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The banking industry in the emerging market economies: competition, consolidation and systemic stability - an overview

John Hawkins and Dubravko Mihaljek

I. Introduction[1]

The banking industry world wide is being transformed. The global forces for change include technological innovation; the deregulation of financial services at the national level and opening-up to international competition; and - equally important - changes in corporate behaviour, such as growing disintermediation and increased emphasis on shareholder value. In addition, recent banking crises in Asia and Latin America have accentuated these pressures. The banking industries in central Europe and Latin America have also been transformed as a result of privatisations of state-owned banks that had dominated their banking systems in the past. The implications of these developments were considered by a small group of senior central bankers at the BIS during a two-day meeting in December 2000. Key data on banking systems in the emerging and advanced economies confirm these trends. In particular, the tendency towards a reduced number of banks and other deposit-taking institutions is evident from Table 1.

Table 1
Trends in banking systems

	East Asia[1]		Latin America[2]		Central Europe[3]		Advanced[4]	
	1990	1999	1990	1999	1990	1999	1990	1999[5]
Number of deposit-taking institutions[6]	10,100	11,761	1,344	1,741	2,087	1,154	39,766	30,361
of which: banks	1,148	1,059	323	302	1,819	929		
Concentration[7]	44	43	47	59	70	55	39[9]	42[9]
Employment in DTIs[6] ('000s)	303[8]	344[8]	943	773	…	252	5,638	5,477
Assets of DTIs ($bn)	835	1,917	364	766	105	188		
Branches of DTIs ('000s)	17	24	26	24	…	15	275	286
Banks' return on assets (%)	0.9	– 1.6	1.4	0.5	2.5	1.8		
Banks' simple capital ratio	4.9	10.9	9.0	8.8	8.2	7.6		
Banks' risk-weighted capital ratio	…	11.7	…	12.6	9.0	13.9		

[1] Sum or simple average of Korea, Malaysia, the Philippines and Thailand. [2] Sum or simple average of Brazil, Chile, Colombia, Mexico and Peru. [3] Sum or simple average of the Czech Republic, Hungary and Poland. [4] Sum or simple average of Australia, euro area, Hong Kong, Japan, Singapore, Switzerland, the United Kingdom and the United States. [5] 1998 data, other than for Hong Kong and Singapore. [6] Including commercial, savings and various types of mutual and cooperative banks, and similar intermediaries such as building societies, thrifts, savings and loan associations, credit unions, postbanks and finance companies but *excluding* insurance companies, pension funds, unit trusts and mutual funds. [7] Percentage share of DTIs' assets held by five largest institutions. [8] Excluding the Philippines. [9] Excluding Singapore.

Sources: BIS questionnaire; British Bankers' Association; Building Societies Association; national data.

Yet the summary statistics on the banking systems in individual economies (shown in Table A1 of Annex 3) strongly suggest that there is much potential for further bank consolidation. Many emerging economies, notably in Asia, still have vast numbers of small deposit-taking institutions. And the banking systems in Latin America and some central European economies remain relatively underdeveloped, a legacy of the lack of confidence in the currency or the banks.

[1] This overview has benefited greatly from the cooperation, comments and statistical input of the central banks invited to the meeting and central bankers and private sector bankers interviewed before the meeting. Special thanks go to Philip Turner for extensive comments and Marc Klau for statistical assistance, to Emma Warrack and Edith Sutton for secretarial assistance and to Nigel Hulbert, Tom Minic and Liliana Morandini for editorial assistance. Background work on Asian economies was partly carried out by George Pickering, Robert McCauley and Ben Fung of the BIS Representative Office for Asia and the Pacific. Agustin Villar contributed to the discussion of developments in Latin America. Helpful comments were received from Palle Andersen, John Heimann, Masanori Ishizuka, Phil Lowe, Setsuya Sato, Kostas Tsatsaronis and Bill White. Opinions expressed are those of the authors and are not necessarily shared by the BIS or the central banks involved.

Against this background, the paper first reviews the main forces for change in the emerging economies' banking industry (Section 2), and then analyses how these forces are affecting the structure of their banking systems through privatisations (Section 3), domestic mergers (Section 4) and entry of foreign banks (Section 5). As discussed in individual sections, these structural changes raise a number of microeconomic questions about economies of scale and scope, competition within the banking market, and the business focus of domestic and foreign banks. In addition, bank consolidation raises some important macroprudential issues - in particular, about the impact of consolidation on supervisory structures and systemic stability in an industry dominated by a small number of institutions (Section 6).

2. Forces for change

This section provides an overview of some of the main forces shaping the banking industry in the emerging market economies in recent years.[2] The approach followed is eclectic and no attempt is made to assign weights to the different forces for change that are identified. The reason for such an approach is simple: banking, like other economic activities, is in the midst of rapid - many would argue historic - structural change driven by the development and application of new information technology (IT). Because the core area of this technology is information processing - which also lies at the heart of financial intermediation - and because the development and use of IT are bound to continue (regardless of the movement in new technology stock indices), it is still far too early to grasp where exactly the banking industry is headed. At least three other forces underlie recent changes in the emerging economies' banking industry: domestic deregulation and external opening-up of financial sectors, changes in corporate behaviour and banking crises.

Deregulation and opening-up to foreign competition

Banking in the emerging economies was traditionally a highly protected industry, living off good spreads achieved on regulated deposit and lending rates and pervasive restrictions on domestic and foreign entry (see Section 3). For many years, there was little pressure to disturb this cosy and wasteful world. However, global market and technology developments, macroeconomic pressures and banking crises in the 1990s have forced the banking industry and the regulators to change the old way of doing business, and to deregulate the banking industry at the national level and open up financial markets to foreign competition. As a result, borders between financial products, banks and non-bank financial institutions and the geographical locations of financial institutions have started to break down. These changes have significantly increased competitive pressures on banks in the emerging economies and have led to deep changes in the structure of the banking industry. As discussed in the sections that follow, these changes include the establishment of many new institutions, privatisation of state-owned banks, mergers and consolidation, and a large increase in the presence of foreign banks.

One of the main catalysts for increased competition at the domestic level has been the removal of ceilings on deposit rates and the lifting of prohibitions on interest payments on current accounts. These deregulation measures have reduced sources of cheap funding for many banks and put pressure on their profits. Intensified competition has made it harder for banks to cross-subsidise different activities and has forced them to price risks more realistically and to charge explicitly for previously "free" services. This has been unpopular and poses considerable public relations challenges for banks. Banks also increasingly face competition from the non-bank financial industry, especially for lending to large companies (see below). Accompanying deregulation has been greater emphasis on capital adequacy, which has encouraged banks to securitise some assets, generate more fee-based income, and try to improve efficiency. In some emerging economies, higher required capital ratios have been an important spur to mergers (or sales to foreign banks) for poorly performing banks, which would have had trouble raising new capital to meet such standards (see Sections 4 and 5).

2 The causes of financial consolidation in the advanced economies are similar; see Group of Ten (2001).

At the international level, the easing of restrictions on foreign entry and the search by global institutions for profit opportunities in the emerging economies have led to a growing presence of foreign-owned financial institutions in domestic banking systems. As a result, most emerging economies now increasingly look to foreign banks to provide the capital, technology and know-how needed in banking (see Section 5). But most international banks are investing through local vehicles and local brand names, seeking both to exploit customer loyalty and to avoid antagonising local nationalist sentiments. Another reason for this approach is that it enables international banks to focus their "brand name" activities on large financial centres and reduce the number of locations in which they are present.

Technology

According to conventional wisdom, new information technology is not at present likely to impinge much on the development of the banking industry in the emerging economies, which remain technologically behind the industrial countries. For example, the low level of penetration in most emerging economies (Table A2 in Annex 3) means that the internet is not seen as a threat to traditional banks. Given the signs of a possible bursting of the e-banking "bubble" in the United States and Europe, some have also argued that the issue of electronic banking may go away before the emerging markets need to worry about it.[3]

This conventional view can be challenged on several grounds. As noted above, the major issue about new IT is its impact on the processing of information, which is the very essence of the banking business. Perhaps the most significant innovation has been the development of financial instruments such as derivatives that enable risk to be reallocated to the parties most willing and able to bear that risk, thereby inducing more investment in real assets and fostering the development of banking and financial markets in general.[4] The use of such instruments is not the preserve of industrial countries: with their increasingly sophisticated IT applications, banks in the emerging economies use new financial instruments daily in their transactions. Their banking systems and financial markets are thus in a position to advance much more rapidly from a rudimentary to a fairly advanced stage of development of risk management and other commercial banking functions. Such potential skipping of financial development stages would not have been possible in the past, when information processing technology was not readily available, and when the development of futures markets and other domestic financial institutions that enable unbundling and shifting of risks on a large scale was much more time-consuming and costly.

Likewise, the potential for rapid development of commercial banking functions offered by alternative delivery channels such as ATMs, debit cards, telephone, internet and electronic banking should not be underestimated.[5] Despite the still low level of usage of such channels (with the exception of ATMs, which are now very widespread), the vast majority of banks in the emerging economies see such channels as a must for their industry. Banks fighting for some important part of the retail market believe that they have to offer such services as an essential marketing tool, although the true demand for them has so far been limited.

As in advanced economies, new technology is affecting the structure and performance of the banking industry in the emerging markets mainly through its impact on the costs and the determination of optimal scale. Branch-based transactions are much more expensive than alternative delivery channels (Table 2). This cost advantage would seem to favour smaller institutions, as investments needed to attract deposits or provide banking services via the internet are in principle lower than the costs of setting up a traditional branch network. At the same time, investments needed to develop adequate back office and risk assessment systems are very high, creating considerable cost advantages for larger institutions. Moreover, branch networks are not expected to shrink as a result of the

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3 However, just because share prices of internet stocks fall, this does not mean that the impact of new technology on banking will disappear.

4 See Greenspan (2000).

5 For example, Brazil's Banco Itaú reports that 1.2 million of its 7 million customers use PC banking. See Sato, Hawkins and Berentsen (2001) for an overview of developments in e-finance.

development of alternative delivery channels, although branches are generally expected to become smaller.

Table 2

Costs of banking transactions (in US dollars)

	USDC[1]	**BAH**[2]	**GSBCG**[3]
Physical branch	1.07	1.07	1.06
Phone	0.52	0.54	0.55
ATM	0.27	0.27	0.32
PC-based dial-up	0.11	0.02	0.14
Internet	0.01	0.01	0.02

[1] Estimates by US Department of Commerce, 1998. [2] Estimates by Booz, Allen & Hamilton in 1997. [3] Estimates by Goldman Sachs & Boston Consulting Group.

Sources: Sato, Hawkins and Berentsen (2001); Group of Ten (2001).

More fundamentally, banks are increasingly losing their privileged access to information about investment opportunities, and are thus under pressure to merge or build alliances with domestic or foreign-owned banks and technology companies in order to share the costs and exploit the benefits of the development of new IT applications.[6] For example, Hong Kong has a number of small family-owned banks that are currently well capitalised and at no imminent risk of failure, but may not have sufficient size to undertake major upgrades in computer capacity to meet competitive challenges in the medium term. While unwilling to force mergers, the authorities have clearly indicated they see them as desirable (see Section 4).

One source of concern related to new banking technology is the emergence of a "digital divide" in the access to banking services. According to this view, better educated and more affluent customers will be able to obtain improved service from banks through the internet over the medium term, while the services provided to poorer and older customers will deteriorate as branches are closed, particularly in remote areas. These concerns have led some policymakers to seek a continued role for the state-owned commercial banks that maintain traditional, nationwide branch networks (see Section 3).

Changes in corporate behaviour

The spread of information technology has affected the banking industry both directly, through IT applications in risk management and marketing of financial products, and indirectly, through its impact on corporate behaviour and the development of financial markets, especially in the area of financing new capital investments. This impact is most clearly felt in the case of technology firms, which are more or less forced to turn to capital markets to finance their projects because banks are not prepared to deal with the high level of uncertainty associated with the development of new technologies. However, disintermediation is not limited to new economy firms; it is also beginning to be felt in the more traditional "old economy" sectors. Bonds outstanding (in domestic and international markets combined) have risen strongly in almost all emerging economies over the past few years, and are now more important than borrowing from domestic banks in some of them (Table A3 in Annex 3). Many large firms can now raise funds by issuing securities more cheaply than they can borrow from banks. Indeed, many large companies can borrow more cheaply in the capital markets than the banks themselves, given their better credit ratings.

Non-bank funding sources are not open to all companies, in particular small and medium-sized firms. In addition, deep and liquid markets for non-bank funding are not developed in many countries - only the United States has, for example, a large market for high-yield corporate bonds. Nonetheless, banks

[6] For example, Banco Itaú is building an alliance with America Online to advance its e-banking business, while Mexico's Banamex has put substantial resources in a joint venture with Commerce One to develop a B2B project.

are under increasing pressure to keep their customers, and to the extent that more and more creditworthy firms turn to alternative funding sources and the proportion of higher-risk bank customers increases, banks, especially in the emerging economies, are forced to develop techniques for better pricing and provisioning of credit risks. Because of economies of scale in the management and diversification of credit risks, banks have an incentive to merge with other institutions, including foreign banks, which in turn leads to consolidation and a growing presence of foreign banks in the banking industry.

Another implication of these developments is that commercial banks in bank-centred financial systems can no longer maintain their traditional, close relationships with corporate customers. Because of pressure from alternative funding sources and other domestic and foreign banks, there is growing emphasis on shareholder value as the sole commercial objective of banks. Banks in industrial countries such as Germany and Japan and in many emerging economies with bank-based financial systems are therefore increasingly divesting their non-financial shareholdings, establishing arm's-length relationships with their traditional corporate customers, cutting operating costs, and concentrating on core activities where they can generate the highest rate of return. As with new IT applications, risk management and risk diversification, the achievement of these cost benefits often provides incentives for privatisation, mergers and the entry of foreign banks.

The new emphasis on shareholder value is apparently beginning to be reflected in the data on total bank profitability (Tables 1 and 3). Latin American banks steadily improved their relatively high profitability during the 1990s, although net interest revenue has been stable. Their high operating costs (as well as high interest rate spreads) are in large part the legacy of the high-inflation period of the 1980s and the early 1990s, when the float generated easy profits for the banks and there was little pressure to cut costs. Central European banks have also improved their profitability in recent years, but mainly by cutting their operating costs. In Asia, however, banks suffered large losses in 1998 as a result of the financial crisis, but already in 1999 these losses were considerably reduced by cutting loan losses through better management of credit risks.

Table 3

Banking sector performance

as a percentage of total assets

	East Asia[1]			**Latin America**[2]			**Central Europe**[3]			**G3**[4]		
	1992-97	**1998**	**1999**	**1992-97**	**1998**	**1999**	**1992-97**	**1998**	**1999**	**1992-97**	**1998**	**1999**
Net interest revenue	2.6	1.8	2.2	5.2	5.3	5.4	3.1	2.8	2.5	2.0	1.8	2.0
Other income	0.7	1.2	0.8	2.3	2.0	1.8	2.3	2.1	2.0	0.7	0.8	1.0
Operating costs	1.6	2.4	2.3	5.5	5.5	5.7	4.1	3.5	3.1	1.7	1.6	1.8
Loan losses	0.6	6.3	1.8	1.2	1.1	1.7	0.6	0.6	0.4	0.2	0.4	0.3
Pre-tax profits	0.8	– 5.5	– 0.7	1.4	1.3	2.4	0.5	0.7	1.0	0.7	0.6	0.8

[1] Simple average of Indonesia, Korea, Malaysia, the Philippines and Thailand. [2] Simple average of Argentina, Brazil, Chile, Colombia, Mexico, and Peru. [3] Simple average of the Czech Republic, Hungary and Poland. [4] Simple average of Germany, Japan and the United States.

Source: Fitch-IBCA.

Some commentators have expressed concern about the adverse impact on stability of the pressure to boost (short-run) shareholder value. In this respect, a norm of a return on equity of around 15-20% appears to be expected. Given an 8% capital ratio, this norm would translate into a 1-2% return on assets. This expectation may not fully reflect the transition to a world of lower inflation, and may be based on growth assumptions that are not likely to be sustainable. It also seems relatively ambitious compared with risk-free returns. To the extent that shareholder expectations of returns are too demanding, the emphasis on shareholder value could thus push banks into riskier areas in the future. Alternatively, the shift to fee-based services could continue, and banks could become more involved as asset gatherers and active intermediaries in the capital markets.

Banking crises

There were many banking crises during the 1990s, often occurring shortly after the external and banking systems were deregulated. Despite all the attention given to complicated derivative products that have led to the high-profile collapses of some individual banks, most systemic banking crises are still caused by poor lending (see Annex 1). The proportion of loans that have become impaired during banking crises in the emerging market economies has generally been much greater than that in the industrial world, implying also higher economic costs, especially in the relatively large, bank-centred, financial systems in Asia (Table 4).

Table 4

Banking crises

		Peak non-performing loans as % of total loans	**Cost of restructuring: as % to GDP**
Chile	1978-83	19	41
United States	1984-91	4	5-7
Norway	1988-92	9	4
Finland	1991-93	9	8-10
Sweden	1991-93	11	4-5
Mexico	1995-97	13	14
Argentina	1995	…	2
Brazil	1995-	15	5-10
Thailand	1997-	47	24
South Korea	1997-	25	17
Indonesia	1997-	55	58
Malaysia	1997-	25	10
Philippines	1998-	12	7

Sources: IMF, *World Economic Outlook*, May 1998; JP Morgan, *Asian Financial Markets*, 28 April 2000; World Bank, *Global Economic Prospect* and *Developing Countries*, Table 3.6; Barth, Caprio and Levine (2000), Table 12; central banks.

One of the most important consequences of the banking crises in the emerging economies has been changes in the structure of bank ownership. Fears of bank runs and a vicious circle of credit contraction (as a first-round contraction of bank credit weakens aggregate demand, lowering asset prices and borrowers' cash flows, leading to more delinquent loans and a further credit contraction) led most governments to intervene, either by nationalising the banks in trouble and subsequently returning them to private ownership (Section 3), or by encouraging bank mergers and foreign takeovers (Sections 4 and 5).[7]

3. State banks: privatisation

The role of state-owned commercial banks (SOCBs) has diminished considerably over the past decade. In the late 1980s and early 1990s, the SOCBs often accounted for over half of total banking system loans and deposits in emerging economies. A decade later, the average share of state banks' assets had declined to 20% in central Europe and 15% in Latin America (Table 5). In Indonesia, Korea and Thailand, an opposite shift took place as a result of temporary bank nationalisations during the 1998-99 crisis, but governments in the region are committed to divesting their shares in nationalised banks as soon as circumstances permit. State ownership of banks remains dominant only in China,

[7] Methods of bank restructuring in emerging economies are summarised in Hawkins and Turner (1999).

India and Russia. India has, however, exposed banks to greater competition in recent years, and a draft law has been submitted to parliament to reduce the government's shareholding in the nationalised banks to 33% from 51% at present. In China, the listing of SOCBs is part of a three-stage bank reform plan adopted in 1999 that aims at building a modern, competitive banking system.

Table 5

State-owned banks

	Assets as a percentage of total bank assets			Return on assets	Capital ratio: risk-weighted
	1980	1990	2000	1998	1998
China	100	100	99[1]	…	…
India	91	91	80	0.4	11.2
Russia	…	…	68	…	…
Hong Kong	0	0	0	–	–
Singapore	0	0	0	–	–
Indonesia	…	55	57[2]	– 19.9	– 21.4
Korea	25	21	30	– 5.2	6.9
Malaysia	…	…	0	…	…
Philippines	37	7	12	0.5	13.3
Thailand	na	13	31	– 12.1	8.7
Argentina	na	36[3]	30	– 0.0	18.7
Brazil	33	64	43[2]	– 0.1	12.9
Chile	23	19	12	1.7	13.3
Colombia	27	45	13[2]	– 10.0	6.9
Mexico	0	100	0	–	–
Peru	65	55	3	0.1	11.4
Venezuela	…	6[4]	5[2]	1.5	15.8[5]
Czech Republic	…	78[3]	28	– 0.4	12.0
Hungary	…	81	9[2]	– 27.1	23.5
Poland	…	80[4]	23	1.0	8.8
Israel	…	…	45[2]	0.5	9.8
Saudi Arabia	0	0	0	–	–
South Africa	…	5[3]	2[1]	…	…

Note: State-owned banks are defined as those where the government has a majority of the equity.

[1] 1998. [2] 1999. [3] 1994. [4] 1993. [5] Simple ratio.

Sources: World Bank; Hawkins and Turner (1999), p 79; central banks; Barth, Caprio and Levine (2000), Table 1.

Up to the early 1990s, most developing countries took state ownership of commercial banks for granted. As with utilities, telecommunications companies, railways and airlines, commercial banks were considered to be too important for the national economy to be completely in private hands, and financial markets were regarded as too thin to exert effective discipline, especially given capital controls and the prevalence of prohibitions on foreign ownership.

What factors account for this remarkable turnaround? Why has privatisation of banks apparently been so successful - especially in central European transition economies - when the privatisation of state-owned enterprises has often failed? Is this trend likely to continue in the future, or is there a residual role for some state banks? In addressing these questions, first the available data on the performance of state-owned banks are reviewed, then some issues and lessons concerning SOCB privatisations are considered, and finally the future role of SOCBs is discussed.

Performance of state-owned commercial banks

The main reason for privatisation of the SOCBs was their poor performance and frequent costly bailouts, resulting from inadequate systems of governance under state ownership. A second reason was a widely held perception that the presence of state-owned banks tends to hold back the development of the financial sector. Several empirical studies have indeed established that the presence of state-owned banks generally is associated with a lower level of financial development.[8]

Although lending by SOCBs was subject to numerous controls, bank managers never knew exactly who was the real owner of the SOCB and to whom the management was accountable: the central bank, line ministries, or central or local governments. The SOCBs found it difficult to evaluate the feasibility of projects they were asked to finance and the value of the collateral their customers had to offer. Many problems of the SOCBs could be further traced to the obligation to lend to governments (local as well as central) and to the poor performance of public enterprises, which were the banks' main customers. These enterprises often received extensive credit privileges, being allowed to roll over bank loans and accumulate arrears.

This state of affairs had left the SOCB-based banking systems weak and vulnerable, and many SOCBs succumbed to the banking crises of the late 1980s and the early 1990s. In response to the disruptions caused by these crises, many emerging economies introduced reforms, first to improve bank governance systems, and ultimately to privatise the SOCBs. Thus, most SOCBs gained autonomy in formulating their business plans; their boards of directors were reorganised; and new, professional senior management teams were brought in.[9] These measures, complemented by fiscal adjustment, have helped restore banking stability, in particular in Latin America and central Europe. In these regions, the authorities also put in place a "second generation" of reforms in the late 1990s, focusing on the implementation of prudential regulations, the improvement of risk management, and finally the privatisation of the SOCBs.

Industry surveys in general confirm that considerable improvements in SOCB governance took place over the past decade (see eg Euromoney, 2000). However, the available data do not allow a reliable comparison of the performance of state-owned banks over time, given that so many banks were privatised and those that remain in public hands either are problem cases or are having their balance sheets cleaned up in anticipation of future privatisation. In addition, the SOCBs were much more involved in various forms of directed lending in the early 1990s, when banking and fiscal sector reforms were just starting. Nonetheless, the fragmentary data that are available indicate some improvements: Indian banks improved their return on assets from a negligible level in 1990 to 0.4% in 1998, and their capital ratio rose from a low level to 11.2% (Table 5). The return on assets of the remaining Polish state-owned banks was almost the same in 1998 as in 1994, but their capital ratios improved substantially.

Another comparison is that of the performance of state-owned, foreign-owned and domestically owned private banks. State-owned banks typically have lower return on average assets (with the exception of

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8 In particular, Barth, Caprio and Levine (2000) established a negative, statistically highly significant relationship between state ownership of bank assets and several measures of financial development, including bank credit to the private sector, stock market capitalisation, and lending to the private sector by non-bank financial institutions. In addition, the degree of industrial competition was found to be lower, and net interest margins higher in countries with a large presence of state-owned banks, although these relationships were not statistically highly significant. These results were obtained after controlling for differences in the level of economic development (measured by real per capita GDP) and the quality of government (measured by a composite index of expropriation risk, the law and order tradition of the country, and the level of corruption). The same study also showed that state ownership of banks increased the probability of a banking crisis in the period from the late 1970s to 1999, although this relationship was not found to be statistically significant.

9 The main vehicles for fostering bank governance were memoranda of understanding between a high representative of the state as the owner of the SOCBs (usually the Ministry of Finance) and the banks' boards of directors, and performance-related management contracts, which specified the responsibilities and incentives of top management teams in charge of operational restructuring.

the Asian economies), lower operating costs, and high interest expenses (although not as high as foreign-owned banks) (Table A4 in Annex 3). Lower return on assets is not surprising in view of the SOCBs' involvement in various directed or subsidised lending operations. However, one would have also expected the SOCBs' funding costs to be lower: since they are typically backed by the full resources of the government, the SOCBs offer greater security of deposits, and therefore should be able to offer lower deposit rates than other categories of banks without losing customers (discussed below).[10] There are also some remarkable differences in funding costs and operating efficiency within regions. In Asia, the interest expenses of domestically owned banks are half those of foreign-owned banks, but there are practically no differences in return on assets and operating costs among the three types of banks. In Latin America, the state-owned banks are less profitable but cheaper to operate than either domestically or foreign-owned banks.[11]

Another feature of state-owned banks can be gleaned from the approach used by rating agencies in assessing the credit risk of these institutions (Table 6).[12] In terms of intrinsic financial strength (ie before allowing for government guarantees), only a third of state-owned commercial banks in the sample, compared with two thirds of private banks, were rated D or higher (adequate or good financial strength)[13] In Latin America, 79% of private banks were rated as having adequate or good financial strength, compared with 59% of Asian and 54% of central and eastern European private banks. Among state-owned banks, 44% of Asian and only 14% of central European banks were rated as having adequate or good financial strength. Most banks rated E in this sample (very weak intrinsic financial strength, requiring periodic outside support) were from Russia and Indonesia.

Table 6

Bank ratings and government guarantees

	Moody's long-term bank deposit rating				
Moody's BFSR rating[1]	**State-owned banks**	**Other banks**		**Large banks**[2,3]	**Small banks**[2]
B	–	A		A	–
C+	–	Baa		Baa	Baa
C	Baa	Ba		Baa	Ba
D+	A	Baa		Baa	Ba
D	Ba	Ba		Ba	Ba
E+	Baa	Ba		Ba	Ba
E	Ba	B		Ba	B

[1] Moody's Bank Financial Strength Ratings measure the likelihood that financial institutions will require financial assistance from third parties; they do not incorporate the probability that such support will be forthcoming. Hence a bank with a low BFSR will have a higher deposit rating if third-party support is expected to be available. Note that some banks may have been evaluated more recently than others and some ratings are unsolicited and hence based only on public information. [2] Relative to the size of banks in their country of incorporation; only private banks. [3] Top five.

Source: Fitch-IBCA.

[10] In the past, many SOCBs had more or less unrestricted access to cheap central bank credit, but in the 1990s virtually all countries adopted legislation requiring central banks to lend to commercial banks only against collateral through the discount window, or for emergency liquidity support.

[11] These results should be interpreted with caution because the data used are of relatively poor quality, and the comparison assumes that the different classes of banks do similar types of business within each economy.

[12] Bank deposit ratings measure a bank's ability to repay punctually its foreign and/or domestic currency deposit obligations, whereas bank financial strength ratings (BFSR) measure the likelihood that a bank will require assistance from third parties such as its owners, its industry group, or official institutions. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honour its obligations.

[13] The sample referred to in Table 6 consists of 235 banks operating in the 23 emerging economies covered in this paper.

In terms of deposit ratings, half of the state-owned banks in the sample were rated Baa or A (adequate to good credit quality), compared with only a third of privately owned banks. Regionally, nearly half of Asian and central European private banks had deposit ratings of Baa or higher, compared with only 7% of Latin American private banks.

Combining the two criteria confirms the widely held view that the state-owned banks offer greater safety of deposits: for the same inherent financial strength rating, state-owned banks' deposits were on average rated one notch higher than other banks' deposits (eg among banks rated C in terms of financial strength in Table 6, state-owned banks' deposits were rated Baa, and other banks' deposits were rated B). In other words, if the SOCBs were actively issuing bonds, government ownership alone would have helped them cut the borrowing costs by 100-700 basis points.[14]

Privatisation experiences and issues

Although each emerging economy had its own motives for privatising its state-owned banks, the desire to enhance competition and efficiency in the banking sector, and the lack of capital, formed a background to virtually all privatisation programmes. The experiences discussed in this section can be tentatively summarised as follows:

- The most successful method for privatisation of SOCBs in recent years appears to have been sale to strategic partners, usually reputable foreign banks. Most successful sales were conducted through open competitive bidding processes to ensure transparency in the divestiture of the government's equity holdings. Some privatisations through the sale of shares on the local stock exchanges were also successful (Hungary's OTP Bank is one example). But this method could not be applied to the majority of state-owned banks in a given country because of the lack of solid bank governance systems and experienced management teams who could run the banks efficiently. In addition, the lack of private domestic savings, especially in the aftermath of a crisis, would severely constrain the demand for bank stocks.
- The experiences of Hungary (positive) and the Czech Republic (partly negative) indicate that it pays to clean up the SOCBs' balance sheets and make their operations transparent before they are privatised. Serious investors are not interested in turning to the government after the privatisation, and need to know in advance what assets and liabilities they are buying. Privatisation should therefore be contemplated as the last - not the first - transaction in the process of restructuring a SOCB.
- A particularly thorny question is the treatment of hidden liabilities (various off-balance sheet items, unfunded pension obligations, tax arrears) and loans that could turn bad at some future date. Potential buyers usually request some form of guarantee or a mechanism that would allow buyers to sell back assets found to be bad during a specified initial period of ownership. Virtually all the emerging economies (with the exception of Poland) were forced to offer some form of guarantee to pay the cost of any deterioration in selected existing liabilities, a practice known as "ring fencing".[15] But even with government guarantees, it may take years to cleanse the SOCBs' balance sheets of all their past sins.[16]
- Another difficult issue is how banks nationalised during a crisis should be run on commercial lines while sustaining efforts to collect on bad loans. The best approach seems to be the implementation of governance reforms that clearly specify the responsibilities and incentives of the boards of directors and the top management teams. Increasing globalisation of financial services and continuing development of new financial products suggest that banks

[14] In the US corporate bond market, bonds rated BAA on average had a yield 110 basis points lower during 1990-2000:Q3 than bonds rated BB, which in turn had a yield 670 basis points lower than bonds rated CCC.

[15] Hungary did not offer any guarantees but, as noted above, the government spent large sums to clean up the banks' balance sheets before the privatisations.

[16] During 1994-2000, the government of Brazil spent $15 billion (6% of GDP) in order to privatise seven SOCBs; so far, it has received $6 billion from privatisation of these banks.

need to cope with an ever more competitive environment: temporarily nationalised banks should therefore be returned to private ownership as soon as possible.

- SOCB privatisations also raise the issue of mechanisms for the residual influence of the state in these large institutions. Some countries have resolved this issue by reserving a certain percentage of shares for the state (eg the proposed 33% in India). In other countries, the state has kept a “golden share” in some large privatised retail banks, ie a share giving the state the right of veto over some strategic decisions (Hungary’s OTP Bank is one example). In Israel, the government set up a public committee to nominate managers of two banking groups that were privatised in the late 1980s. The latter two approaches seem attractive as they potentially provide both the benefits of private (in particular foreign) ownership and protection from possible disruptive changes in the banks’ business orientation. On the other hand, such arrangements could be potentially disruptive for the shareholders, and raise questions about continued non-market influences on the commercial decisions of private institutions.
- In some countries, bank privatisations have led to concerns about misalignment of private incentives and public interests. These concerns often stem from excessive concentration of ownership in the hands of rich individuals or families (as in Israel), foreign banks (as in Chile, Poland and Hungary), foreign non-bank financial institutions (as in South Africa and the Czech Republic) or non-financial corporations. However, with few exceptions, there is little evidence that such changes in ownership structure have made privatised banks unsound, or that foreign banks have siphoned off domestic deposits and crowded out small borrowers (see Section 5).

Central Europe: role of strategic foreign partners

In central and eastern Europe, bank reforms did not focus on privatisation in the early stages of the transition. Pressing issues at the time were the resolution of a large stock of inherited bad debts and recapitalisation of the financially very weak SOCBs. However, the authorities in the region quickly realised that the development of an efficient banking system was not possible without the active cooperation of foreign banks.

Polish policy provides an interesting case study. Since the mid-1990s, foreign banks have set up many subsidiaries or have participated in the privatisation of the Polish banks by taking up equity shareholdings as strategic investors, sometimes in stages.[17] Some banks were sold through the Warsaw Stock Exchange without gaining a strategic investor. Such banks were subsequently subject to takeovers, which left the government with lower budget revenue and no influence on the choice of the final owner. As a result, this method was dropped in recent privatisations.

Hungary privatised most banks through sales to strategic foreign partners in the second half of the 1990s. Having cleaned up the banks’ balance sheets, the Hungarian authorities did not ask foreign investors to pay an “entry fee”. A total of 10 banks were sold through tenders during 1995-2000. The shares of the largest bank (OTP) were introduced on the stock exchange and subsequently sold to small foreign financial investors, with the state holding only one gold share in the bank, which gives the state veto power over the shareholders’ appointment of one executive board and one supervisory board member.

In the *Czech Republic*, the prevailing mood at the outset of transition was that private sector was far more efficient than the public sector. Privatisation of the SOCBs and licensing of a large number of private banks were therefore foregone conclusions. However, after the disappointing results of voucher privatisation, the Czech authorities also started looking for strategic foreign investors for their four large SOCBs. The first such privatisation - of the Czech Republic’s third largest commercial bank IPB - ended up in a bank run and bank closure in June 2000. IPB’s problems were partly inherited (its balance sheet was not cleaned up prior to its sale) and partly acquired (corporate governance at IPB was weak following its sale in 1998 to a Nomura Securities’ subsidiary in London, which saw itself as a

[17] The remaining shares were sold through IPOs or to institutional investors, with 10-15% of shares being offered to the bank’s employees at a discount, and 5% remaining as the government’s “privatisation reserve”.

portfolio investor, not a strategic owner). The Czech National Bank acted swiftly and decisively, however, selling IPB to a rival Czech commercial bank just two days after forced administration was implemented, thus calming depositors and investors.

Latin America: privatisation as part of structural reforms

Latin American countries launched bank privatisation programmes at different stages during the 1990s. These programmes in general formed part of longer-term public sector reforms, which also involved privatisation of major public enterprises with the aim of consolidating the public finances and cutting borrowing requirements. Deepening the role of the market and of the private sector was also a major motive. This task was seen not only as a question of making banks more efficient in their own operations, but also of strengthening banks' allocative role in a market economy.

In *Argentina*, substantial progress has been achieved in the privatisation of the provincial banks and the national mortgage bank. The number of SOCBs fell from almost 40 to 15 in 2000, leading to higher deposit concentration and, reflecting greater penetration of foreign banks and stiffer competition, to a substantial drop in interest margins. However, the two largest banks, Nacion and Bapro, which hold almost 25% of deposits nationwide, remain publicly owned and are often seen as serving a social purpose, including lending to farmers and possibly to small businesses in the future.

In *Mexico*, commercial banks were nationalised by a presidential decree in 1982 in the context of a major macroeconomic crisis. The nationalised banks were subject to strict government controls, and were forced to concentrate their business on the public sector. In the late 1980s, the government embarked on an ambitious financial liberalisation and deregulation process; new commercial banking laws were introduced in 1992 and banks were sold to the private sector. After a decade of strict controls, however, the banking system was left without experienced managers and supervisors: financial deregulation and increased availability of funds contributed to the 1994 crisis. To contain the crisis and prevent a generalised run on the banks, the deposit insurance fund took over 15 banks and subsequently restructured their balance sheets over a period of years or sold them. In some cases, the branches and portfolios of banks were carved out and sold to different entities. Other banks were placed under the administration of potential buyers, who acquired the institutions after restructuring their balance sheets.

In *Brazil*, the share of state-owned banks has fallen markedly. Major state bank privatisations in 2000 included two large regional state banks (Banestado and Banespa), which were sold to a leading domestic bank (Banco Itaú) and Spain's BSCH, respectively. As with many other state-owned banks in Brazil, Banespa has a strong retail network but high overhead costs. An attraction of such banks is that they may bring in new customers, such as the payroll of a provincial government. On the other hand, many SOCBs have large unfunded pension obligations (which can reportedly reach $5 billion in some cases), tax arrears, and strong and militant unions. When the programme for restructuring of the state-owned banks is completed in about two years, only six banks are expected to remain in public hands, compared with 30 banks in mid-1996. The speed of this change has been attributed to the federal government's commitment to finance all of the costs of restructuring provided that the state-owned banks are either privatised, converted into development agencies, or liquidated. As in Argentina, however, there are no plans to privatise the two largest SOCBs, which compete with each other across the country, but find it politically difficult to close branches because they are partly used for social purposes and remain a major source of financing for state and local governments.

Public ownership of commercial banks in Peru reached 50% in the early 1990s. By 1995, after the liquidation of eight institutions and the sale of two banks, the financial system became fully private. The banks were sold through public auctions, in which both domestic and foreign bidders (including banks) participated. The only restrictions were those imposed by the prudential rules in place in the market. Before the auctions, the banks underwent a restructuring process and the Treasury assumed a part of the bad loans.

Crisis-hit Asian countries: how to re-privatise nationalised banks?

The Asian emerging economies have faced a different privatisation challenge in recent years: when and how to return to private ownership the banks that were nationalised during the 1997-98 crisis, and how to run such banks on a commercial basis in the interim. In a period of extreme banking system distress, bank nationalisations enabled the governments to force shareholders to write down their equity and share the burden of writing off NPLs. Nationalisations also increased the capacity to negotiate debt forgiveness and restructuring deals with foreign creditors and local borrowers, and to change management. However, the traditional risk of nationalisation - that of weakening banks' commercial orientation by allowing official/political/employee considerations too much influence - is ever present.

