- **New ways to improve how they conduct their business**
- **Proactively alerts them to products, services or special offers that may be of interest**

Simplifying and standardizing operating models

In the wake of the GFC, cost to income ratios have trended downwards in a number of APAC markets. But, in the last five years, many APAC banks have struggled to further improve efficiency. The rapidly evolving regulatory landscape is pushing up compliance costs. Minimum wage rules and talent shortages are driving up labor costs and reducing the opportunities for labor arbitrage. IT investment and maintenance is costly. According to Celent, IT spend by APAC banks will grow 5.6% in 2015 and will remain relatively consistent in 2017.¹⁰

In the context of the low growth environment of developed markets and the slowing growth of emerging markets, real transformation will be required to get costs back under control and to ensure there is sufficient scope to invest in new technology and not cede more ground to new entrants.

To date, technology investment to replace manual processes has stalled in low-cost labor markets such as Malaysia, Vietnam and to a lesser extent, Thailand. However, banks across APAC are realizing that simplification and standardization have benefits beyond cost reduction. Integrated operating structures will ultimately equip banks with a single customer view and detailed profile of accounts and interactions that are vital to delivering an engaging customer experience.

Using mobile to achieve a breakthrough in financial inclusion

A lack of banking infrastructure, geographic challenges and regulatory impediments have kept financial inclusion low in a number of emerging markets in the APAC region. But now regulators are recognizing the major role that non-bank mobile money providers, such as telcos, can play in fostering financial inclusion and are establishing enabling regulatory frameworks.

Although smartphone penetration in APAC emerging markets lags that of the developed markets, penetration rates are increasing. This brings the opportunity to expand financial inclusion through mobile money solutions. If regulator and customer concerns over the security aspects of mobile money can be addressed (including appropriate customer identification), the cost of obtaining banking services in emerging markets can be reduced and penetration rates increased.

Innovating with pure direct models

Although APAC has an increasing number of online banks associated with existing bricks and mortar banks, few successful pure online players have emerged to date. Regulation in different markets has constrained the development of stand-alone direct banks; for example, requiring that banks must have a physical presence and face-to-face channels. But now governments are keen to open up financial services and encourage innovation, we expect more online-only banks to emerge – like WeBank and Alibaba-affiliated MYbank.

A purely digital bank is particularly attractive to markets with high mobile penetration and dispersed populations, such as Indonesia, where a new entrant with a strong digital offering could disrupt the market. However, direct banks must still contend with regulation requiring interaction in person, and the need to maintain a lean cost base to offer the best rates – the critical differentiator for an online-only bank. The risk is that if too many online-only banks emerge, the market becomes uncompetitive and therefore, unsustainable.

In response, banks across APAC are starting to invest more in technology to both drive efficiency, through simplification and standardization, and maximize growth opportunities. Simplification is proving a major challenge for APAC banks with aging legacy systems and product and segment silos. Certain banks, primarily international players and the Australian banks, have had some success in consolidating back office functions to create operating efficiencies. This is yet to be replicated in the front office, leaving inconsistent customer data between different parts of the business. This both hampers cross selling and creates inefficiencies.

Banks in the region have had more success in standardizing processes. However, regional banks, with some exceptions, have struggled because of their federated operating models. Banks that have expanded rapidly, especially through poorly integrated acquisitions, have often been left with inefficient operating models.

<table>
<thead>
<tr>
<th>Average cost to income ratio</th>
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<tbody>
<tr>
<td>FY10</td>
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<tr>
<td>Developed APAC</td>
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<tr>
<td>Emerging APAC</td>
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Source: SNL Financial, EY analysis

What’s next?

Over the next five years, we expect further polarization among the international banks in APAC as they determine what they do well in each market, and which markets are worth staying in. There will be further exits from subscale operations. White labelling arrangements will become increasingly common. Consolidation will progress as ASEAN economic integration moves closer, with strong pan-regional champions emerging. These banks will seek to be a top ranking bank within the region, rather than within their domestic market. They will offer an enhanced range of services to better compete with the international banks. Over the medium term, we see these banks continuing to focus on ASEAN regional opportunities to maximize their share of wallet rather than seeking to become global players. Other banks in APAC will remain largely domestic or will operate in nearby cross border markets rather than becoming fully regional banks.

