

## Regulatory Challenges in a World of Rising Rates

Rules meant to fix the problems behind the global financial crisis ten years ago may paradoxically be making markets more vulnerable to crisis in a region where those problems didn't need fixing – Asia.

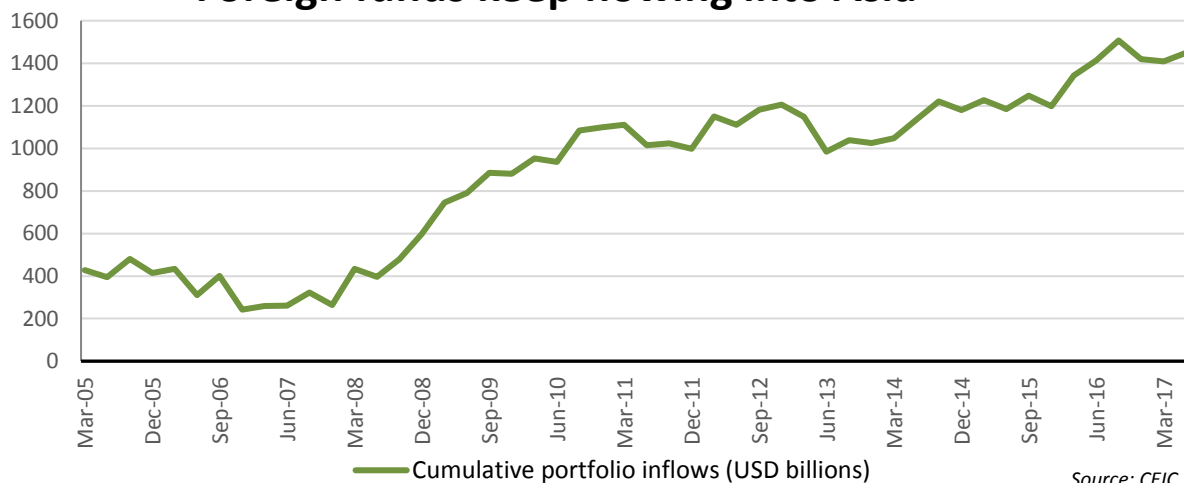
Efforts to limit how much risk global banks take in search of profits are forcing them to pull back from riskier markets around the world. Their retreat has been largely camouflaged, however, by record-low interest rates and money-printing by central banks struggling to revive inflation and, with it, economic growth. Investors hungry for higher returns have rushed to fill the void created as global banks withdraw, sending asset prices soaring everywhere.

Now, though, Asia's markets may be at a turning point. While inflation remains stubbornly low, economic growth has found its footing and the world's biggest central banks – the U.S. Federal Reserve and the European Central Bank – are turning off the cash spigots. Interest rates in lower risk, developed markets are rising. That threatens to spoil investors' appetite for Asian risk, triggering a rapid *volte-face*.

As the cash they supply recedes, it is likely to expose markets that remain dangerously underdeveloped in supplying capital to economies worryingly dependent on debt. Despite steady progress in the past 20 years, Asia remains overly reliant on bank lending and on short-term debt. With global banks increasingly hobbled by tougher rules, therefore, a retreat in global investment could not only roil Asia's markets, but also pinch funding for its vital exports and infrastructure.

It's difficult to sense any worry in Asian markets at the moment. Asia is flush with liquidity. Since mid-2007, foreign portfolio investors have pumped roughly \$1.2 trillion into Asian financial markets, according to data from CEIC, with the biggest net inflows – \$401 billion – coming in 2009 at the depths of the global crisis. Asia was seen as a haven from the storm and a fast-growing alternative to the West's slow-growth narrative.