In *Thailand*, seven out of 15 commercial banks were taken into public ownership following the outbreak of the crisis in July 1997. One of these banks was merged with an existing state-owned bank (Radhansin Bank), and along with two other nationalised banks sold at auction to both Thai and foreign investors.[18] Another state-owned bank existing before the crisis (Krung Thai Bank) took over two of the intervened banks. The authorities are planning to sell the existing state-owned banks in the medium to long term only. In the meantime, these banks are being run on commercial lines outlined in MOUs between the Ministry of Finance and the banks' boards of directors, while the management teams are bound by performance-related contracts. Unlike banks in Korea and Malaysia, Thai banks kept non-performing loans on their books for almost three years. In September 2000, the authorities decided to transfer a large portion of NPLs from Krung Thai Bank to a government asset management company to accelerate the process of debt restructuring and the new government plans to extend this process. Thai privatisations are more cautious than other such efforts in the region: although foreign banks are allowed to hold more than 25% of a domestic bank's shares, after 10 years they will not be allowed to take up additional equity unless their equity share is below 49%.[19] This limitation may partly explain the relatively lukewarm interest of foreign banks for acquisitions in Thailand thus far.

To forestall systemic risk, the *Korean* government and the Korea Deposit Insurance Corporation at the outset injected large amounts of public funds into the banking system. Banks with a capital adequacy ratio below the required 8% had to sell their NPLs to a government-owned asset management company at a significant discount and accept government equity, after writing down their shareholders' equity to near zero.[20] In addition, several relatively sound private institutions received capital support to take over some banks that were closed (see Section 4). In December 1999, after lengthy negotiations, the government sold its majority stake in Korea First Bank to Newbridge Capital, a US investment fund, which represented the first foreign acquisition of a Korean commercial bank. A new chief executive officer was appointed for Seoul Bank, which is being prepared for privatisation by foreign investors. The government plans to sell off its shares in other temporarily nationalised banks in steps from the first half of 2002, once these banks have had an opportunity to demonstrate their ability to earn an attractive return on equity.

Indonesia nationalised four banks in 1998 and seven banks in 1999, adding to the existing seven state-owned banks, all of which were taken over by the Indonesian Bank Restructuring Agency (IBRA), along with 67 private banks that were closed during 1997-2000. Public capital injections into private banks, which form part of the bank recapitalisation programme introduced in 1999, resulted in further de facto large-scale nationalisations. Owners who wanted to keep managing these banks had to inject about 20% of new capital requirements after writing down their doubtful and bad loans, and were given the first right to buy back government shares within three years. The government plans to divest its ownership in nationalised banks within five years.

The *Malaysian* government set up in 1998 a special agency (Danamodal) to recapitalise and strengthen the banking industry affected by the crisis and to help consolidate and rationalise the banking system in the medium term. Danamodal has injected the equivalent of about 14% of the banking sector's total 1998 Tier 1 capital into 10 banking institutions so far. In 1999, several banks began repaying capital injections. The divestment of the government's ownership in the sole institution with a government presence (Bank Bumiputra Malaysia Berhad) was carried out through a merger with a private bank in October 1999, with bad assets of the state-owned bank being transferred to a subsidiary of the national asset management corporation. Danamodal's investments in the remaining

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18 In late 1999, Nakornthon Bank was sold to Standard Chartered Bank and Radhansin Bank was sold to United Overseas Bank. In late 2000, Bangkok Metropolitan Bank was sold to HSBC after a lengthy approval process.

19 Foreign banks will not be forced to sell any shareholdings above the 49% limit.

20 Before the Korean government nationalised Korea First Bank and Seoul Bank, the two largest private banks, it wrote down each bank's existing capital from Won 820 billion to Won 100 billion. Then it raised each bank's capital to Won 1.6 trillion by injecting public capital, raising the government's share in each bank to 94%.

five banks are expected to be fully divested in the next few years through strategic sales of Danamodal's equity stakes to third parties, in line with the ongoing consolidation exercise.

Is there a residual role for state-owned commercial banks?

Policymakers in general no longer see a useful role for the SOCBs. Even for development banks, there is a strong preference for institutions pursuing a clear function in an area of market failure. Such banks are increasingly asked to finance themselves by issuing bonds rather than taking deposits. Sometimes, commercial banks are used on a contract basis as distribution channels for state housing and agricultural programmes (as in Mexico). Private banks often find this intermediary role profitable, as they assume no credit risk on their own. Nonetheless, there are a few special cases where the SOCBs are seen as institutions playing a useful role.

- In large countries (Russia, Brazil, Argentina), only state-owned banks are willing to serve customers in remote areas.[21] Even the UK and New Zealand governments are in the process of establishing new banks to be run by the post office to deliver banking services to the poor and to rural areas. Some countries (including Poland and China) see cooperative banks and credit unions as a better alternative to banks in serving customers in remote areas, however.
- Some countries (eg Thailand, Brazil and Argentina). also see a continued role for the SOCBs as a conduit for lending to farmers and small and medium-sized enterprises outside large cities. The reason is that the government is often better able to administer specific lending programmes if it owns the banks that provide subsidised loans. In Chile, however, private banks have performed better than the SOCBs in supplying credit to the small and medium-sized enterprises.
- There are some indications that lending by the SOBCs is less procyclical than lending by the private domestic and foreign banks. During recent recessions in the Asian countries, Brazil, Chile and Colombia, state-owned banks expanded credit faster (or cut credit to a smaller extent) than domestic and foreign-owned private banks (Table A7 in Annex 3). This finding could have policy implications for small open economies, where policies for dealing with the question of cycles were generally limited.
- In smaller economies domestic capital is limited, so there is a tendency for foreign capital to dominate the privatisation of banks. This may create a backlash against foreign ownership and privatisation in general. There are also cases where the SOCBs' balance sheets need to be cleaned up in order to attract serious foreign investors (as in Brazil, the Czech Republic and Hungary). Therefore, continued (but temporary) state ownership of banks may in some cases be preferable to quick privatisation.
- In some less developed countries the lack of basic market and legal infrastructure may be so severe as to make market failure pervasive and the SOCBs the only viable alternative. In Russia, private banks are financially weak and small, so only state-owned banks are in a position to provide loans of meaningful size and offer security for household deposits.

While accepting the state ownership of banks as a second best solution, policy makers have nonetheless found it useful to subject the remaining SOCBs to market discipline and treat them like all other banks from a supervisory perspective, requiring, for example, full monthly disclosure of their operations (as in Thailand).

[21] In Russia, about 40% of the territory is in permafrost regions. Private banks have shown no interest in serving some 20 million people living in those areas.

4. Domestic mergers and consolidation

The banking systems of many emerging economies are fragmented in terms of the number and size of institutions, ownership patterns, profitability and competitiveness of banks, use of modern technology, and other structural features. Very often, three or four large commercial banks coexist with a large number of smaller urban and rural banks, many of them family-owned (especially in Asia) or under the influence of the public sector (as in Latin America and central Europe). In general, few commercial banks, even larger ones, are listed on a stock exchange. Profitability varies widely, with some banks earning high returns but operating very inefficiently, and other banks competing fiercely for a narrow segment of the market. Likewise, while some commercial banks in the emerging economies are at the cutting edge of technology and financial innovation, many are still struggling with the basic operations such as credit risk assessment and liquidity management. Finally, recent banking crises have weakened banking systems in a number of countries, and banks in some countries remain on the brink of insolvency.

In this environment, it is natural to consider bank mergers as a possible vehicle for improving the structure and efficiency of the banking industry. As bank consolidation in the emerging economies often involves foreign banks and government intervention, this section covers a broader range of issues than domestic mergers per se. Evidence on various motives for bank consolidation is reviewed along with an examination of recent experience with bank consolidation in the key emerging economies. The issues that arise include the following:

- Is there a regulatory role for encouraging bank mergers?
- How can institutions with different governance structures or not subject to the same degree of market discipline (family-owned or foreign-owned banks, banks with no dominant shareholder) be merged without undermining public confidence in the banking system?
- How does one address the trade-off between reaping the benefits of economies of scale and maintaining competition, which is more acute in the emerging economies given the lower level of financial development and greater prevalence of market distortions?
- What constitutes contestable markets in the emerging economies' banking industry?
- Is there a role for large, regionally (or internationally) competitive banks ("national champions") in the emerging economies?

Potential for bank consolidation

Empirical studies on mergers and acquisitions in banking (see Annex 2) have concentrated on the US banking market, where a long history of restrictions on inter-state banking has left a large number of banks. Mergers of western European banks have attracted more attention recently, but there are still only a handful of studies referring to emerging economies.[22] This is surprising, given that there was an upsurge in mergers and acquisitions in the emerging economies in the 1990s, even before the 1997-98 crisis (Table A5 in Annex 3).

Some of the motives and modalities of this merger activity are described in the next section. But first a simpler and more basic question has to be addressed: What is the potential for bank mergers in the emerging economies based on the traditional criteria identified in the literature? Three simple tests are considered.

To test for the potential for mergers stemming from inefficient banking structures, Table A6 in Annex 3 compares some crude indicators of efficiency in the emerging economies and industrial countries.[23] In terms of the number of banks, Hungary, Indonesia, Korea, Malaysia and Thailand seem "overbanked"

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[22] See Berger et al (1999) for references. Group of Ten (2001) concludes that only relatively small banks in the advanced economies could generally become more efficient from an increase in size, and many of these efficiency gains could also be achieved by outsourcing some functions rather than by merger.

[23] Note that geography, population density, and the role as international financial centres should be taken into account in interpreting the results for Australia, Hong Kong, Singapore and the United Kingdom.

relative to industrial countries but, in terms of the number of branches per capita, most emerging economies still appear “underbanked” (only Hong Kong, Korea, Singapore, Poland, the Czech Republic and Israel have well developed branch networks). Banks in most emerging economies also tend to be small: even in the upper-middle income economies in Latin America and central Europe (ie those with per capita GDP of $5,000-10,000), banks on average hold assets worth under $3,000 per capita. In terms of the number of staff per branch, most emerging economies are similar to industrial countries (with the exception of Hong Kong, Singapore, South Africa and Peru).

The relationship between profitability (measured by return on assets) and the size of banks in the emerging economies is further explored in Graph 1. Judging by the slope of the estimated regression lines, smaller rather than larger banks were more profitable in all three emerging market regions in 1998, mainly because larger banks, in contrast to smaller institutions, included a greater number of loss-making institutions (especially in Asia).[24] Larger banks, however, have an advantage in terms of return on capital, because they are generally able to operate with smaller capital relative to the size of assets. One interesting implication of these data is that medium-sized banks in Asia have essentially lost their role in the market.

Some evidence on economies of scale in the emerging economies’ banking industry is shown in Graph 2. In Latin America, the average large bank does have lower operating costs relative to assets, but there are many small banks that are just as efficient as the large banks.[25] (Note, however, that the vertical scale for the Latin American panel is smaller, indicating much higher operating costs - due to a history of high inflation - than in other regions.) In Asia, large banks also tend to have lower operating costs, but there is also a significant cluster of small banks that operate efficiently. In the other emerging economies, there appear to be diseconomies of scale, with the larger banks being less efficient.

Country experiences: market-driven versus government-led consolidation

Although the evidence reviewed above suggests some potentially significant cost and revenue benefits from bank consolidation, *market-driven* consolidation is a relatively new phenomenon in the emerging economies and has mainly been observed in central Europe. Most mergers have instead resulted from *government* efforts to restructure inefficient banking systems (as in many Latin American countries), or from intervention following banking crises (as in Korea and Southeast Asia). However, as competition in a growing number of market segments has intensified through deregulation, privatisation and entry of foreign banks, consolidation is becoming more market-driven. In addition, some economies with mature financial markets (Singapore, Hong Kong) are increasingly looking at consolidation as a broader competitiveness issue in a regional or even global context.

In addition to economic factors, legal and judicial considerations often play a major role in determining the outcomes of bank consolidation. In some countries (eg the Czech Republic), governments have ended up in court in cases where they forced bank mergers. In others, governments have ended up in courts in cases where they did not allow mergers to take place (as in South Africa). Finally, there are countries where government efforts to consolidate the banking system cannot be challenged in courts (eg Malaysia), but banks can nonetheless undermine these efforts by other means.

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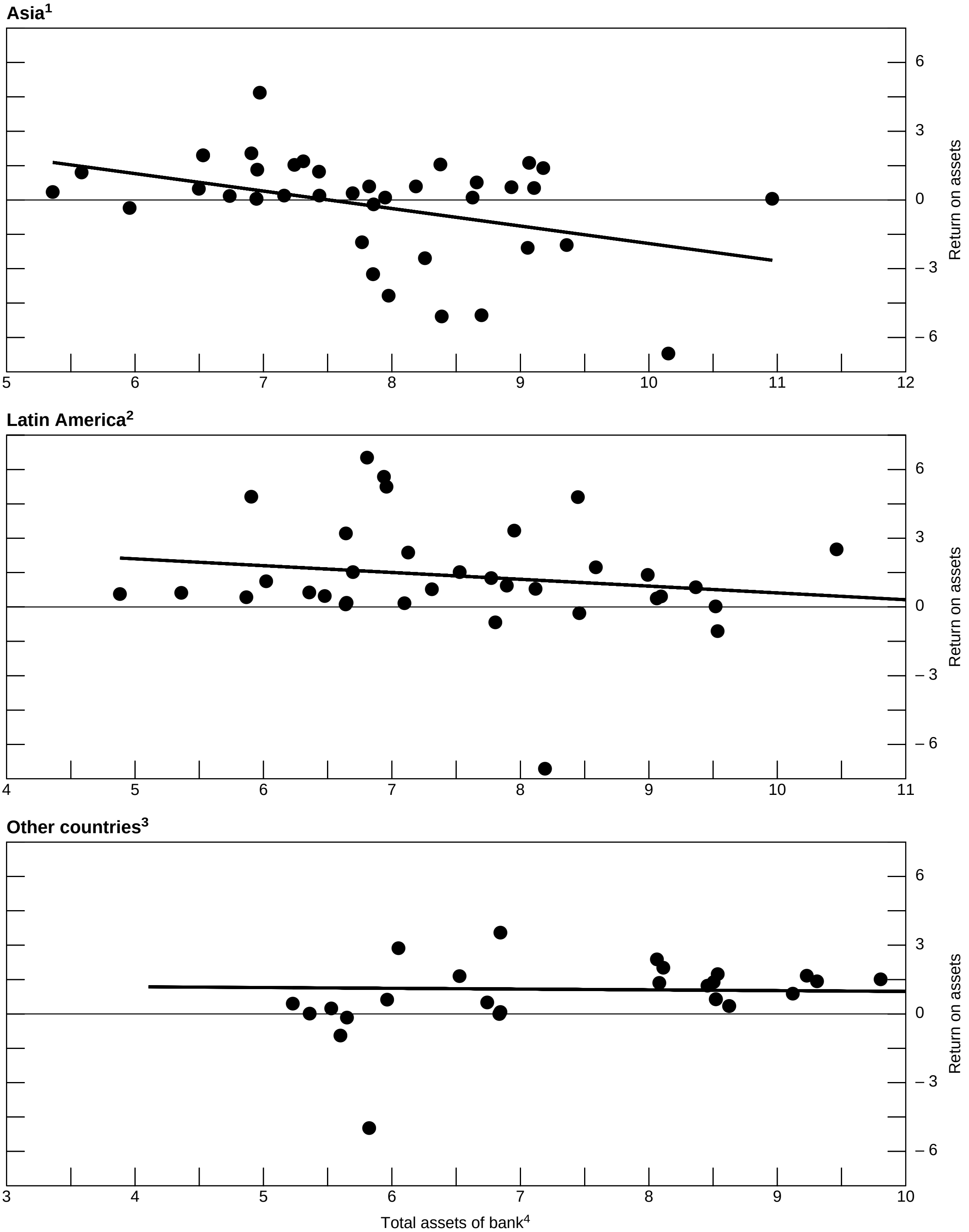
24 Many Asian banks were making extraordinary losses in 1998.

25 These results are in line with Burdisso’s (1997) study of the Argentine banking industry.

Graph 1

Return on assets and asset size of banks in 1998



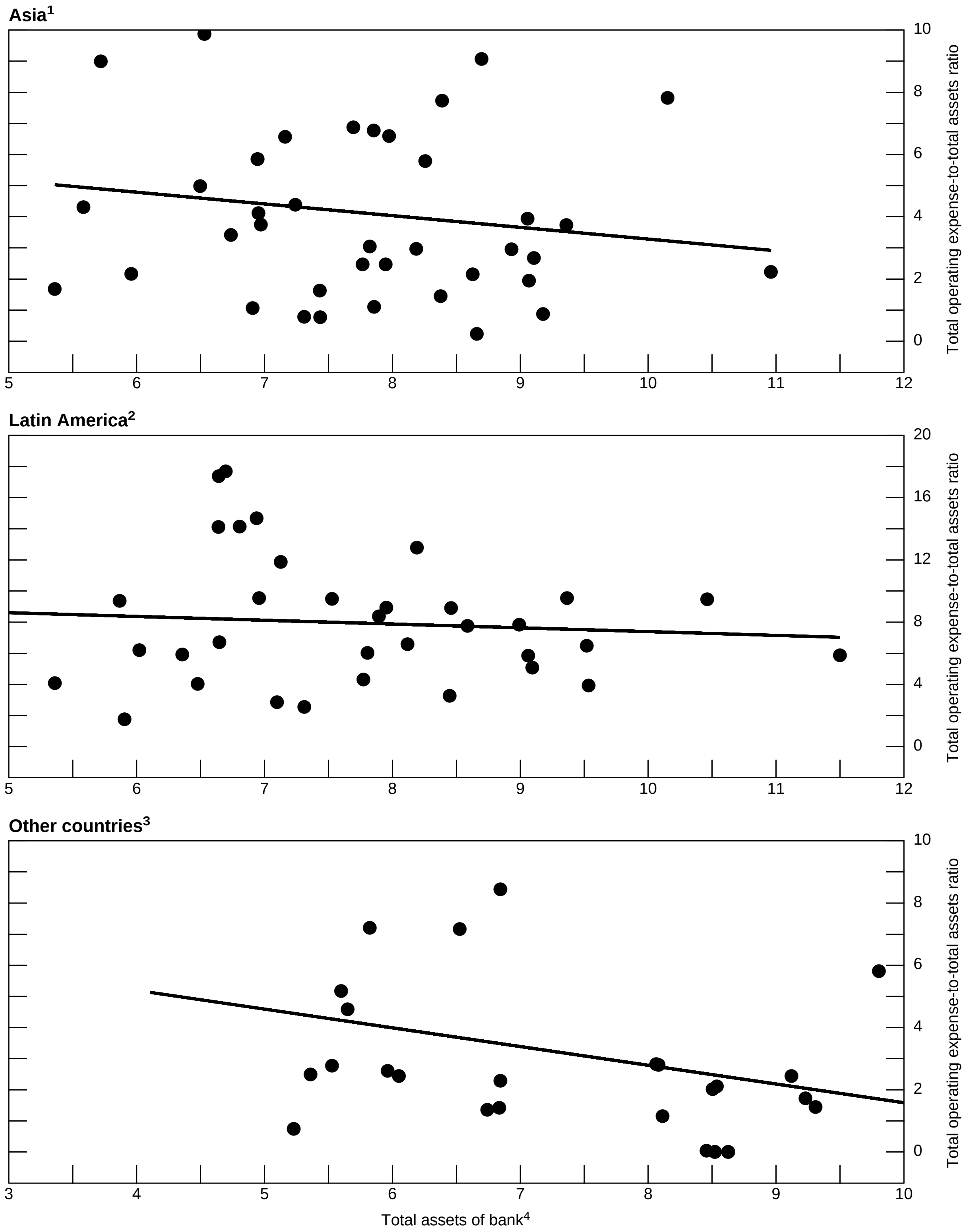
Note: Bank sample based on the five largest private domestic banks in the respective regions.

[1] China, Hong Kong, India, Korea, Malaysia, the Philippines, Singapore and Thailand. [2] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [3] The Czech Republic, Hungary, Israel, Poland, Saudi Arabia and South Africa. [4] In US dollar terms expressed logarithmically.

Source: Fitch-IBCA.

Graph 2

Expense to assets ratios and asset size of banks in 1998



Note: Bank sample based on the five largest private domestic banks in the respective regions.

[1] China, Hong Kong, India, Korea, Malaysia, the Philippines, Singapore and Thailand. [2] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [3] The Czech Republic, Hungary, Israel, Poland, Saudi Arabia and South Africa. [4] In US dollar terms expressed logarithmically.

Source: Fitch-IBCA.

Central Europe: market-driven consolidation has only started

At the outset of transition, central European economies licensed a large number of private banks, often under very easy conditions. At the time, it was widely believed that liberal licensing rules would promote competition, speed up the development of financial markets, and provide an important counterweight to the large state-owned commercial banks spun off from the monobanks. But after a large number of bankruptcies of private banks, the Czech Republic, Hungary and Poland have ended up with 40-80 commercial banks each, with no dominant bank in the corporate sector, and usually one large retail bank with a market share of 20-25%. As building a new branch network has become very costly, a wave of market-driven consolidations has started recently. The authorities in the region sometimes promote mergers to strengthen domestic banks (a 15% market share is generally viewed as a threshold for profitable operations), or to restructure ailing banks, especially ahead of privatisation. Increasingly, mergers between parent banks in EU countries are a factor behind bank mergers in central Europe. The upcoming privatisations of the remaining large savings banks are expected to lead to further consolidation.

In *Hungary*, some 40 institutions are currently competing for the retail and corporate markets of a population of just 10 million, with the former monopoly lender OTP Bank still a dominant player. Last August, ING Bank sold its 12 branches to Citibank, after reportedly realising large losses from its organic growth strategy. At the same time, Belgium’s KBC and ABN-Amro merged their Hungarian operations to exploit market synergies.

Competition to acquire local banks is also intense in *Poland*, where there is more room for expansion due to the larger size of the economy (38 million people) and the relatively low level of financial development.[26] Locally owned Kredyt Bank rose from 19th to fourth position in the country after a series of acquisitions and mergers in the second half of the 1990s that were aimed at creating more efficient structures by cutting costs and competing more successfully with foreign banks. Meanwhile, foreign banks are targeting the few remaining independent banks to achieve a greater market share.[27] The government has often actively promoted bank consolidation. In the first half of the 1990s, it encouraged smaller banks to merge because many of them were weak and there was no deposit insurance system. Recently, the government has in several cases asked foreign banks to merge their “greenfield” operations and newly acquired banks.

It is still too early to assess the potential risks from bank consolidation in central Europe. So far, both Hungary and Poland seem to have benefited from increased competition and a greater foreign bank presence: interest rate margins have dropped significantly and in some market segments (eg corporate customers) are below the EU average; banks are increasingly focusing on lending to small and medium-sized enterprises and households; and total deposits and lending are growing at healthy rates. Recent bank failures were not related to excessive competition: in Hungary, the failure of a major retail bank (PostaBank) in 1998 was due to fraud while in Poland recent bank failures occurred mainly in the relatively inefficient and poorly supervised cooperative bank sector. One concern, however, is that the acquiring (ie foreign) banks often expand the activities of merged institutions into non-bank financial services, including insurance, portfolio management and investment banking. To the extent that domestically-owned institutions are under competitive pressure to follow such moves, there is a risk that they will make mistakes, as few of them have extensive experience with such products. Indeed, one such case in the Czech Republic has already ended up as a costly failure (see Section 3).

Latin America: consolidation as a response to inefficient banking structures

Latin American countries have more varied experiences with bank consolidation. In *Argentina*, bank consolidation has been largely driven by the domestic and external financial liberalisation launched in

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[26] A third of Poles have no bank account, and total bank debt is only 32% of GDP, compared with 95% in the Czech Republic and 120-130% in most industrial countries. Polish banks have twice as high operating costs relative to assets as banks in industrial countries. Interest margins are also higher (4%) than in western Europe (usually 2-4%) and Hungary (about 2%), but are declining.

[27] Citibank Poland, which is already strong in both corporate finance and high-end retail banking, has recently acquired the old foreign trade bank (Handlowy) for around $1 billion.

the early 1990s, and by the progressive tightening of prudential regulations. Mergers involving overlapping operations have been rare but painful. Reducing staff was politically difficult (especially in a recession), and many customers were lost to competing banks when attempts were made to rationalise overlapping branches. Most mergers took place between banks having complementary strengths in different regions. As a result, the number of banks has dropped considerably (from 180 in 1994 to 102 in 2000), but the number of branches has shrunk much less.

In *Brazil*, bank consolidation has been driven by the privatisation of state-owned banks. Once these privatisations are over, many of the 170 medium-sized banks that are still family-owned are expected to become takeover targets. These banks are generally poorly managed and unprofitable, but mergers between them are rare and hard to organise because of the family ownership structure. Only a few of these banks are expected to continue to operate as small but profitable niche players. The rest will have to merge in order to survive, in part because lower inflation has eliminated a major source of their traditional revenue (ie the float).

In *Mexico*, consolidation has taken place in response to the lack of capital after the 1995 banking crisis. Thirteen private domestic banks that survived the crisis were recapitalised by the government through a scheme that bought their non-performing loans. As further capital infusions were needed, and domestic players were not in a position to provide the funding, regulations governing the entry of foreign banks were eased. Most observers believe that the Mexican banking system will go through one more round of mergers among the top five banks, which control almost 80% of total banking sector assets. After that, further mergers could become difficult for the authorities to approve, as they could threaten competition.

There have also been a spate of mergers in *Venezuela*, prompted by new legislation and a banking crisis. The number of financial intermediaries fell from 167 in 1993 to 75 in 2000, and was expected to drop to 60 in 2001. It was hoped the mergers would strengthen the capital base and improve the capacity of banks to adopt new technology. The banks had requested incentives for further mergers, but the authorities were reluctant to provide them.

Despite considerable merger activity, analysts believe that there are still far too many banks in Latin America, and that takeover activity is likely to intensify in the future. In particular, the recent purchase of Brazil's large state-owned bank (Banespa) by Spain's BSCH is expected to accelerate the purchases of the remaining SOCBs and middle-sized family-owned banks by large private domestic banks, which have so far successfully competed with foreign banks but now risk losing that advantage. As a result, only a few medium-sized banks that can refocus their business strategy as niche players are expected to remain independent.

Government-led consolidation in the crisis-hit Asian economies

In the crisis-hit Asian economies, bank mergers have for the most part been a government-led process, motivated by the need to strengthen capital adequacy and the financial viability of many smaller, often family-owned banks affected by the 1997-98 crisis.

The clearest example of the government-led approach is *Malaysia's* Danamodal, a special purpose institution with the twin objectives of recapitalising the banks (see Section 3) and facilitating consolidation and rationalisation in the banking system. The government initially tried to persuade banks to merge voluntarily, providing certain incentives to larger institutions. However, these efforts were unsuccessful. In 1999, the central bank therefore selected 10 "anchor" banks to lead the consolidation of smaller institutions from 54 groups into large, financially viable groups, and the government has offered tax concessions as part of a package of incentives for bank mergers. By the end of 2000, the mergers were for the most part completed. The promotion of mergers was deemed justified because the structure of the banking industry was considered inefficient, and because the government provided guarantees for bank deposits.

In *Korea*, recent mergers were for the most part initiated by the government in order to resolve unsound banks. Mergers usually involved banks with overlapping operations and were supported by large injections of public funds. The government provided capital support to several private banks in 1998 to take over, through purchase and assumption operations, the assets and liabilities of five commercial and 17 merchant banks that were closed. In 2000, the government devised a new plan to establish financial holding companies as a vehicle for additional bank mergers. Healthier banks are being induced to merge through government buyouts of non-performing loans and the prospect of increasing their market share. Weaker banks are expected to be joined up under a separate holding company umbrella that would enable them to share in IT, internet and securities ventures. Although larger banks were better placed to introduce new technology and eliminate duplication, strong labour unions made it harder to realise efficiency gains from mergers.

In the *Philippines*, a range of incentives is being offered to the merging banks, including better access to rediscount facilities and temporary relief from certain prudential requirements. In Thailand, the government has been involved in only one merger so far, but is supportive of private merger initiatives, especially among non-bank finance companies.

In *Indonesia*, four of the seven state banks existing before the crisis were consolidated into a new state bank (Bank Mandiri), which now controls about a quarter of total commercial bank deposits. In addition, eight private banks that had been taken over by IBRA were merged during 2000 into a new institution (Danamon). As a result of these mergers, 90% of the staff are expected to be laid off and 80% of the branches closed. Such high retrenchment costs have naturally raised questions about the fundamental purpose of mergers. Some policymakers have argued that mergers were useless if they led to the near extinction of banks, while others have observed that the policymakers should be concerned exclusively with the safety of bank deposits and not the job cuts.

Government involvement in mergers during banking crises is often inevitable, as viable but distressed institutions are rarely in a position to attract potential buyers without moving some non-performing loans to an asset management company and/or receiving temporary capital support. Such intervention may still be more cost-effective than taking the bank into public ownership. However, while a large well capitalised bank can readily absorb isolated small banks and improve the quality of their management, it is unlikely that merging two weak banks can quickly create a single strong bank. Moreover, forcing a healthy bank to assume a heavy burden of bad loans may make it even less willing to lend, particularly if such action is taken when the banking system as a whole faces difficulties. This has been one reason behind the slow growth of bank credit in Mexico since 1994.

When and how to promote mergers therefore requires a delicate balancing act on the part of the authorities. One example of successful intervention is the 1980s crisis in Hong Kong, when financial assistance in the form of guarantees and liquidity support was provided to four troubled banks to facilitate their takeover by private sector entities, and three were taken over by the government itself. This uncharacteristically activist approach was used because it was judged that allowing these banks to fail might have had systemic implications, and could have had an impact on the value of the Hong Kong dollar at a time of political uncertainty. But the authorities did not rescue any of the 20 smaller intermediaries that experienced severe difficulties, as failures of such institutions were not considered to have systemic implications.

Bank consolidation dilemmas in the mature emerging economies

In the emerging economies with mature banking systems (eg Hong Kong and Singapore), bank consolidation raises a new policy challenge: how to foster development of major domestic institutions whose long-term interests are aligned with the local economy, and that are at the same time able to compete on a wider regional basis with the best international banks? The challenge does not come from the viability and soundness of local banks, but from the structure of ownership in the domestic banking industry. Most local banks in Hong Kong and Singapore started as family banks and are still run by their controlling shareholders, and so find it difficult to compete with the best international banks in areas such as size, technology, expertise, range and quality of service, and shareholders' returns.

Singapore has taken a proactive approach to this challenge. In 1999, the Singapore market was further opened to foreign banks, with the hope that this would spur efficiency and innovation among the local banks, and push well run banks to seek scale and expand not only at home but also abroad.[28] The Development Bank of Singapore has thus taken control of banks in Hong Kong, Indonesia, the Philippines and Thailand. At the same time, the authorities did not want liberalisation to weaken domestic banks and destabilise the financial system, so the market is being opened up only gradually, first to financially strong, committed foreign banks. To motivate the local banks to strengthen themselves, disclosure and corporate governance standards were raised to international norms, and

[28] See Lee (2000).

banking groups were asked to establish a clear separation between their financial and non-financial businesses by divesting all control of non-financial businesses and removing all cross-shareholdings.

Hong Kong has a similar structure of family ownership in the banking industry, although it has also served as a base for some large, internationally active banks (HSBC, Standard Chartered). As local banks have traditionally derived a large proportion of their revenue from net interest income, especially mortgage lending, the growth potential of such smaller banks is increasingly seen as restricted given a more competitive domestic and regional environment. The authorities have therefore publicly advocated the desirability of mergers in the banking industry, but have so far taken a less proactive approach than Singapore. Nevertheless, some remaining barriers to competition (such as interest controls on current and savings accounts) are being removed so as to encourage innovation and greater efficiency in the provision of deposit products, and foreign banks have been allowed to open more branches (up to three instead of just one). The Hong Kong authorities also agreed to review whether foreign banks should be allowed to set up subsidiaries. Although less ambitious, the aim of these measures is the same as in Singapore: to retain a strong indigenous element at the core of the banking system, and at the same time to encourage local institutions to improve their competitiveness.

It remains to be seen which approach proves more useful. As incentives to mergers under both approaches are essentially market-based, it would be hard to dismiss them as industrial policy in disguise. But one risk is that encouraging domestic banks to enter foreign markets might stretch the managerial capacity of the domestic banks too far. Furthermore, large banks that are active abroad may lose small customers at home if personalised, relationship-based banking services are discontinued. However, such risks would seem minor compared with the potential benefits of reinvigorating the more traditional domestic banks.

Besides Hong Kong and Singapore, the authorities in *Korea* have also advocated bank mergers on the grounds that domestic banks had to be large enough to compete effectively with foreign banks, especially in the domestic market given the size of the Korean economy. Yet it is not clear that large banks are automatically stronger and more competitive (see Graphs 1 and 2). Moreover, even if the domestic market consisted of a single bank, it would still have fewer assets than those controlled by each of the large global banks (Table 7).[29]

Table 7

Capital (Tier 1) of selected banks and banking systems

Global banks	**(US$ billion)**	**Banking systems**[1]	**(US$ billion)**
Citigroup	54	Argentina	7
Mizuho Financial Group[2]	51	India	8
HSBC	35	Malaysia	10
Crédit Agricole	26	Poland	2
Deutsche Bank	20	South Africa	8
UBS	19	Thailand	6

[1] Only includes banks ranked in the world's top 1,000. [2] Formed from merger of Fuji Bank, Dai-Ichi Kangyo Bank and Industrial Bank of Japan.

Source: *The Banker,* July 2001.

[29] If foreign banks are present as subsidiaries, then their capital base is probably comparable to the domestic banks' capital. However, if foreign banks operate via branches or the lending is done directly by head office, then the maximum loan size will be related to the global capital base of the parent bank.

5. Entry of foreign banks

As noted in Section 2, banking crises, deregulation and globalisation of financial services led to a dramatic increase in the presence of foreign banks in the emerging economies in the second half of the 1990s. In central Europe, the share of foreign banks in terms of both total assets and capital is now around two thirds or higher, making these countries' banking systems among the most open in the world (Table 8). In Latin America, the market share of foreign banks rose to 40% in 2000 from an average of 7% a decade ago. In Asia, foreign banks have increased their presence in Thailand and the Philippines. Elsewhere, foreign bank presence has declined as a result of expansion by domestic banks (Hong Kong and Singapore) and government-led restructuring (Malaysia). However, there is no doubt that the region has become more open to foreign banks: Indonesia, Korea and Thailand have raised allowable foreign equity levels in local banks to around 100%, the Philippines now allows 50% foreign ownership, and only Malaysia has retained a 30% ceiling on foreign ownership.

The entry of foreign banks reflects the desire of both large international and regional banks to enter profitable markets and of the local authorities to improve the efficiency and stability of their financial systems, as well as to help reduce the cost of recapitalising weak domestic banks.[30] Adopting a liberal approach to foreign bank entry has also been laid down by international trade agreements (WTO, NAFTA), or has been a condition of membership of the OECD or the European Union, or is part of reciprocity requirements for domestic banks to expand into foreign markets.

Greater foreign participation in the banking industry raises a number of important analytical and policy issues for emerging economies. The analytical issues include: the factors determining a bank's decision to expand its activities abroad, its choice of countries to invest in, and the form of participation (branch, subsidiary, ownership of local banks); differences in the business focus of foreign and domestic banks; and the impact of foreign entry on the performance of the domestic banking industry. The policy issues include how much and what sort of foreign participation to permit, and what key supervisory issues arise as a result of greater foreign participation (the latter issue is discussed in the next section).

Expanding abroad

Historically, the pattern of international bank shareholdings followed that of the economic integration between countries: banks extended their services abroad in order to assist their home country customers in international transactions; with a growing understanding of the foreign market (in particular of regulatory and institutional aspects) and a developed network of relationships with local financial institutions, some banks were subsequently induced to increase the range of their operations and provide services to the local population.[31] Following this pattern, foreign banks would first establish representative offices to handle trade credit operations and possibly arrange international private debt and equity placements between borrowers in the host (emerging) country and lenders in the source country. At a later stage, foreign banks would open branches, which are typically involved in the wholesale deposit and money markets. Eventually, they would establish subsidiaries, ie institutions that are incorporated separately from the parent bank (whose financial commitment consists of the capital invested), and use them to enter retail banking markets.

Today, the actual pattern of bank international shareholdings depends on a wider range of factors than just the overall degree of integration between countries. In particular, the profit opportunities in the destination market have become a key factor in determining the pattern of foreign bank shareholdings.[32] As a result, forms of foreign bank participation have become more varied, including

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[30] A cross-country econometric study by Mathieson and Roldos (2001) suggests that a banking crisis during the previous three years raises foreign participation in the banking system by about 10 percentage points. But even after including a number of other explanatory variables, there are still regional differences in the extent of foreign bank involvement.

[31] Pomerleano and Vojta (2001) note that some foreign banks are content to stop at the first stage and just serve multinational firms from their home country.

[32] Focarelli and Pozzolo (2000) identify country-specific variables (degree of trade openness, size of the banking sector, return on assets in the banking sector) and bank-specific factors (equity interest abroad, share of non-interest income, size of the bank) that have a statistically significant impact on the decision to expand abroad.

Table 8

Foreign-owned banks[1]

	Assets as a percentage of bank assets			Return on assets	Capital ratio: risk-weighted
	1980	**1990**	**2000**	**1998**	**1998**
China	0	0	1		
India	4	5	8[2]	0.9	…
Russia	…	6[4]	9		
Hong Kong	…	89	72	0.1	
Singapore	86	89	76[2]	…	…
Indonesia	…	4	7	0.8	15.6
Korea	6	4	3[2]	1.8	28.6
Malaysia	38	24	18	1.1	13.3
Philippines	8	9	15	0.6	22.0
Thailand	…	5	12[2]	– 5.6	9.3
Argentina	…	10[4]	49	0.4	17.9
Brazil	…	6	23[2]	0.4	17.8
Chile	…	19	54[2]	0.4	15.5
Colombia	9	8	26[2]	– 0.5	10.9
Mexico	…	0	24[5]	– 0.2	14.4
Peru	2	4	40	0.5	11.4
Venezuela	…	1[6]	42[2]	3.5	14.0
Czech Republic	…	10[3]	66	0.8	18.6
Hungary	…	10	62	0.9	15.6
Poland	0	3[6]	70	0.5	15.0
Israel	…	2[4]	9[2]	0.3	11.1
Saudi Arabia	0	0	0[5]	…	…
South Africa	…	1	1[2]	– 21.1	18.7

[1] Banks where more than 50% of equity is held by foreigners. [2] 1999. [3] 1994. [4] Average 1988-95 from Claessens et al (2001). [5] Including those where foreign banks have effective control without holding more than 50% of equity, the proportion would be over 40%. [6] 1993.