Growth will be driven by technology innovation, which will be fast and furious. There will be many more technology-based non-bank competitors, bringing new competition and new offerings, not only in retail but also in SME banking. Auction-based invoice financing and P2P lending may take share from traditional banks in the SME segment. To respond to this, banks will need to be more service centric rather than credit centric.

Digital developments will also accelerate growth through increased banking penetration levels and improved profitability through lowering costs. Regulatory reforms will facilitate the development of digital and branchless banking and help overcome the need for certain activities to be conducted in person. Eventually, this reduced dependence on physical distribution networks will provide the opportunity for foreign banks to (re)build their retail offerings.

“Growth will be driven by technology innovation, which will be fast and furious.”
ROE across the region has been highly divergent in recent years, from as low as 4% in South Korea to as high as 20% in China.
Emerging markets

In a number of markets, NIM is under pressure and the cost to income ratio is trending up, increasing the need for sustainable productivity improvements.

Source: SNL Financial, EY analysis
Corporate and business lending in the Australian market is subdued, contributing to low balance sheet growth. The economy’s struggling transition away from mining is placing pressure on business confidence.

Net interest margin is under pressure as banks seek to gain market share and manage the reliance on offshore funding. Competitive pricing remains a core growth strategy, with strong competition for residential housing mortgages. The banking sector continues to experience significant exposure to the housing sector, with balance sheets heavily reliant on housing mortgages (50% of the big four banks’ balance sheets, and higher for regional and mutual banks). House prices continue to rise well ahead of inflation, which has prompted heightened government and regulatory scrutiny on serviceability and new housing commitments at high loan to valuation ratios (LVRs).

Margins are also under pressure from the need to maintain higher levels of regulatory capital and liquid assets to meet Australian Prudential Regulation Authority (APRA) capital requirements. The regulator has however eased liquidity requirements for foreign bank branches.

Australia’s big four banks dominate a sector that also includes three regional banks, other domestic banks, more than 40 inbound banks, and nearly one hundred mutuals (mutual banks, credit unions and building societies). The big four banks are among the top 50 banks in the world by assets and among the top 30 by market capitalization. They account for 80% of the Australian market.

Australian banks face a demanding regulatory agenda, including accelerated implementation of the Basel III capital and liquidity requirements. Rules on capital are also stricter, causing concern for banks about the impact on dividends and credit growth. The big four banks have been designated domestic systemically important banks (D-SIBs), with additional capital requirements. Conduct risk, and risk culture and management are receiving elevated prominence from the regulator, with close monitoring for excessive risk-taking.

The final report of the government’s Financial System Inquiry was released at the end of 2014. If implemented, the report recommendations will reshape the landscape for Australian banks. The Inquiry recommendations call for capital ratios that will put Australian banks in the upper quartile of international peers with which they compete for funding.

Another area of focus is innovation, with recommendations to support new business models and new players. Over the past two years, non-financial sector players have been introducing new product and service innovations, especially in payments and P2P lending.
With the growing importance of RMB and the launch of Shanghai-Hong Kong Stock Connect, banks in Hong Kong are well-positioned to benefit from the increasing usage of RMB in trade finance and opportunities from offshore business.

As Asia’s prominence in global wealth increases, Hong Kong continues to maintain its status as a private wealth hub for the region, especially in serving clients from mainland China and North Asia.

Hong Kong’s banking sector is highly developed, with a three-tier banking system made up of 159 licensed banks (including 138 foreign banks), 21 restricted license banks and 23 deposit-taking companies. Unlike other APAC markets, foreign banks are the dominant players.

Hong Kong banks are well on-track to meet Basel III requirements on capital, liquidity and leverage ratios. Given many of the global systemically important banks have operations in the city, the regulators are under pressure to implement a bail-in resolution regime, and the second round of public consultation was launched in January 2015.