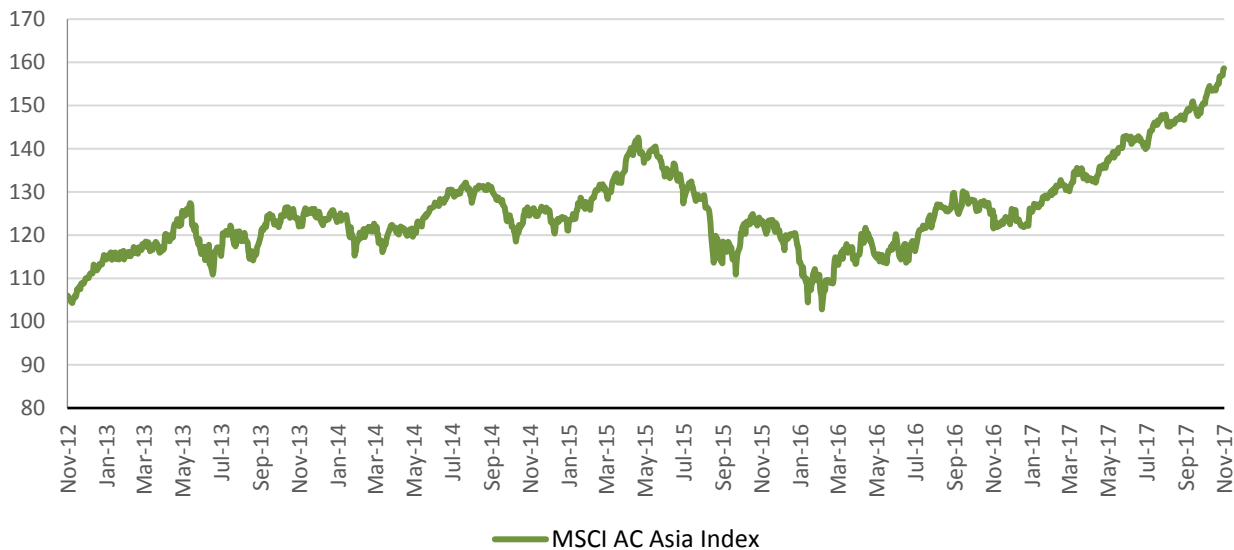
### Foreign funds keep flowing into Asia



## DEVELOPING ASIAN CAPITAL MARKETS

That's pushing up Asian asset prices dramatically. The MSCI AC Asia Index of regional stock prices has climbed 29% this year and is up 50% in the past five years. Ample inflows have pushed down Asia's borrowing costs, too. The yield on Thailand's 10-year government bonds has sunk more than a full percentage point, to just 2.3%, from 3.55% five years ago. India's 10-year government yields have dropped just below 7%, down from 8.2% five years ago.

### Stock prices are soaring



Source: Thomson Reuters

This isn't inconsistent with Asia's economic prospects. The region's economy is still growing roughly 5% a year, according to economists at HSBC. And after a long slump between 2010-2015, recovering global demand for electronics has boosted the region's exports. But this may not fully justify investor enthusiasm for the region: while export growth is accelerating again, it still lags output growth in developed economies. This suggests that Asia's export engine is missing a gear. One possible explanation is that demand in developed markets has shifted to services, which Asia doesn't produce.