Sources: Central banks; World Bank; BIS estimates.

full acquisition, targeted purchases of specific activities, joint ventures or alliances with local banks, and outsourcing of administrative and financial services. As discussed above, in many transition and post-crisis economies, the restructuring of banks and subsequent privatisation have provided incentives to enter markets through the acquisition of local banks rather than the more costly establishment of "greenfield" operations. Even the wholly owned acquisitions are often kept as local subsidiaries rather than as branches of the parent. Major international banks that originally created networks of branches around the world (Citibank, HSBC, ING, ABN-Amro, Deutsche Bank, and Spanish banks operating in Latin America) have gradually moved towards a strategy of making selective acquisitions in key emerging markets and have kept them as subsidiaries.

Business focus of foreign banks

As foreign banks have historically followed their home-country customers to the emerging markets, they are often seen as specialising in servicing large corporate customers, either multinational companies or "cherry-picked" host country corporations. This has led to concerns that in banking systems with a large foreign participation some segments of the market - rural customers, small and medium-sized firms - would be left unattended. As a result, domestic banks could be left with the less creditworthy customers, increasing the overall riskiness of domestic banks' portfolios, and credit markets could become segmented.

One shortcoming of the "cherry-picking" argument is that it does not spell out the assumptions made about the pricing of risk. If risks were properly priced, local banks would be able to balance having less creditworthy customers with higher spreads, and therefore would not be at a disadvantage vis-à-vis foreign banks. Perhaps the implicit assumption underlying the "cherry-picking" argument is that the entry of foreign banks undermines the subsidisation of poorer credit risks by domestic banks. If this is the case, foreign bank entry would actually be welcome since it would discourage much economically wasteful activity. The authorities in some countries may still feel that certain market segments (eg farmers) require special treatment because of institutional and market imperfections or for distributional reasons. In such cases, they may want to ensure at least a minimum of cooperation on the part of banks with a large branch network in the distribution and administration of small grants and subsidised loans from the budget.

Another concern has been that, with foreign banks using the interbank market for much of their funding, local banks could put more funds into that market and make fewer domestic loans. Effectively this would enable large companies to gain better access to loans at the expense of small companies. This concern has been largely unsubstantiated in practice, but is nonetheless persistent in several emerging economies.

Evidence on whether the business focus of foreign and domestic banks diverges is rather mixed.[33] As a result of strong competition and significant penetration, foreign banks in central Europe are increasingly focusing on lending to small and medium-sized enterprises and households. In India, foreign banks have generally followed the guidelines for lending policies towards "sensitive" sectors. In most emerging market economies, however, foreign banks appear very cautious about lending to smaller firms because of their limited knowledge of local industry. In Latin America, for example, Spanish banks reportedly shelved plans to extend their lending activities to middle-market and retail customers following the recent Brazilian devaluation, citing increased credit risk and the lack of credit histories and transparent balance sheets.

Impact of foreign entry on domestic banks

There is widespread agreement on the benefits of foreign bank participation for the emerging economies. Foreign banks usually bring state of the art technology and training for domestic bankers. Moreover, they are familiar with sophisticated financial instruments and techniques, and have faster and cheaper access to international capital markets and liquid funds. Their presence may also

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[33] Pomerleano and Vojta (2001) note that foreign banks have gained large market shares in areas such as credit cards but not in lending to small businesses, possibly because the former area is more suited to data processing methods such as "credit scoring".

encourage other foreign firms to invest in the domestic economy. They may add to the stability of the financial system "by allowing domestic residents to do their capital flight at home".[34] Empirical studies have found that foreign bank entry improves the functioning of national banking markets, both by increasing the degree of competition and by introducing a variety of new financial products and better risk management techniques.[35] The efficiency effects of foreign banks appear to occur on entry, and do not depend on gaining a substantial market share. Foreign banks have higher interest rate margins, profitability and tax payments than domestic banks in emerging markets, and significant foreign bank entry is associated with a reduction in both operating expenses and the profitability of domestic banks.[36]

Because foreign banks can avoid the burden of lending to public enterprises, attract better credits with more sophisticated products and marketing and have "deep pockets" to fund early losses, they can put domestic banks at a competitive disadvantage, at least initially, and temporarily stall the development of the local banking sector. This was, for example, the Australian experience in the 1980s. In the longer-run, the influence is rather positive, albeit only for those domestic banks that survive.

Performance indicators for central European and most of the Latin American banks confirm that foreign banks are more efficient than domestic banks (Table A4 in Annex 3). In some countries foreign banks appear less efficient. The latter experience is in line with the results obtained for more mature markets, where domestic banks are generally more efficient.[37] In the Asian countries, performance indicators of foreign banks are also worse than those of domestically owned banks, perhaps because ownership changes have been very recent and because previously weak banks have been taken over by foreigners.

An important issue concerning the relative performance of foreign and domestic banks has been their behaviour during recessions in host countries and the foreign banks' home base.

- One opinion is that domestic banks are more committed to the domestic economy, in the sense of having both longer-term business relationships with customers and a patriotic affinity with the national interest. Foreign banks, by contrast, are said to look at lending opportunities around the world and may neglect the host country economy if its prospects deteriorate or if prospects improve in other countries. Foreign banks are also less likely than domestically owned banks to heed exhortations by the domestic authorities to maintain lending during recessions. In some cases, foreign banks have been less cooperative in rescheduling loans in times of crisis.
- The behaviour of foreign banks may also be driven by events at their home base. One recent example is the pullback of Japanese banks from lending in Asia when they faced difficulties in the Japanese market. In addition, changes in strategy of global banks taken at headquarters - for example, change of chairman or CEO - can have a major impact on markets where these banks have a presence.[38] Such disruptions can sometimes be reduced by avoiding the granting of licenses to too many banks from a single foreign country.

These criticisms apply more to foreign banks with only a small and recent presence in the domestic banking system. Larger, longer-established foreign banks are not in a position to risk their reputation and behave more like the domestic banks. There is also evidence that local management is usually strongly committed to the local operation, and that their business interests are often closely aligned with those of the authorities.

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[34] Mathieson and Roldos (2001).

[35] See eg Claessens and Klingebiel (1999).

[36] See Claessens et al (2001).

[37] See Berger et al (2000). This "home ground advantage" in mature banking markets has been explained by organisational problems (persuading good managers to move abroad and monitoring their performance), better knowledge of local customers (raising cheap deposits and making astute small loans may be much harder for foreigners), and difference of language and culture. Berger and DeYoung's (2001) US study finds that even within a single country there may be organisational diseconomies in operating a long way from head office.

[38] There is some evidence from Asia that smaller subsidiaries of global banks tend to suffer the most in such circumstances.

The contrary opinion is that foreign banks are better placed to ride out domestic recessions because they can more readily access international financial markets or draw on credit lines from their parents. Furthermore, they have better diversified balance sheets. The empirical evidence from Latin America suggests that foreign banks have generally had lower volatility of lending than domestic banks and notable credit growth during crisis periods, and that only offshore lending tended to contract in bad times.[39] Foreign bank operations may also keep international markets better informed about domestic conditions and so help dampen panic withdrawals of international funding (as in Saudi Arabia during the Gulf war), or can help reduce resident capital outflows during crises because they are usually perceived as safer.

The behaviour of foreign-owned banks during recent recessions is compared with that of domestic banks in Table A7 in Annex 3. The data, admittedly of fairly low quality, show no clear difference in behaviour between domestic and foreign banks.

Opening up the domestic banking system

Many emerging market economies have major shortcomings which create a need for foreign bank participation: the lack of capital, the lack of commercial banking skills and an inefficient banking structure. The first two factors have been important in central European transition economies, while the lack of capital and inefficient market structures have played a major role in opening up the banking systems in the Asian crisis economies and Latin America.

Considerations that determine the extent and scope of allowable foreign bank participation are often political. In theory, protecting domestically owned banks may lead to an inefficient financial system. Indeed, for a small economy it may make sense not to have any domestically owned banks at all, as they may not be able to diversify their risks sufficiently.[40] Even in medium-sized economies, there are potentially considerable benefits to be gained from foreign banks (discussed below). Nonetheless, in practice there are only a few fully foreign-owned banking systems, with the degree of foreign ownership lying somewhere between 15 and 80%.[41] While announcing a major liberalisation programme, the authorities in Singapore stated explicitly that they wanted local banks to retain at least half the market. Another example is the Philippines, where existing law provides that the market share of foreign-majority owned banks shall not exceed 30% of the banking industry.

A common argument against selling banks to foreign owners is that one should not sell the “family silver”. There may also be a populist objection that domestic savings will be used to fund projects in foreign countries. Political sensitivities may be particularly acute if foreign banks are perceived to be buying local banks at a discount, especially if taxpayers’ money has been used to clean up the banks’ balance sheets ahead of privatisation. As a result, political resistance to the entry of foreign banks has often had to be overcome gradually, for example as in Poland. In some cases, only a failure of domestically-led privatisation and restructuring has persuaded the authorities to allow foreign bank entry (eg in the Czech Republic). The government of Mexico also restricted foreign ownership to 30% with a 5% cap on individual foreign bidders when it first started selling off the SOCBs in the early 1990s; however, these restrictions were later relaxed and eventually removed.

Governments also face domestic pressure to limit the role of foreign banks because of fears that foreign banks will quickly come to dominate the local market or lead to a lowering of credit standards by increasing competition, especially if they use their deep pockets to subsidise early losses. Until 1995, the government of Brazil required that foreign banks have a minimum capital double that required for domestic banks. Recently, the authorities announced that foreign banks would not be allowed to open new branches or acquire smaller banks unless they purchase one of the troubled government-owned banks. Sometimes, foreign bank entry is restricted in order to maintain the

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[39] See Crystal et al (2001), Mathieson and Roldos (2001) and Peek and Rosengren (2000).

[40] A rare case where this issue is being addressed from scratch is the world’s newest nation of East Timor. The economics minister is reported as preferring not to have any domestic banks but another senior politician found it hard to imagine a nation without at least one domestic bank (*The Economist*, 2 September 2000).

[41] Nepal and Swaziland appear to be the only countries where 100% of banking sector assets are owned by foreign banks (Claessens et al 2001). Other countries with a high rate of foreign bank penetration include Greece (77% of assets held by foreign banks), Luxembourg (89%), New Zealand (91%), Botswana (94%), Jordan (95%) and Bahrain (97%).

"franchise value" of domestic banks, which may encourage domestic shareholders to contribute new equity. For example, Mexico used to limit foreign ownership in domestic banks with a substantial market share.

Governments may also be reluctant to have their domestic banking systems dominated by banks from a single country, in case these banks suddenly cut their activities when faced with problems at home (eg Japanese banks in Asia, and possibly Spanish banks in Latin America), or are able to exert political pressure for favourable treatment. For this reason, the emerging economies may seek to "diversify" foreign owners. For example, the Saudi authorities have been selective and have licensed foreign banks from different parts of the world, with different management cultures, systems and technologies. Similarly, the authorities in China have been concerned about the impact of foreign banks on the competitiveness of domestic banks, and have sought to limit their market share by licensing banks from different countries, and by restricting their activities to doing business in foreign currencies only, or to doing business in local currency in only two cities. They have also ensured that banks have more familiarity with the local market by requiring them to have a representative office for two years before commencing banking operations.

6. Issues in systemic stability

The changing structure of the emerging economies' banking systems has implications for systemic stability and in particular the supervisory regime. This section addresses three specific issues that arise in this context. The first is how to license foreign banks - as branches or subsidiaries - and how to monitor their activities. The second is whether official "safety nets" such as deposit insurance should be extended to foreign banks. The third is whether bank consolidation poses risks for systemic stability, and how these risks can be addressed.

Branches versus subsidiaries of foreign banks

The presence of foreign banks generally leads the domestic supervisory authorities to upgrade the quality and increase the size of their staff in order to supervise the more sophisticated activities and new products that are usually introduced by foreign banks. This effect has been observed for example in Brazil and Hungary, and has often led the authorities to merge all financial sector supervisory activities in a single institution. Before they gain sufficient skills, however, supervisors may be exasperated by highly sophisticated foreign bank operations, not knowing what questions to ask, or not being able to convince the courts to withdraw the licences of institutions with suspect operations. This is a particular concern in the cases of rapid expansion of foreign (and increasingly domestic) commercial banks into non-bank financial services, including insurance, portfolio management and investment banking. In the Czech Republic, for example, banks were major actors in the failed voucher privatisation programme of the early 1990s, and often seemed to be at least one step ahead of the supervisors.[42]

From a supervisory perspective, foreign bank branches have some advantages. They are less likely to engage in connected lending; they are subject to additional oversight by foreign supervisors on a consolidated basis with the parent under the terms of the Basel Concordat; they are more likely to obtain financial support from the headquarters; and they may be subject to more rigorous accounting, disclosure and reporting requirements. In case of branch failure, however, foreign creditors would generally have an advantage over domestic creditors.

Local subsidiaries of international banks are stand alone entities with their own capital, and are supervised on a consolidated basis by the parent's supervisory authority only when the subsidiary is part of a holding company or a universal bank. Nonetheless, reputable international banks closely monitor the activities of their subsidiaries so as to preserve the parent's good name and solid standing.

[42] While trying to understand the structure of IPB, a foreign-owned bank mentioned above that eventually failed, supervisors at the Czech National Bank reportedly drafted a chart that covered an entire wall.

Country practices vary considerably on the issue of branches versus subsidiaries. Many countries in Asia allow foreign bank entry only via branches. Israel allows foreign banks to open either a branch or a subsidiary, while South Africa and central European and Latin American countries are much more flexible and leave the decision to foreign banks, supervising both entities on an equal, consolidated basis. The Reserve Bank of New Zealand recently announced a new regulatory policy under which three significant categories of banks will need to establish locally incorporated subsidiaries instead of operating as branches.[43]

Domestic supervisory authorities in emerging economies often have strong views on their choice of licensing policy for foreign banks. Many Asian supervisory authorities note that branches have the advantage of being backed by the full strength of their parent institution, including financial resources, supervision, and information technology. They also point out that, under the proposed Capital Accord, branches of banks incorporated in less risky countries will be able to obtain cheaper funds because they will be subject to lower capital weights, whereas subsidiaries will be covered by the ratings of their host country. Countries that favour subsidiaries stress their ability to better regulate, supervise and “ring fence” subsidiaries in periods of distress. Branches are more difficult to sell to third parties when problems arise. The countries concerned point out the widespread practice of restricting the operations of branches as a major weakness of branches from a supervisory perspective.[44] To ensure that the parent institution stands behind a subsidiary, host country supervisors often ask parent banks (and sometimes parent country supervisors) to provide “comfort letters”.

In summary, as most rules on foreign bank licensing were determined historically, usually under conditions of strict capital controls, they may no longer appear sensible in a world of free capital movement and supervision on a consolidated basis. The issue of branches versus subsidiaries could therefore be ill-posed. What matters most in practice is that, regardless of the legal form of their presence, foreign banks be initially licensed to carry out those activities that host country supervisors are familiar with and are able to monitor properly. At the same time, the licensing rules should not be too rigid, and supervisors should continuously upgrade their capacity to monitor banks’ activities on a consolidated basis.

Foreign banks and depositor protection

One of the most important supervisory issues is to determine whether depositors in foreign banks should receive the same degree of protection as depositors in domestic banks. With backing from their parents, foreign banks may have no need for lender of last resort loans and may not want to participate in deposit insurance arrangements. Arrangements for according (small) depositors priority in the event of a wind-up of a foreign bank, or arrangements for empowering the central bank to take over an impaired foreign bank, may be hard to apply in practice. There is also empirical evidence that, regardless of deposit insurance arrangements, foreign banks (especially large ones) are perceived as safer in host countries in times of crisis and this might suggest that they do not need to be subject to formal deposit protection arrangements. On the other hand, a strong argument in favour of extending deposit insurance to all banks is that, if foreign banks are authorised to collect deposits in the host country, their depositors should receive the same degree of protection as depositors of domestic banks. Otherwise, foreign banks could have an unfair advantage over domestic banks (not having to pay deposit insurance premia), and therefore an incentive to finance riskier activities with deposits collected in the host country.

In practice, virtually all emerging economies require foreign banks to participate in deposit protection arrangements on the same basis as domestic banks. Several countries (Israel, Saudi Arabia, Singapore, South Africa) do not have formal deposit insurance arrangements and therefore this issue does not arise. Hong Kong has in place only a priority payment scheme for small depositors, which

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[43] These categories are: (i) systemically important banks, (ii) banks that take a significant level of retail deposits and come from countries with legislation giving home country depositors a preferential claim in a winding-up, and (iii) banks that take a significant level of retail deposits but, in their home countries, fail to publish the full information depositors would need to assess financial soundness (see Reserve Bank of New Zealand, 2000).

[44] These restrictions usually take one of the following forms: restrictions on taking funds from domestic depositors, restrictions on territorial expansion, restrictions on funding in local currency, requirements for capital to be held in the domestic market or in the form of so-called “endowment capital”.

applies to all fully licensed banks. Indonesia does not have a deposit insurance scheme either but has nonetheless provided a blanket guarantee to all depositors in domestic banks. Thailand does not extend protection to depositors of foreign bank branches operating in the offshore market. As mentioned above, the need for equal protection for depositors has also prompted the Reserve Bank of New Zealand to require that certain foreign banks re-register as subsidiaries.

Competition, moral hazard and systemic stability

Bank consolidation in most emerging economies has not yet been associated with any marked rise in concentration, as most mergers appear to have involved smaller banks (Table 1).[45] One reason for this pattern could have been reluctance on the part of the authorities to sanction mergers between the largest banks, which can raise both competition and moral hazard concerns. Many industrial countries follow explicit policies that limit the concentration in the banking industry. For example, the Australian government announced in 1997 a "four pillars" policy under which mergers among the four major banks would not be permitted until the authorities were satisfied that competition had increased, especially in the area of lending to small businesses.

Central bankers at the meeting held differing views about the maximum desirable market share for a single bank. Some were uncomfortable about a bank having a market share of over 15% while others would not object to a single bank having a 30% share so long as they were confident it was very well managed and that the banking market remained contestable. In particular, the issue of market power should not be a concern in an open economy, as collusion is virtually impossible in such an environment. It has also been pointed out that the authorities could not prevent banks from growing bigger if there was intrinsic market advantage in size. Larger banks are better diversified, able to hire better managers and deploy better risk management, and therefore may be less likely to get into difficulties. The issue was, then, how to adapt supervisory techniques to large banks, not how to regulate their size.

The possible threat of excessive concentration, arising from risks that banks could exert market power and extract higher interest margins and fees, nonetheless seems to be alive, especially in some large Latin American countries and South Africa.[46] A related concern is the increase in concentration due to mergers of foreign parent banks. Recent experience in Chile, where the Spanish parent banks of two domestic banks with a combined market share of 28% have merged, is particularly instructive.[47] Although the two Chilean operations continue to be run separately, this merger raised three associated issues: Would the new institution become too big to fail? Would it pose any risk to the domestic payment system? Would a 30% market share set a benchmark for future bank mergers? The Chilean authorities adopted several measures to address these concerns. Banks that exceed a 20% market share are required to fulfil any of these conditions: higher capital adequacy ratio (up to 14%), further restrictions on liquidity requirements, and lower exposure to the interbank market. To increase competition, two new bank licences were issued and banks were allowed to offer interest on deposit accounts. Finally, domestic corporations were allowed to access international capital markets, where they can now issue peso-denominated bonds.

There is other evidence that concentration is not necessarily a good indication of whether a market is contestable, and that the more efficient banks both gain market share and earn higher profits. Burdisso and D'Amato (1999) note that in Argentina concentration is generally low in urban areas but very high in the remote rural areas. The banks operating in the more competitive urban markets tend to be more efficient but less profitable while those operating in the rural markets are less efficient but more profitable. But within each market the larger banks do not tend to be any more profitable.

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[45] By contrast, Group of Ten (2001) highlights the rise in concentration in the advanced economies, and notes it is particularly prevalent in off-balance sheet activities.

[46] South Africa's finance minister recently ruled against a merger between two of the three largest banks on the grounds that the merger would harm competition. See the paper by Marcus in this volume.

[47] As noted above, this issue is increasingly arising in central Europe as a result of cross-border mergers of parent banks from the European Union.

In the context of foreign bank entry, the authorities in many countries feel that their banking systems would not be viable without the presence of at least one strong domestic institution. However, if a local bank candidate for such a position was aware of the government's intention to secure a role for one domestic institution, its corporate behaviour could become affected by the perception that it was "too big to fail". In such circumstances, it might be preferable to foster a larger number of domestic banks. How large that number should be is not entirely clear. There are few countries with just two large domestic banks (Switzerland is one example), and an industry with only three large players could be unstable as one of the players would probably be pursued as a takeover target. In many small and medium-sized countries, this creates a dilemma. To try to keep, say, four domestic banks afloat as independent entities (Australia's policy) in order to preserve competition and avoid moral hazard may mean that each bank operates at sub-optimal scale given the size of the local market.

One approach could be to look carefully at any merger that could create a bank big enough to cause systemic problems if it were to fail. But how can one define systemically important banks in practice? One attempt to address this issue is the new policy proposal from New Zealand. This proposal defines systemically important banks as "banks whose failure could have a material impact on the financial sector as a whole and/or the wider economy."[48] The rationale for this approach is that if a systemically important bank were to fail, it is likely that the Reserve Bank would recommend that it be placed under statutory management. If the bank were incorporated locally, the manager would take control of the local bank, and all assets and liabilities on its balance sheet. With a locally incorporated bank, the Companies Act provides some protection from the transfer of assets out of the local bank in the period immediately prior to the failure. However, managing the failure of a bank incorporated overseas could be significantly more difficult, particularly if the statutory manager wished to reopen the bank quickly in order to limit the spillover effects to the wider economy.[49] For this reason, the authorities proposed to require all systemically important banks to incorporate locally.

[48] See Reserve Bank of New Zealand (2000). In terms of liabilities, systemically important banks are defined as having more than $10 billion in liabilities, or about 7½% of the banking system aggregate.

[49] If the bank was incorporated overseas, the statutory manager would have the power to take control of the assets and liabilities of the bank's New Zealand branch. However, in practice, it may be difficult to ascertain which assets belong to the branch. Furthermore, since there are no constraints on the transfer of assets between different branches of the same legal entity, branch assets could be transferred overseas between the date of the last disclosure statement and the date of failure, even if they are clearly related to the local branch.

Annex 1: Common causes of banking crises

Considerable attention in the financial crisis literature has been devoted to macroeconomic and institutional causes of banking crises. In particular, unsustainably high growth of lending to the private sector during much of the 1990s, poor prudential regulations and bank supervision, the entry of excessive numbers of new banks which spread the available pool of skilled bankers too thinly, and premature capital account liberalisation were identified as major contributing factors. However, some of the most common sources of banking crises are microeconomic in nature, including the following.[50]

- ***Excessive optimism*** about lending to rapidly expanding manufacturing firms and speculative property developers, whose booming output and rapidly rising collateral (ie property) values gave banks a false sense of security and allowed firms to become highly leveraged.
- ***Insufficiently diversified loan books*** made specialist banks overdependent on the particular region or sector served.
- Credit assessment by banks was often very poor, and banks often made loans to related ***companies or state-owned enterprises***, frequently at the behest of governments.
- ***Management incentives*** were often inappropriate: top management was unduly concerned with increasing the banks' overall size, and loan officers typically were rewarded for the volume of loans made rather than repaid.
- The risks from ***excessive maturity and currency mismatches*** were not fully appreciated. While banks' direct ***exposure to foreign exchange risk*** was limited by prudential regulations, banks neglected the exposure of their customers to such risks. As a result, when large devaluations occurred and weakened the ability of the corporate sector to service foreign currency loans, banks were suddenly faced with enormous credit risk.

[50] For a more detailed discussion of the causes of banking crises, see eg East Asia Analytical Unit (1999) or Goldstein and Turner (1996). Banking crises also have a generational aspect: bankers who survive a crisis tend to be more conservative, but their successors gradually seek more risk.

Annex 2: Evidence on the motives for bank mergers in industrial countries

The motives for bank mergers identified in the literature on industrial countries fall under four broad headings: *cost benefits* (economies of scale, organisational efficiency, cost of funding, risk diversification, economising on capital); *revenue benefits* (economies of scope, making large deals, enhancing monopoly rents); *economic conditions* (mergers after crises or during an upswing of the business cycle); and *other motives* (private managerial benefits, defence against takeovers, etc). Besides banking crises, the following merger motives seem relevant for the emerging economies.

Economies of scale. Banks with similar operations often have an incentive to merge in order to eliminate overlapping branches and pool back office, administrative and marketing functions. Empirically, the gains seem to be particularly large from the pooling of marketing functions.[51] There is also evidence of productivity gains from the wider use of new information technology, such as internet and telephone banking, which favours larger institutions because the initial setup costs are too large compared to the scale of operation of smaller institutions.

Economies of scale have historically been the main underlying cause of consolidation in the banking industry.[52] However, merging to realise cost benefits is not always trouble-free: difficulties can (and do) arise in reorganising management, merging institutional cultures, linking computer systems, dismissing excess staff, etc.[53] In particular, the cost of IT expenditures is often underestimated.

Recent empirical evidence on gains from mergers is therefore often weaker than the claims of the merging institutions.[54] Some empirical studies have also found that economies of scale could be exhausted at relatively low levels.[55] The size benefits could also be smaller in the emerging economies as they are less likely to enjoy the same degree of managerial depth and are more likely to face higher communication costs between different sites and branches.

Mergers allow ***diversification of credit risk***, which may be particularly relevant for small urban and rural banks that service relatively narrow segments of corporate customers and households. Larger banks are in a better position to develop and use new, more complex financial instruments such as derivatives, and to put in place sophisticated risk management techniques.

Improving organisational efficiency. Mergers are frequently motivated by the desire to reduce inefficiencies in organisation, staff motivation and other non-market transactions internalised within firms. Such inefficiencies are estimated at about 20-25% of the costs in the banking industry, suggesting that there exists a significant potential for achieving cost efficiencies through mergers.[56] The literature also suggests that acquiring banks tend to be more efficient than target banks, but the spreading of better techniques to less efficient banks is not an easy process.

Cheaper funding costs. Larger banks can generally raise funds more cheaply, partly because markets view such banks as safer (due to better risk diversification), and partly because of implicit beliefs that governments cannot let big banks fail. Data in Table 6, which compares the average "stand alone" credit ratings of large and small banks with the same inherent strength, suggest that the larger banks tend to be rated more highly than their inherent strength would justify. In other words, markets do believe that large banks are more likely to obtain government assistance in a crisis than small banks.

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[51] Kane (1999) argues that economies of scale (as well as scope) in marketing far outweigh those in service production and operations, and cites Citigroup as a global brand name on a par with Coca Cola and McDonald's.

[52] See Cameron (1991).

[53] Rhoades (1998) finds that the most frequent and serious problem was unexpected difficulty in integrating data processing systems and operations.

[54] Rhoades (2000) shows that the number of bank branches in the United States has increased over the past two decades despite a large number of bank mergers and the spread of ATMs and e-banking. See also Berger et al (1993), Borio and Tsatsaronis (1996), White (1998), Berger et al (1999) and De Nicolo (2000).

[55] McAllister and McManus (1993) found increasing returns to scale up to about $500 million in assets and constant returns thereafter. Berger et al (2000) found that average costs were usually minimised somewhere between $100 million and $10,000 million in assets, considerably lower than the assets of the world's largest banks. IMF (2001) found some evidence of scale economies for banks in emerging economies with assets of more than $1 billion but less than $10 billion.

[56] See Milbourn et al (1999), Berger et al (2000) and Allen and Rai (1996).

Economies of scope. Banks with complementary businesses - or banks and non-bank financial institutions - may have an incentive to merge in order to realise synergies from offering a wider range of financial services. For example, banks with a strong corporate customer base may wish to expand into retail business, while retail banks may wish to become a "one-stop financial shop" offering insurance, asset management and other services. In *Mexico*, Banamex has developed a number of strategic partnerships to distribute insurance products, conduct telephone banking and facilitate e-commerce. Cost savings can be expected from using information on existing customers to market other financial products, more efficient use of branches and physical inputs, extending a reputable brand name across a wider range of products, sharing investment departments and account service centres, etc. Merging banks with other financial institutions may also reduce risk through diversification.[57]

Another recent trend has been the development of *alliances of banks*, under which common processes are outsourced to the member of the alliance that can carry out such processes most efficiently.[58] Such an alliance was recently announced in Hong Kong: 10 banks are sharing the costs of developing a pension product which they will market through their branches. This approach seems particularly promising in view of the growing synergies between banking and information technology.

Mergers to explore economies of scope may pose considerable challenges for management, as they bring together staff with different institutional backgrounds and different approaches to risk management. Supervisory concerns are also greater: the health of financial conglomerates is harder to assess; banks face conflicts of interest (eg engaging in underwriting securities issuance for companies already indebted to the banks); and the process of working out a troubled conglomerate can be more disruptive for the markets. Empirical studies have so far found economies of scope to be relatively small.[59] At the same time, countries that impose more restrictive regulations on banks' non-bank financial activities were found to have higher interest margins, less well developed banking sectors and securities markets, lower levels of industrial competition, and a significantly higher probability of suffering a major crisis.[60]

[57] Boyd et al (1993) concluded that mergers of banks with insurance companies in the United States had a potential for reducing risk, but mergers with securities or real estate firms actually increased risk.

[58] See White (1998) and Thakor (1999).

[59] See Berger et al (2000).

[60] See Barth et al (2000).

Annex 3: Additional background tables

Table A1

Summary of banking systems in individual economies, 1999

	DTIs (number)	Large banks[1] (Number)	Assets of DTIs (US$ bn)	Assets of DTIs (% to GDP)	Concen-tration[2]	Banks' capital ratios: Simple capital ratio	Banks' capital ratios: Risk-weighted: actual (required)
China		14			75		(8)
India	300	17	253	60	42	...	11.5 (8)
Russia		5		16[3]	80		12.0 (8)
Hong Kong	285	18	870	550	45[3]	...	19.0 (8)
Singapore	217	5	693	816	...	20.5	20.0 (12)
Indonesia	9,556[4]	4	142	90	62	– 4.0	– 8.1 (4)
Korea	3,738	12	915	225	33	4.5	10.8 (8)
Malaysia	1,448	14	681	861	32	9.8	11.8 (8)
Philippines	1,067	12	74	100	39	15.4	17.5 (10)
Thailand	4,928	6	247	199	94	16.8	12.4 (8.5)
Argentina	116	8	126	45	46	12.9	14.0 (11.5)
Brazil	1,542	14	489	92	51	9.4	15.8 (11)
Chile	30	5	48	71	54	5.8	13.5 (8)
Colombia	81	3	43	49	32	10.8	10.6 (9)
Mexico	36	3	165	34	68	9.1	16.0 (8)
Peru	52	3	21	40	71	9.0	12.0 (9)
Venezuela	78	3	23	22	62[5]	13.6	14.0 (8)
Czech Republic	42	1	70	182	66	5.8	13.6 (8)
Hungary	254	2	31	64	51	8.6	15.0 (8)
Poland	858	6	88	56	48	8.5	13.1 (8)
Israel	45	6	166	172	93	5.1	9.2 (9)
Saudi Arabia	11	10	109	77	75	10.4	21.0 (8)
South Africa	57	7	118	90	85	8.7	11.0 (8)

Note: DTIs: Deposit-taking institutions; see footnote 6 in Table 1 for definition.

[1] Number of banks in the world's top 1,000. [2] Share of total DTI assets held by top five. [3] Banking groups. [4] Includes 9,392 rural banks but excludes finance companies. [5] Share of total DTI assets held by top four.

Sources: Central banks; World Bank; *The Banker*, July 2001.

Table A2

Banking and the internet

	Percentage of bank customers using online banking (late 1999)	**Internet users as a percentage of population (1999)**	**Personal computers per '000 persons (1999)**	**Internet hosts per '000 persons (July 2000)**
China		1	12	0
India	<1	0	3	0
Russia		2	37	2
Hong Kong	<2	36	298	18
Singapore	5	24	437	39
Indonesia	0	0	9	0
Korea	3	23	182	10
Malaysia	<1	7	69	3
Philippines	<1	1	17	0
Thailand	0	1	23	1
Argentina	3	2	49	5
Brazil	4	2	36	4
Chile	10	5	67	3
Colombia	<5	2	34	1
Mexico	4	2	44	5
Peru		2	36	0
Venezuela		2	42	1
Czech Republic		7	107	13
Hungary	<1	6	75	13
Poland	<1	5	62	7
Israel	<10	13	246	26
Saudi Arabia	<1	1	57	0
South Africa		4	55	4
Memo:				
Finland	*29*	*41*	*360*	*136*
Sweden	*31*	*41*	*451*	*70*
United States	*6*	*27*	*511*	*…*
United Kingdom	*6*	*21*	*303*	*35*
Germany	*12*	*18*	*297*	*23*

Sources: Central banks; Claessens, Glaessner & Klingebiel (2000, 2001); World Bank, *World Development Indicators,* 2001, Table 5.10.

Table A3

Rival sources of finance for the non-bank private sector[1]

	Borrowing from domestic banks[2]		Borrowing from international banks[3]		Borrowing from bond issuance[4]	
	1995	**2000**	**1995**	**2000**	**1995**	**2000**
China	88	125	10	6	15	26
India	23	27	5	5	23	29
Russia	8	12	14	14	1	11
Hong Kong	144	154	368	118	12	23
Singapore	101	100	338	239	55	25
Indonesia	53	21	24	27	2	7
Korea	51	74	17	14	44	73
Malaysia	84	100	21	23	53	75
Philippines	39	45	11	22	3	18
Thailand	98	86	55	23	4	10
Argentina	20	23	13	17	10	25
Brazil	31	30	10	16	1	7
Chile	53	67	21	26	1	11
Colombia	18	19	11	15	1	8
Mexico	37	12	26	10	12	16
Peru	16	26	9	13	0	0
Venezuela	9	10	15	11	4	9
Czech Republic	75	52	15	19	10	19
Hungary	24	36	18	30	57	49
Poland	18	30	6	10	11	18
Israel	70	87	5	8	1	4
Saudi Arabia	25	29	11	16	0	0
South Africa	58	68	10	15	2	4

[1] As a percentage to GDP; end-year data. [2] Domestic credit to the private sector. [3] Liabilities to BIS reporting banks. [4] Domestic and international securities on issue.

Sources: IMF, *International Financial Statistics*; national data; BIS statistics.

Table A4

Performance of banks by ownership

1994-99 average

Return on average assets	**Domestically owned**	**State-owned**	**Foreign-owned**
Korea	– 0.1	– 1.2	– 0.9
Malaysia	0.6	1.3	1.2
Philippines	1.5	1.6	1.4
Thailand	– 1.6	0.7	– 0.7
Argentina	– 1.1	0.6	– 0.5
Brazil	3.2	– 0.5	2.7
Chile	1.2	0.8	1.1
Colombia	– 0.2	– 0.4	– 0.4
Mexico	0.2	–	– 0.9
Czech Republic	– 1.7	– 2.2	0.8
Operating costs[1]			
India	2.4	2.8	3.0
Korea	3.3	3.0	1.7
Malaysia	1.8	–	3.5
Philippines	3.6	4.0	4.1
Thailand	4.1	3.1	3.1
Argentina	7.5	8.1	8.4
Brazil	7.1	4.6	8.6
Chile	8.0	3.6	4.5
Colombia	4.9	7.8	10.0
Mexico	4.3	–	4.8
Czech Republic	5.0	5.7	2.5
Interest expense[2]			
India[3]	7.8	6.2	6.8
Korea	8.2	12.0	33.3
Malaysia	5.8	–	4.9
Philippines	6.2	9.6	9.4
Thailand	8.1	9.3	9.4
Argentina	6.2	9.6	9.4
Brazil	27.0	53.2	51.0
Chile	11.0	9.9	10.8
Colombia	28.5	15.2	14.2
Mexico	14.6	–	27.2
Czech Republic	8.3	8.0	8.8

[1] As a percentage of total assets. [2] As a percentage of total deposits. [3] 1998-99. [4] 1998-99.

Sources: Central banks; Fitch-IBCA.

Table A5

Mergers and acquisitions in banking

	Number		Value (US$ bn)	
	1990-96	**1997-99**	**1990-96**	**1997-99**
India	0	2	0	…
Hong Kong	0	0	0	0
Singapore	1	5	18	146
Indonesia	14	15	…	…
Korea	0	11	0	323
Malaysia	2	21	1	17
Philippines	14	6	na	7
Thailand	1	2	0	39
Brazil	8	38	1	84
Chile	6	6		1
Colombia	3	11	1	4
Mexico	5	7	7	22
Peru	5	8	0	1
Czech Republic	1	6	0	0
Hungary	3	4	4	3
Poland	124[1]	580[1]	…	…
Saudi Arabia	0	2	0	7
Memo:				
Europe	*799*	*427*	*95*	*231*
United States	*1,607*	*970*	*190*	*507*

[1] Mainly between cooperative banks.

Source: Central banks; Group of Ten (2001), Tables A.4 and A.5.

Table A6

Efficiency of the banking system, 1999

	DTIs per million persons	DTI branches per million persons	DTI assets ('000 US$ per person)	Number of DTI staff per branch
India	0.3	68	0.3	16[1]
Hong Kong	42	261	129.0	44
Singapore	69	160	219.2	61
Indonesia	48	76	0.6	10
Korea	80	215	19.7	12
Malaysia	65	127	30.7	34
Philippines	14	90	1.0	…
Thailand	80	76	4.0	26
Argentina	3	119	3.5	24
Brazil	9	11	2.9	28
Chile	2	92	3.3	30
Colombia	2	93	1.0	21
Mexico	0.4	84	1.7	16
Peru	2	10	0.9	94
Czech Republic	4	208	6.8	25
Hungary	256	118	3.1	23
Poland	22	312	2.3	14
Israel	8	177	27.8	32
Saudi Arabia	0.5	60	5.3	18
South Africa	1.4	60	2.8	50
Memo:				
Australia	*18*	*321*		*52*
Euro area	*23*	*557*		*13*
Japan	*5*	*180*		*23*
Switzerland	*56*	*471*		*32*
United Kingdom	*9*	*242*		*25*
United States	*79*	*288*		*26*

Note: DTIs: Deposit-taking institutions; see footnote 6 in Table 1 for definition.