Increasing business and financial integration between Hong Kong and mainland China, and the further development of Hong Kong as an important RMB offshore center not only brings new business but also risk, through banks’ increasing exposure to mainland China and its economic slowdown. This may increase banks’ risk profiles and lead to higher credit costs. Chinese banks’ continuous expansion in Hong Kong has pushed up deposit rates and placed interest margins under pressure. This may negatively impact smaller banks struggling to maintain income growth without increasing risk.

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Hong Kong SAR

- Highly developed market in an open economy
- Gateway to China
- Offers opportunities from the increasing business integration with China and RMB internationalization

**Population**
- 7.3 million

**GDP per capita**
- $39,871

**Banking penetration**
- 96.1%

**FDI inflows**
- $103.3 billion

**Trade flows**
- Exports: $687 billion
- Imports: $716 billion

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There are 21 banks registered in New Zealand. The largest banks are subsidiaries of the Australian big four banks and account for 80% of the market. Other foreign banks have established subsidiaries, including major banks from China in recent years. Several foreign banks also have branches.

New Zealand banks have strong fundamentals. They are well capitalised, supported by early adoption of Basel III capital provisions. Capital, liquidity and funding buffers are above minimum regulatory requirements. The sector is profitable and asset quality is good.

As in Australia, the balance sheets of New Zealand banks are heavily reliant on housing mortgages. Competition for housing loan customers is intense, particularly for loans with low LVRs. In response to house price inflation concerns, the Reserve Bank introduced lending caps on home loans with LVRs over 80% in 2013. The Reserve Bank is now establishing a new asset class for bank loans to residential property investors. This will attract a higher risk weighting than for owner-occupier mortgages. The Reserve Bank is also tightening the LVR policy, including a new restriction on loans to Auckland property investors with an LVR greater than 70%.

These changes are expected to take effect from October 2015. House price inflation also remains high in Christchurch as the re-build of the city continues following the 2010 earthquake. House prices remain largely flat across the rest of New Zealand.

Banks also have significant exposure to the dairy industry, which has experienced a sharp fall in revenues due to lower international prices. If low prices continue, asset quality may deteriorate.

There is significant foreign property investment, particularly from China.
Banks in Singapore have continued to grow their cross-border loan books as an increasing number of local and international corporates use Singapore as a funding hub to expand across Asia, especially to emerging Asia. SMEs expanding their Southeast Asian operations are increasing demand for cash management and other transaction services. Strong capital positions and rising financial integration among major Asian economies are also pushing Singapore’s domestic banks to expand their overseas operations within the region.

Singapore has five local banks (two of which are subsidiaries of the three major local banks) and 122 foreign banks (28 foreign full banks, 57 wholesale banks and 37 offshore banks). The banks have good asset quality and strong capital and liquidity.

The regulatory agenda includes a stricter approach to implementation of the Basel III capital and liquidity requirements. The Monetary Authority of Singapore (MAS) has also published a framework for D-SIBs, which requires designated banks with a significant retail presence to have mandatory local incorporation and be subject to higher liquidity and capital adequacy metrics.

Macro-prudential measures on housing loans, as well as a subdued domestic and regional growth outlook, is contributing to decelerating growth in loans and profit. Risks associated with exposure to Chinese loans and a softening domestic property market may exert pressures on credit quality.

MAS has undertaken a number of initiatives to promote RMB internationalization and to secure Singapore as one of Asia’s leading offshore RMB centers and potentially the world’s largest offshore wealth hub.
South Korea has seven national commercial banks, six regional banks, 39 branches of foreign banks and five specialized state owned banks. There are also eight financial holding companies and 89 mutual savings banks. The mutual savings bank segment has been restructured due to high levels of project finance loan defaults following the financial crisis. This saw the number of savings banks fall significantly.

Banks are subject to strong regulatory controls and supervision, which some see as a hindrance to development. The Financial Supervisory Service (FSS) has indicated that the current rules based system will transition to become more principles-based. This should provide banks with greater flexibility in their operations. Banks in South Korea are not expected to have any difficulty in meeting Basel III requirements.

A number of high profile data security breaches has caused reputational damage and resulted in litigation. Banks now face more stringent regulatory requirements to ensure they have sufficient controls in place to protect customer data.