### Asian exports are rebounding (sort of)



Source: Thomson Reuters

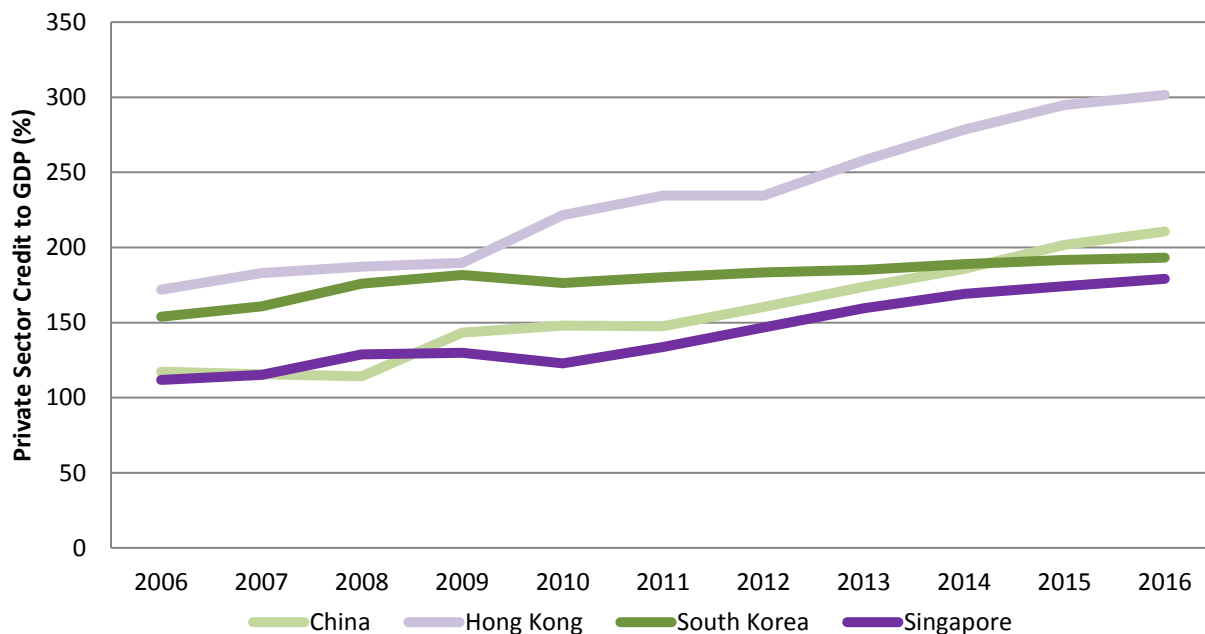
However attractive Asia's real growth prospects might be, therefore, the real lure for international investors are the region's relatively high yields and, in 2017, a falling U.S. dollar. The U.S. Dollar Index has dropped 7.5% this year, helping investors who bought Asian currencies to even juicier returns.

As long as central banks are printing cash, this trend is likely to continue. According to McKinsey, the combined balance sheets of central banks in Europe, Japan, the United Kingdom and the United States have more than tripled, from \$3.7 trillion in 2007, to \$13.4 trillion last year.

Faced with near-zero returns at home, investors in developed markets have developed a newfound taste for emerging-market assets in Asia and elsewhere. Their demand has pushed foreign ownership of global equities to 27%, from 17% in 2000, according to McKinsey. Foreign ownership of bonds has climbed to 31%, from 18%, over the same period. Drawn by 10-year bonds yield of 6.6%, foreigners own two-fifths of all Indonesian government bonds and two-thirds of the country's combined issuance of corporate and government bonds.

While this deluge of cheaper funding has undoubtedly been a boon to Asia, it has also contributed to growing vulnerabilities in the region's capital markets. Asian borrowers have gorged on cheap credit, sending private-sector debt levels soaring. Much has been written about the rise in credit to China's private sector, where debt has climbed to double the size of China's GDP from 116% in 2007. But credit to Hong Kong's private sector has jumped to three times its GDP from 183%, according to data from the Bank for International Settlements.

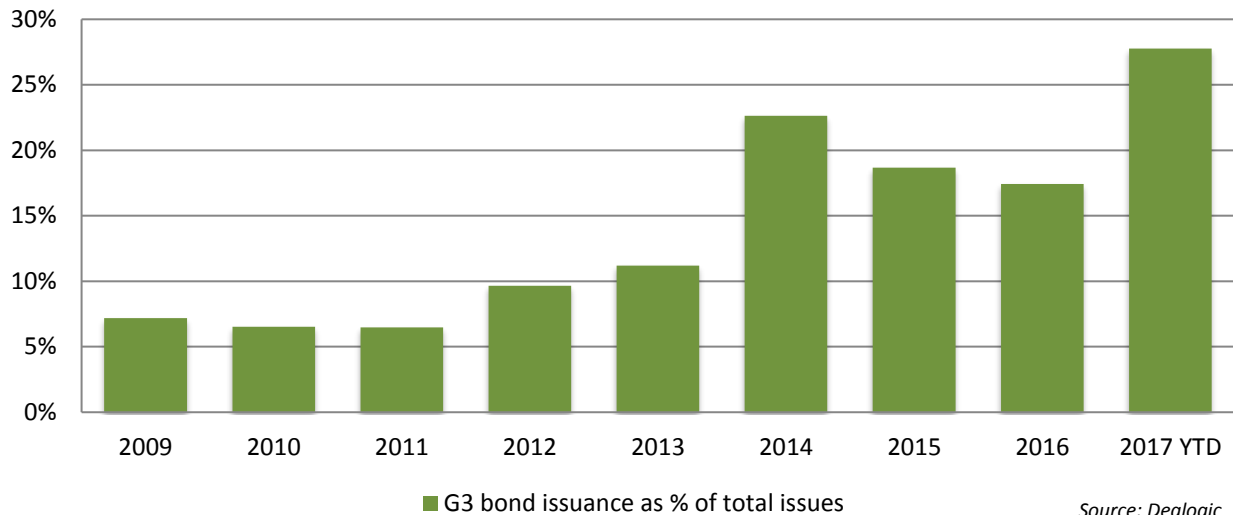
### Asian borrowers have gorged on cheap debt