[1] 1991.

Sources: Central banks; Group of Ten (2001).

Table A7

Cyclicality of lending by ownership of banks

Percentage change in total customer loans in the latest recession period (in brackets); in real terms

	Domestically owned	State-owned	Foreign-owned
Korea (1998)	– 2	– 18	– 27
Malaysia (1998)	– 3	– 1	2
Philippines (1997-98)	– 12	2	– 15
Thailand (1996-98)	8	10	7
Argentina (1999)	6	5	8
Brazil (1997-98)	15	24	2
Chile (1999)	17	23	2
Colombia (1999)	– 38	– 8	– 3
Mexico (1995)	– 17	–	6
Czech Republic (1997-99)	6	– 15	23

Note: The selected bank samples might not be representative for the groups.

Sources: Central banks; Fitch-IBCA.

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The banking industry in Chile: competition, consolidation and systemic stability

Antonio Ahumada and Jorge Marshall[1]

1. Introduction

Recent decades have witnessed remarkable changes in the banking industry around the world. Chile has been no exception. Higher penetration, consolidation and international integration have changed the banking industry structure. Many aspects of this process have important implications for the way the central bank accomplishes its work, particularly as regards ensuring financial system stability.

This paper has three main sections. Section 2 reviews the recent evolution of the Chilean banking industry in terms of growth, consolidation and internationalisation. Section 3 analyses the main challenges posed by banking consolidation and the reaction of the central bank. Finally, conclusions and closing remarks are presented. The analysis in this paper mainly considers developments since 1992, because changes in the Chilean banking structure before 1992 were strongly aimed at resolving the 1982-83 banking crisis, including repayment of subordinated debt.

2. Main trends

The Chilean banking industry experienced three important changes in the 1990s: (i) strong growth and an increase in efficiency; (ii) market consolidation and higher concentration; and (iii) international integration and an increase of foreign ownership. A comprehensive analysis needs to consider these developments as interrelated processes, since considering each tendency in isolation may give a misleading impression of the origin, direction and challenges of the transformation of the banking industry that was under way.

2.1 Penetration and efficiency

Penetration and efficiency are two features of the recent development of the Chilean banking industry. Penetration, measured by loans and deposits as a percentage of GDP, is far more advanced in Chile than in any other country in Latin America. Banking loans amounted to 70% of GDP and total deposits to 61% of GDP in 2000. These figures compare with 54% and 47%, respectively, in 1990. However, current levels of financial intermediation in Chile, while relatively high in the region, are still low by global standards.[2]

A related tendency is the increase in efficiency. Operating efficiency, measured as the percentage of expenses against gross interest margin, improved from 61% in 1992 to 58% in 2000, whereas gross interest margin went from 5.4% to 3.6% in the same period (Table 1). From these figures it can be computed that expenses over total assets went from 3.3% in 1992 to 2.1% in 2000, which can mainly be attributed to increased efficiency. At the same time, net margins (gross margins minus expenses over total assets) went from 2.1% in 1992 to 1.5% in 1999, reflecting increased competition during the period.

Interest spreads of Chilean banks are low by regional standards. Large banks in Chile exhibit gross interest margins of around 4.5%, lower than large banks in Argentina and Brazil, which fall within the

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1 The views expressed are those of the authors.

2 See Table A1 of the overview paper in this volume.

range of 5% to 10%. These differences reflect low interest rates and inflation and possibly higher competition in financial markets.

In addition, labour productivity, measured as operating income per employee, shows an increase of 110% between 1992 and 1999 (at 1998 prices). Investment in new technologies has had a favourable impact on banking efficiency, although this impact is difficult to measure.

Table 1

Banking penetration and efficiency, 1992-2000

	Loans (% of GDP)	**Expenses (% of operating margin)**	**Operating margin (% of total assets)**	**Return on equity (%)**
1992	54.0	61.2	5.4	17.0
1993	59.2	58.6	5.5	20.6
1994	56.7	63.8	4.9	19.1
1995	59.9	64.2	4.4	13.9
1996	65.1	63.5	4.5	16.6
1997	70.1	63.2	4.1	14.8
1998	71.5	59.4	4.6	12.4
1999	73.4	58.9	4.0	9.8
2000	70.0	58.3	3.6	12.7

As indicated by these figures, banks are functioning with high penetration and at an increasing level of operating efficiency relative to their asset bases. These trends are the result of a long and stable period of economic expansion and sustained economic stability, which forced banks to be disciplined. Significant participation of foreign banks in the domestic market has also enhanced competition and efficiency. A stable and strong banking system is in a better condition to accommodate structural changes, as higher penetration lowers lending risk.

2.2 Consolidation

A second trend of the banking industry in the 1990s was increased concentration. The Herfindahl-Hirschman index (HHI) rose 200 points between 1992 and 2000. However, this index had declined before 1992 as a result of Banco del Estado, a state-owned commercial bank, and Banco de Chile, the largest private bank, simultaneously reducing their market share. Market share of the five largest banks (C5) shows the same pattern in the 1990s, increasing from 52% in 1992 to 61% in 2000.

Even considering the recent increase, the concentration level in Chile is moderate if compared with small developed and emerging economies. For instance, average C5 of Latin American countries, excluding Chile, was 61% in 1999. Small OECD countries also show high concentration. For example, Denmark, the Netherlands, Portugal, Sweden, and New Zealand have a C5 market share above 80%. Finally, in a sample of 15 major US metropolitan statistical areas, the average C5 share is around 65%.[3]

This evidence suggests that, depending on the definition of relevant market boundaries, high concentration ratios are frequently observed. Banks are becoming less specialised entities and traditional boundaries between market segments are tending to disappear. Moreover, customers

[3] See also Table A1 of the overview paper in this volume.

favour obtaining most services from a single institution, as they can reduce search and transaction costs. Consequently, in relatively small markets banks have incentives to diversify their services to acquire a dominant position. In this environment, market forces encourage higher concentration.

The total HHI increase in Chile between 1992 and 2000 is the result of a number of mergers, but it remains well below the levels defined in US Bank Merger Screening Guidelines as a trigger for further examination. These guidelines establish that if post-merger market HHI is over 1800 points and the increase is over 200 points, then the merging parties should be prepared to provide qualitative information that will mitigate possible anticompetitive behaviour. This relates to geographical market definition, impact on medium-sized and small businesses, and supply of specialised products that very few other banks would be able to provide after the merger.

Two forces driving the increase in concentration are: internal growth and external moves, such as mergers and acquisitions. Internal growth of large banks reflects competitive advantages of size, whereas growth dominated by external factors is consistent with the existence of excess capacity or inefficiencies derived from an excessive number of banks. In such case, mergers and acquisitions bring benefits through economies of scale.

HHI and C5 concentration measures show a U-shaped curve in the 1990-99 period. The turning point takes place around 1994. Changes before that year mostly reflect the efforts to resolve problems inherited from the 1982-83 financial crisis. Concentration increased in 1995 due to external factors, as Banco O'Higgins acquired some small foreign banks. Then in 1996 Banco Santander Chile (6.8% of assets) merged with Banco Osorno (6.5%) and Banco O'Higgins (6.8%) merged with Banco Santiago (8.5%). These operations produced noticeable changes in market structure as HHI went from 731 in December 1995 to 913 in December 1997, the largest two-year increase within the analysed period. Apart from these acquisitions, average growth for merged banks was lower than the growth rate of other banks with similar attributes, suggesting that endogenous forces tended to decrease the concentration level.

Table 2

Banking consolidation, 1992-2000

	HH index (total loans)	C5 (loans plus investment)	Private banking institutions	Non-banking institutions
1992	704	51.7	35	4
1993	722	51.2	33	4
1994	673	50.9	32	4
1995	731	50.8	30	3
1996	799	55.5	29	3
1997	913	61.0	28	3
1998	922	61.7	28	3
1999	926	62.5	28	1
2000	904	60.8	27	1

Evidence from the banking sector in the United States supports the hypothesis that external forces, through mergers and acquisitions, largely explain the consolidation and concentration trend in the 1990s (Stiroh and Poole, 2000). Excess capacity in this market is considered as a consequence of large-scale deregulation on interstate and intrastate branching, technological innovation in distribution networks (ATM and online banking) and new financial products. In contrast, the Chilean regulatory environment has been stable since the 1980s, but globalisation and technological innovation are forces that produce analogous results. The strategy of large banks has been to grow in dynamic segments of the market.

Another feature of consolidation is the emergence of a single category of bank, providing an increasingly wide range of financial services. The number of non-bank institutions in loan and deposit activities (finance companies) declined from four in 1992 to one in 1999. This process has also changed the structure of bank income, with an increase in the portion of fee income and earnings from subsidiaries at the expense of traditional intermediation earnings. The latter went from 84% of net income in 1995 to 77% in 1999.

2.3 International integration

International financial integration was a clear trend in the 1990s, and was reflected in both volume and composition of private sector external financing, which grew from around 20% of GDP in 1990 to nearly 40% of GDP in 2000. A substantial part of this increase was in the form of bonds and ADRs placed by domestic companies, mainly in the second half of the decade. External loans to the banking system also acquired greater relevance during this period.

It is important to note the considerable increase in domestic investors' holdings of international assets. Private sector direct and portfolio investment abroad went from a tiny 2% of GDP in 1992 to 36% of GDP in 2000. Chilean banks have started to engage in commercial activities in the region, representing 17% of the stock of domestic investment abroad. Domestic pension funds have played an important role in this process, mainly after the 1997-98 financial turmoil. Financial institutions hold the bulk of international investment. In all, these structural changes are forcing the banking system to operate in a more open and competitive environment.

Another defining characteristic of international integration in banking is the high level of foreign ownership and control. Chile has no restrictions on foreign ownership in financial markets as it applies national treatment to foreign investors. Of 28 private banks, 10 are domestically controlled while foreigners control 18 institutions. As of June 2000, domestic private banks represented 35% of the financial system's assets and foreign private banks 53%. Out of this share, BSCH and BBVA control around 55% of total assets. Approximately 30% of foreign bank ownership is by American banks.

Table 3

International integration, 1992-2000

	External financing to private sector (% to GDP)	**Private investment abroad (% to GDP)**	**Asset share of foreign banks (% of total assets)**	**Foreign banking institutions**
1992	7.1	1.5	20	22
1993	9.9	2.5	19	20
1994	12.9	4.5	20	19
1995	13.2	4.5	22	17
1996	18.0	5.7	27	17
1997	25.6	8.8	29	17
1998	29.9	15.8	32	17
1999	34.9	29.4	53	19
2000	36.2	35.6	56	19

Although the presence of foreign banks is usually related to innovation and productivity increases, domestic banks show standards of development and efficiency similar to foreign banks. For instance, average asset quality, measured by non-performing loans as a percentage of total loans, has been comparable for domestic and foreign banks (0.7% and 0.9% for the 1992-99 period). Expenses over total assets evolved along similar lines during this period, with slightly better performance for foreign banks (2.7% for domestic banks and 2.3% for large foreign banks). But undoubtedly the significant presence of foreign banks has enhanced market competition.

Market strategies among foreign banks may be put in two categories: multiproduct and niche competition. Banks that follow the first strategy compete in all segments and seek a significant market share. This is the case of BSCH and BBVA. In the second group, there are some regional foreign banks that compete in trade and related services generated by MERCOSUR, like Banco Nación Argentina and Sao Paulo. Also in this category are some foreign banks specialised in financial trading of securities, foreign exchange, interbank loans and money market dealing, with limited participation in domestic loans.

3. Challenges of banking consolidation

The Chilean Central Bank Act establishes that its basic objectives are to safeguard currency stability and the normal functioning of domestic and international payments. These are permanent objectives, although how they are implemented can be significantly affected by the changing economic and financial structure. The relevance of implementation lies in the fact that financial development has a clear positive effect, but at the same time domestic and international financial disturbances have been an undesirable by-product of the process.

New challenges that arise from international financial integration and capital mobility have received considerable attention. The consequences of banking consolidation for the central bank mission have also received increasing consideration. This section addresses the latter issue using three questions. First, to what extent should banking consolidation be a concern for central banks or financial market regulators? Second, are central bank objectives a complement to that of reducing the risk that may arise from banking consolidation? Third, what are the implications for the future? These questions are addressed on the basis of recent Chilean experience.

3.1 Banking consolidation concern

From the central bank standpoint, the main concern over banking consolidation is its effect on systemic risk and hence on financial system stability. There might also be some negative consequences of consolidation for the competitive environment. But ultimately, the degree of competition in the banking industry strongly depends on the quality of the regulatory and supervisory framework, international financial openness, degree of penetration of the banking sector in the economy and overall economic stability. However, questions remain about the effect of banking concentration on systemic risk, financial stability and monetary policy management. This connection also depends on the specific circumstances in each economy and may evolve with some of the trends that have characterised the recent transformation of financial markets and with the policies of regulators and central banks.

The latter subject was highlighted in Chile after the merger of Banco Santander and Banco Central Hispano in Spain in 1999. These two banks controlled the largest and fourth largest banks in Chile, in terms of percentage of total loans. A merger of the two banks in Chile appeared likely, which would have created the largest bank in the domestic market, with a market share of around 27%, well ahead of the 14% share of the second largest bank. In the case of a merger, the market share of the five largest banks (C5) would have gone from 63% to 69%.

The Banking Act does not contemplate specific mechanisms to deal with a major bank merger. The Superintendency of Banks (SBIF), when examining a merger or large acquisition considers several issues, like solvency and other attributes of investors, but not market competition or concentration. The joint control and possible merger of these two banks in Chile generated an investigation by the Competition Authority and an active public debate with the participation of legislators, especially from the Finance Committees of both chambers of Congress.

In dealing with this operation, the SBIF consulted the central bank's view on the legal, economic and financial consequences of merger of Banco Santander and Banco Santiago. The central bank based its response on financial stability and monetary policy management and, given the economic circumstances, concluded that on balance the merger was not desirable. The central bank's line of reasoning centred on three effects of an increase in concentration: higher systemic risk in the banking industry, transition risk and difficulties for monetary policy management.

The effect of concentration on systemic risk depends, in turn, on the specific characteristics of the banking industry. As a general rule, a higher degree of concentration is related to larger systemic risk, because "too big to fail" conditions may expand the safety net and increase the risk of the payment system. But this connection is conditional on other characteristics of the banking sector and the international integration of the domestic financial market, with less integration leading to a stronger effect of concentration on systemic risk. In addition, if higher banking concentration coincides with concentration in the countries owning subsidiary banks, there may also be third-country risk in the domestic market.

Transition risk relates to dynamics of consolidation and industry restructuring. The basic idea is that systemic risk increases with the magnitude of changes in concentration, apart from its long-term level. Rapid consolidation, through accelerated growth or acquisitions, tends to disrupt some institutions and threatens financial system stability.

The third point in the central bank's response concerned the difficulties that concentration may create for monetary policy management. This assessment is related to specific characteristics of managing peso liquidity and the exchange rate band system in Chile.

Soon after this episode, the Banking Act was amended to explicitly cover mergers and acquisitions. The new provisions state that mergers or acquisitions involving a "significant market share" must have prior approval of the SBIF, which would only be able to reject the merger petition with the consent of the central bank. This approach confers limited ability to stop mergers outright. However, the new provisions also give the SBIF the option to stiffen its prerequisites for banks' mergers. Specifically, the SBIF could mandate that banks comply with one or more of the following: (i) maintain a higher weighted capital/asset ratio, up to 14%; (ii) meet a higher liquidity requirement; or (iii) limit the balance of interbank loans to a maximum of 20% of the bank's capital. A key aspect of this legislation is the percentage equivalence of "significant market share", which was set by the SBIF at 20% of total loans. However, a market share between 15% to 20% also requires the authorisation of the SBIF, and the bank is required to maintain a Basel capital requirement of at least 10% for a period of one year.

In sum, banking consolidation may have adverse consequences on systemic stability and monetary policy management. The magnitude of this effect depends on the quality of the regulatory and supervisory framework, international financial openness, degree of penetration of the banking sector in the economy and its capital base and overall economic stability.

3.2 Central bank's policies and banking consolidation

Central banks need to adapt their policy framework to the new challenges posed by economic and financial developments, including financial globalisation and technological innovation, which are at the root of banking industry restructuring. So an important aspect for the aforementioned assessment of banking concentration is to determine whether pursuing the central bank's objectives in the new environment is complementary to the purpose of reducing risk of banking consolidation.

Three developments in the Central Bank of Chile's policies are important to address: exchange rate regime; international financial integration and financial market development.

(a) Monetary policy and exchange rate regime

In September 1999, the central bank abandoned a prolonged period of exchange rate bands and opted for a floating regime. This decision was taken to improve the capacity of the economy to absorb foreign shocks and give more independence to monetary policy management. The central bank will only intervene in exceptional circumstances and give detailed reasons for doing so.

Direct consequences of this new regime have been less foreign exchange market interaction between the central bank and commercial banks and the regulation of peso liquidity following monetary policy considerations. These two effects point to a lower impact of banking concentration on monetary policy management, as there is less scope for exchange rate speculation against the central bank.

On the other hand, the floating regime creates incentives to increase private sector international assets, deepen the exchange rate market and widen the use of risk coverage mechanisms. Steps to develop domestic financial and foreign exchange markets have accompanied these market trends.

Again, these processes reduce the effect of banking concentration on monetary policy management as the exchange market widens. For example, the increase of private international assets leads to a reduction of bank's percentage of private international assets. This, in turn, means a decrease in the incidence of banking concentration on the foreign exchange market.

Another innovation in monetary policy management is an electronic procedure for open market operations, starting in 2001. This system maximises the market's competitive potential and allows for a prompt reaction by the central bank if any anticompetitive conduct in the interbank liquidity market is discovered.

(b) International financial integration

International financial integration is a vehicle with which to deepen the domestic financial market, to buffer economic shocks and to maintain the normal functioning of external payments. Central bank policies on prudential regulation in this area follow the same lines as the exchange rate regime. Currently, there are no restraints on capital account transactions other than prudential regulations for banks and institutional investors. Since the reserve requirement reduction to 0% in 1998, several measures have been taken in the same direction. First, the minimum one-year period for foreign investments to remain in the country before repatriation of the principal was removed. Second, peso-denominated foreign debt instruments were introduced. Third, banks' use of interest rate and credit derivatives was extended both domestically and abroad, especially for hedging on fixed income portfolio and commercial loans. These instruments may be denominated in domestic or foreign currency. Fourth, the percentage of international investment allowed for pension funds and insurance companies has been steadily increased.

The links between international financial integration and the lower risk of banking consolidation are unmistakable. The former cuts financial costs, increases market competition, eases liquidity restrictions in difficult times, diversifies domestic risk and reduces economic dependence on export prices. Together with prudential regulation, these effects lower the risk of banking concentration.

In addition, international financial integration reduces the small market size effect and hence the impact of concentration in the domestic market. Corporations face more diversified financing alternatives and there is less freedom to exercise market power.

Chile joined the General Agreement on Trade in Services promoted by the WTO. In this setting, Chile committed to a certain level of openness in financial services, which is nonetheless a minimum expected to expand further as we embark on future negotiations with different trade areas.

(c) Financial sector development

An important element of central bank policies is aimed at strengthening the domestic financial system by improving the regulatory framework, comprising good supervisory practices and stringent disclosure requirements. This framework provides the disciplinary function that market failure hinders, especially managing risk. Recent steps in this direction include measures to monitor diverse sources of risk better, as banks began embarking on more sophisticated activities. These new guidelines incorporate standards for interest rate, currency and liquidity mismatches for the banking sector.

Application of these norms checks the risk increase associated with new financial products, enabling banks to use a much wider set of contracts than in the past, which also helps to deepen the financial market. Regarding the use of more instruments, banks have been authorised to carry out futures, forward and swap transactions in domestic and foreign currencies and interest rates. Domestic banks are now allowed to extend their international operations, including investment and loans abroad.

These measures put domestic banks on the same footing as foreign banks that could perform these operations from their international headquarters. Moreover, a more complete market strengthens competitive forces, lowering the potential market power. More equitable competition in the banking industry reduces the portion of consolidation that does not correspond to technology advances or genuine competitive advantages, but to unevenness in regulatory norms. Aligned with this effort to produce equitable competition is the new treatment of licence applications, enacted in 1997, which is based on objective parameters and evaluations.

Finally, it is important to mention that the central bank is currently implementing an ambitious reform of the payment system, in order to enhance efficiency in transaction management. Improving payment systems increases financial system efficiency as costs reflect more appropriately the risk of payment and settlement transactions.

3.3 Implications for the future

Judging by existing trends and changes in the banking industry, consolidation is likely to continue in financial markets. Among several consequences of this process, however, the most important concerns from a central bank's perspective are the effects on systemic risk and expansion of the safety net. Some of these concerns can be partially alleviated by improving the operational and supervisory approaches to international financial integration and financial sector development, which are among the permanent objectives of the central bank.

However, since banking consolidation is an ongoing process, additional consideration needs to be given to better understanding its consequences and policy implications. Particularly important in this regard is the promotion of efficiency in financial markets. Prices of financial products should reflect their cost, including the associated risk, in order to increase transparency and efficiency. The possible spread of cross-subsidies, asymmetric information situations and lack of transparency become particularly important, and difficult, when systemic risks and the safety net are implicated. Moreover, trying to maintain competitive equity in financial markets makes for genuine competition among institutions reducing the adverse consequences that banking consolidation may have. Levelling the playing field between domestic and foreign banks is particularly important for a competitive setting.

A further topic regarding the future implications of consolidation is banking organisational design and the need for consolidated supervision of financial conglomerates. In particular, capital adequacy requirements need to be expressed on a consolidated basis in order to prevent double or multiple gearing. This would address part of the concerns about safety net expansion to non-bank subsidiaries.

These principles will serve as a basis for designing new policies to strengthen the financial system in the presence of a sustained consolidation trend.

4. Conclusions

Consolidation is one of the trends that characterise banking industry restructuring in Chile, although the level and magnitude of changes of concentration are still less significant than in other markets in the region or in small developed economies. This trend interrelates with the expansion of banking activities in the domestic economy and international integration of the financial sector.

Banking consolidation is a matter of concern to central banks as it may have adverse consequences on systemic stability. The magnitude of this effect depends on specific circumstances of each economy, such as quality of the regulatory framework, supervision practices, international financial integration, competition equity and financial market sophistication.

The pursuit of the central bank's permanent objectives is complementary to the goal of reducing the risks that arise from banking consolidation. Policies aimed at providing financial system stability and efficiency should take into account the processes of banking consolidation and increasing globalisation of financial transactions. Three improvements of the Central Bank of Chile's policy framework in this respect are the floating exchange rate regime, increased international financial integration and financial market development. Actions taken in each of these categories have helped reduce the risk that arises from banking consolidation.

However, since consolidation is likely to continue in financial markets, further policy measures may be necessary in order to maintain a competitive environment and strengthen market efficiency. To achieve their purpose, these policies have to work with the incentive structure of market forces, including technological progress and international financial integration.

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The entry of foreign banks into the Chinese banking sector

Liu Tinghuan

1. The four stages of opening-up the Chinese banking industry

The process of permitting a greater role for foreign banks in the Chinese banking sector has been a gradual one, spread over two decades. Adopting this gradual approach has allowed China to avoid some of the problems observed in other countries, where a rapid entry of foreign banks has been associated with excessively rapid growth in overall bank lending fuelling speculative excesses. The process has comprised four main stages:

- *Stage I: late 1970s to early 1980s.* Foreign banks were allowed to open representative offices.
- *Stage II: 1980s to early 1990s.* Foreign banks were allowed to open operational branches in Special Economic Zones. Early instances included Hong Kong banks operating in nearby Shenzhen. In 1990, arrangements were put in place for them to operate in Shanghai. Later the arrangements were extended to seven other coastal cities.
- *Stage III: Mid 1990s.* Improved regulations on opening up to and supervising foreign banks were formally promulgated, allowing foreign banks to operate in 23 cities.
- *Stage IV: Since 1996.* Foreign banks have been allowed to open branches all across China. A pilot programme was initiated in the Pudong area of Shanghai for foreign banks to undertake local currency business. Foreign banks in Shenzhen and Shanghai have been allowed to undertake a wider range of activities.

2. The role of foreign banks

By the end of October 2000, there were 234 foreign bank representative offices, 157 foreign bank branches and 13 locally registered foreign bank subsidiaries and joint ventures in China. Total assets of foreign banks reached US$ 34 billion. Thirty-two foreign banks have obtained business licences to do renminbi business in Shanghai and Shenzhen.

Foreign banks have played an important role in attracting foreign capital, introducing advanced management experiences and expertise, intensifying competition in the Chinese financial market and promoting the improvement of efficiency and corporate governance of Chinese banks.

3. Further opening-up to foreign banks

Further opening-up of the banking industry is an objective that follows from the requirements of a socialist market economy and economic globalisation. With China’s forthcoming accession to the World Trade Organisation, its financial industry will further open-up to the world in terms of market entrance and national treatment. In time, foreign banks will be able to offer their services to the household sector. Chinese banks will compete with foreign banks in all respects, especially for qualified personnel.

Several factors will become critical for domestic banks to survive and develop in the face of this competition. These include further development of the supervisory system by the central bank. This will involve implementing international standards, such as the Basel Committee’s Core Principles, and moving closer to international best practice. It will also require improvements to the legal framework.

Foreign banks in China are allowed to be fully foreign-owned. However, only large and financially strong banks are allowed to enter the Chinese market. A minimum asset size of US$ 10 billion is required. They must be subject to high quality supervision from the supervisors in their home country. To ensure that foreign banks have the necessary familiarity with the Chinese market before commencing full operations, they are required to have operated a representative office in China for at least two years.

4. Conclusions

The gradual approach to financial opening-up has served China well. Adopting this gradual approach has allowed China to avoid some of the problems observed in other countries, where a rapid entry of foreign banks has been associated with excessively rapid growth in overall bank lending fuelling speculative excesses. Foreign banks have close relations with international financial markets, and there is a risk that their presence could mean international financial disturbances being more readily transmitted to the domestic market. There is also a risk that if foreign banks face difficulties in their home market, they could suddenly withdraw from the Chinese market, causing considerable disruption.

The banking industry in Colombia: competition, consolidation and systemic stability

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1. Antecedents

At the beginning of the 1990s Colombia's financial sector was characterised by its small size, its segmented and oligopolistic structure, and a dominant presence of the state, which held 50% of the banking system's assets. The sector was severely repressed and highly inefficient. Reserve requirements were more than 40% of total deposits and interest rate spreads exceeded those of the developed countries by more than 500 basis points. In a context of high inflation and directed subsidised credit, the banking sector concentrated most of its voluntary credits in maturities of one year or less, limiting long-term financing to the indexed system of Savings and Loans.

During the period 1990-92 Colombia embarked on an ambitious programme of economic modernisation oriented towards improving the efficiency of resource allocation and increasing competitiveness. This programme included a set of structural reforms and macroeconomic policies designed to achieve 5% annual real GDP growth and a significant reduction in the rate of inflation. The main components of the programme consisted of establishing an open economy (Law 9 of 1991) and financial liberalisation. The central bank lost its monopoly on the purchase and sale of foreign currency and was made independent (Law 32 of 1992). Complementary policies were undertaken to rationalise the public sector, improve transport infrastructure, support business renewal programmes and define a general framework for foreign investment.

With regard to the financial sector, Laws 45 of 1990 and 35 of 1993 redefined its role and structure. Among other things, these laws simplified the entry and exit rules, established a scheme akin to universal banking aimed at reducing specialisation, and introduced stricter prudential regulations. Thanks to this, the process of re-privatising the institutions that were nationalised as a consequence of the crisis at the beginning of the 1980s gained momentum. In addition, Colombia's businesses were given increasing access to external credit, and foreign direct investment in the financial sector was encouraged. The number of financial institutions rose from 91 in 1989 to 148 in 1995. At the beginning of the decade, domestic assets of banks and other similar financial institutions had represented 34% of GDP. Then, a rapid expansion of the system occurred, reaching its peak in 1997, when the same category of domestic assets amounted to nearly 50% of GDP.

With the positive prospects generated by the economic reforms, the expected appreciation of the exchange rate and domestic interest rates higher than foreign, there was a marked capital inflow, which could not be completely sterilised. This brought about a pronounced increase in credit provided by the financial system. Loans rose from 26% of GDP in 1989 to 40% in 1997. A large part of that increase was accounted for by housing and consumption funding, which in turn led to a rise in the price of real estate and an expansion of aggregate demand, reflected in a significant fall in private sector savings.

Parallel to the strengthening of private demand, a sizeable in public sector expenditure occurred from 1997, generating a deficit close to 4% of GDP. The expansion of public and private expenditure exceeded the productive capacity of the economy, leading to a growing current account deficit in the balance of payments that reached 5.2% of GDP in 1998. The existence of a fiscal and an external imbalance, together with significant public and private debt, weakened Colombia's economic fundamentals, making it more vulnerable to external shocks. Under these circumstances, the Asian

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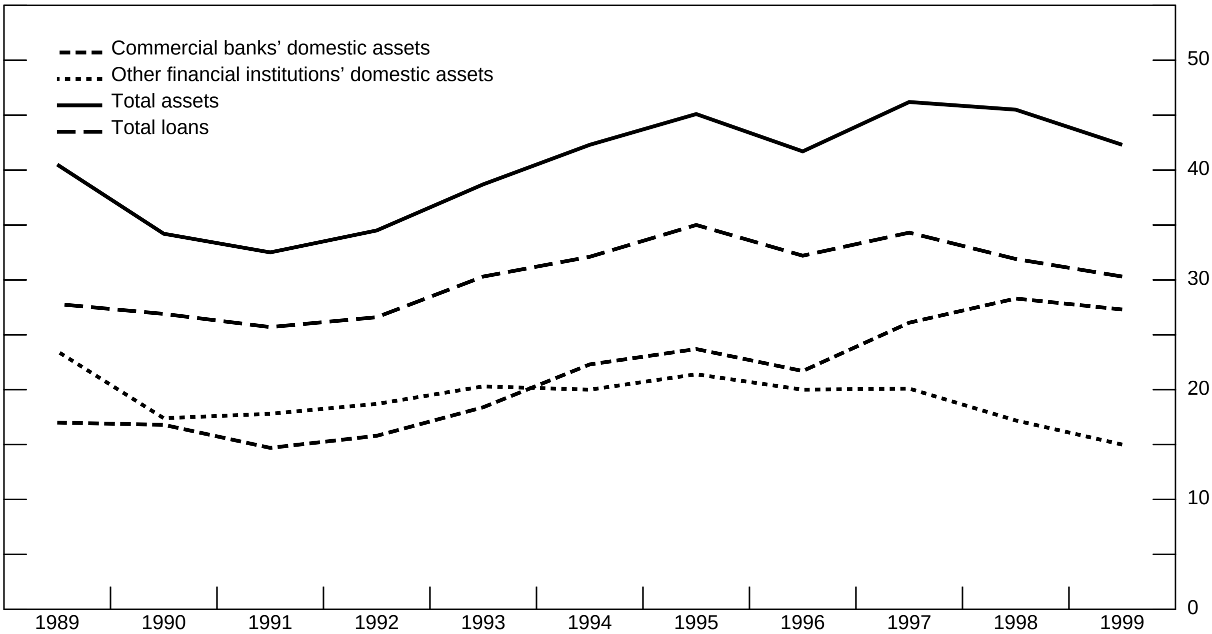
and Russian crises of 1997-98 had severe repercussions. Indeed, GDP decreased by 4.3% in 1999, the unemployment rate surpassed 20% and the fiscal deficit widened to 5.2% of GDP.

Graph 1

Financial system in the 1990s

As a percentage of GDP



The economic recession, among other factors, sharply affected the financial sector. Non-performing loans rose from 8% of total loans in 1998 to more than 14% in 1999. Most of the deterioration was concentrated in the state-owned institutions, whose NPLs reached an average of 25% in 1999. As a result, the financial system's losses climbed to $2.8 billion, which was reflected in equity prices dropping by 28% in real terms. As a result, the solvency ratio declined from a level of 13.4% at end-1996 to 11.6% in 1999. This deterioration was much more accentuated among the state-owned financial institutions, whose solvency ratio in 1999 fell below 6%. The financial crisis brought about major changes in the structure of the financial system, through the privatisation of some state-owned institutions and liquidation and merger processes, as described below.

2. Structure

In the second half of the 1980s, Colombia's financial system had 91 financial institutions with assets equivalent to 46% of GDP. Public banks held approximately 43% of the system's assets (20% of GDP), banks with foreign participation only 3% (1%), domestic private banks 20% (9%), and the Savings and Loans corporations 15% (7%).

The number of financial institutions increased considerably during the first half of the 1990s. It peaked in 1995 at 148 institutions, with total assets equivalent to 68% of GDP. This number of institutions was high relative to the size of the economy. The concentration level of the banking system was particularly low; the three largest banks held only 38% of total assets, compared to 68% in the richest countries and 81% in the poorest.

In the second half of the 1990s the financial system's assets fell by 6.4% of GDP. The biggest decrease was recorded by the state-owned banks (2.9%) and the Savings and Loans corporations and other non-bank financial institutions (3.3%). The size of private domestic banks increased by 1.7% of GDP, and foreign banks by 0.5%. The number of financial institutions dropped to 105, slightly higher than before the structural reform process began.

Table 1

Colombia's financial system in the 1990s

	Total		Banks					Savings & loans		Other	
			Total		Private domestic	Private foreign	State-owned				
	no	Assets[1]	no	Assets[1]	Assets[1]	Assets[1]	Assets[1]	no	Assets[1]	no	Assets[1]
1986-89	91	45.6	…	29.7	9.1	1.2	19.5	…	7.0	…	8.9
1990	135	64.5	26	29.9	14.1	2.3	13.5	10	10.5	99	24.1
1995	148	67.8	33	34.3	18.6	7.2	8.5	9	14.4	106	19.2
2000	105	61.4	35	33.6	20.3	7.7	5.6	6	11.9	64	15.9

[1] As a percentage to GDP.

Source: Superintendencia Bancaria.

The involvement of financial conglomerates in the intermediation process also increased. At the beginning of the decade financial intermediation was mostly the domain of individual financial institutions, while by the end financial conglomerates owned close to 70% of assets. This brought the Colombian financial system nearer to a universal banking scheme.

The two biggest conglomerates, Aval group and Sindicato Antioqueño, accounting for 18% and 16% of total assets respectively, are domestic. Another seven minor conglomerates, three of which are foreign, have assets of more than 1% of total assets. The largest conglomerate, the Aval group, owns three commercial banks, four commercial financing companies, two savings and loans corporations, three leasing companies and four insurance companies, among others.

Table 2

Participation in the financial system (% of total assets)

	Banks				Savings & loans	Other
	Total	Private domestic	Private foreign	State-owned		
1986-89	65	20	3	43	15	20
1990	46	22	4	21	16	37
1995	51	27	11	13	21	28
2000	55	33	13	9	19	26

3. Domestic mergers

It is the responsibility of the banking supervisory agency (Superintendencia Bancaria), which is attached to the Ministry of Finance, to approve or reject the institutional reorganisation of any credit establishment. The central bank has no jurisdiction over such authorisations.

To assess a merger proposal, the Superintendency of Banks requires the following information:

- The motives for the merger and the administrative and financial conditions under which it will take place.

- The relevant financial statements, to be assessed by the fiscal auditor with a view to establishing the conditions under which the merger will take place. The financial statements cannot predate the merger statement by more than six months.
- Corporations must add an explanatory annex on the evaluation methodology used by them and the exchange relationship resulting from its application.
- Copies of the acts by which the commitment to the merger was approved. In the case of an advance announcement, once the commitment is approved, copies of the acts are remitted to the supervisory agency.

A domestic merger plan can be disapproved by the Superintendency of Banks if any of the following cases occurs:

- the absorbing or new institution does not comply with the minimum capital requirements established by law and, under the Superintendency's judgment, there is no likelihood of the institution being sufficiently capitalised in adequate time.
- the absorbing or new institution does not comply with the minimum equity requirements or the solvency regulation currently in effect and, according to the Superintendency's judgment, it is not feasible for the institution to satisfactorily adjust its balance sheet in adequate time.
- according to the Superintendency's judgment, the managers or the stockholders that own more than 5% of any of the merging institutions do not satisfy the character, responsibility or suitability criteria necessary to participate in the merger operation.
- as a result of the merger, the absorbing or new institution can maintain or determine unequal prices, limit services, or limit free market competition. It is understood that this does not apply if the absorbing or new institution controls less than 25% of the corresponding markets.
- according to the Superintendency's judgment, the merger can harm the common interest or the stability of the financial system.

The current regulation applies to all credit establishments, in particular banks; institutions specialised in mortgage loans; financial corporations (investment banking); commercial financing companies and financial cooperatives. There are no restrictions on the fusion of credit establishments with non-bank institutions, so long as they are credit intermediaries or credit establishments. Nonetheless, these types of institutions are not allowed to merge with insurance companies, fiduciaries or retirement funds. For example, when a commercial financing company merges with a financial corporation, all of the requirements for operating as a financial corporation must be met.

Between 1997 and October 2000, there were 42 financial institutions merged in Colombia. Thirty-seven of these mergers (88%) were between private institutions and five of them (12%) between state-owned institutions. The largest portion of the mergers (33%) took place between commercial financing companies, the majority of which are small financial intermediaries. Next in importance were the mergers between financial corporations (19%), between banks (14%), and between banks and commercial financing companies (12%). In the case of the absorption of institutions specialised in mortgage loans or commercial financing companies by a bank, the resulting institution was a bank. Most merger procedures have been the outcome of financial difficulties inside the institutions. This explains why most mergers have taken place between institutions with overlapping operations or between institutions operating in different markets.

4. State-owned banks

4.1 Antecedents

Colombia has a long tradition of direct state participation in the financial system. In 1931 Caja Agraria was created as an entity with exclusively public capital, directed towards extending credits to small agricultural producers. Its first task was to refinance the debts of coffee growers, badly hit by the Great Depression. The following year Banco Central Hipotecario (BCH) was founded, with the purpose of buying bad loans from mortgage and commercial banks. Banco de la República bought half of the stock options of BCH. With these two banks, the share of public assets in the financial system reached levels close to 50%.