The government is pushing for the use of fintech and creation of online banking service providers as part of an initiative to encourage financial innovation. With the emergence of fintech, the Korean banking sector is undergoing structural changes. The increasing use of online banking is a key driver of branch and ATM closures, while the increase in mobile users has seen significant increases in mobile banking services. Newcomers, in the form of online banking service providers, may enter the market.

Banks are struggling to identify new sources of profit in the face of low interest rates, intense competition and a subdued operating environment, which are dampening banks’ profitability and growth opportunities. Regulatory interventions on loan pricing and fees put further pressure on banks’ NIM and profitability. The challenging market conditions have contributed to branch closures and withdrawal by some international banks. Domestic banks are seeking offshore expansion and targeting of more lucrative segments such as affluent Chinese customers.
Taiwan's banking sector is overcrowded and has a largely domestic focus. The 39 locally registered commercial banks dominate and hold over 90% of the market's total loans. There are also 30 local branches of foreign banks, 23 credit cooperatives and over 300 credit departments of Farmers' and Fishermen's Associations.

Taiwan's banks are well on track to meet Basel III capital and liquidity requirements. Taiwan has one of the highest minimum common equity Tier 1 ratios at 7%.

Other regulatory reforms, including easing of offshore banking units' investment rules and bank consolidation, are enhancing banks' ability to compete in both the domestic and overseas markets. To address the fragmented and over-crowded financial sector, the government is pushing for consolidation of selected state-run banks. The government also intends to grow select financial holding companies into regional institutions in the next three to five years to encourage overseas expansion, especially in ASEAN markets.

Taiwan is moving closer to becoming a competitive RMB hub. Potential initiatives such as retail investment in RMB-denominated bonds and ROFII quota renegotiation would allow banks to better grow and utilise RMB deposits and diversify their products.

Areas of risk to the banking sector are its exposures to China and the domestic housing market. With increasing investment in China by Taiwan's banks, the economic slowdown in mainland China may increase risk profiles and lead to higher credit costs. A possible bubble in the domestic housing market poses asset quality risk, with real estate loans accounting for 40% of banks' total loan books.
Intense competition from newcomers, such as third-party payment providers and internet finance platforms, is driving banks to develop innovative e-banking services and channels in order to improve the customer experience.

Growing household wealth and an aging population is expected to support banks’ development of wealth management, private banking and custodian business.

To serve the needs of Chinese enterprises seeking to expand internationally, Chinese banks are achieving overseas growth via organic expansion and minority equity investments.

China’s commercial banking market includes five large-sized state owned commercial banks; 12 national joint stock commercial banks; 145 city commercial banking institutions and 42 locally incorporated foreign banks. The state-owned banks account for 52% of the market and are among the top 20 banks in the world by assets and regulatory capital.

Chinese banks face growing regulatory pressure, including accelerated implementation of the Basel III capital, liquidity and leverage requirements. Asset quality pressures are spreading into more regions, while write-offs and disposals may accelerate. The potential risks are mainly posed by over-capacity industries, property developers and country-level local government financing vehicles. Banks have been seeking to boost capital as asset quality and profitability weaken.

Key developments of the domestic financial reform agenda include interest rate liberalization, RMB internationalization, the establishment of the Shanghai Free Trade Zone, and allowing private investment in China’s banking sector. This reform agenda challenges banks’ profitability, but also provides opportunities for new product offerings and operating model transformation.

Intense competition from newcomers, such as third-party payment providers and internet finance platforms, is driving banks to develop innovative e-banking services and channels in order to improve the customer experience.

Growing household wealth and an aging population is expected to support banks’ development of wealth management, private banking and custodian business. To serve the needs of Chinese enterprises seeking to expand internationally, Chinese banks are achieving overseas growth via organic expansion and minority equity investments.
Emerging markets

- Fast-growing and underpenetrated market, dominated by public sector banks
- Weak capitalization and asset quality mainly in public sector banks
- Large potential from low banking penetration, large consumer base, rising middle-class and the government’s financial inclusion initiatives

The banking system in India is dominated by 27 public sector banks with a widespread reach. It also includes 20 private sector banks, 43 foreign banks and 57 regional rural banks. Two new banks have received in-principle approval to commence operations as universal banks this year. With product boundaries between banking, securities and insurance sectors becoming blurred, a significant number of private and public sector banks operate as universal banks. Foreign banks operate across varied businesses, but are particularly strong in investment banking.