Source: Bank for International Settlements (BIS)

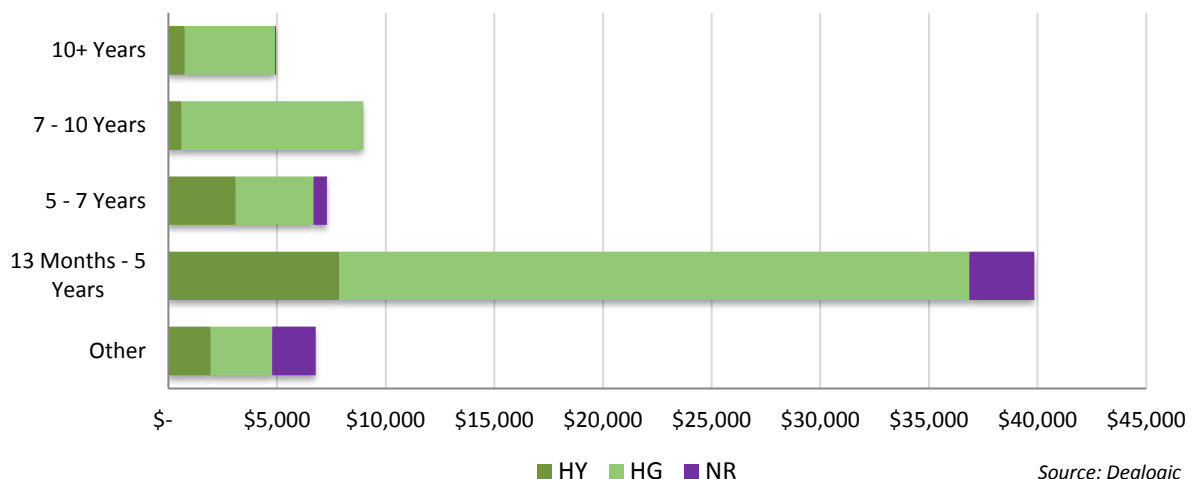
And while Asia has made significant headway in reducing its foreign debt imbalance, low rates and a weaker dollar have boosted Asia's demand for foreign-currency debt. After falling as low as 6.5% in 2010, sales of bonds denominated in dollars, euros and yen have jumped this year to roughly 28% of overall bond sales as Asia has sold a record \$528.2 billion in G3 currency bonds.