In 1951 Banco Popular was founded, with the specific purpose of granting credits to commerce and small urban businesses. Later, in 1953, on the initiative of the National Federation of Coffee Growers, Banco Cafetero was created. In 1954 it became a semi-public bank, when the National Coffee Fund, an institution with state participation, became its main stockholder. Two years later Banco Ganadero started operations, as a state-owned institution oriented towards the financing of commercial cattle raising. All of these banks were created to channel resources at subsidised prices towards sectors that faced liquidity restrictions.

The four banks mentioned above were, until the 1990s, the prime state-owned financial institutions. Other important public institutions were the Institutes of Industrial Development (Instituto de Fomento Industrial, IFI) and the Institute of Territorial Credit (Instituto de Crédito Territoral, ICT), lending institutions founded in the 1930s. However, they were not financial intermediaries because their funds came from the national budget.

In the first half of the 1980s, the financial crisis severely affected the private banks. As a result, the share of total assets held by domestic private banks fell from 33% to 18%. In contrast, the commercial state-owned banks increased their share, reflecting the confidence of the public in state-owned institutions and the nationalisation of six insolvent banks (Banco Nacional, Banco del Estado, Banco de Colombia, Banco Tequendama, Banco de los Trabajadores and Banco del Comercio). These banks, four returned to the private sector in the first half of the 1990s (two of them sold to foreign investors from Venezuela - Banco de los Trabajadores and Banco Tequendama - and the other two to domestic investors - Banco del Comercio and Banco de Colombia).

4.2 The 1990s crisis

The privatisation of four state-owned institutions in the first half of the 1990s and the growth in those years of the domestic and foreign private banks reduced the state-owned banks' share of financial system assets to approximately 25%. Moreover, in the framework of the financial reform of 1990-93, some public institutions acquired the character of rediscount financial institutions, which offer financial resources at market prices (IFI, Finagro, FEN and Bancoldex). By the middle of the 1990s, the assets of these institutions, together with the assets of the traditional state-owned banks, reached nearly 30% of the total assets of Colombia's financial system.

When the financial crisis exploded in 1998, the assets of the state-owned banks represented barely 15% of the system's assets or, taking into account rediscount banking, 22%. From the mid-1990s, non-performing loans for the state-owned financial institutions were about 10% of loans, twice the system average. By end-1999, for the financial system as a whole, 14% of loans were non-performing, while for the state-owned institutions NPLs exceeded 26%. In October 2000 these ratios were 12% and 21% respectively.

These statistics include the loans of three nationalised institutions, namely: (i) one institution specialised in mortgage loans (Granahorrar); (ii) one bank (Uconal); and (iii) one commercial financing company. At the time of nationalisation, the institution specialised in mortgage loans represented 10% of the total assets of its sector, the bank 1%, and the commercial financing company 16% of the total assets of the commercial financing companies.

Apart from Banco Agrario (formerly Caja Agraria) and rediscount institutions, the other public financial institutions will disappear or be sold to the private sector. For that purpose a general strategy has been designed which involves the following steps: First, the cleaning-up of assets, through the adoption of necessary provisions. Second, equity strengthening, through the recapitalisation of the institutions until a solvency ratio of at least 9% is reached. Third, separate management of the unproductive assets through an institution designated for their recollection and sale (CISA), with the purpose of recovering the highest possible value from them. Fourth, the administrative restructuring of the institutions. And finally, the sale of the institutions, or their dismantling if sale is not possible.

The general strategy for dismantling the state-owned banks has been accompanied by special treatment according to the specific circumstances of the institutions. Caja Agraria was liquidated and a new state-owned bank was created under the name of Banco Agrario, with the same functions as the old Caja Agraria but with fresh financial resources, a reduced number of branches and fewer labour commitments. In the case of Granahorrar and BCH, it was considered convenient that the former receive the productive loans and a major part of the liabilities vis-á-vis the public of the latter. Consequently, the loans need to be valued, a process that is still under way. When this stage finishes, Fogafin (the financial institutions guarantee fund) will strengthen its equity and initiate the sale process. Banco del Estado was merged with Banco Uconal, their assets were cleaned up and the resulting institution had its equity strengthened. Subsequently, the institution was administratively and technologically restructured and its sale will go ahead. Banco Cafetero has been cleaned up and capitalised, with bad loans and repossessed assets sold to CISA. At the moment Banco Cafetero is under administrative restructuring and will pass on to the sale phase in 2001.

The cost of the crisis in the state-owned financial system is estimated between 5.5 billion and 6.5 billion pesos, or 8.5 billion pesos if the liquidation of Caja Agraria is included. These figures represent approximately 3.5% and 5.8% of GDP respectively. Considering that at end-1999 the total capitalisation required by the private banks was estimated around 2.5-3.0% of GDP, the capitalisation required by all of Colombia's financial system would be between 6.0% and 6.5% of GDP, or 8.3-8.8% if the liquidation of Caja Agraria is included. Hence, solving the equity problems of the state-owned banks, including Caja Agraria, would represent approximately 70% of the rescue of the whole financial sector. At this moment no studies exist on recouping the resources of the state through the privatisation of some financial institutions.

4.3 Privatisation: legal framework

The Organic Statute of the Financial System and Law 226 of 1995 regulate the privatisation of the financial system, establishing the following:

- When a privatisation is due to take place, the operation must be conducted through the stock market and be sufficiently publicised and open to all. The Superintendency of Securities will establish the requirements and procedural rules of the auction.
- special conditions apply to the active and former or pensioned workers of the institution undergoing privatisation, labour unions, mutual investment funds, pension funds and cooperative entities.
- The state's stock participation will be transferred under conditions that maintain the public equity. The balance resulting from the transfer will be incorporated into the budget of the relevant holder so as to comply with the development plans, except where it is part of the quasi-fiscal funds, in which case the same objectives as for the quasi-fiscal funds will apply.
- The approval of the Superintendency of Banks must be obtained when, as a result of a transaction, more than 5% of the stocks (or the bonds exchangeable for stocks) are acquired.
- The approval of the Superintendency of Banks is not needed provided the persons interested in acquiring the stocks (or the bonds exchangeable for stocks) of the institution have obtained such approval in the previous three years, and are not subject to any sanction or charges.
- If difficulties arise in connection with these arrangements, Fogafin will propose alternative procedures to the Council of Ministers.
- When the privatisation involves a financial institution that has contributed to capitalising Fogafin, the latter will present the stock and bond transfer programme, once the Superintendency of Banks certifies the institution's equity is sound. In the remaining cases, Fogafin will present the proposals according to the petition submitted either by the ministry to which the institution is assigned or by any insurance or public agencies that hold stock in the institution.

The state or its decentralised entities can entrust Fogafin with the valuation, the preparation of the programme as well as the administration or transfer of the stocks and bonds.

5. Foreign direct investment (FDI)

5.1 Antecedents

The 1970s and 1980s in Colombia were a period of severe restrictions on foreign investment in general, and in the financial sector in particular. Decree Law 444 of 1967 gave the government a set of tools to channel FDI towards the sectors considered “a priority for economic development”. This meant that for many years no foreign investment in the financial sector was approved. Later, Law 75 of 1975 applied Decision 24 of the Andean Pact to the financial sector, requiring foreign banks to become joint ventures within three years. It was established that at least 51% of the property concerned had to be in hands of Colombians, and limits were set on the reinvestment and external transfers of profits.

In practice, the conversion to joint ventures was implemented without foreign investors relinquishing control of their institutions; the financial joint ventures did not increase their capital but their relative size increased. All of this was contrary to the government’s initial intention of preventing a further portion of domestic savings coming under foreign control. Furthermore, the FDI inflows to the financial system completely stagnated. On average the inflows of foreign investment to the financial system as a portion of total foreign investment in the country decreased from 23% in 1975-79, to 7.4%, 4.5% and –3.9% in the following five-year periods respectively. As a proportion to GDP, the magnitude of these flows was negligible.

As previously mentioned, in the first half of the 1980s the private banks faced a particularly difficult financial situation. However, the banks with some foreign ownership performed on average slightly better. In 1985, the capital-to-assets ratio of the domestic banks was 4%, while the joint venture banks maintained levels close to 6%. Similarly, the percentage of non-performing loans for the domestic banks was double that for the banks with foreign capital (17% versus 6% respectively). Differences also existed in the average profits-to-assets ratios, even though these were negative for both groups (–5% and –2% respectively). Some foreign banks, however, faced serious difficulties. For example, Banco Tequendama and Banco del Comercio were nationalised and the prohibition whereby foreigners could not own more than 49% of an institution was waived for Banco Mercantil, Banco Crédito y Comercio, Banco Colombo and Banco Real with the purpose of avoiding their total collapse.

5.2 Liberalisation in the 1990s and results

As stated above, at the beginning of the 1990s the restrictions on foreign investment in Colombia were significantly reduced with the Law 9 of 1991 enabling the greatest transformations. This law established the foreign exchange principles which the government drew on in drafting the statute on foreign investment, itself based on three key principles: (i) equality of treatment for nationals and foreigners and equal investment opportunities; (ii) universal access to all sectors of the economy; and (iii) automatic authorisation of the establishment of foreign investors in the country. For the financial sector this meant free entry for foreign investors, all within a framework of a wider process of financial liberalisation intended to improve the allocation of resources, promote competition and improve administrative efficiency.

The institutional changes had a positive effect on foreign investment in the financial sector. The banks that had been foreign-owned before 1975, and were transformed into joint ownership banks in the second half of the 1970s or 1980s, became foreign-owned banks (ie Citibank, Anglo and Sudameris). Foreign investors bought banks that had been nationalised during the 1980s crisis (Banco Tequendama and Banco Mercantil, purchased by Venezuelan investors), and others that had not been (Banco Ganadero and Banco Comercial Antioqueño, bought by the Spanish banks Bilbao Vizcaya and Santander, respectively). Lastly, some banks entered Colombia for the first time (for example Banco del Pacífico, owned by Ecuadorian investors, and ABN-Amro and Bank of Boston). With these investments, the participation of foreign banks in the total assets of the banking system increased from 10% in the second half of the 1980s to more than 30% in 2000.

The largest foreign banks are the Spanish banks Ganadero and Santander, and Citibank. These banks conduct similar lines of business to the domestic banks. Banco Ganadero and Banco Santander also have an extensive number of branches in the country. The rest of the foreign banks are significantly smaller than these banks and their principal activity is investment banking. Some institutions do not take deposits from the public and the majority of them manage their risk by conducting depository and loan operations with triple-A sectors and multinationals. These types of institutions offer support to businesses oriented towards the international markets, related to commercial credit operations and the management of private foreign debt, and run active treasury operations (ie the purchase and sale of foreign currencies).

A recent detailed evaluation of the role of foreign banks in Colombia's financial system showed that foreign banks have fewer non-performing loans, lower reserve requirements and are more productive than the domestic banks. Regardless of this, foreign banks do not appear to have lower spreads, possibly benefiting from the lack of competition inside the financial system. Moreover, the largest improvements in the indicators of the foreign banks have been seen for the banks that were formerly government-owned. As a consequence, these banks have been operating with lower spreads than the rest of the foreign banks. However, based upon an econometric analysis, the authors conclude that the lower administrative costs and the better quality of the loans extended by the foreign banks have allowed these banks to establish spreads slightly lower than those of the domestic banks.

Bank consolidation in the Czech Republic

Oldřich Dědek

1. General features

The domestic banking sector is the core of domestic financial intermediation. For historical and legal reasons it enjoys a role which goes far beyond that of securitised markets or of other financial institutions.

Private banking structures have only developed since the early 1990s, when the state banking monopoly was dismantled and the entry of foreign institutions permitted. The banking system follows the principle of universal banking; thus banks are allowed to carry out a vast range of financial services beyond the core deposit and loan business. In particular, banks are major participants in the capital markets and, via subsidiaries, providers of insurance services.

The domestic banks suffered from a number of weaknesses: undercapitalisation, a shortage of the long-term funds necessary to support their development plans, inexperienced staff, non-existent risk management, and underdeveloped information systems. The risks were heightened by shortcomings in professional skills and by a number of legal loopholes that could be exploited through fraudulent behaviour. Thus, the political pressure to satisfy the enormous financial needs, combined with the credit expansion and high rates of growth in the banking business as a whole, led inevitably to the generation of losses. In addition, the large banks (which are the backbone of the Czech financial sector) were faced with the difficulty of low capital adequacy coupled with an inherited burden of bad loans.

In this way, the potential arose for destabilisation of the banking sector. Since the banking sector was unable to address this problem on its own, state financial injections became inevitable.

2. Consolidation process

Major rounds of cleaning up banks' balance sheets were undertaken in order to establish a healthy banking industry. Konsolidacní banka (KOB) was established in order to take on bad loans, accumulated before 1991, from the banking sector. In a first step, starting in 1991, larger banks were freed from bad loans.

As of 1994 emphasis shifted to smaller banks. In particular, the failure of Kreditní banka in August 1996, and a subsequent partial run on Agrobanka, caused some strain on the Czech banking system. The programmes concerned led only to a temporary increase of state ownership in banking in 1995, and again in 1998, due to the revocation of the license of Agrobanka. Overall, the government share in banking rose to 32% at the end of 1995 from 29% at the end of the preceding year.

Moreover, to support the small banks, another programme - the Stabilisation Programme - was approved in 1997. This essentially consisted of replacing poor-quality assets with liquidity of up to 110% of each participating bank's capital through the purchase of poor-quality assets from the bank by a special company called Ceska financni, with subsequent repurchase of the residual amount of these assets within a five- to seven-year horizon. Six banks joined the programme. However, five of these were excluded after failing to comply with its criteria and subsequently went out of business. Thus, the Stabilisation Programme has not been successful. The macroeconomic deterioration together with the inability of banks to cope with the existing situation led to participation in the programme being halted. Most participating small banks were closed and liquidated.

The main impact of these programmes has been a marked decrease in the number of banks, because of the licence revocations, mergers, acquisitions, liquidations and bankruptcy proceedings involved. The total cost of the efforts made by the Czech National Bank and the government to support the stability of the banking sector is estimated at roughly CZK 200 billion (including preparations for the privatisation of banks).

By the end of 1998, 63 banking licences had been granted (60 of these before the end of 1994). As of 30 September 2000, 41 banks and branches of foreign banks remained in business, 16 were under extraordinary regimes (in other words, out of business - eight in liquidation and eight involved in bankruptcy proceedings), four had merged with other banks, and the licence of one foreign bank had been revoked because it had failed to start its operations. Out of the 41 remaining institutions (including KOB) 15 were domestically controlled banks and 27 foreign-controlled banks, including foreign subsidiaries and foreign branches. Of the total of nine special banks, one is a mortgage bank. In addition, seven institutions are authorised to issue mortgage bonds.

Table 1

Number of banks (July 2000)

Class of banks	Number
State financial institutions	1
Banks with domestic majority ownership	5
Special banks with domestic majority ownership	7
Banks with foreign majority ownership	9
Subsidiaries of foreign banks	6
Foreign-owned special banks	2
Branches of foreign banks	10
Banks under conservatorship	1

The number of banking institutions actively operating on the Czech market has been slowly declining since 1994. That year marked the turning point between the first phase after the economic liberalisation, with a considerable number of small and medium-sized domestic start-ups, and the subsequent phase of ongoing consolidation of the Czech market, in particular among the smaller domestically controlled institutions.

The large number of banks that went out of business contrasts with their low share in the total assets of the banking sector. This peaked at around 5% in 1994 and then steadily decreased to about 3% at the end of 1997. Consequently, the loss-making business of these small banks presented no systemic risk in itself. Nevertheless, the possibility of a negative impact on the public could not be ignored and costly preventive measures were necessary. Customers were indemnified up to a limit of CZK 4 million, although a Deposit Insurance Fund was in place with a maximum indemnity of CZK 300,000.

3. Share of foreign banks

Foreign banks, including branches of foreign banks, had by the end of 1999 attained a market share of 39% of assets. Foreign banks have gradually strengthened their position in the Czech banking sector. Their typical business profile, however, is more wholesale business oriented, as in securities business and lending to large industrial customers and foreign-owned enterprises, than the average of the banking sector as a whole. Therefore, at the end of 1999, the share of foreign banks in lending (23%) and deposit-taking (18%) was considerably lower than the respective figure for the total balance sheet. Of the larger foreign-controlled banks and branches, most have a German, Dutch, French or US parent company. Austrian companies are also in the market, with one large institution, and a number of very small ones established primarily on the Austrian-Czech border. The number of foreign banks continued to increase until the end of 1995, but has remained stable in recent years.

The banking sector in the Czech Republic comprises:

(i) banks and branches of foreign banks which, given the scope of their activities, can be characterised as universal banks;

(ii) banks with a special products and services profile, namely:

- KOB (Consolidation Bank, a state credit institution), the only wholly state-owned Czech bank, administering long-term state claims;
- Ceskomoravska zarucni a rozvojova banka a.s. (Czech-Moravian Credit and Development Bank Ltd), supporting small and medium-sized private businesses;
- Ceska exportni banka (Czech Export Bank Ltd), established for export support;
- building savings banks: the core business of the six building societies consists in collecting long-term deposits from the public and granting long-term housing loans. Their banking activities are regulated by the Act on Building Savings Banks. Personal deposits with these banks are subsidised by a state contribution up to a limit set by the law;
- mortgage banks: at present, there is only one specialised mortgage bank in the Czech Republic. Seven other banks are also authorised to issue mortgage bonds. These banks are, in addition, entitled to provide state-supported housing mortgage loans to natural persons.
- credit unions, established pursuant to a special legislative act. In the Czech Republic these are not classified as banks: they do not have direct access to the money market and are allowed to offer their products and services only to their members, not to the general public. Compared to the banking sector, their share in financial intermediation is very low.

4. Banking supervision

The CNB is the supervisory authority responsible for the licensing as well as for the prudential supervision of all banking institutions. The Banking Supervision Department, which was established at the beginning of the 1990s, has created its supervisory system according to the standards and rules set by the Basel Committee on Banking Supervision.

Banking supervision activities proceeded in 1999 in harmony with the medium-term concept of the further development of banking supervision approved by the CNB board in January 1998. This comprehensive document expresses the basic objectives of banking supervision and the measures required for their accomplishment. It was based on the organisational changes in the bank that took place at the end of 1997. Its primary aim was to create the preconditions for intensive development of on-site supervisory activity - one of the principal methods of banking supervision in the Czech Republic - by establishing separate supervisory teams. In the methodological area (as discussed later) activity was focused on preparing new regulations implementing capital adequacy, incorporating market risk and consolidated banking supervision in line with EC directives and the Basle Core Principles for Effective Banking Supervision. Laws and regulations under preparation were thoroughly reviewed by experts with regard to their compliance with EC directives.

5. Banking sector trends

The development of the Czech banking sector is closely connected with that of the domestic economy. Since 1997 the economy has been in recession. Household income in 1999 grew only very modestly and banks did not have enough sources of deposits.

On the assets side, the nascent recovery, the first signs of which appeared in the second quarter of 1999 when GDP growth resumed, still remained too weak to change main trends in the structure of banking sector assets;

- first, the “flight to quality” represented by a decline in the share of credits to below 50% and a rising share of liquid assets. However, behind this overall trend lie differences between the big banks, whose volume of credits decreased, and foreign banks and branches of foreign banks, which recorded growth;
- second, since 1999, banks have exported capital in amounts exceeding their (balance sheet) liabilities vis-à-vis non-residents.

These trends were not only banks’ reaction to the decline in economic activity itself but also to the structural and institutional weaknesses that the recession fully revealed on the microeconomic level. The biggest risk in banking remains credit risk. The worsening financial situation of a significant section of businesses, together with the difficulty of recovering credits and seizure of collateral, placed credit risk at a level no longer acceptable to banks. Banks increased their prudence in granting credits and tightened their criteria for customer evaluation. On the other hand, the same factors that curtailed the supply of credit restricted the room for an increase in the efficiency and creditworthiness of troubled enterprises. Thus, the demand for credit remained strong, but only partly met the creditworthiness criteria set by the banks.

6. Classified credits

The Czech banking sector’s main problem is its heavy burden of classified credits and its limited ability to deal effectively with them. During 1999 the share of classified credits in overall credits rose to 32%. This increase seems to reflect, in particular, the cooling-down of the economy and the slow growth in the volume of newly granted loans.

The overall nominal volume of classified loans rose, too. However, the “weighted classification”, which represents potential losses, dropped. Underlying this relatively favourable development was the high volume of write-offs against loan loss provisions and the transfer of bad loans to KOB.

At the end of July 2000 the total volume of classified credits had fallen by 16% from the end of 1999, and their share in the overall loan volume fell by 4 percentage points to 29%. However, this decline was all due to the transfer of part of the loan portfolio from Komercni banka to KOB. The volume of reserves and provisions set aside to cover potential losses from the loan portfolio stood at CZK 92 billion as of 31 March 2000. These reserves and provisions covered almost 80% of the potential losses from the loan portfolio, with the remaining part being covered by collateral.

The heavy burden of classified credits has been the main factor behind the poor profitability of the banking sector in the past three years. Banks have been able to generate a solid operating income, and their cost/income ratio (operating costs/operating income before write-offs and loan loss provisioning) has also been satisfactory. Provisioning and write-offs, however, are pushing net profits into the red.

7. Bankruptcy legislation

The amended Act on Bankruptcy and Settlement and the Act on Public Auctions became effective on 1 May 2000. The new legislation aims at accelerating bankruptcy proceedings and balancing creditors’ and debtors’ rights by allowing specialised firms or legal persons to act as trustees in bankruptcy proceedings and by offering the possibility to negotiate out-of-court settlements. It is expected that the changes in legislation will strengthen creditors‘ rights, reduce debtors' opportunities to dispose of property during the bankruptcy procedure and give incentives for the restructuring of enterprises rather than their liquidation. However, the successful implementation of this new legislation will depend on the qualification of the authorities involved in the procedures.

8. Banking business structure

Overall, financial intermediation by banks has been growing modestly over the past few years. Credit growth was restrained and below the levels of GDP growth. As a result, total credit fell to 57% of GDP over the period 1994-97. This is a relatively low level compared to EU member states' economies. This reflects both the prudent approach to monetary policy adopted by the CNB, and the more cautious credit policy adopted by the banks. In particular, smaller companies still find it difficult to access the credit markets. As this sector of the economy has been growing more rapidly than the large corporate sector, credit expansion has not kept pace with economic development and might, in some instances, have put a lid on a possibly more dynamic restructuring and growth of the Czech corporate sector. At the same time, financing via other channels, such as direct access to the capital markets, remains, for different reasons, restricted. Hence, the slow expansion of credit is a serious burden for the domestic economy.

This slow expansion is also to be seen in the context of a tighter stance from the regulatory authorities on the capital adequacy of banks, which itself is an important and overdue step towards strengthening the stability of the financial sector. However, it underlines the insufficient capital base of Czech banks, and the limited scope for increasing such capital. Partly to blame for this situation is the continued state ownership in banking. With the principal goal of privatising banks, the state seems reluctant to capitalise adequately the banks still in its control.

The share of loans to the private sector has, with the privatisation of the Czech economy, gradually increased and is now equivalent to more than 50% of total GDP. The balance sheet of the aggregate banking sector reflects the broad picture of the state of financial intermediation in the country. Credits still constitute the main type of assets. At the end of 1999 they amounted to 37%. However, this share has fallen considerably over recent years, down from nearly 52% at the end of 1994. Securities' holdings account for a relatively small share (19%) in the total assets portfolio of the banking sector. Interbank deposits, on the other hand, and particularly funds with the CNB, including CNB bills, have increased over the last few years. Credits to the public sector (mostly companies in public ownership and, to a much lesser degree, loans to government), are continuously decreasing in relative terms. At the end of 1999 they amounted to 9% of the total credit portfolio, down from 18% at the end of 1996. Credits to households rose from 6% to more than 7% during 1999. Thus, the bulk of loans are granted to the private corporate sector, standing at the end of 1998 at 69% of total credits, up marginally from the end of 1996.

9. Privatisation of the banking sector

The issue of completing the privatisation of the state-controlled banks has been discussed several times by consecutive Czech governments and has been postponed from year to year. With the benefit of hindsight, it is obvious that the method of voucher privatisation of the large state banks (see Table 2) was not an optimal technique. The structure of ownership was not transparent, too diluted, and the control by the state was inefficient.

The underlying motive for privatising the remaining state stakes in the large banks is to increase their efficiency, profitability and competitiveness and to strengthen their reputations, in particular with respect to future EU membership. Although the three largest Czech banks are the biggest in the central European transition countries, by international comparison they are only medium-sized banks. Thus, finding a strong strategic investor and partner is a crucial precondition for their stabilisation and further growth. The possibility of purchasing stakes in the privatised banks is open to any strong, trustworthy and strategic banking or financial investor, or to any transparent group of such investors.

Since 1998, substantial progress has been made with the privatisation process. In February 1998, the state's minority 36% stake in Investicni a Postovni banka (IPB) - the third largest Czech bank - was sold to Nomura International. Furthermore, in June 1998, General Electric Capital Services, a subsidiary of General Electric, acquired substantial parts of Agrobanka, the then largest private bank, but which had been effectively state-managed for the previous two years, as it had been put under conservatorship in 1996 due to financial problems encountered at the time.

Table 2
Privatisations of banks

Bank	CS	CSOB	KB	IPB
Voucher privatisation	1992		1992	1992
Vouchers (%)	37		53	52
Restitution investment Fund stake (%)	3		3	3
Municipalities (%)	20			
Sales to investors	2000	1999		1998
Investor	Erste Bank	KBC		Nomura
Acquired share in equity (%)	52	66		36
Share in voting rights (%)	56	66		36

The state's almost 66% stake in Ceskoslovenska obchodni banka (CSOB), the fourth largest bank in the Czech Republic, was sold off in June 1999. CSOB's sale at a good price to the Belgian Kredietbank (KBC) is an example of a successful privatisation resulting in the entry of a reliable and strong investor into the Czech banking sector.

In case of Ceska sporitelna (CS), the second largest bank, the government called for preliminary offers from potential investors in May 1999. In September it started exclusive sale talks with Austria's Erste Bank and in March 2000, it signed a contract with that institution about the sale of its 52% stake for CZK 19 billion.

As regards Komercni banka (KB), the Czech government is still considering and preparing the privatisation. After two capital increases in January 2000, the government effectively renationalised the bank and holds around 60% of it. More recent information indicates that the investor will be chosen only in 2001.

In June 2000 - based on liquidity problems and subsequent evidence of undercapitalisation, which were not addressed by majority owner of the bank in a timely manner - the CNB in a joint action with the government, decided to impose a forced administration on Investicni a Postovni banka, the third biggest bank in the domestic market. Subsequently, its assets and liabilities were sold to CSOB, one of the strongest private banks in the country. This quick action protected the banking sector from potential destabilising effects and preserved the stability of the resolved bank´s clientele.

10. Implementation of EU legislation

The Czech Republic is ready to implement the Community acquis concerning banking services by the date of accession. EC banking directive standards are now to a high degree incorporated in the Czech law in the Act on Banks and the Act on the CNB, in the CNB´s provisions and in relevant articles of the Commercial Code, Bankruptcy Law, Administrative Proceedings and Civil Proceedings.

During 1999, great attention was paid to further improving the regulatory framework towards gradual harmonisation with the prudential rules in force in EU countries and conformity with the Basel Core Principles. The main emphasis was laid on preparing new regulations implementing capital adequacy, incorporating market risk and consolidated banking supervision.

The next important harmonisation step will be adoption of the harmonisation amendment to the Act on Banks, which was submitted to the Government in March 2000. The Act is expected to enter into force in 2001.

In the field of capital adequacy and consolidated supervision, the only regulatory difference is in the scope of supervision on a consolidated basis, which will not cover financial or mixed-activity holding companies (of which a bank is a member) and will not incorporate market risk. This difference will be removed by a new Provision of the CNB on supervision on a consolidated basis, after the harmonisation amendment to Act No. 21/1992 Coll., on banks, enters into force. Single banking licence, mutual recognition and home country supervision principles will also be introduced by the harmonisation amendment to this act, although it is envisaged that full application of these principles will be effectively enforced as of the date of accession.

11. Concluding remarks

The banking system remains the core financial intermediary in the economy, so there is a need for change in the near future to diversify the risk of concentration. Faster development of other segments of the financial market must be achieved. And the foundations for promoting the trust of investors and the public in our financial system must be in place. This involves the following goals:

- ensuring stable macroeconomic and microeconomic policies;
- improving the legal environment and law enforceability;
- developing an effective regulatory framework, based on international standards, for all segments of the financial market;
- promoting market discipline in the corporate sector;
- improving accounting standards and public disclosure practices.

The Czech Republic's application for European Union membership makes these issues all the more pressing.

The banking industry: competition, consolidation and systemic stability: the Hong Kong experience

David Carse

1. Structure of the banking industry

This paper describes the Hong Kong experience in relation to competition, consolidation and systemic stability with the banking system. By way of background, it should be noted that the Hong Kong banking system includes 155 licensed banks that are authorised to conduct the full range of banking business. Of these, 31 are locally incorporated (though a significant number are foreign-owned) and the rest are branches of foreign banks. Some of these foreign banks have been present in Hong Kong for many years and have built up an extensive network of branches though which they carry on both retail and wholesale business in the domestic market. In effect, the business focus of such banks is much the same as that of their local competitors. Many foreign banks, however, operate through only one branch and are not active in the domestic market. In addition to the licensed banks, there are 50 restricted licence banks and 62 deposit-taking companies that are subject to certain restrictions on the type, maturity and minimum size of deposits that they are allowed to take. Such institutions tend to specialise in a variety of activities, including wholesale banking, securities business, trade finance and consumer finance.

The banking market in Hong Kong is quite highly concentrated. The top three banking groups (one locally incorporated and two incorporated overseas) account for over half of total customer deposits in Hong Kong and almost half of domestic loans. A typical medium-sized local bank in Hong Kong would account for less than 3% of total customer deposits and normally 1% or less.

There is no overall competition authority in Hong Kong. Instead, competitive issues are addressed on a sectoral basis. The Hong Kong Monetary Authority does involve itself in competitive issues relating to the banking industry. However, its primary responsibility is to act as banking regulator with a view to maintaining the stability of the banking system.

2. Mergers of banks

The structure of the banking industry has changed very little in the last ten years. There have been a number of changes of ownership of local banking operations driven by a variety of factors, including:

- death of the major shareholder;
- privatisation of a bank acquired by the government during the crisis of the mid-1980s (following this, there are now no government-owned banks in Hong Kong); and
- change of strategy by the foreign owner, leading to sale of the business in Hong Kong to another foreign owner.

Apart from these “one-off” cases, there have been no recent examples of mergers among local banks designed to achieve economies of scale or scope. Some of the reasons for this are as follows:

- family ownership of a number of banks discourages mergers, partly because of reluctance to give up the family heritage and partly due to less pressure to generate shareholder value;
- presence of significant minority shareholders and relatively small “free floats” of shares may also lead to less focus on return on capital and complicate merger plans;
- profitability has been satisfactory in absolute terms. Local banks recorded significant growth in pre-tax profits prior to the Asian crisis (average of 15% per annum from Hong Kong operations during the six years 1992-97);

- even during the Asian crisis, all but a few Hong Kong banks remained profitable. All continued to maintain high capital ratios (over 18% on average) and none required official support. Financial distress was therefore not a driving force for merger as it has been in other Asian economies; and
- the large banks in Hong Kong already have substantial market share and are generally not anxious to increase it further, though they may well wish to take advantage of particular opportunities to increase scale in certain products or areas (such as credit cards).

The combination of all these factors means therefore that Hong Kong banks have not been under significant economic pressure to merge, acquire or be acquired.

This situation may, however, be changing due to changes in the competitive environment. These are being driven partly by economic factors and partly modifications to the regulatory structure.

As regards the first of these, the Hong Kong economy has rebounded sharply from the recession induced by the Asian crisis with growth in real GDP of over 10% in 2000. This recovery has been mirrored in a revival in pre-tax profits derived from the local banks' Hong Kong offices, which rose by 54% in the first half of 2000. While some of this reflected an underlying improvement in profits before provisions, the bulk reflected a sharp drop in the bad debt charge. To some extent, this will be a non-recurring item.

Looking ahead, the profitability of the banks is subject to some uncertainty for two main reasons. The first is that domestic loan demand has been on a declining trend since the Asian crisis and, while this may now have bottomed out, there are no clear signs as yet of a sustained recovery in domestic lending. This reflects continued sluggishness in private sector investment, recourse by the corporate sector to other types of financing (eg the equity market) and the lack of revival in the residential property market that has reduced the demand for mortgage loans. Given that residential mortgage lending accounts for a large proportion of the loan portfolios of most of the local banks, this has had a dampening effect on overall loan growth.

Related to this is the fact that the banks are flush with liquidity, and are competing actively for the limited amount of new business that is available. This is putting increasing pressure on lending margins, particularly in the all-important residential mortgage market. Margins on mortgage loans have fallen from 1.25% above prime lending rate prior to the crisis to a typical 2.25% or more below prime. This price-cutting has spread to other types of lending, such as syndicated loans and personal loans.

So far, the impact on the banks' overall net interest margin has been mitigated by the fact that the ample liquidity has kept funding costs low. But the net interest margin is likely to come under pressure in the future as more loans are refinanced or rolled over at the lower lending margins, or if funding costs rise.

The implication is that the local banks (and other players in the domestic market) will have to take advantage of new business opportunities to maintain profit growth and broaden income sources. In particular, they need to reduce reliance on net interest income, which is relatively high by international standards.

The opportunities exist for banks to do this. The high level of per capita GDP in Hong Kong and the demographics of a maturing population point for example in the direction of greater emphasis on wealth management products such as pensions, insurance, asset management and mutual funds. These are relatively underdeveloped in Hong Kong and thus offer opportunities for growth.

Another avenue for the banks is to follow their customers into the capital markets. In other words, they will become increasingly involved in helping their customers to raise equity and debt finance, and in providing facilities to trade securities. China's accession to the WTO is also expected to generate new business for the banks in capital market activities as well as in traditional banking products such as trade finance.

The problem from the banks' point of view is that the skills required to develop and market these types of product and services, and to manage the risks, are more complex than those required for mortgage loans. They are also demanding in terms of resources and technology. Banks have to spend money to make money. This argues in favour of scale to spread the costs of the technology and to save on costs. This is why a number of the local banks have joined together in a strategic alliance to provide a common business platform for the new Mandatory Provident Fund. The alliance has since branched off into other areas of cooperation, including credit cards, e-commerce, life insurance and syndicated loans. This initiative enables the smaller local banks to compete on more equal terms with their larger rivals. But it is perhaps something that can be taken only so far. The strategic partners are still competing for essentially the same pool of customers, and that may impose limits on the extent of their cooperation.

The more fundamental solution may therefore be to join together under common ownership. This is something that the HKMA has been advocating for the smaller banks. We have taken the view, however, that it is not something that we can mandate, for healthy banks at least. It would be difficult for the authorities to form a better view than market participants of what was an appropriate ownership structure. Forced marriages between banks are unlikely to be successful. The HKMA has therefore taken the position that it will rely on market forces to achieve the desired consolidation of the industry.

There are, however, certain actions that the HKMA can take to try to achieve the desired result. One is to state its position on the need for industry consolidation in speeches and media comment with the aim of stimulating public debate on the issue. This can be supplemented by private advocacy of the desirability of merger in discussions with individual institutions.

More specifically, the HKMA has taken steps to remove possible barriers to competition and resistance to change by altering the regulatory structure. A programme of banking reform, covering a three-year period to end-2001, has been put in place. The key feature of this is the final phase of the removal of the remaining controls on interest rates. All time deposits in Hong Kong have now been deregulated, and the controls on current accounts and savings accounts are due to be removed in the middle of 2001. This is intended to encourage innovation and greater efficiency in the provision of deposit products. But the HKMA has also stated that one of the purposes is to encourage the banks to think more seriously about consolidation. There are indications that this is happening, as shown by the acquisition of one local bank by another towards the end of 2000.

3. Foreign banks

Another aspect of the reform package is to further liberalise Hong Kong’s already open regime for the admission of foreign banks. Foreign banks licensed in Hong Kong after 1978 were formerly restricted to one branch (pre-1978 banks have unrestricted branching rights). This rule has recently been relaxed to allow three branches to be opened. It is due to be reviewed again in 2001, and the decision may then be taken to dispense with the restriction altogether. The HKMA also intends to review whether the market entry criteria should be further relaxed to allow greater scope for foreign banks to set up banking subsidiaries in Hong Kong. This is effectively disallowed under the current rules, because Hong Kong has traditionally had a bias towards foreign entry in branch form. This rested on the view that it was better to rely on the strength of the bank as a whole.

Such measures have aroused concern among the local banks that they may be further squeezed by foreign competition. The HKMA is sympathetic to these concerns, and this is reflected in the phasing of the reform programme. However, we believe that a protectionist approach is unlikely to be successful in today’s globalised markets and would in any case be inappropriate for an international financial centre like Hong Kong. Thus, while we believe that it is desirable to retain a strong indigenous element at the core of the banking system, the best way of achieving this is for the local banks to improve their competitiveness - which, as noted above, means that they need to think seriously about merger. While this would be the optimum solution from the HKMA’s point of view, we would not try to discourage takeover of local banks by foreign banks if the parties concerned reached a commercial decision to that effect.

Large foreign participation in the local banking sector naturally gives rise to the concern that foreign banks will be less committed to the domestic economy and more likely to cut back if conditions become adverse or head office strategy changes. There was some evidence of this in Hong Kong during the Asian Crisis, when the Japanese banks in particular reduced both their physical presence and their lending in Hong Kong. However, to a large extent, this was a special case, reflecting the particular circumstances of the Japanese banking industry. A number of other foreign banks with a major presence in Hong Kong have taken the opportunity to build up their operations, both by organic growth and acquisition. Our experience is that such banks behave in much the same way as local banks. This reflects the fact that banks which have attained a sizeable market share tend to be more committed to the market, because they take a long-term view and do not overreact to a crisis.

The HKMA considers that the experience of Hong Kong as regards foreign banks has been generally positive. Foreign banks have brought with them the latest skills and techniques, and this has both enabled the transfer of these skills to the local banks and forced them to try to emulate the foreign banks in order to remain competitive. The fact that a number of large foreign banks are at the heart of the banking system also provided stability during the Asian crisis. The HKMA believes that the relative openness of the Hong Kong banking system helps to explain why it survived the crisis in better shape than most of the other systems in the region.