Indian banks face a growing regulatory agenda including the implementation of the Basel III capital requirements by March 2019. Minimum core equity is rising steeply from 3.6% under Basel II norms to 8%. Other regulatory priorities include detailed priority sector lending targets for commercial and foreign banks, and a distressed assets guideline and mechanism for early identification and resolution. There are also proposals to reform the corporate governance structure of banks, particularly public sector banks, through the transfer of government shareholdings to a Bank Investment Company.

Improving financial inclusion is a government priority and a number of initiatives have been launched. In November 2014, the Reserve Bank of India (RBI) issued Guidelines for Licensing of Payments Banks aimed at licensing non-bank entities with wide distribution reach to provide basic, low cost banking services for the underserved in the population. Permitted services include payments and deposits but not credit. Simultaneously, the RBI also issued Guidelines for Licensing of Small Finance Banks aimed at enabling non-banking financial companies such as micro-finance institutions to convert into banks and raise deposits while furthering the financial inclusion agenda by focusing mainly on priority sector lending. The deadline for applying for the above bank licences closed in February 2015 and several new differentiated banks are expected to receive licenses over the next few months.

Indian banks’ performance continues to be soft. Slower deposit growth in an environment of negative real interest rates impacts banks’ credit growth potential. Asset quality of state owned banks remains particularly affected given the macro-economic slowdown. Public sector banks also face a capital shortfall due to Basel III implementation, high levels of stressed assets and weak earnings. Profitability of banks has been under pressure on account of lower revenue growth due to subdued credit growth, as well as higher provisioning requirements due to deteriorating asset quality.

RBI is incentivizing foreign banks to convert to subsidiaries, which will provide a level playing field to foreign banks and give them a platform to expand in the country. Low banking penetration, a large consumer base and growth of the middle-class also offer large banking growth potential, especially in retail and consumer banking business. Furthermore, the Government’s financial inclusion plan may pave the way for more banks.
will be required to become legal entities and the maximum foreign ownership in banks will be reduced from 99% to 40% (though authorities will have the discretion to permit foreign investors to have a greater stake in certain circumstances). Transition periods will apply for existing foreign investors. If enacted, the foreign ownership cap is likely to be a deterrent to new investment in the banking sector, particularly given Basel III capital treatment of minority stakes. This may make sector consolidation more difficult.

Indonesia’s banking market offers major growth potential. Increasing industrialization and urbanization are driving higher consumer spending, pointing to opportunities in both retail and corporate banking services. Low banking penetration, a large consumer base and growth of the middle class also provide growth potential in consumer banking. With the large Muslim population (the largest in the world), Islamic banking business is expected to increase in importance within Indonesia.

Indonesia’s four state-owned banks dominate a banking sector that also includes 35 foreign exchange banks, 30 non-foreign exchange banks, 26 regional banks, 15 joint venture banks and 10 foreign banks. At the end of 2013, banking supervision was transferred to a new regulatory body, the Financial Services Authority (OJK).

The OJK is developing a consolidation plan with the aim of reducing the number of banks in Indonesia by up to half, particularly small banks. This is part of efforts to ensure Indonesia’s banking sector remains competitive after the ASEAN Economic Community comes into operation in 2020. In addition to Basel III implementation, various banking regulations have been issued in recent years. Among these are a categorization scheme that determines a bank’s permitted scope of business, regional network expansion and maximum equity participation in financial institutions based on its tier 1 capital. Other regulation places limits on the level of single ownership in banks, according to the type of investor. For banks and non-bank financial institutions, the cap is 40%. Regulation also stipulates that banks direct at least 20% of lending to SMEs by 2018. Certain foreign banks can extend credit to export-related industries as an alternative to SMEs.