## Foreign-currency borrowing is soaring

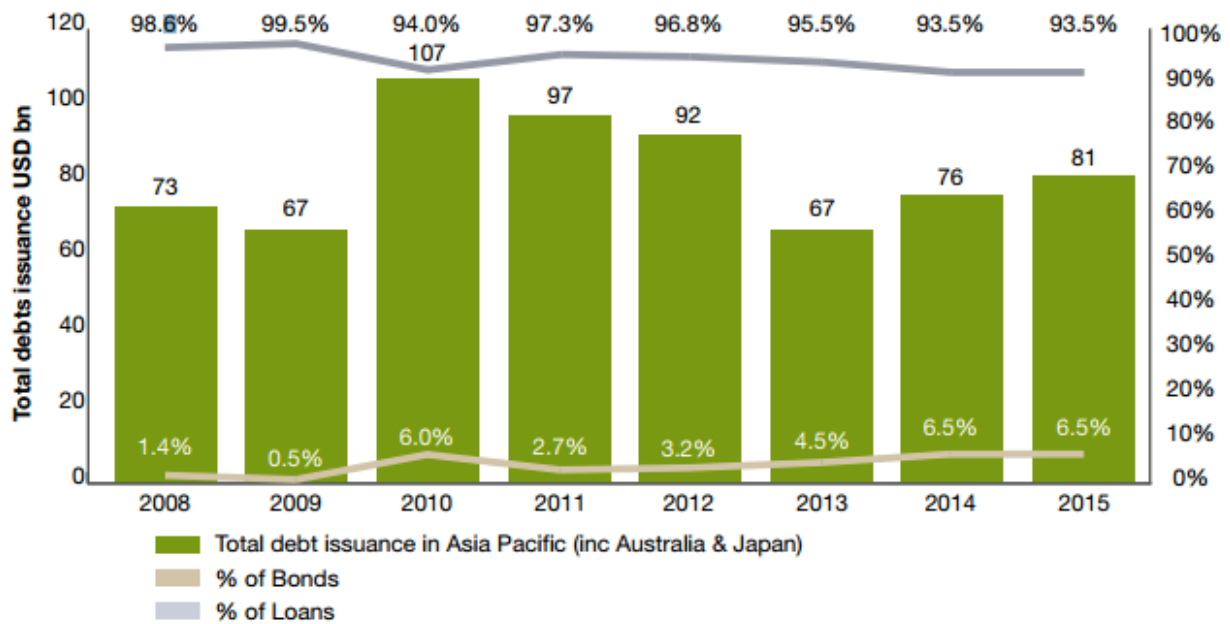


Most of Asia's bond issuance remains short-term: more than half of the G3 currency-denominated bonds sold mature in between 13 months and five years. Partly as a result of this reliance on short-term issuance, Asia faces a spike in repayments in 2019, when roughly \$1 trillion of its debt will mature, according to HSBC. Most of that is in China.

## Bonds are largely short-term



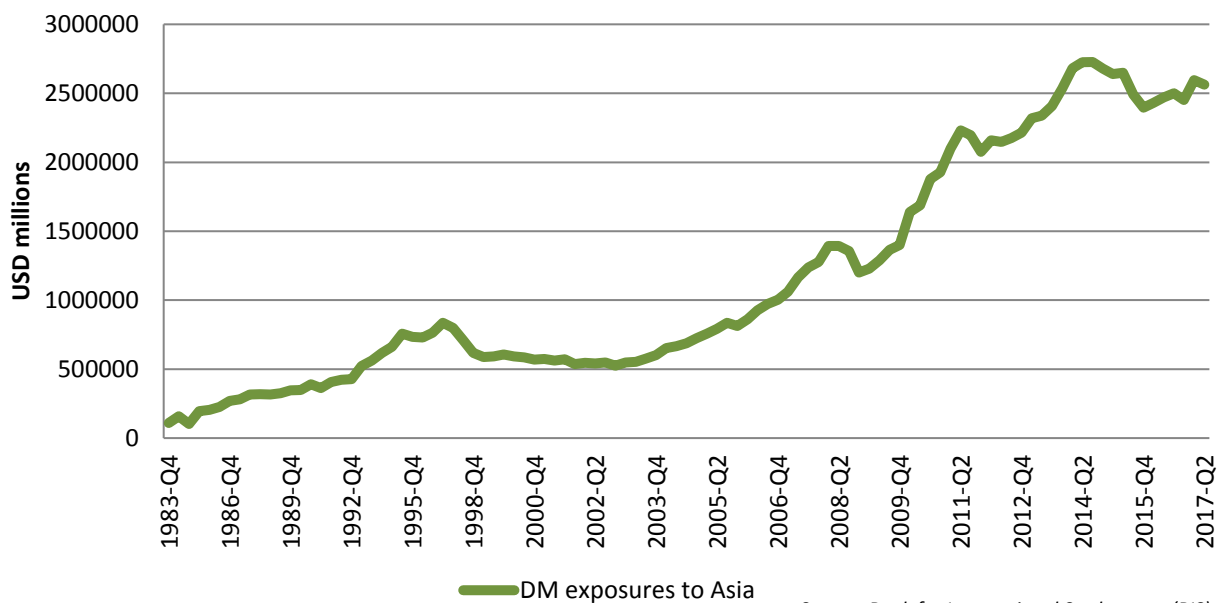
Despite the rapid growth – and vulnerabilities -- of the region's bond market, Asia still relies much more heavily on bank financing than on bond sales for its financing needs. More than 93% of Asia's total debt issuance in 2015 was bank loans. Europe's economies have an average bond market equivalent to 11.7% of GDP; Asian economies' average bond market size is just 6.8% of GDP.