4. Concluding remarks

The HKMA is conscious of the fact that increased competition following liberalisation can lead to increased risk. We are trying to address this in a number of ways. First, like many other regulators, we are trying to improve our supervisory policies and techniques by adopting a more risk-based approach. The aim is to anticipate problems rather than react to them. Second, we are trying to address the issue of the safety net. We have already released a formal statement that clarifies and sets out the HKMA's role as lender of last resort. We are also in the process of consulting the banking industry and the wider community on proposals to introduce a deposit insurance scheme in Hong Kong. If we were to go ahead with this, it is likely that foreign banks would be included within its scope given the important role of a significant number of such banks in the retail deposit system.

Competition, consolidation and systemic stability in the Indian banking industry

S P Talwar

1. Introduction

The banking sector reforms undertaken in India from 1992 onwards were basically aimed at ensuring the safety and soundness of financial institutions and at the same time at making the banking system strong, efficient, functionally diverse and competitive. The reforms included measures for arresting the decline in productivity, efficiency and profitability of the banking sector. Furthermore, it was recognised that the Indian banking system should be in tune with international standards of capital adequacy, prudential regulations, and accounting and disclosure standards. Financial soundness and consistent supervisory practices, as evident in our level of compliance with the Basel Committee's Core Principles for Effective Banking Supervision, have made our banking system resilient to global shocks.

2. Forces for change

India has not faced any major economic/financial crises, though in 1990-91, there was some pressure on the external sector with the current account deficit and external debt servicing reaching large proportions. However, due to prudent macroeconomic policies, it was possible to return the country to a sustainable growth path. As well as the long history of regulation and supervision, Indian banks have limited exposure to sensitive sectors such as real estate, equity, etc, strict control over off-balance sheet activities, larger holdings of government bonds (which helps limit credit risk), relatively well-diversified credit portfolios, statutory restrictions on connected lending, adequate control over currency and maturity mismatches, etc, which has insulated them from the adverse impact of financial crisis and contagion. Banks in India have played a significant role in the development of the Indian economy. However, with the structural reforms initiated in the real economy from the early 1990s, it was imperative that a vibrant and competitive financial system should be put in place to sustain the ongoing process of reforms in the real sector.

The financial sector reforms have provided the necessary platform for the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability. The reforms also brought about structural changes in the financial sector and succeeded in easing external constraints on its operation, introducing transparency in reporting procedures, restructuring and recapitalising banks and enhancing the competitive element in the market through the entry of new banks. The ongoing revolution in information and communication technology has, however, largely bypassed the Indian banking system given the low initial level of automation. The competitive environment created by financial sector reforms has nonetheless compelled the banks to gradually adopt modern technology, albeit to a limited extent, to maintain their market share. Banks continue to be the major financial intermediaries with a share of 64% of total financial assets. However, non-bank financial companies and development finance institutions are also emerging as alternative sources of funding.

In India, foreign banks account for only around 8% of the total assets of the banking system. Further, domestic households are not allowed to place deposits abroad. Similarly, conditions for accessing overseas capital markets by domestic corporates have been stringent, in terms of size, maturity, pricing, etc. The impact of the entry of foreign banks on domestic banks is likely to depend on various factors such as the structure, strength and competitiveness of domestic banks, the share of foreign banks, and the regulatory/supervisory framework. While the entry of foreign banks could definitely improve the competitive environment, they are not likely to weaken domestic banks. With better technology and expertise in offering specialised banking products such as derivatives, advisory services, trade finance, etc, the entry of foreign banks can enhance healthy competition and has a positive spillover effect on the domestic banks. The domestic banks would be under peer pressure to improve operational efficiency. It needs, however, to be recognised that the banking system in India is quite competitive with the presence of public, private and foreign banks.

Thus, the major forces for change in the Indian context have been the following:

- consistent and strong regulatory and supervisory framework;
- structural reforms in the real and financial sectors;
- commitment to adopt and refine regulatory and supervisory standards on a par with international best practices; and
- competition from foreign banks and new-generation private sector banks.

3. Privatisation of state banks

State banks in India have, over the years, played a very significant role in the development of the economy and in achieving the objectives of the nationalisation undertaken in 1969 and 1980, namely to reach the masses and cater to the credit needs of all segments, including weaker sections, of the economy. The period 1969-90 witnessed rapid branch expansion and an adequate flow of credit to all sectors, including the neglected sectors of the country. From 1990, however, it was recognised that steps were needed to improve the financial health of banks to make them visible, efficient and competitive to serve the emerging needs and enhance the efficiency of the real sector. While the role of the large state banks has not undergone any structural changes and they continue to serve the varying needs of the economy, what has changed significantly, as a result of the reform process, is the *focus* on their consolidation, efficiency, resilience, productivity, asset quality and profitability through liberalisation, deregulation and adoption of prudential standards in line with international best practices.

As a part of financial sector reforms and with a view to giving the state banks operational flexibility and functional autonomy, partial privatisation has been authorised as a first step, enabling them to dilute the stake of the Indian government to 51%. The government further proposed, in the Union Budget for the financial year 2000-01, to reduce its holding in nationalised banks to a minimum of 33% on a case by case basis. The major problems for gradual privatisation are likely to be resistance from staff to rationalisation of the branch network and emphasis on higher staff productivity.

The optimal size of a bank depends on several factors and differs between countries depending on the level of economic development, the number and diversity of financial institutions/instruments, the competitive situation in the market, etc. Looking at the typical Indian situation, the big banks operating in international markets have to coexist with banks operating only at the national level, regional rural banks and cooperative banks, which will induce the necessary competition in the market. Most of the state banks have a strong national presence and are catering to the needs of various segments of the economy. We do not expect to split the state banks into smaller entities even after the gradual disinvestment of government equity in them. Rather, there is a possibility of consolidation for synergising business/regional strengths, and efforts in this area may be "board-driven" with the functional autonomy that will emerge as a result of such disinvestment.

4. Domestic mergers

Under the Banking Regulation Act, banking companies cannot merge without the approval of the Reserve Bank of India. The government and the Reserve Bank do not play a proactive role in either encouraging or discouraging mergers. It is our endeavour that the government and the RBI should only provide the enabling environment through an appropriate fiscal, regulatory and supervisory framework for the consolidation and convergence of financial institutions, at the same time ensuring that a few large institutions do not create an oligopolistic structure in the market. Mergers should be based on the need to attain a meaningful balance sheet size and market share in the face of heightened competition and driven by synergies and locational and business-specific complementarities.

While there is no regulatory deterrence to bank mergers, their incidence has not been significant and hence no problems have occurred in India.

Mergers of banks help to reduce the gestation period for launching/promoting new places of business, strengthen product portfolios, minimise duplication, gain competitive advantage, etc. They are also recognised as a good strategy for enhancing efficiency. Ideally, mergers ought to be aimed at exploiting synergies, reducing overlap in operations, “right-sizing” and redeploying surplus staff either by retraining, alternate employment or voluntary retirement, etc. As banks are leveraged and the credibility of the top management has tremendous supervisory implications, we prefer consensual mergers to hostile takeovers. The takeover codes should, therefore, reflect the supervisory concerns.

4.1 Issues in banks’ mergers with non-banks

It has been our endeavour to preserve the integrity and identity of banks. The activities that the banks and their subsidiaries can undertake are restrictive, to ensure that the interests of existing and future depositors are fully protected. Banks are also not allowed to undertake trading in commodities. In pursuit of these objectives, the merger of a bank with a non-bank is generally not favoured. However, the merger of a non-bank financial company with a bank is allowed subject to the prior approval of the Reserve Bank of India and compliance with all the regulatory and supervisory standards applicable to banks. The issues that may arise in such mergers would be the bank’s ability to comply with statutory and regulatory requirements in respect of liabilities and assets taken over by it from the non-bank.

4.2 Mechanism for preserving competition

There is no separate agency/mechanism for preserving competition in the banking sector. Promoting competition is, however, one of the key objectives of financial sector reforms. The entry of new private sector and foreign banks and introduction of new products and technology and operational freedom to banks have ensured a competitive environment in the financial market.

4.3 Impact of consolidation

Since the consolidation process has not gone very far in India, its impact has not been significant. Mergers of certain foreign banks at the global level have also not affected the Indian market, as their market share is currently very low. However, the deregulation process has brought in more competition in the banking sector, resulting in delivery of innovative financial products at competitive rates. The consolidation of banks may not significantly affect the functioning of various segments of the financial markets. In a liberalised environment, the mere size of the bank may not be an enabling condition for distorting the pricing mechanisms or liquidity in the market. The presence of large banks would result in more competition and narrowing spreads.

4.4 Role of banks and development finance institutions (DFIs)

India being a geographically vast country with its rural population constituting almost 70% of the total, the role of regional rural banks remains important. The banking sector, characterised by the presence of internationally active banks, national-level banks and regional rural banks, is likely to be preserved to cater to the needs of a varied customer base. Consequent to liberalisation and financial sector reforms, there has been some blurring of distinction between the activities of banks and DFIs. In particular, the traditional distinction between commercial banking and investment banking has tended to narrow somewhat. Banks have been moving into certain areas which were the exclusive domain of the DFIs, eg project finance and investment banking. DFIs have recently been given the option to convert themselves into universal banks with the RBI’s approval. To this end, a DFI would need to prepare a transition path in order to comply fully with the statutory and regulatory requirements applicable to banks. The RBI will consider such requests on a case by case basis.

5. Entry of foreign banks

Domestic banks account for 92% of total banking assets in India. Given the size of the country and the policy to ensure that foreign banks' market share does not exceed 15%, domestic banks are likely to dominate the banking markets.

5.1 Behaviour of foreign banks

The presence of foreign banks does not imply negligence of particular sectors of the economy. In India, foreign banks are required to comply with priority sector lending norms, where the commitments are lower than those applicable to domestic banks under a tailor-made structure suitable to them. The experience is that foreign banks adhere to the Reserve Bank prescriptions. Generally, however, due to their limited knowledge of the local industry and branch network, foreign banks are very conscious about their asset quality and a major shift in the share of foreign banks may result in neglect of the credit requirements of small and medium-sized businesses, whose development is crucial for emerging markets, but which are perceived as carrying relatively higher risks.

Foreign banks constantly evaluate the political, economic and financial climate in financial markets and vary their investment/lending decisions. While the credit risk management processes and practices vary among banks, all internationally active banks have centralised policies and country and transfer risk monitoring, reporting and limiting mechanisms. While the traditional scope encompassed only sovereign and transfer risk, large flows of loans to non-G10 countries' commercial entities have induced banks to broaden the scope of country and transfer risk management to incorporate the potential default of foreign private sector counterparties arising from country-specific economic factors. In response to the Asian crisis and more recent events, banks in India are required to strengthen their country and transfer risk monitoring and analysis in an effort to identify incipient problems and to adjust exposures more promptly and systematically.

5.2 Competition from foreign banks

While entry of foreign banks is bound to affect the overall competitive situation in the market, much depends on the policy of the sovereign in regard to their entry/expansion, the existing share of domestic banks, etc. One of the main thrusts of the banking sector reforms in India has been to introduce more competition in the banking industry. With regard to mergers, only very few foreign banks operating in India have gone through the process of global mergers. The impact of megamergers taking place at the global level on the competitive position of the Indian banking system has been minor, in view of foreign banks' limited share in the financial system. At the same time, foreign banks have the potential, even without megamergers, to improve their market share, given their use of sophisticated technology and capability of introducing innovative products.

6. Systemic stability

The existence of only a few large banks potentially exposes the system to undue risk, as even a bank-specific liquidity crisis could trigger systemic problems. Ideally, the banking system should comprise a few large banks to ensure a healthy competitive environment and smaller banks and sector-specific financial institutions to cater to the needs of small business and agriculture.

The domestic and foreign banks are covered under a uniform regulatory and supervisory regime. Foreign banks are also covered by the deposit insurance arrangements applicable to domestic banks. As lender of last resort, the Reserve Bank has not faced any problem with foreign banks as their operations and asset size are very limited. There have been no major difficulties experienced in coordination with the home country supervisors of foreign banks.

The open and competitive environment provides opportunities and challenges to the banks. The narrowing spreads force banks to assume more risks. At the same time, banks should ensure an appropriate trade-off between risks and returns. Recognising the need for effective risk management systems, the Reserve Bank has issued comprehensive guidelines on risk management systems and banks are required to address risk management in a structured manner. The implementation of risk management guidelines is also a key supervisory concern.

The large size of banks is a systemic issue and the monetary authorities are often compelled to act as lender of last resort to obviate dislocation in the payment and settlement systems. Banks, especially large banks, should therefore be adequately capitalised, put in place strong internal control and risk management systems, supported by proper disclosure, and so forth.

7. Conclusion

The financial sector reforms have brought about significant improvements in the financial strength and the competitiveness of the Indian banking system. The prudential norms, accounting and disclosure standards, risk management practices, etc are keeping pace with global standards, making the banking system resilient to global shocks.

The consolidation and convergence of banks in India has, however, not kept pace with global phenomena. The efforts on the part of the Reserve Bank of India to adopt and refine regulatory and supervisory standards on a par with international best practices, competition from new players, gradual disinvestment of government equity in state banks coupled with functional autonomy, adoption of modern technology, etc are expected to serve as the major forces for change. In the emerging scenario, the supervisors and the banks need to put in place sound risk management practices to ensure systemic stability.

The Indonesian banking industry: competition, consolidation and systemic stability

Burhanuddin Abdullah and Wimboh Santoso

1. Introduction

A banking crisis occurred in Indonesia following the persistent depreciation of the Indonesian rupiah (IDR) from mid-1997. A number of banks experienced illiquidity and insolvency during the crisis due to a lack of public confidence in the banking system that forced Bank Indonesia (BI) to bail out several systemically important banks. To restore the solvency and the stability of the banking system, the government embarked on a restructuring programme in 1998. However, the government only recapitalised and restructured viable banks. As a consequence, several banks were frozen out of operation or closed in 1998-99 to prevent the financial system and the economy from further disruption.

The restructuring programme has involved:

- the injection of government capital into viable banks through the issuance of recap bonds;
- the introduction of a blanket guarantee;
- the establishment of the Indonesian Bank Restructuring Agency (IBRA);
- corporate restructuring;
- improvement of corporate governance; and
- bringing supervisory and regulatory practices closer to international standards.

The government also encouraged the merger of several small banks into a stronger bank in 2000 and that of four state banks into a new large bank - Bank Mandiri - in 1999. Bank Mandiri is now the largest bank in Indonesia with total assets of IDR 290 trillion (29% of the market) in Indonesia in August 2000. This consolidation strategy, as well as the closure of frozen banks, significantly reduced the number of banks from 241 in 1997 to 153 in October 2000. Nevertheless, the present banking industry remains vulnerable, such that strengthening of the restructuring programme is of the utmost importance.

This paper analyses the dynamics of competition, and consolidation of the Indonesian banking industry before, during and after the crisis, as a basis for policy recommendations. It is organised as follows: Section 2 outlines the forces for change in the Indonesian banking industry after the crisis; Section 3 examines the privatisation of state banks; Section 4 discusses domestic mergers between local banks; Section 5 analyses the role of foreign banks; Section 6 discusses systemic stability in the banking industry; and Section 7 provides a summary and conclusion.

2. The forces for change

The weaknesses in the banking sector could be identified long before the crisis occurred. This section tries to explore the crucial aspects of the banking industry in the period prior to, and after, the crisis. The findings of this discussion will be used as a basis for improving the stability of the banking system in the future.

2.1 History of the banking crisis

The weaknesses that might have led to the banking crisis had been recognised from the late 1980s to the early 1990s. For the sake of a better overview of specific problems, the evolution of the banking industry may be split into three periods: 1970-83, 1983-88 and 1988-97. The periodisation itself can be attributed to the characteristics of banking business, which moved from a distressed financial situation resulting from heavy regulation and limitation, to a more "optimistic" atmosphere due to deregulatory measures adopted by the government.

In the period 1970-83, the economy benefited from the oil boom as the government budget relied heavily on the revenues from oil and gas. BI applied credit ceilings and interest rate controls, and limits on prefinancing credit to contain the inflationary pressures. Under the liquidity support scheme, banks obtained a certain margin of interest for credit extended to borrowers. This incentive, which was given only to state banks and selected private banks which met minimum criteria regarding soundness, became the motivation for banks to mobilise public funds.

In the period 1983-88, initiated by the fall in oil prices in the early 1980s, the government could no longer provide resources at subsidised interest rates. Hence it introduced a number of reform packages, including one covering monetary and banking policy in 1983. Under the June 1983 reform, the government decided to reduce the interest rate subsidies and prefinancing credit except for small and medium-sized enterprises, and simultaneously introduced discount window facilities, Bank Indonesia Certificates (SBI) and Money Market Commercial Paper (SBPU). The SBI was designed to absorb banks' excess liquidity, while SBPU was to provide an instrument for money market operations and liquidity management for banks. The discount window was intended as a facility for banks to borrow funds from BI in case of liquidity mismatch. Such big changes necessitated banks adjusting to a new policy environment. Due to lack of expertise, in the initial phase, banks mostly relied on funds from the money market to finance their loans; therefore, banks' profits were very sensitive to the volatility of interest rates.

In the period 1988-97, the government continued to roll out a series of reform packages. These were aimed at improving the effectiveness of banks as financial intermediaries and the stability of the banking system. In general, the reform packages covered the following areas:

- promoting fair competition among banks by allowing new entry, widening the network, reducing segmentation between state banks and private banks, and allowing more independence in decision-making;
- promoting more prudent regulation, such as the adoption of net open position limits, use of the Basel Capital Accord of 1988 to assess the adequacy of capital, and statutory lending limits;
- promoting the effectiveness of money market instruments; and
- shifting from relatively fixed to more floating interest and exchange rates.

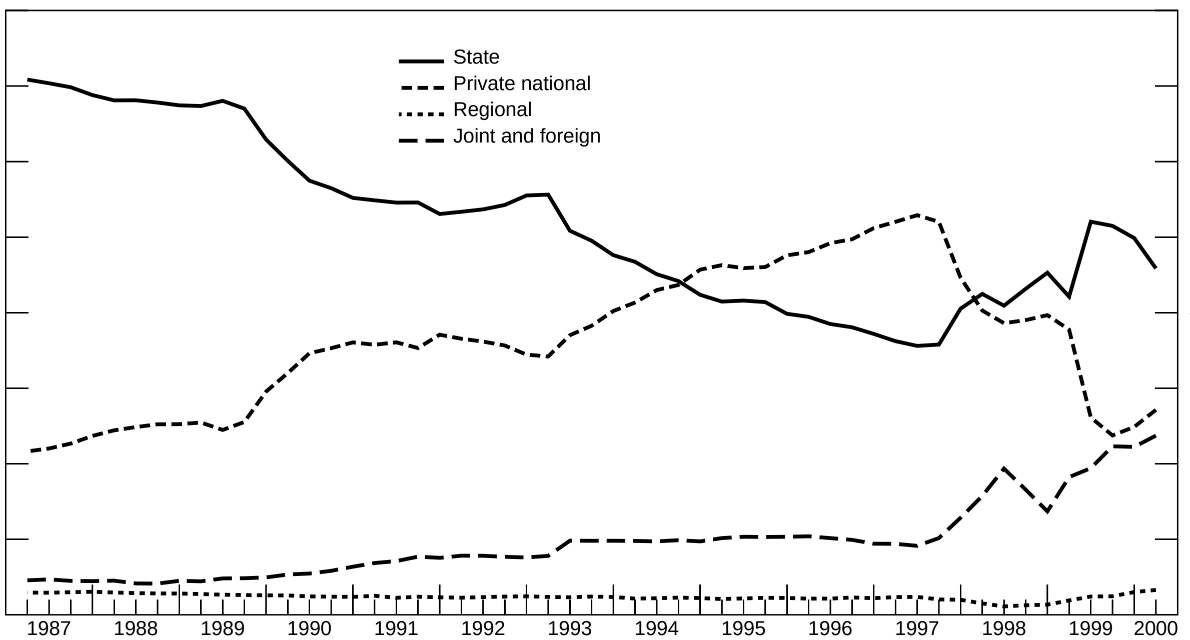
These reform packages were issued in October and December 1988, March 1989, and January 1990.

Prior to the adoption of this series of reform packages, the banking industry had been very restricted and the financial market, in general, depressed. Lifting the barriers to entry encouraged banks to mobilise deposits and hence reduce their reliance on the government. The dominance of state banks also began to decline due to, inter alia, the abolition of the guideline for state enterprises to place deposits with state banks and to borrow from them. Graph 1 shows the evolution of market shares of loans from 1980 to 1999.

After the implementation of those reform packages, applications for new bank licences were soaring, submitted mostly by groups of companies. In just two years, BI granted 73 licences for new commercial banks and 301 for new branches. The rapid growth of banks and branches encouraged banks to be more aggressive in tapping the deposit market, without a clear view of to whom they would lend. Private banks intentionally started to lend their money extensively to related companies without sound credit analysis. These practices led to a high level of non-performing loans (NPLs), which was the root of the worst banking crisis in Indonesian history. The following sub-sections discuss the key issues facing Indonesian banking before the crisis.

Graph 1

Share of loans



Sources: Bank Indonesia annual reports, various issues.

Problem loans

Problem loans had been quite worrisome for many years prior to the crisis. Lack of credit analysis was the main problem for state banks because most of the credit policies were intervened by the government and/or top government officials. NPLs within private banks were normally related to loans within the group, violating the statutory lending limit, which was only minimally enforced by a dependent central bank (the Governor of BI was a member of the cabinet).

In February 1993, Booz Allen & Hamilton forecast that the problem loans of Indonesian banks would be around 5 to 20% of total outstanding credits. The problem loans, which increased gradually from 6% in 1990 to 11% in 1991 and 17% in 1992, were the main sources of bank failure in the 1990s. Annex 1 shows the growth of NPLs from January 1995 to December 1999.

Banking regulation and supervision

Under the existing regulations, the authorities have experienced difficulties in detecting problem banks at an early stage. In our view, banking regulation in Indonesia needs further improvements.

First, risk-based capital requirements, which rely solely on credit risk, fail to assess the true risk borne by banks. Theoretically, bank risks comprise not only credit risk, but also interest rate risk, foreign exchange risk and other risks. Therefore, there is a clear danger of banks failing to pay due regard to those risks not covered in the capital requirements.

Second, BI adopted the “gross approach” to these capital regulations, incorporating the portion of loans which have been covered by provisions for expected losses in the calculation of risk-weighted assets. This approach may discourage banks from monitoring their loans as good-quality loans attract the same risk weights as bad loans in the assessment. The gross system was replaced by a net system in June 2000.

Third, the risk assessment methodology fails to capture the actual performance of management. While other criticisms may be levelled against the BIS proposal (BIS, 1988), we have identified some weaknesses in the current capital adequacy regulations. Therefore, banking regulation in Indonesia calls for further improvement. Nasution (1998) criticised the October 1998 reform for requiring strong legal and accounting systems, which could not be established promptly. Disclosure was poor due to weak implementation of accounting standards. It was reasonable to suspect there were loopholes for bribery and corruption. The government could easily be tempted to intervene in the selection process of lending.

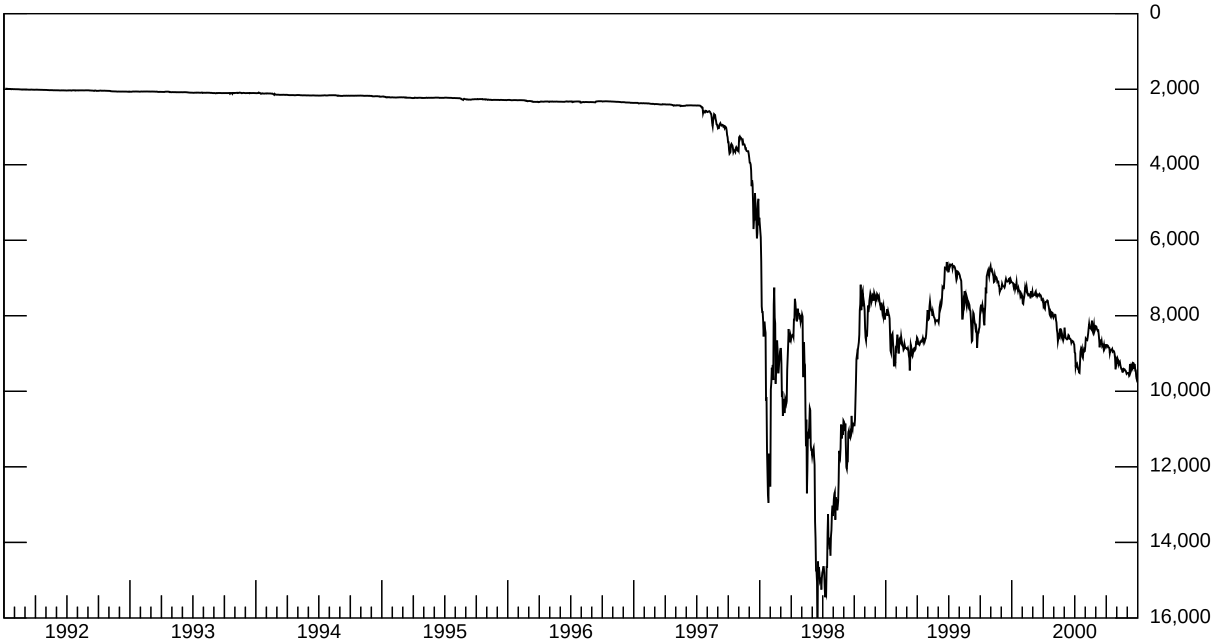
As we have already mentioned, the rapid growth in the number of banks' offices, together with their exposures, on the one hand, and the shortage of professional managers and weaknesses in bank supervision, on the other, were the factors contributing to the banking crisis. In fact, a number of banks had suffered financial problems before the crisis.

Exchange rate environment

The crisis in 1997-98 caused a sharp fall in banks' capital as a consequence of huge losses. The banking crisis in 1997 was triggered by the persistent fall in the IDR exchange rate from July 1997. The USD/IDR exchange rate dropped from IDR 2,450 per USD in July 1997 to IDR 11,000 in March 1998. In response, BI initially widened the spread of its intervention band (ie the difference between BI's buying and selling rate) from 8% to 12% to curb speculation on the IDR. However, this strategy was no longer adequate and finally BI abandoned the band in August 1997. See the plot of the IDR/USD exchange rate in Graph 2 below.

Graph 2

Exchange rate: rupiah per US dollar



Source: Bloomberg.

The managed floating exchange rate policy was an implicit guarantee given to the market by the government. From time to time, the government publicly announced the USD/IDR rate that it envisioned. The players, therefore, could make an accurate estimate of the exchange rate for the forthcoming period. Given this exchange rate policy, market participants prefer borrowing funds from overseas without hedging. However, when the government was unable to maintain the intervention band, the exchange rate plunged and the players, including banks, suffered huge losses.

The exchange rate turmoil negatively affected the weak banks, which had suffered financial problems even before the crisis. Consequently, the government revoked the licences of 16 private national banks on 1 November 1997, and closed seven banks in April 1998 and 38 in March 1999. The level of NPLs reflected the worsening of banks' performance during 1995-99, as shown in Annex 1.

2.2 The structure and the regulatory and supervisory frameworks of the banking system

To address the banking crisis, the government in 1999 introduced the banking restructuring programme, which led to considerable changes in the banking industry in Indonesia.

The Government also formed the Indonesian Bank Restructuring Agency (IBRA) at the end of January 1998 to: (i) verify customer claims under the blanket guarantee scheme; (ii) dispose of assets from banks taken over; (iii) restructure and sell loans transferred from banks; and (iv) divest ownership of recapitalised banks.

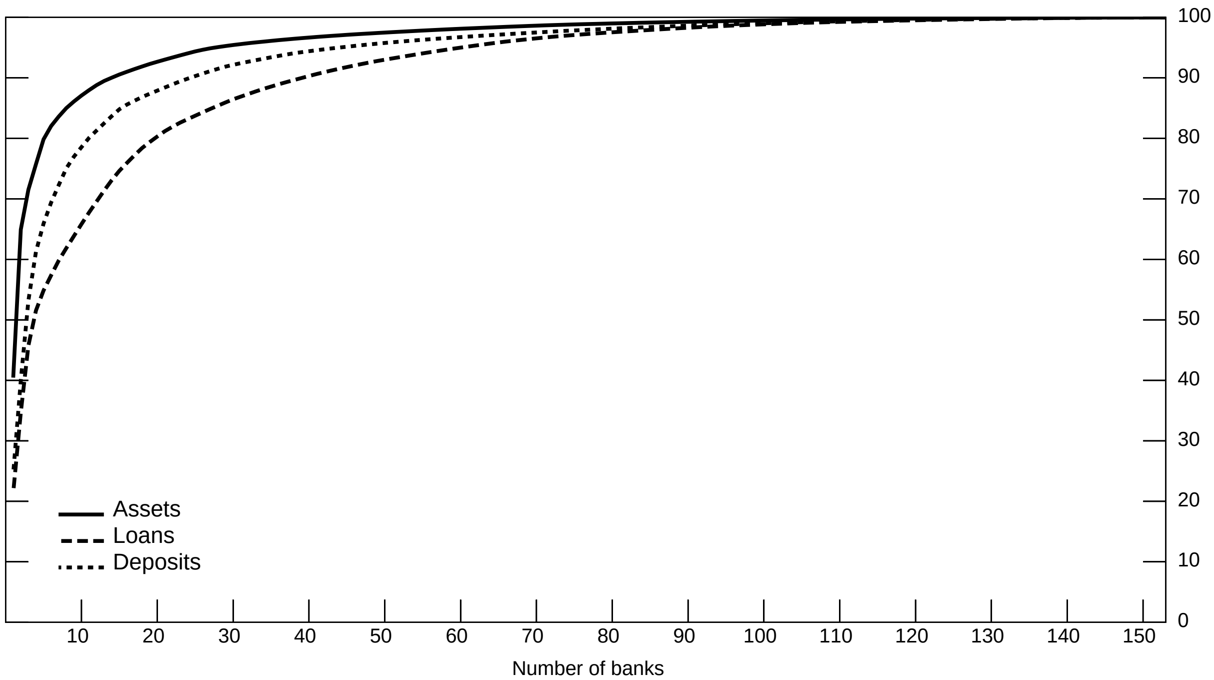
The following discussion shows the current structure and the regulatory and supervisory frameworks of the banking system.

The structure of the banking system

The number of banks in Indonesia has shrunk from 239 to 153 comprising five state banks, 38 private national foreign exchange banks, 45 private national non-foreign exchange banks, 26 regional banks, 29 joint banks and 10 foreign banks. By the end of 1999, the top 20 banks, which included five state banks, accounted for almost 80% of total assets, loans and deposits as shown by Graph 3. The remaining 20% share was shared by 133 small banks.

Graph 3

Market share of deposits, credit and assets



Sources: BI Call Reports, various issues.

Since the regulatory authority (BI) treats all banks equally, large banks with national branch networks have competitive advantages. However, when the crisis struck, these large banks suffered the most while small banks were generally immune. Most of the problem banks were large banks with wide networks because the banks were highly exposed to credit and market risks. One may then infer that the future structure of the banking system may comprise a small number of large banks with wide networks and small unit banks at the regional and district level. However, BI has no plan to intervene by directly reducing the number of banks. Instead, BI will only impose tight requirements on establishing new banks and opening branches, in addition to enforcing the exit policy regulation for insolvent banks.

The regulatory and supervisory frameworks of the banking system

Under the existing regulations, the authorities have encountered difficulties in detecting problem banks at an early stage due to, inter alia, the following factors:

- Some prudential regulations have not been addressed in Indonesia, eg those concerning market risk, country risk and foreign exchange settlement risk. If the market risk regulation had been in place, the impact of the exchange rate and interest rate volatility on Indonesian banks during the 1997-98 crisis would have been more modest.
- Some regulations, such as the minimum capital adequacy requirement and statutory lending and net open position limits, need further improvement at the implementation level as well as in their coverage. The capital adequacy requirement just covers credit risk but still ignores market risk, unlike in most countries. Banks could find loopholes in statutory lending limits through credit swaps with other banks and because the net open position was based on an aggregate calculation (setoff between currencies).
- The approaches to supervisory techniques are conventional rather than risk-based. Conventional approaches normally use ratios to assess the past performance of banks (ex post). However, banks' past performance is less important for stakeholders than their future performance (ex ante). A risk-based supervisory approach is intended to reflect the future condition of banks.
- This supervisory approach for banks in Indonesia is based on solo supervision rather than consolidated supervision. BI is responsible for the supervision of banks while the Minister of Finance is responsible for non-bank financial institutions, including insurance and leasing companies. The stock exchange is under the supervision of the Stock Market Supervisory Board. Any problems at non-bank financial institutions may spark a problem at banks since the former are affiliated with banks. Consolidated supervision could be applied to prevent that from happening.

To improve its supervisory framework, BI has been setting some targets such as improving corporate governance, strengthening banking supervision, and encouraging a sound banking environment.

To promote good corporate governance, BI has introduced several rules, such as:

- enhancing the competence and integrity of bankers by imposing a Fit and Proper Test on each bank's shareholders and management;
- requiring banks to appoint Compliance Directors, responsible for ensuring the bank's compliance with existing regulations;
- maintaining consistent law enforcement by establishing a Banking Investigation Special Unit, to uncover violations against banking rules.

BI is fully aware that the banking crisis stemmed from weaknesses in the performance of banking supervision. In coping with such unfavourable conditions, BI has been focusing on the following aspects:

- harmonising the organisation of bank supervision, particularly regarding structure and responsibility;
- improving bank supervision management including, but not limited to, more efficient and transparent supervision, more competent supervisors, accountability and recognition, as well as reward and enforcement;
- introducing risk-based supervision;
- rectifying prudential regulations with emphasis on risk control.

The efforts to create a safe and sound banking system should be followed by strategic measures to produce a conducive banking environment through:

- the establishment of a deposit insurance programme, expected to come into effect by 2004, as a financial safety net to replace the existing blanket guarantee;
- the involvement of the Public Accountant Firm in banking supervisory tasks so that BI may obtain early and objective information on problems encountered by banks;

- the reactivation of the Bankers' Association, which may partner BI in developing the national banking system and overseeing the conduct of bankers. Such an effort involves training and surveillance of the members of the association, as well as providing needed counsel.

Other efforts have been under way to improve the stability of the Indonesian banking system, such as the introduction of new banking and central banking acts, including the new Banking Act of 1998, which:

- transferred the authorisation for bank licensing from the Minister of Finance to BI;
- relaxed the limit on foreign ownership of Indonesia-incorporated banks, raising it to 99%;
- encourages the development of sharia banking;
- narrowed bank secrecy provisions to cover only the information on deposits (name and amount) instead of total assets and liabilities;
- provides for more comprehensive and stricter criminal sanctions, and determines their minimum level;
- provides for the establishment of a deposit protection scheme by 2004 at the latest;
- provides for the establishment of a temporary special agency to assist with the banking restructuring programme.

Additionally, the government introduced the Act on Foreign Exchange Traffic and the Exchange Rate System in 1999. This provides a legal basis for monitoring the foreign exchange flow and enforcing prudential provisions. The act requires banks to submit to BI a report containing the movement of financial assets and liabilities between residents and non-residents. Complete, accurate and timely information about foreign exchange flows is key to supporting a prompt monetary policy response, primarily directed at maintaining the stability of the rupiah.

2.3 Information technology

The development of information technology allows banks to offer services to customers at lower cost. However, the application of sophisticated information technology may create operational risk related to fraud, the unreliability of information systems and discontinuity of operation. Therefore, rules of conduct in the application of information technology are necessary for banks. The following discussion outlines the regulations on the adoption of information technology and internet banking in Indonesia.

Application of information technology

BI has released regulations requiring banks to report the IT applications used in their products and activities. These reports will be used to monitor the application of IT at banks, particularly in relation to the efficiency of banks and the safety of public funds.

Compared with the development of IT in other countries, the application of IT in Indonesian banks is still relatively low. Based on the survey conducted by the Committee on Payment and Settlement Systems (2000), there is no bank in Indonesia offering services or products related to electronic money (e-money). E-money is defined as stored value or prepaid products in which a record of the funds or value available to the consumer is stored on a device in the consumer's possession. This definition includes both prepaid cards (sometimes called electronic purses) and prepaid software products that use computer networks such as the internet (sometimes called digital cash). These products differ from so-called access products that allow consumers to use electronic means of communication to access otherwise conventional payment services (for example, use of the internet to make a credit card payment or for general "online banking").

Internet banking

To date, six banks have offered internet banking to customers. However, the operation is still at an initial stage, being simply a means of providing communication and information rather than transaction facilities. The development of internet banking in other countries will surely contribute to the spread of internet banking in Indonesia in the future. Consequently, BI is now in the early phase of developing a regulatory framework for internet banking. We at BI are all aware that internet banking calls for special attention from regulatory and supervisory authorities due to the associated risks, such as improper disclosure, fraud, discontinuity of business due to hardware interruption or software failure, etc. Errors in software may lead to incorrect messages being transmitted between banks.

From the banking supervision point of view, an IT supervisory review plays an important role in ensuring that adequate policies and prudential internal controls are in place. Currently, the supervisory authority lacks sufficient expertise in internet banking operations. Therefore, the task of examining the operation of internet banking may be outsourced to external auditors who should be instructed to address any shortfall or imperfection coming to their attention in the course of their assignment. For the longer term, the supervisory authorities should develop their own in-house IT expertise so as to ensure that the application of internet banking can be controlled properly by internal sources.