Proposed banking law amendments may further impact foreign bank operations. Under current proposals, foreign branches
The banking market remains fragmented below the top three banks, leading to expectations of further mergers as banks position themselves for greater financial integration in the region.

Strong demand from the predominantly Muslim population and BNM’s aim to increase the share of Islamic financing to 40% by 2020, as well as the growing internationalization of Islamic finance, provide great potential for Islamic banks to grow and diversify their businesses and products in both local and overseas markets.

Malaysia's banking market comprises eight domestic commercial banks, 19 foreign commercial banks, 19 Islamic banks and 12 investment banks. Domestic banks dominate the market.

Basel III is being phased in over the period 2013 to 2018, in line with global timelines. The implementation of new arrangements for the prudential oversight of financial groups and improved standards on corporate governance and risk management are also among the key priorities of the regulator, Bank Negara Malaysia (BNM).

Household debt accounts for 50%-55% of loans. To address the growing risk this poses, BNM has implemented a range of measures to curb household indebtedness and property lending. Other measures by the government include increasing property gain taxes, introduction of a GST and cuts to government subsidies.

Banks are facing weaker earnings prospects in the short term due to a slowing economy and moderate credit growth, as well as margin pressure due to competition. There is intense competition for deposits as banks prepare for the Basel III LCR compliance in 2015. To secure profitability, banks in Malaysia are focusing more on cross selling and fee based products, and utilizing mobile and online solutions. Domestic banks are seeking opportunities for offshore expansion.
to foreign banks, local banks are struggling to develop sufficient scale to compete with the larger banks both domestically and regionally. M&A activity is expected to continue. Relatively larger banks will likely acquire smaller banks, either because of pressure on capitalization or to save struggling small banks in exchange for regulatory incentives (for example, waiver of license fees for opening new branches in designated areas).

Favorable macroeconomic and demographic factors provide growth opportunities for both domestic and foreign banks. A rapidly growing economy, an emerging middle class and rising household consumption will drive credit growth and consumer lending. The large unbanked population with rising personal incomes presents further opportunities in retail banking.

The Philippine banking system is fragmented, comprising 36 universal and commercial banks, 70 thrift banks and 561 rural and cooperative banks. Domestic universal banks dominate, with 80% market share (based on total assets). The Financial Stability Coordination Council, a new regulatory body, has been established to improve supervision of the Philippines’ financial system and address systemic risks such as shadow banking and risks from the interconnectedness of financial institutions.

Banks face a wide range of regulatory changes, aimed at preparing them for regional competition and economic integration. In addition to strengthening balance sheets, the regulator is pushing banks to improve their risk management and governance, and to focus on consumer protection. Accelerated adoption of Basel III capital requirements and stricter oversight on mortgage lending has been implemented. There is also a new banking liberalization law which increases foreign ownership limits in local banks from 60% to 100%. Banks in Asia, Europe, and the Middle East are reported to have expressed interest in the Philippines market in response to the easing of foreign ownership limits.

Intense competition, and increasing regulatory compliance and operating costs are putting pressure on banks. With the upcoming ASEAN economic integration and the greater opening up of the market to foreign banks, local banks are struggling to develop sufficient scale to compete with the larger banks both domestically and regionally. M&A activity is expected to continue. Relatively larger banks will likely acquire smaller banks, either because of pressure on capitalization or to save struggling small banks in exchange for regulatory incentives (for example, waiver of license fees for opening new branches in designated areas).

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Emerging markets

The revival of infrastructure construction projects, the introduction of SME support measures and a proposed economic roadmap by the National Council for Peace and Order may improve prospects for corporate and SME lending. The emergence of an educated middle class and increasing household consumption is leading to rising demand for financial services and is expected to support banks’ development in the areas of consumer financing, retail banking and wealth management.

Increasing cross-border activities and investment by Thai companies brings an opportunity for banks to expand across the region to service these companies, and also brings potential demand for investment banking and advisory services.

Thailand has 14 domestically incorporated banks, two foreign bank subsidiaries, 12 foreign bank branches and one retail bank. Domestic banks dominate the market with a market share of 88%. Increasing participation from special financial institutions, non-banks and saving cooperatives promotes financial access for unbanked areas.