Source: PFI, Thomson Reuters

The fact that the world’s largest banks are pulling back from riskier markets as regulation eats into profits is not good news for Asia. In its August report, “The New Dynamics of Financial Globalization,” McKinsey Global Institute found gross cross-border capital flows had fallen 65% since 2007, with half of the decline due to a sharp retreat by the European and US banks that are the targets of global regulation.

### Credit to Asia from DM banks is ebbing



Source: Bank for International Settlements (BIS)

The Basel Committee for Banking Supervision's (BCBS) deadlines for imposing higher capital buffers as part of the Third Basel Accord (Basel III) regulatory framework are looming. So banks are boosting capital and selling off less-liquid assets in favor of lower-risk holdings closer to home, with the biggest pullback so far in credit, commodities and rates. Unless they de-leverage from riskier markets with higher capital requirements being imposed by the new Basel III requirements, banks can expect returns on equity at global systemically important banks to fall from double to single digits.

While Basel III isn't aimed at Asia, some of its capital requirements are likely to hit the region. Basel III's new rules on how banks should calculate the risk of a default, for example, require them to hold more capital against unrated corporate borrowers. But as much as 95% of Asia's outstanding bonds are unrated, according to Bloomberg data.

Basel could also hurt Asia's lifeblood – trade. The new rules would also impose higher capital requirements against trade financing, for which Asia accounts for 40%, including roughly 76% of all letters of credit for exports. "Any increases in capital requirements for trade finance would discourage banks from supporting trade finance in emerging markets," the International Finance Corp. wrote in a letter sent last month to the BCBS. "This would obstruct international trade, compound de-risking and its effects and put economic growth, as well as the availability of critical supplies, at risk."

Basel's efforts to reduce banks' exposure to market risk, laid out in its "Fundamental Review of the Trading Book," also stand to hit trade-dependent Asia. A study in May by ASIFMA's global affiliate the Global Financial Markets Association, the Institute of International Finance and the International Securities Dealers Association estimated that FRTB would boost banks' capital requirements by between 1.6 and 2.5 times present requirements. The largest potential impact, the study found, was in bank's foreign-exchange risk, which could hurt banks' ability to offer exporters products to hedge the risk of currency fluctuations.

Infrastructure finance is another area where funding stands to take a hit. The Asian Development Bank has estimated that Asia will need as much as \$8 trillion to build out necessary infrastructure by 2020. But Basel III's rules on specialised lending raise the capital threshold for project finance. "This can lead to a reduction in project finance investment in countries where investment is most needed," wrote the IFC.

The International Monetary Fund has raised concerns of its own over this trend. With G-SIBs still dominant in global markets, the IMF warned in its latest Global Financial Stability Report that their retreat could hurt liquidity, particularly during a market shock. "The balance between reduced G-SIB riskiness and potential costs to liquidity during stress is an issue deserving of careful ongoing consideration," it wrote.