2.4 Competition from foreign banks

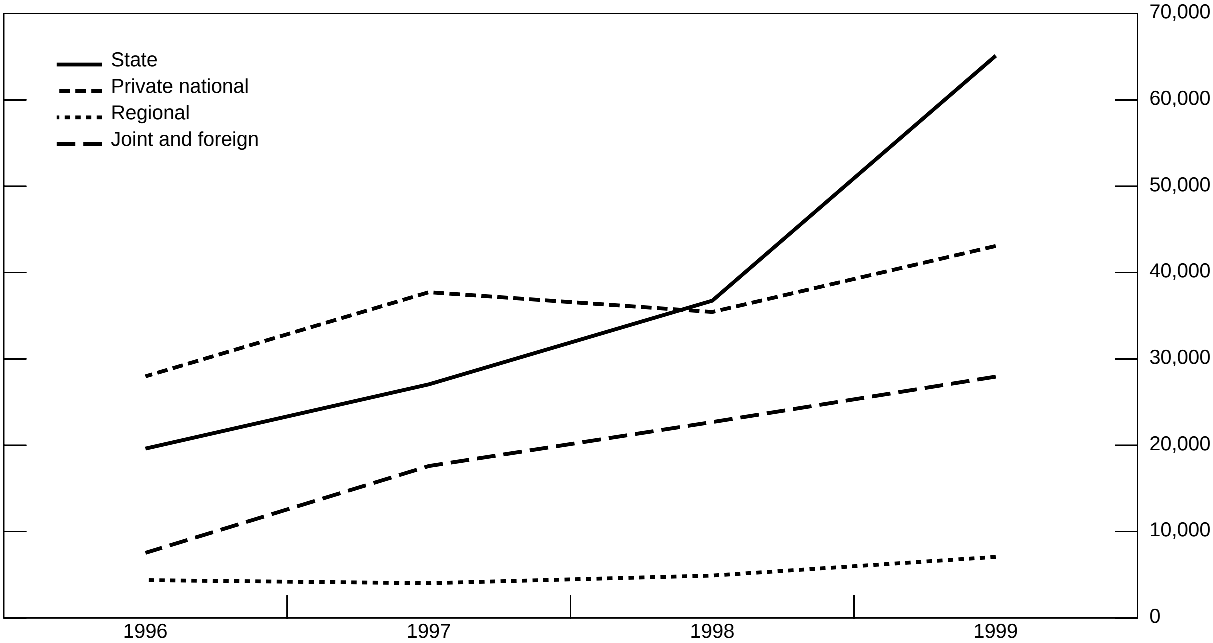
Under the current regulations, foreign banks may open branches or representative offices (but not a subsidiary or entity separate from the head office), but subject to the following conditions:

- the bank should have an international reputation;
- the bank should be ranked among the world's 200 largest banks in term of total assets;
- the initial fund placement should be at a minimum of IDR 3 trillion or equivalent in USD.

Currently, there are 10 foreign banks operating in Indonesia with branches in several major cities. Prior to the implementation of the government blanket guarantee, foreign banks and joint banks experienced a significant increase in demand deposits. However, after the guarantee scheme was adopted, the public returned to state banks. Graph 4 shows the growth of demand deposits by groups of banks.

Graph 4

Demand deposits by groups of banks (in billions of IDR)[1]



[1] Blanket guarantee scheme implemented in January 1998.

Source: BI Annual Report, 1999.

Obviously, the advantages of foreign banks in terms of support from their head offices, skilled human resources and a less regulated environment will pose challenges for national banks in terms of competition within the industry.

3. State banks: privatisation

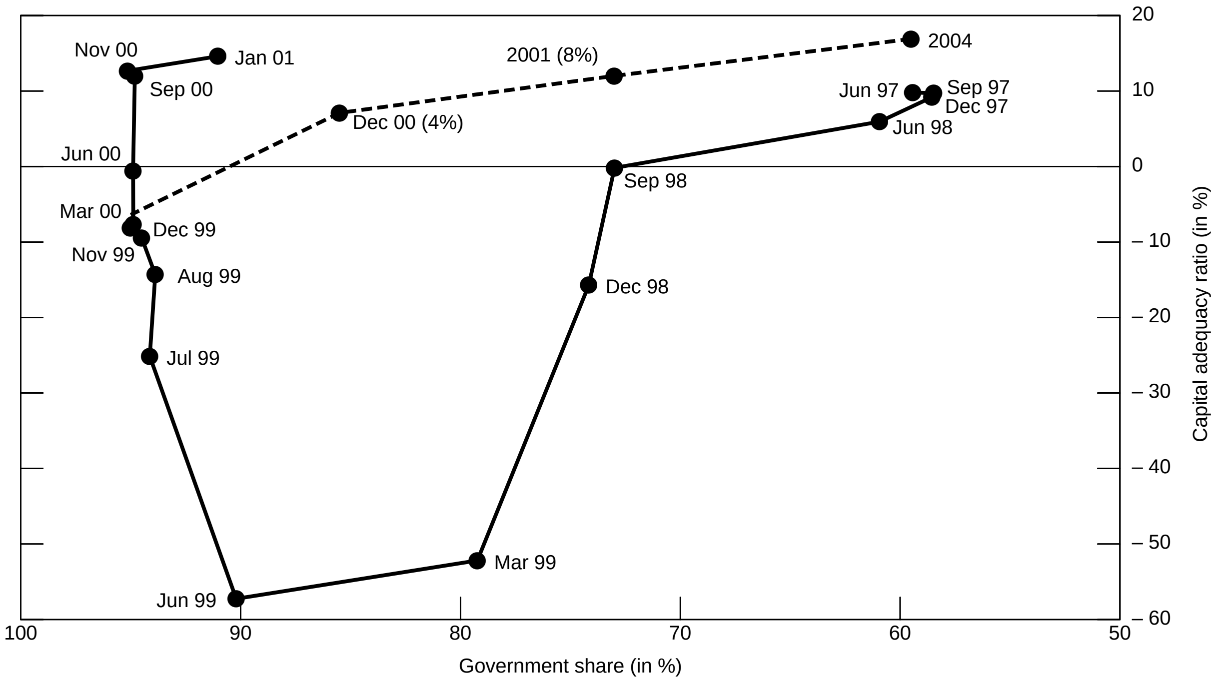
Many countries have a number of state banks, which are established either to achieve certain goals (ie foster development) or for political reasons. When state banks are inefficient, privatisation is often an important element in improving efficiency, especially where these banks have been the primary cause of banking difficulties. State banks in developing countries have generally been marked by less efficient operation, with a large proportion of their loan book consisting of "directed" lending to public-sector enterprises, often large loss-making enterprises. Restructuring of the banks may require restructuring the large public sector enterprises as well. Often state banks are fully backed by the government and, hence, their funding costs are lower. However, the government may not be prepared for the corresponding contingent liability, which may be difficult to meet. This has been the case despite the fact that, in some instances, supervisory standards have been less stringent for state banks (Hawkins and Turner, 1999).

Until the adoption of the reform package in June 1983 and October 1988, state banks in Indonesia commanded a major role in the banking industry (Annex 2). They continued to dominate loans to the public sector even in the period after the crisis, accounting for 83.7%, 86.7% and 86.8% of the market at the end of 1997, 1998 and 1999 respectively.

Prior to the crisis, credit quality had been deteriorating for years. Lack of credit analysis was the main problem for state banks because most of their credit decisions were influenced by the government and/or top government officials. As mentioned above, connected lending limits were weakly enforced and so loan quality continued to deteriorate, even after the crisis, as shown in Annex 1.

Graph 5

The evolution of CAR and government ownership of banks



As part of a government plan to privatise the state banks, the state bank regarded as the most profitable and best managed, offered 25% of its shares to the public in 1996 on the Jakarta Stock Exchange. After the recapitalisation programme had been carried out, the public share stood at 1% in October 2000. The performance of all banks deteriorated during the crisis, including the privatised state bank. In order to maintain financial system stability and public confidence, particularly in relation to the state banks, the government has:

- arranged a merger between four state banks and established a new single state bank;
- established a new state bank specialising in export financing;

- recapitalised a (prospective) new state bank and three remaining state banks to reach a capital adequacy ratio of 4%. These prompt steps were taken to address the negative capital and bad performance in the aftermath of the crisis. The government's recapitalisation programme has changed the structure of ownership of Indonesian banks. The evolution of government ownership is shown in Graph 5. Total government recap bonds accounted for IDR 412 trillion or 60% of GDP in July 2000.

In the future, the government will continue to privatise state banks in order to create sound, modern and well managed banks. Furthermore, the funds raised from the privatisation process will be used to repay the government bonds issued for recapitalisation.

4. Domestic mergers

Domestic mergers and takeovers often constitute the least costly way of restructuring the banking system. In many cases, a consolidation of the banking system may become the authority's choice even without a crisis if the authority considers the industry "overbanked" and some banks are inefficient. Mergers could become remedial steps to isolate problems in small banks. A large and well capitalised bank can absorb NPLs from weak and small banks, and then improve the quality of management. However, it is still questionable whether merging two or more weak banks can create a strong single bank.

The latter question arose when the government arranged a merger between four state banks, each of them having high levels of NPLs. The new problems faced by the new bank are very obvious. While there may be synergies or cost reductions from eliminating overlapping branches, the immediate practical difficulties in merging cultures, linking computer systems, dismissing excess staff, consolidating data and reports, and so forth can be formidable. Therefore, it may be unrealistic to expect mergers to produce the quick cost reductions needed in a crisis.

Since the crisis, 17 private banks and four state banks have been involved in two mandatory government-sponsored mergers and three voluntary mergers. The first mandatory merger took place in July 1999, involving four state banks, which suffered negative capital and huge losses. The merger will make the prospective bank the largest bank in Indonesia, with a 29% market share in loans and 21% in credits. The bank was recapitalised in 1999 with the issuance of IDR 179 trillion government bonds to bring its capital adequacy ratio up to 4%.

The second mandatory merger was in June 2000, involving nine small and medium-sized private banks which were bundled together to form a large private bank. The new bank has kept the brand name of the large banks and most of their managers. However, it will take a while to assess the effectiveness and benefits of these mergers. On the other side, the remaining voluntary mergers involving seven private banks seem to be benefiting from synergy and improved efficiency. However, the prospective bank is still encountering some problems related to the unification of accounting systems and liquidity.

5. Entry of foreign banks

In a systemic banking crisis, the difficulty of finding large and healthy domestic banks has led governments to invite foreign banks to take over domestic banks. Claessens, Demirgüç-Kunt, and Huizinga (1998) suggest that an increase in the foreign share of bank ownership tends to reduce profitability and overheads at domestically owned banks, so the general effect of foreign bank entry may be positive for bank customers. The existence of foreign banks in domestic banking may have other benefits, such as:[1]

- less connected lending;

[1] See Hawkins and Turner (1999).

- improved quality and availability of financial services;
- greater competition, which in turn reduces the costs of banking products;
- new skills and technology;
- faster and cheaper access to international capital markets and liquid funds (via parent banks);
- additional oversight by foreign supervisors, which may make them sounder; and
- meeting entry conditions to international "clubs" (notably the OECD).

However, some governments of developing countries often face domestic pressure to keep foreign banks out. This has not prevailed in Indonesia since the current regulations allow foreign banks to open branches or representative offices and even take over domestic banks with the maximum permitted ownership reaching 99% (only 1% minimum share of domestic partner). So far, however, there has been no strong interest in owning Indonesian-incorporated banks through either direct or portfolio investments. This could be due to the perceived low quality of their assets, even after the government has taken remedial actions such as transferring the NPLs to IBRA and recapitalising the banks with government bonds. Nevertheless, the government has prepared the next steps to divest its ownership in recapitalised banks after five years, in line with the Letter of Intent co-signed with the IMF.

6. Systemic stability

The weak recovery of Indonesia's economy is due to the slow resolution of three chains in the vicious circle that magnified the depth of crisis. The three chains were: unstable monetary conditions, a weak banking sector, and a heavily indebted business sector (BI Annual Report, 1999).

According to Goodhart et al (1998), there are three basic principles for managing a banking crisis to gain systemic banking stability, namely:

- ensure that the parties have benefited from risk-taking bear a large proportion of the cost of restructuring the banking system;
- take prompt action to prevent problem institutions from extending credit to highly risky borrowers or capitalising unpaid interest on delinquent loans into new credits;
- gather the political will to make bank restructuring a priority by allocating public funds while avoiding sharp increases in inflation.

In systemic crises where a large proportion of the banking system becomes insolvent, the funds prepared to resolve bank failures, such as deposit insurance and emergency central bank credit, are usually inadequate. Hence, public funds often must be used to resolve bank failures. The objective of public policy is to ensure that the transfer is limited to those parties whose protection from bankruptcy is necessary to preserve the integrity of the banking system.

Based on our experiences after significant reform in 1988, the future structure of the Indonesian banking system will most likely comprise a small number of national/multinational banks with national branch networks and international activities and a relatively high number of regional banks operating in particular regions across the country. The performance of large banks (core banks) will be very important as an indicator of systemic stability. Therefore, supervision may be focussed mainly on these banks. The task of improving the regional banks may be delegated to the regional governments.

In order to limit the impact of the crisis, the disadvantage in the funding pattern of domestic banks will be remedied by applying different treatment between national banks and regional banks. The national banks will be subject to more stringent regulation due to their higher exposures to various risks. The supervisory approach will also be improved by adopting risk-based supervision focusing on ex ante assessment, in place of the previous ex post monitoring.

7. Summary and conclusion

The deregulation packages in the 1980s and 1990s might have contributed to the fragility of the banking sector in Indonesia due to lack of prudential regulation, good governance, market discipline and law enforcement. Given the inherent fragility, the industry was prone to a crisis, which was triggered by a sharp depreciation of the rupiah in mid 1997. Experience shows that large banks with wide networks encounter more difficulties than small banks, which are less exposed to foreign exchange rate and interest rate risks.

The rapid growth of banking operations, in terms of the number of banks and offices as well as products, was not fully anticipated by the supervisory authority. It is therefore necessary to bring regulatory and supervisory approaches closer to international standards. Consolidation of banks will allow banking supervision to focus more on systemically important banks (core banks). Consistent law enforcement practices will promote the development of market discipline and good governance in the banking sector.

Privatisation is necessary to ensure that fresh money will be received to repay the recap bonds. However, domestic investors may be unable to absorb all the privatised shares from the government. Therefore, foreign investors will be potential buyers in the market as they are allowed up to 99% ownership in Indonesian banks.

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Annex 1

Classified credits for the period 1995-2000						
	1995	1996	Dec 1997	Dec 1998	Dec 1999	Aug 2000
Total credits (trillions of rupiah)	267	331	450	545	277	280
	Classified credits as % of total					
Sub-standard	2.7	2.6	2.6	10.4	10.2	11.5
Doubtful	2.4	3.3	2.5	15.2	12.8	6.0
Bad debt	3.3	2.9	3.2	23	9.9	10.4
	Distribution of classified credits by bank ownership (%)					
State-owned banks	72.7	67	52.7	38.9	52.6	48.2
Private banks	16.3	22.8	42.3	52.7	23.1	26.9
Regional development banks	5.5	4.9	0.4	0.1	1.2	3.4
Foreign and joint venture banks	5.5	5.3	4.6	8.4	23.2	21.5
	Classified credits as % of total credit by bank ownership					
All banks		10.4	8.3	48.6	32.9	27.9
State-owned banks		16.6	4.4	18.9	31.5	28.1
Private foreign exchange banks		3.7	2.8	21.1	35.9	26.4
Private non-forex banks		13.8	0.7	4.5	15.7	6.3

Sources: Data for the period January 1995 to April 1997 were derived from Nasution (1998) and for the period December 1997 to August 2000 from the BI database.

Annex 2

Market share of each group of banks in 1983 and 1987 (%)								
	1983				1987			
	Assets	Deposits	Public sector loans	Private sector loans	Assets	Deposits	Public sector loans	Private sector loans
State banks	75.6	81.5	99.3	70.9	71.2	86.7	99.5	61.8
Private FX banks	8.2	6.7	0.2	9.1	11.8	6.6	0.1	15.5
Foreign banks	8.3	11.8	0.1	7.9	6.1	6.6	0.1	6.1
Private non-FX banks	4.6	0.0	0.0	7.6	7.9	0.0	0.1	13.0
Regional dev. banks	3.2	0.0	0.0	4.4	3	0.0	0.3	3.7

Sources: BI Annual Reports, 1983 and 1987.

Banking industry consolidation in Korea

Hyung-Gon Ro

1. Introduction

Korea undertook a strong drive for financial liberalisation and market opening from the early 1990s. The structural weaknesses brought about by high costs and low efficiency in its 30-year process of concentrated growth, however, meant that its financial and economic system had become destabilised and barely able to stand the associated strains.

Most notably, in 1997, a string of large corporate insolvencies and the consequent rapid build-up of financial institutions' bad loans undermined their soundness and threatened the systemic health of the financial system. Furthermore, the negative effects of the southeast Asian currency crisis deepened foreign investors' misgivings about the health of the Korean economy. Accordingly, there was a large net outflow of foreign portfolio capital. Korea found itself in crisis, lacking sufficient foreign currency liquidity to meet its maturing liabilities, following a sharp decline in its foreign exchange reserves from early November 1997.

This left the government no option but to turn to the IMF for standby credit. An emergency package was agreed upon on 3 December 1997, under which Korea began an economic reform programme focused on macroeconomic stability and reform of its financial and corporate sectors as well as its labour market. The drive for financial sector restructuring focused on a shakeout among financial institutions, the clearing out of bad loans, the tightening of prudential regulations, the heightening of transparency of financial information, and the reorganisation of corporate governance at financial institutions.

2. Structural reforms in the financial sector

2.1 Closures, purchase and assumption transactions, and mergers

The government adopted a policy of closing down financial institutions which were no longer viable because of an overhang of non-performing loans (NPLs), while inducing an early normalisation of those still viable through injection of public funds under the condition of their own intensive self-rescue efforts.

During the financial crisis period, the top priority in financial sector restructuring was given to the earliest possible resolution of unsound financial institutions. The government acted swiftly and decisively to close down financial institutions deemed non-viable after an exhaustive review of their financial situations.

At the end of June 1998, five banks with capital adequacy ratios below the 8% BIS guideline were forced to exit the market through a "purchase and assumption" formula. Nine banks merged to form four successor banks in 1999, and two were merged to form one successor bank in July 2000. As a result, the total number of banks in Korea had been reduced from 33 to 22 by the end of 2000.

In the case of non-bank financial institutions, 21 merchant banking corporations, six securities companies, eight securities investment trust companies, and 12 insurance companies had been closed down through exits or mergers by the end of August 2000.

Table 1

Changes in the number of financial institutions

	As at end-1997 (a)[1]	Type of resolution			Newly established (c)	As at Aug 2000 (a-b+c)
		Exit[2]	Merger[3]	Total (b)		
Banks	33	5	6	11	–	22
Merchant banking corporations	30	18	3	21	–	9
Securities companies	36	6	–	6	13	43
Securities investment trust companies	31	7	1	8	4	27
Insurance companies	45	5	7	12	1	34
Mutual savings and finance companies	231	52	17	69	–	173[4]
Credit unions	1,666	215	69	284	–	1,391[4]
Total	2,072	308	103	411	18	1,679

[1] Excluding bridge financial institutions and branches of foreign institutions. [2] Including revocations of licence, bankruptcies and liquidations. [3] Represents the number of financial institutions ceasing to exist following mergers. [4] Number of institutions at the end of March 2000.

Table 2

Consolidation in the banking sector: June 1998 to March 2001

Type	Contents	Time
Purchase and assumption	Five insolvent banks were ordered to be taken over by healthy banks through a purchase and assumption formula;	
	Daedong Bank → Kookmin Bank	
	Dongnam Bank→ Korea Housing & Commercial Bank	
	Dongwha Bank → Shinhan Bank	
	Chungchung Bank → Hana Bank	
	Kyungki Bank → KorAm Bank	Jun 1998
Merger	*Government-led mergers*	
	Korea Commercial Bank, Hanil Bank → Hanvit Bank	Jan 1999
	Kookmin Bank, Korea Long-Term Credit Bank → Kookmin Bank	Jan 1999
	Chohung Bank, Chungbuk Bank → Chohung Bank	May 1999
	Chohung Bank, Kangwon Bank → Chohung Bank	Sep 1999
	Voluntary merger	
	Hana Bank, Boram Bank → Hana Bank	Jan 1999
Sell-off	Korea First Bank → Newbridge Capital (US financial consortium)	Dec 1999
Government-initiated financial holding company	Hanvit Bank, Peace Bank, Kwangju Bank, Kyongnam Bank, Hanaro Investment Banking, nine member-bank subsidiaries → Woori Financial Holding Company	Apr 2001

2.2 Injection of public funds

In the process of the sweeping financial sector restructuring, the government had to inject a huge amount of public funds into commercial banks through two government agencies - Korea Deposit Insurance Corporation (KDIC) and Korea Asset Management Corporation (KAMCO).

The total amount of financial support devoted to financial restructuring stood at 123 trillion won at the end of 2000. Out of this total amount, 48 trillion won was used for recapitalisation, 42 trillion won for the purchase of NPLs and 19 trillion won for the payment of deposit insurance claims.

In order to support financial restructuring, the government raised a total amount of 104 trillion won of public funds (including 40 trillion won for supporting the second round of financial restructuring) by issuing government-guaranteed bonds - Deposit Insurance Fund Bonds by KDIC and Non-performing Loans Management Fund Bonds by KAMCO. Out of the total amount of 104 trillion, about 73 trillion won had been used by the end of 2000. The government contributed a total of 19 trillion won from fiscal resources.

Table 3

Public funds injected into the banking system (trillion won)

Source	Support type	Nov 1997-Dec 1998	1999	2000	Total
KDIC	Total, of which:	26	28	23	78
	• Recapitalisation	6	16	14	36
	• Compensation of losses	7	4	1	12
	• Purchase of distressed assets	–	3	6	9
	• Insurance claim payment	12	5	2	19
	• Loans issued	2	0	–	2
KAMCO	Purchase of NPLs	12	3	12	27
Fiscal resources	Total, of which:	16	2	–	19
	• Recapitalisation	11	2	–	12
	• Purchase of subordinated debentures	6	1	–	6
TOTAL		55	33	35	123

Fiscal support to financial institutions for recapitalisation was inevitable and necessary in order to ensure the soundness of the financial system and to prevent systemic risk in the process of financial sector restructuring. As a result of this provision of government support, eight of the 17 commercial banks were temporarily nationalised. However, the government is committed to the withdrawal of its involvement in the commercial banking system.

The government sold its majority stake in Korea First Bank to Newbridge Capital, a US investment fund, in December 1999. This represented the first foreign ownership of a Korean commercial bank. As for Seoul Bank, a new chief executive officer has been appointed, and the bank is being groomed for privatisation in consultation with Deutsche Bank. Once a management turnaround has been achieved, the government intends to sell Seoul Bank to foreign investors by June 2001 as originally planned, If the sale does not happen by that time, the government plans to place Seoul Bank under a state-run financial holding company, Woori Financial Holding.

As for other temporarily nationalised commercial banks, the government will sell off its shares in them in steps from the first half of 2002, in accordance with its memorandum on economic policies agreed with the IMF. Government-owned preferred stock is being redeemed.

Table 4

Status of state-ownership in commercial banks (% at end-2000[1])

	Bank	Government[2]	KDIC[3]	Foreigners[4]	Largest shareholder
Nationwide commercial banks	Hanvit	–	100.0	–	KDIC 100.0
	Chohung	–	80.1	0.2	KDIC 80.1
	Korea First	3.1	45.9	51.0	Newbridge Capital 51.0
	Seoul	–	100.0	–	KDIC 100.0
	Korea Exchange	–	35.9[5] (43.2)[6]	26.4 (34.2)	Commerz AG 23.6 (32.6)
	Kookmin	6.5 (5.7)	– (9.4)	58.2 (51.3)	Goldman Sachs 11.1 (9.8)
	Housing & Commercial	14.5 (9.4)	– (10.6)	66.4 (43.0)	Bank of New York 15.4 (9.8)
	Shinhan	– (–)	– (18.3)	49.5 (40.4)	Korean residents in Japan 17.9 (14.8)
	KorAm	2.3 (1.7)	– (18.5)	61.5 (48.6)	Korea Investment 17.9 (14.9)
	Hana	4.2 (2.7)	– (35.0)	32.2 (20.9)	Allianz 12.5 (KDIC 35.0)
	Peace	–	100.0	–	KDIC 100.0
Regional banks	Taegu	0.1	–	0.8	Samsung Life Insurance 8.1
	Pusan	–	–	7.0	Lotte affiliates 14.2
	Kwangju	–	100.0	–	KDIC 100.0
	Cheju	–	100.0	–	KDIC 100.0
	Cheonbuk	–	–	0.1	Samyang affiliates 10.9
	Kyoungnam	–	100.0	–	KDIC 100.0

[1] Figures in parentheses represent percentage of shareholding calculated by including preferred stocks issued in the process of financial reforms in 1998-99. [2] Includes government-invested institutions (except financial institutions) in which the government holds a stake of at least 50%, or of which it holds less than half the equity but has provided funding support. [3] Refers to “Korea Deposit Insurance Corporation”, which was established in June 1996 for the purpose of operating a deposit insurance system. [4] Includes portfolio investment. [5] The Bank of Korea 17.8%, Export-Import Bank of Korea 16.2%. [6] The Bank of Korea 10.7%, Export-Import Bank of Korea 32.5%.

3. The second round of the financial restructuring plan (since end-2000)

In overcoming the financial crisis, efforts had been exerted to prevent systemic breakdown and to form the framework for establishing a market economy, as well as to raise external creditworthiness by pushing forward with the first-round financial restructuring process.

In spite of all efforts in the course of the first round reforms from January 1998 to August 2000, considerable uncertainty about the financial system remained. Most banks that had received public funds, and some other banks judged viable two years ago, could not turn themselves around. The outcome was that many banks found themselves still in a precarious position, and additional injection of public funds became unavoidable.

Accordingly, the government undertook the second stage of financial restructuring with a focus on strengthening the competitiveness of the domestic financial industry by clearing up bad assets such as NPLs, and implementing forward-looking reforms based on the results of the initial financial restructuring.

From the beginning of 2001, major changes have been taking place in the banking sector as the second round of financial restructuring starts. The second round has three aspects; placing banks under government-led financial holding companies, merging unhealthy provincial banks with healthy ones and allowing mergers among healthy banks. At the end of 2000, the government raised an additional 40 trillion won of public funds to support the second round of restructuring, having used up 64 trillion won of the public funds raised for supporting the first stage of restructuring from November 1997 to August 2000.

3.1 Introduction of financial holding companies

In the past, financial institutions in Korea were prohibited from setting up holding companies. This was because areas of financial activity were strictly demarcated among financial institutions and there were fears that financial concentration through holding companies would hamper the effectiveness of the financial market, and also that the unsoundness of one affiliated company would easily infect other affiliates.

The government, however, changed its policy and lowered the barriers to business diversification by financial institutions, showing a positive attitude toward financial holding companies. It is hoped that the establishment of financial holding companies will have numerous positive effects, such as enhancing credit in the financial market through facilitating economies of scale and scope, lowering financing costs, cutting the duplication of investment in information technology etc.

There is also some truth in the argument that it was the commercial banks' reluctance to participate in mergers that led the financial authorities to adopt a positive attitude toward financial holding companies, considering them another strong tool in effecting the consolidation of financial institutions. Staff resistance to takeover is less when the takeover is performed by a holding company than when it is a consequence of a merger of two banks.

In October 2000, the Korean National Assembly passed the Financial Holding Company Act, and the possibility of creating financial holding companies is now open, although there are still comparatively severe restrictions and government authorisation is needed when one is to be set up.

On 23 March 2001, the Financial Supervisory Commission, the state financial sector regulator, approved the establishment of the state-run financial holding company, Woori Financial Holding. The new company was officially inaugurated on 2 April 2001. Financial organisations under the Woori umbrella include four nationalised banks - Hanvit Bank, Peace Bank, Kwangju Bank and Kyongnam Bank - along with their nine subsidiaries, and Hanaro Investment Banking. These banks were all judged not to be self-sustainable. Consequently the government again injected sufficient public funds into them at the end of 2000 to bring their capital ratios up to 10% and pushed ahead with their rehabilitation through a financial holding company scheme.

To promote increased consolidation in the domestic banking sector, the government may also offer priority approval to sound banks and regional banks if they are willing to integrate voluntarily as a financial holding company. Banks wishing to join Woori will be included in it if this will contribute to the formation of a large and financially sound “leading” bank.

Shinhan Bank, one of the nation’s leading commercial banks, is expected to set up its own holding company as soon as May 2001. Its five existing subsidiaries and Cheju Bank, a financially troubled local commercial bank, will be brought under the holding company.

3.2 Mergers between sound banks

During the second stage of financial reform and restructuring now under way, additional mergers between sound banks and the formation of further financial holding companies are expected as banks continue to seek to improve their levels of financial soundness and competitiveness.

Negotiations are already under way between two healthy banks; on 22 December 2000, Kookmin Bank and Housing & Commercial Bank, two of the healthiest domestic banks, officially announced that they had agreed to merge to create a new bank on 30 June 2001. Final merger negotiations are currently in progress. Shinhan and Cheju are currently involved in discussions with a view to consolidation. Other healthy banks are also being encouraged to consider mergers.

4. Main features of consolidation and recent developments

4.1 Mergers pursued as a means of financial reform

As stated above, mergers have been the typical form of consolidation in the Korean banking industry. This is because the top priority in financial sector restructuring was originally given to the resolution of unsound financial institutions. It can be said, therefore, that most of the recent mergers in the Korean financial sector had nothing to do with voluntary restructuring in a true sense, although their aim was the same: to improve individual institutions' competitiveness or their financial status. In line with this, mergers undertaken as the main tool in the resolution of unsound financial institutions were carried out mainly on the purchase and assumption basis.

During the first round of financial restructuring, the government implicitly expressed its hope that voluntary mergers among banks would occur, and announced that preferential tax treatment would be given in cases of mergers. To induce more mergers, it revised the relevant legislation to permit any financial institution to either maintain its existing form, or convert itself into a different type of financial institution through merger with a financial institution of a similar or different type, or convert itself into a different type of financial institution. This paves the way for mergers between banks and non-bank financial institutions.

The government believes that large banks have many competitive advantages in the new financial environment, in which universal and internet banking are flourishing while the internationalisation of the domestic financial market accelerates. It also expects that mergers will increase the efficiency of bank management as a result of downsizing to eliminate the duplicate organisational structures and staff.

4.2 The first round of restructuring cannot be judged a success

Though huge amounts of public money were injected into troubled financial institutions in the course of the first stage of financial sector restructuring during 1998 to 2000, a few banks still had substantial levels of bad loans and failed to achieve the 8% BIS capital adequacy ratio. This has forced the government to undertake the second stage of financial restructuring.

Merged banks have not pursued the hoped-for synergies. The management performance of Hanvit Bank, the result of merging two banks with equal shares, has been very disappointing. An additional 3 trillion won of public money was injected into Hanvit Bank to clean it up, despite its having already been recapitalised with a previous 3 trillion won of public money.

4.3 Mergers among good banks initiated in recent months

Most of the mergers during the first round of the financial restructuring process occurred in response to government prodding. Individual banks were reluctant to merge, and worried about severe staff layoffs in the event of absorption. Every bank considering a merger wanted to be the initiator, not the one taken over in a hostile merger.

Recently, major changes have been occurring in the banking sector as the second phase of financial restructuring starts. Voluntary mergers between sound banks are currently being negotiated.

4.4 Business diversification expanded in the banking industry

Traditionally, there had been strict turf boundaries between the various types of financial business in Korea, and commercial banks could engage only to a very limited extent in the securities business, while being in principle prohibited from carrying on insurance business.

More recently, however, there has been strong pressure to ease the business demarcation among financial institutions. Commercial banks have sought numerous ways to circumvent the boundary lines by setting up subsidiary companies or entering into cooperative alliances with other related companies. This new trend is mainly due to the rapid progress both of information technologies and of securitisation in the financial market.

Domestic commercial banks had a total of 91 subsidiary companies as at April 2001, of which 11 were securities-related companies. As of the end of June 1999, moreover, domestic commercial banks had entered into 265 formal contracts establishing cooperative alliances with other institutions. Of these, fund transfer contracts numbered 136, accounting for the majority.

Table 5

Status of subsidiaries of commercial banks

	Securities companies	Investment trust companies	Insurance companies	Credit card Companies	Merchant banks	Financial companies specialising in loan business[1]	others[2]	Overseas subsidiaries	Total
Nationwide banks	4	7	2	3	2	13	19	31	81
Regional banks	–	–	–	–	–	7	3	–	10
Total	4	7	2	3	2	20	22	31	91

Notes: [1] Refers to venture capital companies and leasing companies. [2] Refers to economic research institutes, credit information companies, futures companies, asset management companies, factoring companies, etc.

Table 6

Types of contract for cooperative alliances of commercial banks (June 1999)

Types	Details	Contents
Settlement and fund transfers	Funds transfer (136)	– Depositing, withdrawing, remitting, transferring of funds for securities companies and insurance agencies
	Credit card business (44)	– Issuing credit cards – Matters relating to debit cards and affiliate cards
	Electronic banking (21)	– Phone banking, firm banking, or PC banking
	Internet shopping mall (2)	– Settlement service for trading through internet shopping mall
Strategic alliances with non-banking financial industries	Stock trading business (2)	– Opening accounts for stock trading – Depositing and withdrawing funds for stock trading
	Asset management or consultation (15)	– Asset management, such as the management of money in trust through stock trading – Consultation
	Insurance business (4)	– Insurance services connected with deposits
Agent service and other services	Interbanking business cooperation (3)	– Business cooperation for international banking or foreign exchange transactions – Joint promotion of business financing projects
	Other services (38)	– Subscribing for online services by proxy – Selecting competent export companies and handling related matters – Bond collection services – Selling travellers' cheques – Consulting

The number of cooperative alliances of financial institutions in 1999 was increasing explosively, especially between banks and non-banking financial institutions.

Table 7
Trends of strategic alliances of financial institutions

	Banks				Non-banking financial institutions			Between same industries (A+D)	Between different industries (B+C+E)	Total
	Between banks (A)	Between banks and non-banking financial institutions (B)	Between banks and others (C)	Sub-total	Between non-banking financial institutions (D)	Between non-banking financial institutions and others (E)	Sub-total			
1995	–	5	7	12	6	15	21	6	27	33
1996	–	–	4	4	1	7	8	1	11	12
1997	2	3	4	9	2	3	5	4	10	14
1998	1	1	2	4	–	1	1	1	4	5
Jan-Aug 1999	3	16	10	29	2	6	8	5	32	37
Total	6	25	27	58	11	32	43	17	84	101

4.5 Internet banking on a sharp rise

Although it is still in its infancy, having begun only one or two years ago, internet banking has been spreading at an overwhelming speed. All domestic commercial banks have introduced internet banking and are expanding its scope.

Table 8
Status of internet banking use

	March 2000		September 2000	
	Volume (thousands)	Value (trillion won)	Volume (thousands)	Value (trillion won)
Information inquiries	3,809	–	16,670	–
Funds transfers	1,005	9.8	2,700	30.1
Loan applications	21	0.2	97	0.9
(Loans executed)	(–)	(–)	(24)	(0.2)
Total	4,835	–	19,467	–

5. Prospects

The financial holding company system will be the axis of the future domestic financial industry, which is now rapidly restructuring. The emergence of financial holding companies will reduce the number of individual financial institutions specialised in specific financial businesses and increase the permeability of the remaining barriers separating banks, securities firms and insurance companies.

Future financial institutions will be classified as bank holding companies, non-bank holding companies, affiliated companies or individual companies. They will also be classified as companies concentrating on the banking business, the securities business or the insurance business.

Table 9

Transition of financial structure in Korea

Before financial crisis in late 1997		**At present**		**After allowing bank holding companies**
Banks		Banking focus (banks, merchant banks, mutual savings and finance companies, etc)		Bank holding companies
Securities companies				
Insurance companies		Securities focus (securities companies, investment trust companies etc)		Non-bank holding companies (focusing on insurance and securities)
Investment trust companies				
Merchant banks		Insurance focus (life insurance companies, non-life insurance companies)		Parent-to-subsidiary or inter-subsidiary ties
Mutual savings and finance companies				
Financial companies specialising in loan business etc		Others		Individual financial institutions

Competition and consolidation in the Mexican banking industry after the 1995 crisis

Jesús Marcos Yacamán[1]

1. Introduction

The Mexican banking system has gone through major changes during the last two decades as a result of its nationalisation in 1982, the financial liberalisation and privatisation of the late 1980s and early 1990s, and finally the banking crisis of 1995. The second section of this paper mentions the main factors that originated the fragile situation of the Mexican banking sector when the 1995 crisis erupted, the third points out the principal causes behind the consolidation process, and the fourth describes the main characteristics of the sector's present structure. Finally, competition issues and the policies implemented to bring about a healthy development of the banking industry are also considered.

2. The onset of the crisis

After a long period of growth and relative stability, commercial banks were nationalised by a presidential decree in 1982 in the context of a major macroeconomic crisis. Nationalised banks were subject to strict government controls: deposit and lending rates were regulated and high reserve requirements prevailed. High fiscal deficits and difficulties in accessing foreign financing forced banks to concentrate their business in lending to the public sector. As a result, credit granted to the private sector by commercial banks decreased during most of the 1980s (Graph 1).

In the late 1980s the government embarked on an ambitious financial liberalisation and deregulation process: deposits and lending rates were freed, liquidity requirements of 30% of total liabilities were eliminated, and credit allocation directives were abolished. In the early 1990s new laws on the formation and operation of commercial banks and financial holding companies were introduced and banks were sold to the private sector. Banks' privatisation strategy was governed by two unquestionable principles: transparency and revenue maximisation. However, no foreign capital was allowed at that time.

As part of far-reaching economic reforms, the size of the public sector was substantially reduced through privatisation of many public enterprises. Consequently, public sector borrowing requirements decreased significantly, freeing a large amount of resources for lending to the private sector. Additionally, the foreign liabilities of Mexican banks increased rapidly (Graph 2).