Regulatory priorities include implementation of Basel III requirements, which are not expected to pose difficulties for Thai banks. Other regulatory priorities include promotion of competition and financial access, and relaxation of the limits on foreign banks’ expansion and equity holdings. Provisioning to absorb potential risks and prudence in corporate lending are also areas of regulatory focus.

Thai banks face a slight rising asset quality risk due to the economic slowdown, political uncertainties and increasing leverage in the household segment. With loan to deposit ratios in the high 90s, competition for deposits is likely to intensify. This will lead to rising funding costs and falling interest margins, especially for small banks with a limited branch network and deposit franchise.

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Vietnam has five state-owned banks, 33 joint stock commercial banks, four joint venture banks, five wholly foreign-owned banks and 46 foreign bank branches. The banking system is transitioning to Basel II in order to deal with NPL challenges and lack of an appropriate credit risk framework. Accordingly, selected commercial banks are starting to apply Basel II governance standards.

NPLs have risen due to rapid growth in lending over several years, followed by a credit squeeze and market downturn. The small private banks and the state owned banks pose significant NPL risk and are a source of weakness in the financial system. A debt management agency, the Vietnam Asset Management Company, has been established to acquire banks’ bad loans.

The government has implemented a restructuring and development strategy to strengthen banks via consolidation, recapitalization and adoption of international prudential standards. Commercial banks have been required to increase their provisioning against NPLs and provide loan classification. Foreign ownership caps have been increased to attract foreign capital and expertise to help strengthen domestic banks. This may also assist in reducing cross-ownership issues that have contributed to NPL issues.

Stricter regulation on bad debt assessment and risk provision is putting downward pressure on profits, making cost reduction and risk management priorities for banks. ASEAN economic integration will increase competition from stronger regional banks. Banks have merged as part of the sector’s restructure. M&A activity is expected to continue as the central bank steps up efforts to strengthen the banking system. The number of banks is anticipated to further decrease over the next few years.
Frontier markets: Cambodia, Laos, Mongolia, Myanmar and Sri Lanka

The frontier markets of Cambodia, Laos, Mongolia, Myanmar and Sri Lanka have shown strong growth in recent years that is likely to continue. IMF forecasts average GDP growth ranging from 6% to 8% for these markets over the next five years and average GDP per capita growth ranging between 4% and 7%. With this growth comes opportunity for the banking sector.

These markets are at differing stages of development, as reflected by their varying bank penetration rates. Rates range from 22% for Cambodia (making it one of the least banked markets in the region), to over 90% for Mongolia (exceeding that of all its neighbors including China). Cambodia, Laos and Myanmar are characterized by underdeveloped branch and ATM infrastructure. All five markets have low internet penetration. Mobile financial services are however being introduced and are likely to become a significant access channel for banking services to the unbanked and underbanked, particularly in rural areas.

In the transition to the global regulatory agenda, Mongolia and Sri Lanka are the most advanced, working to comply with the international Basel II and Basel III capital and prudential standards. In Myanmar, Laos and Cambodia, banks are still operating under Basel I.

Regulation of foreign banks varies across the markets. Foreign banks in Cambodia, Laos and Sri Lanka can operate as branches; 100% foreign ownership is also permitted. Both Cambodia and Laos have JV banks. In Mongolia, it is currently not possible for foreign banks to operate through branch offices, but the establishment of wholly-owned subsidiaries is permitted. It is early days for foreign banks in Myanmar. In October 2014, Myanmar granted preliminary approval for nine foreign banks to commence limited operations in corporate and wholesale banking.

The banking sector in Sri Lanka is undergoing consolidation under a government plan to improve financial stability and increase competitiveness.

The frontier markets remain among the most attractive investment destinations in Asia. The gradual opening of the economies and accompanying FDI influx are anticipated to lift GDP growth and increase the need for banking services for corporates. The increasing regional cooperation in the Greater Mekong sub-region (including Cambodia, Laos, Myanmar, Thailand, Vietnam, and Yunnan Province of China) also provides great potential for financial services.