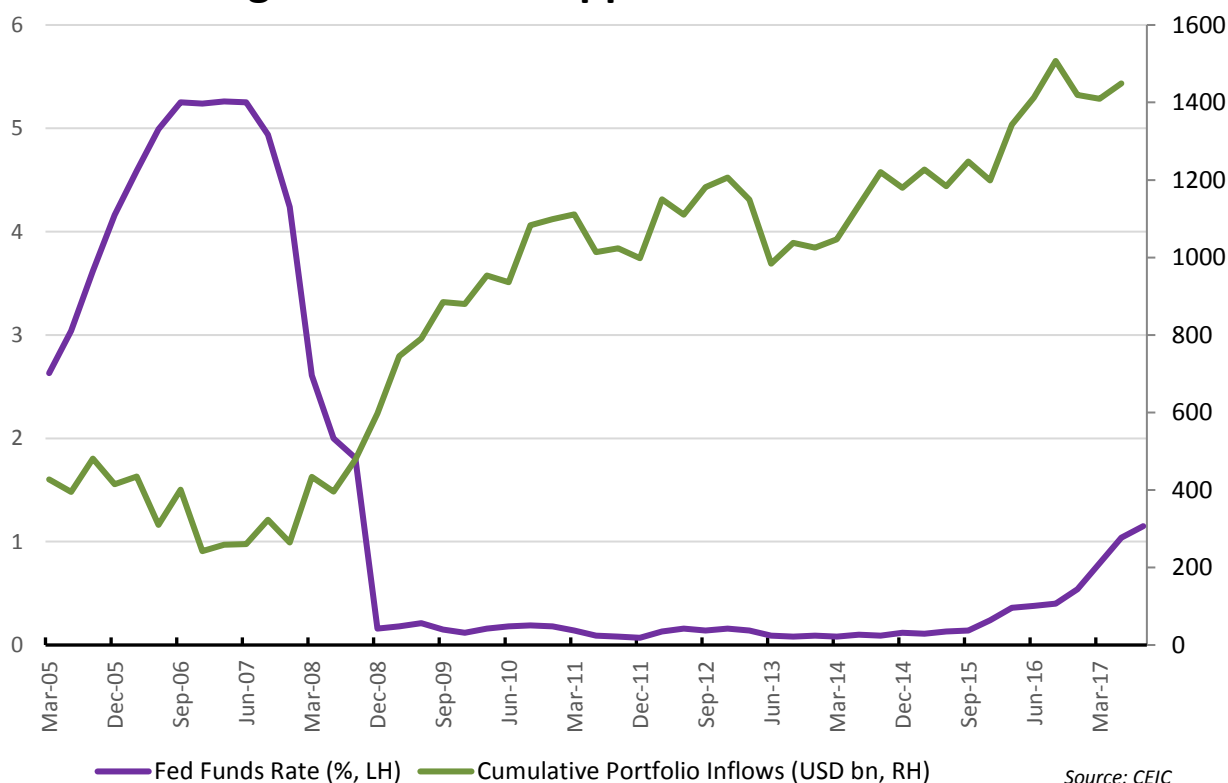
Indeed, skeptics point to buoyant markets and low volatility as a sign that financial markets have moved beyond the need for global banks and their big balance sheets. Smaller, more nimble, technologically savvy non-bank players are filling the void created as the banks turn tail, they say.

But the IMF is among those that have questioned this faith in new market intermediaries. In its Global Financial Stability Report from October 2016, the IMF concluded that when monetary policy tightens and rates rise, non-banks shrink their balance sheets just as banks do, but that "in general, nonbank financial intermediaries contract them more than banks. This behaviour is in part explained by the effect of monetary policy on risk taking, particularly in the asset management sector. As a result, bond yields and risk premiums move, affecting the cost of borrowing and real activity."

In short, non-bank intermediaries are even more sensitive to interest-rate changes than banks.

That's cold comfort to Asia's markets now that global interest rates are rising. Since December, 2015, when the Fed began raising rates from nearly zero for the first time since the crisis, it has pushed its effective funds rate up to 1.16%. That has helped push yields on 10-year U.S. Treasuries up from a low of 1.4% in July 20 to 2.4%. While that may not tempt global investors to turn tail from Asia yet, higher returns on lower risk U.S. assets has a history of sapping their interest in Asia.

### Rising US rates curb appetite for Asian assets



The last time the Fed was in a tightening cycle coincided with a period of lackluster flows into Asia. Stocks, as measured by the MSCI AC Asia index, still climbed 23%. But that was in 2005, when global banks were still rapidly expanding their presence in Asia.

Now, not only is the Fed looking to raise rates amid an improving U.S. economy, but it is also allowing bonds it bought during the crisis to mature without replacing them. That's trimming its balance sheet and withdrawing cash from the economy. At the same time, the ECB is preparing to reduce the scale of its own bond purchases. And investors are betting there is a 91% likelihood the Fed will raise rates again at its next meeting Dec. 13.

With the global banks it relies on as intermediaries retreating in the face of regulation and its economies increasingly reliant on debt, the question for Asia's markets this time around is whether they will be so lucky.