Given the countries’ ongoing efforts to reform their financial sectors, developments in other parts of the financial industry are expected, for example, development of capital markets.

<table>
<thead>
<tr>
<th></th>
<th>Cambodia</th>
<th>Laos</th>
<th>Mongolia</th>
<th>Myanmar</th>
<th>Sri Lanka</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>15 million</td>
<td>7 million</td>
<td>3 million</td>
<td>1 million</td>
<td>21 million</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>$1,081</td>
<td>$1,693</td>
<td>$4,096</td>
<td>$1,221</td>
<td>$3,558</td>
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<tr>
<td>Banking penetration</td>
<td>22%</td>
<td>27%</td>
<td>92%</td>
<td>23%</td>
<td>83%</td>
</tr>
<tr>
<td>FDI inflows</td>
<td>$1.7 billion</td>
<td>$721 million</td>
<td>$508 million</td>
<td>$946 million</td>
<td>$944 million</td>
</tr>
<tr>
<td>Trade flows</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>$15 billion</td>
<td>$3 billion</td>
<td>$7 billion</td>
<td>$14 billion</td>
<td>$17 billion</td>
</tr>
<tr>
<td>Imports</td>
<td>$19 billion</td>
<td>$3 billion</td>
<td>$10 billion</td>
<td>$20 billion</td>
<td>$30 billion</td>
</tr>
</tbody>
</table>
Appendix Notes

- Number and types of banks for each market sourced from the regulator (as at March 2015).
- Data is in US dollars.
- GDP and population sourced from the International Monetary Fund, World Economic Outlook Database, April 2015 (2014 data).
- Banking penetration is based on the percentage of respondents aged 15 years and over who report having an account (by themselves or together with someone else; can include mobile accounts), sourced from the World Bank, Global Financial Inclusion Database (2014 data, except Laos, 2011 data).
- Key financial performance metrics are averages based on the 180 largest banks by assets from 13 APAC markets (Australia, Hong Kong SAR, New Zealand, Singapore, South Korea, Taiwan, China, India, Indonesia, Malaysia, Philippines, Thailand, Vietnam), sourced from SNL Financial.
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Asia-Pacific Banking & Capital Markets

Jan Bellens
Global Banking & Capital Markets
Tel: + 65 6309 6888
Email: jan.bellens@sg.ey.com

Gary Hwa
Managing Partner
Financial Services – Asia-Pacific
Tel: +852 2629 3368
Email: gary.hwa@hk.ey.com

Keith Pogson
Global Banking & Capital Markets
Assurance Leader
Tel: +852 28499227
Email: keith.pogson@hk.ey.com

Regional contacts

ASEAN

Wilson Woo
Banking & Capital Markets Leader
Tel: + 65 6309 6750
Email: wilson.woo@sg.ey.com

Nam Soon Liew
Managing Partner
Financial Services – ASEAN
Tel: + 65 6309 8092
Email: nam-soon.liew@sg.ey.com

Greater China

Kelvin Leung
Banking & Capital Markets Leader
Tel: + 86 10 5815 3305
Email: kelvin.leung@cn.ey.com

Jack Chan
Managing Partner
Financial Services – Greater China
Tel: + 852 2629 3508
Email: jack.chan@hk.ey.com

India

Abizer Diwanji
National Leader Financial Services
Tel: + 91 22 6192 0240
Email: abizer.diwanji@in.ey.com

Viren Mehta
Partner
Tel: + 91 22 6192 0350
Email: viren.mehta@in.ey.com

Korea

Seokryung Jang
Banking & Capital Markets Leader
Tel: + 82 2 3787 6518
Email: seokryung.jang@kr.ey.com

Jong Yeol Park
Managing Partner
Financial Services – Korea
Tel: + 82 2 3770 0904
Email: jong-yeol.park@kr.ey.com

Oceania

Tim Dring
Banking & Capital Markets Leader
Tel: + 61 3 9288 8054
Email: tim.dring@au.ey.com

Andrew Price
Managing Partner
Financial Services – Oceania
Tel: + 61 2 9248 5946
Email: andrew.price@au.ey.com

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