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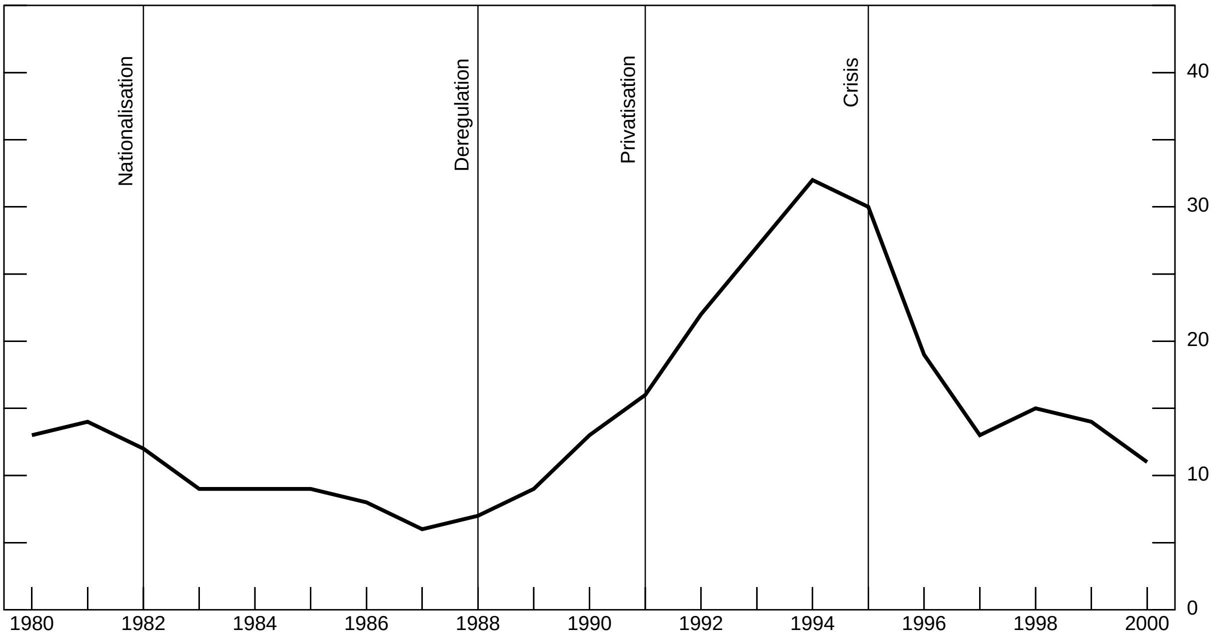
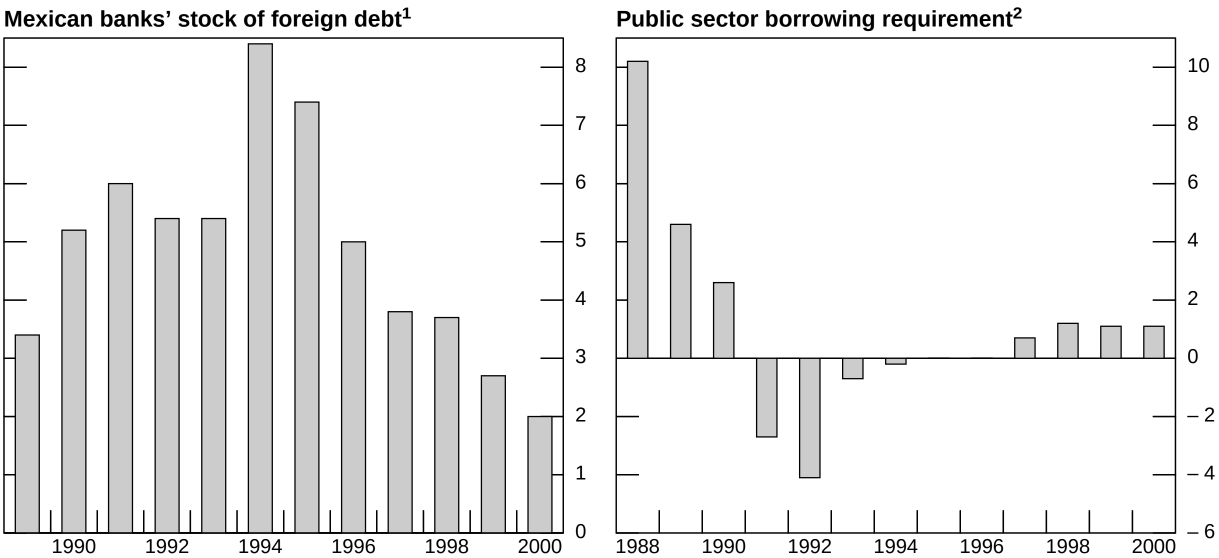
[1] The views expressed in the paper are the author's and do not necessarily represent those of the Central Bank of Mexico.

Graph 1
Bank credit to the private sector
as a percentage of GDP



Note: Data for 2000 are end-September.

Graph 2
Mexican banks' stock of foreign debt and public sector borrowing requirement
as a percentage of GDP



[1] Data for 2000 are end-September. [2] A positive (negative) value indicates a deficit (surplus).

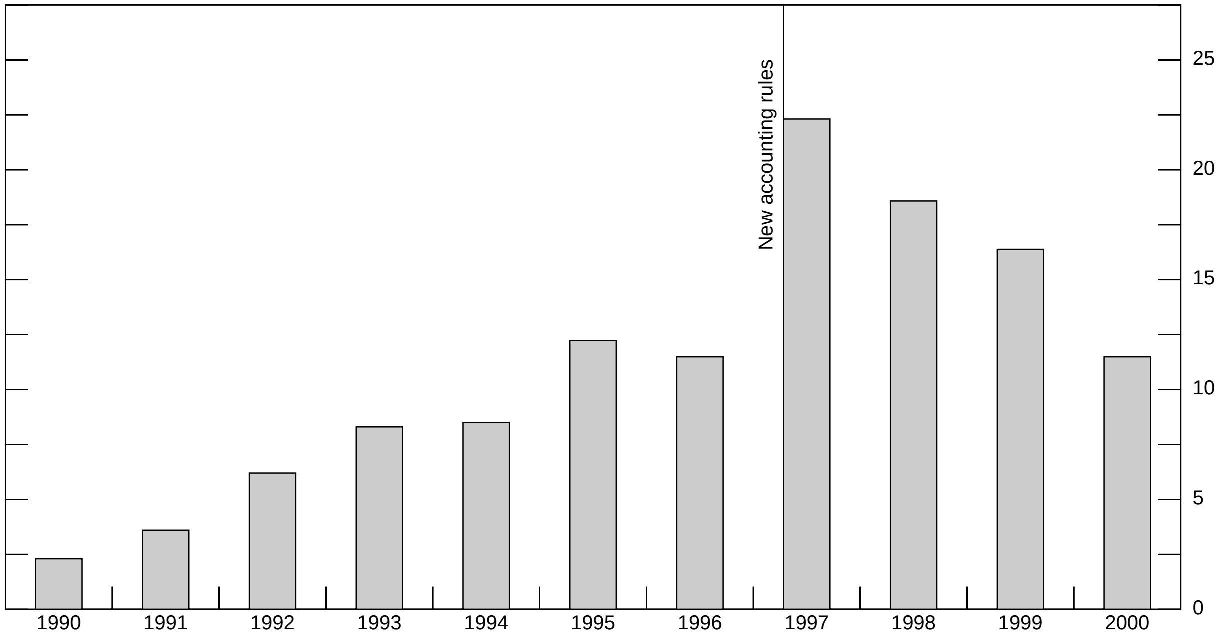
Source: Ministry of Finance.

The combination of financial deregulation and years of government-run banks, which left the sector without experienced bank managers and supervisors, but with an unprecedented availability of resources for lending to the private sector, proved to be a dangerous mixture that resulted in mounting problems in the banking system. Between 1989 and 1994, the total loan portfolio grew at an average annual rate in excess of 30% in real terms. Furthermore, private sector loans increased from 10% of GDP to slightly less than 40% during the period (Graph 1). At the same time, the ratio of past due loans to total loans jumped from 2% to 8% (Graph 3).

Graph 3

Mexican banks' past due loans

as a percentage of total loans



Note: Data for 2000 are end-September.

The devaluation of the peso in December 1994, the high interest rates that prevailed during the first months of 1995 and the fall of real disposable income sharply reduced borrowers' capacity to service their debts and thus the banks' balance sheets. To contain the crisis and prevent a systemic run on the banks, the authorities implemented several measures and programmes to support debtors and strengthen banks' balances. Among the measures taken were liquidity support in foreign currency, temporary capitalisation programmes, loan repurchases and debtor relief programmes.[2]

3. The aftermath of the crisis

As a result of the 1995 crisis, the authorities took over 15 banks. Of those 15 banks, four have already been sold back to the private sector, five have been dismembered and their branches and part of their liabilities sold to different entities, one will be sold at the beginning of next year and the rest will be liquidated. Another three banks[3] were not formally taken over but were offered under administration to potential purchasers, which acquired the institutions after bilateral negotiations with the authorities. Of

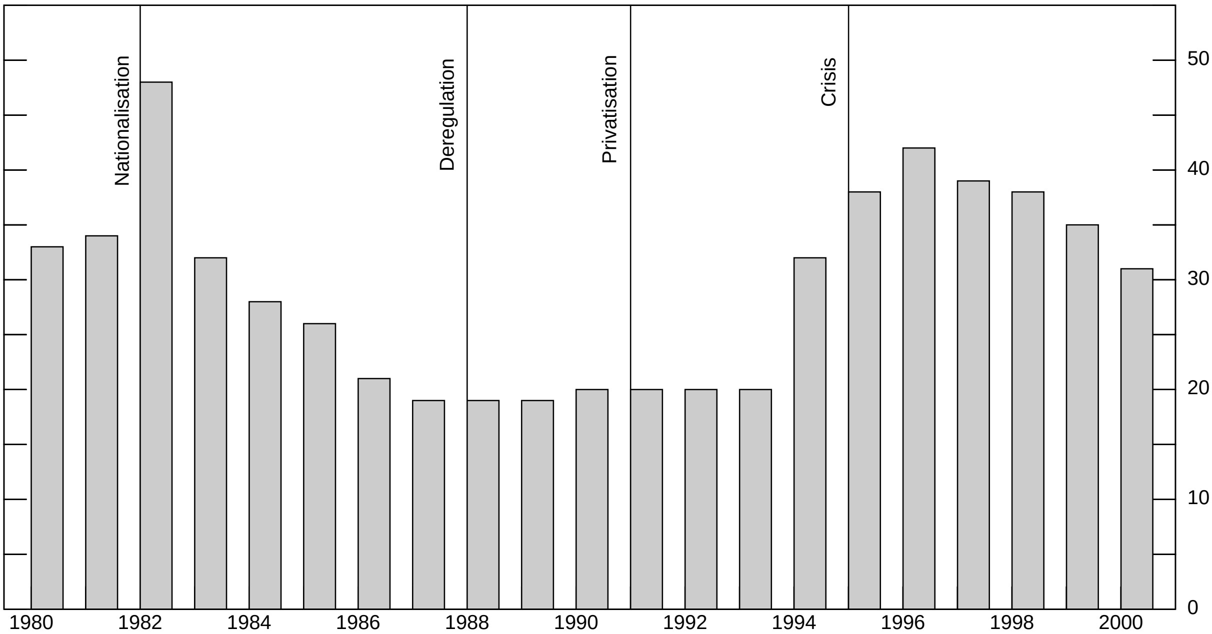
[2] See Graf (1999) for an extensive discussion of these programmes.

[3] In total four banks were handed to other private banks which had the ultimate objective of acquiring them, but only one had previously been taken by the authorities.

the 32 banks existing before the onset of the crisis, only 22 survived. However, after 1995 many banks were merged or acquired by other financial groups and new institutions entered the market. Today the banking system comprises 31 institutions.[4]

Graph 4

Number of commercial banks



Despite the measures taken, the crisis left the banking system undercapitalised and oversized. The consolidation process that has followed is the result of banks' efforts to remain competitive and financial authorities' measures to both strengthen the capital base of the banks and provide the right incentives to shareholders to aim for more prudent management of their institutions.

In this respect, the implicit full coverage of deposits by the deposit insurance agency is being substituted by a more limited scheme and new and more stringent capitalisation rules have been adopted. To facilitate the recapitalisation of banks, legislation was amended to eliminate any restriction on foreign investors' participation in the banking industry. Mexican banks had been protected from foreign competition for a long time. With the signing of the North American Free Trade Agreement with the United States and Canada, some restrictions were relaxed and a timetable was set to gradually open up the banking industry. However, the government accelerated the easing of restrictions and removed them completely at the end of 1998. At present, Mexican law authorises foreign banks to operate within the domestic market as either domestic banks, affiliates of foreign financial institutions or offshore branches. They can also open representative offices (Appendix 1).

The immediate and beneficial effect of the entry of foreign banks has been their contribution to the recapitalisation of the Mexican banking industry. In addition, a recent study has shown that the growth of credit granted by foreign banks in Mexico between 1995 and 1998 appears to have been more stable, or less sensitive to macroeconomic shocks, than that of domestic banks. The same study found, however, that the behaviour of credit was determined more by the extent of non-performing loans in banks' portfolios than by the nationality of their owners.[5]

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[4] Banks owned by the same financial holding company but operating under different franchises are considered as a single entity.

[5] Goldberg et al (2000).

4. The current structure of the banking industry

The crisis, restructuring of distressed banks and incentives created by the new regulatory scaffolding have led to a radical transformation of the Mexican banking industry in just a few years. Table 1 shows the number of Mexican banks according to their ownership, amount of capital and their share of total assets.

Table 1

Structure of the Mexican banking system (September 2000)

	Number of institutions[1]	Capital (US$ bn)	% of assets
Mexican-controlled banks[2]	14	6.9	51.6
Large foreign affiliates and foreign-controlled large banks[3]	4	5.6	46.7
Small foreign affiliates[4]	13	0.7	1.7

[1] Banks owned by the same financial holding company but operating under different franchises are considered as one entity. If they were considered as different entities, there would be 35 banks. [2] Banks controlled by Mexican residents. [3] Foreign majority-owned banks and Mexican majority-owned banks in which foreigners have control of the management. [4] Foreign majority-owned banks without significant presence in the retail market.

Foreign banks have acquired a significant share of the Mexican market in the last few years. Nowadays, besides controlling the largest and third largest financial groups, they manage 48% of the assets of the banking system, 46% of outstanding loans, and hold 48% of the banking system capital. However, the role and participation of foreign banks in different markets differ according to their size. Small affiliates entered Mexico just before the onset of the crisis and play a major role in lending to the corporate sector, and in the derivatives, government securities and money markets. Not being engaged in retail banking, most of these affiliates operate from a single office located in Mexico City.

On the other hand, some foreign bank affiliates have significantly increased their participation in the retail market. Citibank, Canada's Bank of Nova Scotia and Spain's BBVA and BSCH, after having operated in the country with a relatively small presence, recently acquired control of Mexican banks with sizeable participation in retail banking. Spanish banks now have a majority ownership in Mexico's third largest financial group (Santander) and control the largest one (BBVA-Bancomer). Bank of Nova Scotia owns the seventh and Citibank the eighth largest.

Table 2

Participation in the Mexican banking system (September 2000,in percentages)

	Loans	Retail deposits	Derivatives
Mexican-controlled banks[1]	53.8	45.0	13.1
Large foreign affiliates and foreign-controlled large banks[2]	44.4	54.9	36.2
Small foreign affiliates[3]	1.8	0.1	50.7

[1] Banks controlled by Mexican residents. [2] Foreign majority-owned banks and Mexican majority-owned banks in which foreigners have control of the management. [3] Foreign majority-owned banks without significant presence in the retail market.

Some studies suggest that the strategy followed by these four foreign banks does not seem to be particular to the Mexican case. According to IMF (2000), the same behaviour has also been observed in other emerging market countries. Before deciding to get involved in the business of retail banking, foreign banks prefer to establish small subsidiaries to participate in the local money and capital markets. Some of them go further and take minority participation in domestic retail banks. The last step is to establish fully owned subsidiaries to enter retail banking markets. In the case of Mexico, they did so by buying established banks affected by the crisis and recapitalised by the government.

Table 3

Mexico's largest banks: total assets (September 2000)

	US$ billion	% share of market
BBVA-Bancomer	40	24
Banamex	34	21
Santander-Serfin	23	14
BITAL	19	11
Bancrecer	12	7
Banorte	11	7
Inverlat	6	4
Citibank	6	4

5. Preserving competition and efficiency

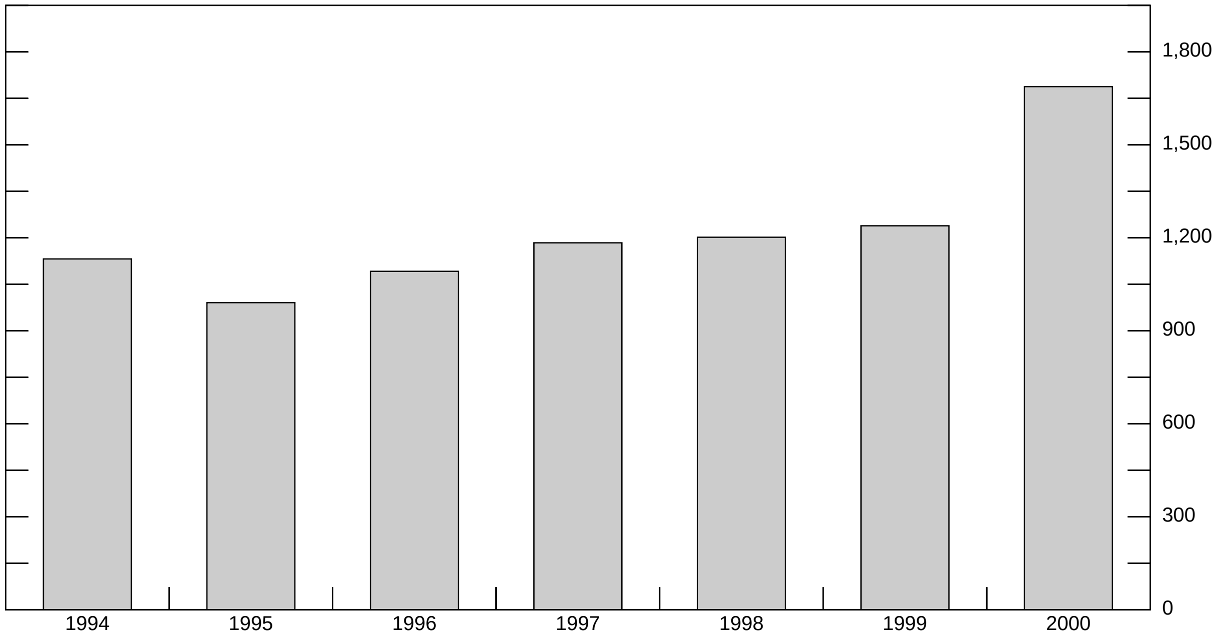
In the last few years many Mexican banks have merged or been acquired by stronger banks and financial groups. This consolidation process was driven initially by the authorities' efforts to remedy the financial situation of some banks either by facilitating their absorption by solvent banks or by liquidating them. The former strategy was followed when it was considered less costly for the government than liquidation.

However, in a second phase, the consolidation of the system has been accelerated by the ongoing reduction of deposit insurance coverage and the publication of new and more stringent capitalisation rules, raising concerns about competition and efficiency in the Mexican banking system. These competitive issues emerged recently during the attempted merger of Mexico's two largest financial groups. The unsolicited attempt by Grupo Financiero Banamex-Accival to acquire control of Grupo Financiero Bancomer was closely analysed by financial authorities. In the end, the targeted group preferred to merge with Spanish BBVA, which had a relatively small presence in Mexico before the merger.

Mergers and acquisitions in Mexico have to be authorised by the Ministry of Finance after considering the opinions of the central bank and the Banking Commission. The Federal Competition Bureau (CFC) can object to any merger if it judges that it could prevent fair competition. According to antitrust laws, "monopolies" are forbidden,[6] as well as practices that diminish or impede competition and free concurrence in the production, distribution and commercialisation of goods and services.

[6] The only monopolies permitted are those indicated in the federal constitution that are operated by the federal government.

Graph 5
Concentration in the Mexican banking industry[1]



[1] As measured by the Herfindahl-Hirschman index.

The CFC can object to or impose restrictions such as divestitures on any merger if it considers that the level of concentration is harmful. In order to evaluate a merger or acquisition, the CFC applies, among other criteria, some quantitative measures. Thus, it could be considered that a merger will not alter the competition structure of a market when at least one of the following results is observed: the Herfindahl-Hirschman index (HHI) is less than 2,000 points; the increase in the HHI is less than 75 points; the Dominance index[7] decreases or its value is less than 2,500 points.

In assessing a merger, financial authorities focus on its potential impact on three broad areas: soundness of the institutions, structure of the industry, and authorities' ability to effectively perform their functions.

To evaluate the potential impact of a merger on the soundness of the institutions involved, the authorities should consider all factors that have any effect on the solvency of the resulting entity and its economic viability such as business strategies, capacity to generate adequate returns and its capital adequacy.

To assess the effects on the structure of the industry, it is essential to identify the relevant markets that could be impaired by the merger in question. A relevant market is defined as a geographic area where a specific product is commercialised and where certain entry barriers exist. Authorities should evaluate the potential impact of a merger on the competitiveness of each relevant market.

Finally, financial authorities should carefully consider how a merger could hinder their ability to conduct monetary policy, guarantee the integrity of payment systems and regulate and supervise the financial system. In relation to the latter, an issue that should draw particular attention is the potential of

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[7] The Dominance index is calculated as $DI = \sum_{i=1}^{n} \frac{\alpha_i^4}{(\text{HHI})^2}$ where α_i is the market share of the i[th] bank in the industry and HHI is the Herfindahl-Hirschman index calculated as $\text{HHI} = \sum_{i=1}^{n} \alpha_i^2$.

mergers to generate moral hazard behaviour on the part of institutions becoming "too big to fail or be unwound" or "too big to discipline adequately".[8]

6. Maintaining systemic stability

The crisis of 1995 reminded us of the importance of preserving financial stability to achieve and maintain healthy rates of economic growth. To uphold the safety and soundness of financial systems, it is essential to have in place a regulatory framework which provides adequate incentives for shareholders to exercise prudence in the management of their institutions and enough capital and reserves to absorb the losses of today's global and volatile financial markets.

It is also crucial to have an environment where banking can be a good and efficient business. For this purpose it is essential to have a legal system that protects and enforces not only the rights of those who hold claims against banks but also those of creditors. The legal system should provide the means for creditors to expeditiously collect their loans or speedily dispose of their collateral. The bankruptcy and foreclosure laws recently approved by the Mexican Congress work in that direction by setting specific time limits for resolution of disputes and by limiting judicial discretion in the resolution of insolvent firms.

Having sound and well managed individual institutions is only the first task for maintaining systemic stability. The other pillar of stability is the capacity of institutions to withstand common disturbances. In emerging market economies one source of such disturbances is the risk of contagion from crises occurring anywhere in the world. This is more likely nowadays since capital markets are globally integrated. The most recent crises in Asia, Russia and Brazil demonstrated that investors show certain herd behaviour, particularly when they face distress situations. Emerging market economies are particularly vulnerable to this type of collective response on the part of investors given the relatively small size of their capital markets and the sharp decrease in liquidity that takes place during financial crises.

Banks located in emerging economies are especially exposed because they usually have a significant part of their balance sheet denominated in foreign currency. The maturity mismatches and fractional reserve that characterise the business of banking make banks vulnerable to distress situations that lead foreign creditors to stop rolling over their loans. Under these circumstances, central banks may be forced to step in as lenders of last resort in foreign currency to prevent systemic runs in the banking system as happened in Mexico during the 1995 crisis.

To force banks to internalise the risk faced by the central bank of having to step in as lender of last resort in foreign currency, the Bank of Mexico implemented compulsory liquidity coefficients in foreign currency according to each bank's foreign currency liabilities and their remaining maturity. Mexican banks nowadays hold more than $10 billion of foreign currency denominated liquid assets. Additionally, Mexico's central bank established ceilings on banks' foreign currency liabilities and holdings of foreign currency denominated securities according to their capital.

7. Challenges ahead

Increasing competition and the development of new technologies are forcing banks to look for innovative ways to maintain their margins and profitability. Banks can obtain large economies of scope by cross-selling products, diversifying their income sources and taking advantage of economies of scale in processing customers' information. As a result, banks and financial holding companies are merging among themselves and expanding their business to include insurance, securities and even telecommunication products and services. These developments are exposing banks and financial

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[8] Kane (2000).

holding companies to new and more complex risks as the borders between financial, commercial and technological firms become increasingly blurred.

Mexico's banking system comprises 31 banks, 17 of which belong to financial holding companies.[9] Thirteen of these financial holdings own brokerage houses, nine own insurance companies, nine participate in pension funds, and two in telephone companies. The increasing involvement of banks and financial holding companies in financial and non-financial businesses is forcing policymakers to evaluate how to update regulatory frameworks to enable their banks to compete in this new global reality.

The speed of technological and financial innovation is challenging traditional arguments in favour of the separation of banking and commerce. However, conventional limits to the transfer of risks from financial holding affiliates to banks will remain a crucial part of any regulatory framework as long as banks are considered special and thus deserving of the protection of safety nets.

There is almost common agreement that regulation should and will move towards greater reliance on corporate governance, internal risk models and market discipline. However, for these to work properly, safety nets have to be substantially reduced and transparency and disclosure procedures enhanced. In this respect, banks will become less special and hence less deserving of special protection, as depositors and investors gain access to more information about the soundness of financial institutions and banks' competitors in the credit business have access to more data on borrowers' expected behaviour. New technologies will contribute in this process by helping to collect, analyse and disseminate enormous amounts of data, reducing some of the information asymmetries that characterise the business of banking.

8. Final remarks

The crisis of 1995 was lengthy, costly and involved the restructuring of the Mexican banking industry. Even today, almost six years after the onset of the crisis, bank credit has not recovered. The current ratio of banks' assets to GDP is less than 40% in Mexico, compared to 50%, 60% and 70% for Argentina, Brazil and Chile, respectively. The ratio of banks' equity to GDP is also lower in Mexico. We believe that macroeconomic stability and the policies implemented to strengthen the banking system will make possible a considerable deepening of intermediation in the years ahead.

However, as the opportunities for banking business expand, additional capital will be needed. If profitability is to be the main source of capital, Mexican banks will face considerable challenges. Reductions of interest margins and increased competition will force banks to reduce further their operational costs, increase non-interest income and expand their income base. One way of achieving this is through further consolidation of the system and more capital injections from abroad.

9 Banks owned by the same financial holding company but operating under different franchises are considered as one entity. This figure does not include banks under government intervention, which no longer operate with the public and which will be closed.

Appendix 1

Mexican law contemplates four different forms of foreign investment in the banking industry:

Domestic banks: Mexican law establishes limits to individual participation in the capital of domestic banks. Individual shareholders can control up to 5% of the representative shares of the capital of domestic banks. However, exemptions from this rule can be authorised by the Ministry of Finance. In this sense, foreigners or foreign banks can own a participation of 5% or more (with prior authorisation).

Affiliates of foreign financial institutions: When foreign ownership of a domestic bank is higher than 51% of the capital, the bank is considered an affiliate of a foreign financial institution. However, to hold more than 51% of a domestic bank, the shareholder has to belong to a country that has a free trade agreement with Mexico that permits the establishment of affiliates from that country.

Offshore branches of foreign financial institutions: Mexican law permits the establishment of offshore branches of foreign financial institutions on Mexican territory only for the purpose of providing financial services to non-residents. Nevertheless, not a single authorisation has been granted for the establishment of a branch of a foreign financial institution on Mexican territory.

Representative offices: Foreign financial institutions can open representative offices on Mexican territory, with the sole purpose of representing their head office. In this respect, these offices are not legally permitted to take deposits, give credits or perform any type of financial operation within Mexico's borders other than receiving and providing information and negotiating the terms of the contracts between residents and the head office.

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The Philippine banking industry: competition, consolidation and systemic stability

Alberto Reyes[1]

1. Introduction

Despite the generally difficult regional conditions which prevailed as a result of the onset of the Asian financial crisis in 1997, the Philippines has emerged as among the most resilient economies in the region. The lesser impact on the Philippine economy of the financial turmoil which hit Asia owes much to the country's sound macroeconomic fundamentals, as well as to the financial reform initiatives implemented by the Central Bank of the Philippines (BSP) even before the Asian crisis struck.

Already in the 1980s, measures were being pursued to encourage greater competition and strengthen supervisory and regulatory systems. In the 1990s, the reform efforts were intensified. A new and more independent central bank was created in 1993. Restrictions on the establishment of new banks, as well as of new branches, were eased. Foreign bank entry was liberalised in 1994, which led to the establishment of 10 new foreign bank branches in 1995. Meanwhile, tighter prudential measures continued to be introduced such as a higher set of minimum capital requirements, liquidity cover on foreign currency liabilities, a cap on loans to real estate and regulations on derivatives trading.

Thus, the Philippine banks entered the crisis period in a relatively well capitalised and robust condition.

2. Reforms during the Asian crisis

To further improve the capacity of banks to face adverse shocks, and to reinforce the institutional framework to deal with problem banks in the face of the Asian crisis, the BSP adopted a programme of reforms, which included:

- a further increase in the minimum capital requirements;
- stricter requirements for granting new bank licences, as well as for setting up new branches;
- higher qualification requirements for bank directors and senior officers;
- tighter regulations on insider loans;
- stringent rules on the restructuring of loans;
- redefinition of non-performing loans to align with the international standards;
- introduction of general loan loss provisioning requirements;
- higher specific provisioning for classified loans;
- expansion of bank disclosure requirements.

The BSP also made significant progress in improving its regulatory and supervisory practices with the adoption of a host of reforms, such as:

- shift in supervisory focus from a compliance-based process to a forward-looking and risk-based framework;

[1] Deputy Governor, Central Bank of the Philippines.

- consolidated supervision of banks and quasi-banks, including their subsidiaries and affiliates engaged in allied activities;
- close monitoring of banks identified as potentially in distress based on a set of forward-looking and backward-looking indicators;
- adoption of a prompt corrective action policy and schedules of sanctions for banks that experience a shortfall in capital;
- a more efficient resolution of problem banks.

Moreover, the BSP continued to encourage mergers and consolidation, particularly of ailing banks with stronger banks as a means to hasten their rehabilitation or to avert a possible bank closure, by offering short-term incentives to merging/consolidating financial institutions.

These additional regulatory and supervisory initiatives had helped hasten the restructuring of the banking industry, enabling it to meet the demands of the economy, which was then recovering from the crisis.

3. Current policy direction

At present, the BSP is building upon the many banking reform initiatives it had started even before the outbreak of the Asian crisis. The objective is to promote a sound, stable and globally competitive financial system anchored on prudent risk management.

The strategy is two-pronged: first, the legislative framework is being strengthened; and second, internationally accepted practices are being integrated into the BSP regulatory and supervisory processes.

This year, substantial progress has been made towards strengthening and modernising the basic legal framework of the banking system.

The General Banking Law of 2000 (GBL) was signed into law on 23 May 2000, amending the country's 52-year-old General Banking Act. The law was primarily crafted to meet the challenges of and provide additional safeguards for new risks attendant on globalisation. The passage of the GBL is expected to enhance the supervisory capability and enforcement powers of the BSP, improve prudential and regulatory standards, and foster greater competition in the industry.

Some of the more important features of the new law are:

- a strong legal basis for consolidated supervision of banks;
- adoption of a stricter fit and proper rule for individuals elected/appointed as bank directors/officers;
- inclusion of at least two independent directors on the board of directors;
- adoption of a risk-based capital requirement in line with the recommendations of the Basel Committee;
- expansion of the coverage of the single borrower's limit;
- stronger safeguards against connected lending;
- liberalisation of foreign bank ownership of existing local banks up to 100% during a seven-year window;
- more flexibility in examining banks onsite in connection with supervisory matters;
- defining unsafe and unsound banking practices;
- greater transparency and disclosure requirements for banks.

Another key piece of legislation, which the BSP hopes to get approved soon, is the proposed amendment to the New Central Bank Act of 1993. The amendment aims, among other things, to promote further the independence of the BSP. The changes sought are mainly aimed at:

- promoting greater stability of the banking system;
- strengthening the supervisory capability of BSP;
- enhancing BSP effectiveness.

More fine-tuning of the BSP's prescribed prudential guidelines is also under way to ensure more competent bank management, greater transparency, reduced moral hazard and more effective bank regulation and supervision. Briefly, the specific actions being pursued include:

- prompting senior management to take full responsibility in the establishment of first lines of defence;
- adopting as a general principle the timely exit of problem banks;
- limiting bank entry only to viable entities meeting the prudential criteria;
- prescribing a minimum capital adequacy ratio;
- prescribing a ceiling on credit to selected industries and/or family/business groups;
- adopting sound accounting rules for the compilation of financial statements, including those relating to classification of loan accounts, loan loss provisioning and loan restructuring;
- compelling external auditors to report adverse findings;
- expanding banks' responsibilities for disclosure;
- adopting a ladder approach in imposing corrective and punitive measures on erring banks;
- providing supervisors with training and logistical support to perform risk-based examination.

4. Mergers and consolidation

A major feature of the reform initiatives undertaken even before the Asian crisis was the progressive increase in minimum capitalisation and the encouragement of mergers and consolidation. The aim has been to promote financially strong and well managed banking institutions.

Given the rapid pace of globalisation and accelerating technological advancement, the BSP sees mergers and consolidation as a means to create stronger and globally competitive banking institutions.

Mergers and consolidation will help merged/consolidated banks harness with greater efficiency their collective experience, expertise and technological know-how. It is implicit that parties to mergers and consolidation must have a strategic vision to make their merged enterprise more competitive, since mergers and consolidation will allow them to complement each other in terms of the markets they serve and the products and services they offer, allowing them to focus on core competencies.

Some of the incentives that merging/consolidating banks may avail themselves of include:

- revaluation of bank premises, improvements and equipment;
- staggered booking of unbooked valuation reserves;
- temporary relief from full compliance with the prescribed net worth to risk assets ratio;
- amortisation of goodwill up to a maximum of 40 years, if warranted;
- payment in instalments of outstanding penalties on legal reserves and interest on overdrafts with the BSP as of date of merger/consolidation;
- higher rediscount ceiling with the BSP;
- restructuring/plan of payment of past due obligations of the proponents with the BSP as of date of merger/consolidation;
- concurrent officership at a merged/consolidated bank/financial institution and another bank/financial institution.

There have been 11 mergers, acquisitions and consolidations since the new package of incentives came into effect in September 1998. These cases involved 15 commercial banks, three thrift banks, two rural banks and four non-bank financial institutions.

To determine the effect of the policy of encouraging mergers and consolidations on market concentration, the BSP conducted a study on the competitive structure of the local commercial banking industry using the Herfindahl-Hirschman Index. The HHI is a statistical measure of market concentration that is used to suggest the degree of monopoly power. The study indicated that the local commercial banking market is still far from oligopolistic, whether in terms of deposit distribution or loan distribution, as there are a relatively large number of competitors with significant market shares. The HHI was 585 for domestic banking deposits and 498 for loans as of end-June 1999. An HHI value of more than 1,800 is considered to indicate an oligopoly within a given industry/market.

The study also showed that while recent big mergers increased market concentration, they were not enough to pose a threat to the overall competition levels since market share remained relatively well dispersed among the remaining players. The study also confirmed that the commercial banking industry still has enough room for more mergers and consolidation without necessarily inhibiting effective competition.

This policy of encouraging the formation of bigger banks does not, however, mean that smaller banks have no place in the financial system. Smaller banks, which cater to a different segment of the population, are expected to reach markets that larger banks may be unable or unwilling to service. On 27 February 2001, the general moratorium on chartering activities was partially lifted to allow the establishment of microfinance oriented banks on a very selective basis, ie particularly in areas not served by existing rural banks or microfinance-oriented entities.

Steadily, the Philippines is moving towards an industry structure with a few domestic megabanks at the centre, with efficiency still being promoted through effective competition from foreign banks and from many niche players.

5. Liberalisation of foreign bank entry

Another major feature of the reform initiatives was the liberalisation of foreign bank entry in 1994. It aims to create a more competitive environment through greater foreign participation in the domestic banking system. The enabling law allows three modes of entry, namely:

- by acquiring, purchasing or owning up to 60% of the voting stock of an existing bank;
- by investing in up to 60% of the voting stock of a new banking subsidiary incorporated under the laws of the Philippines;
- by establishing branches with full banking authority, provided that a foreign bank may avail itself of only one mode of entry, and may own up to 60% of the voting stock of only one domestic bank or new banking subsidiary.

The law further stipulates that the number of foreign bank entrants via the third mode shall be limited to only 10, and that the share of the foreign majority-owned banks shall not exceed 30% of the total resources or assets of the banking system.

The recently approved GBL further liberalised the provisions of the aforementioned law by removing the 60% ceiling on the voting stockholding of foreign banks in a domestic bank or a new banking subsidiary, within seven years of the law taking effect.

As of end-March 2001, there were 13 foreign banks with branches (including four grandfathered foreign banks) and eight foreign bank subsidiaries operating in the Philippines. In terms of market share, foreign bank branches and subsidiaries accounted for 15% of the total resources of the Philippine banking system.

6. Electronic banking

Another development that is expected to boost efficiency and growth in the banking sector is the passage of the E-Commerce Act on 24 June 2000. An emerging trend in the financial industry today is the use of electronic banking. This technology, which is still at an early stage of development, is seen as an effective tool in reducing information and transaction costs. However, given the degree of uncertainty often associated with technological innovations, there are certain risks posed by electronic banking. The E-Commerce Act addresses such risks by defining the legal and regulatory parameters for online commercial transactions. It also provides the legal framework that will promote the security of electronic transactions.

For its part, the BSP has issued regulations requiring banks, among others, to seek prior clearance before they can provide electronic banking services. This is to ensure that the bank has put in place a risk management system that can adequately assess, control and monitor banking risks.

7. Conclusion

The gains in the banking sector notwithstanding, the BSP will continue to implement market-oriented reforms that will further promote the soundness, stability and global competitiveness of the Philippine banking system. To this end, the BSP will continue to pursue legislative reforms and the alignment of supervisory and risk management processes with internationally accepted standards.

At the top of the legislative agenda are the amendments to the 1993 New Central Bank Act, as well as the enactment of anti-money laundering legislation. In addition, prudential regulations will continue to be rationalised and aligned with international best practices, while improvements will be made to regulatory oversight through the full implementation of consolidated supervision and risk-based examination.

The combined effect of these moves should promote a stable and competitive Philippine banking system, more suited to the growing demands of a globalised economy. Domestic banks, with their flexibility in adapting to the changing financial environment, will continue to be the lead players, while foreign banks, with their increased participation, will continue to provide the additional impetus needed to sustain and enhance the competitiveness of the Philippine banking industry.

Structural changes in the Polish banking industry – three dimensions of consolidation processes in an emerging economy

Ryszard Kokoszczyński[1]

1. Introduction

The history proper of the Polish banking system began only at the end of the 1980s when the two-tier banking structure was introduced in 1989. This new legal framework reshaped the conditions for both the old specialised state-owned banks and the new universal banks, created from the commercially active branches of the National Bank of Poland – the country's central bank.[2] At the same time, the new legal framework made it possible to establish new banks, though this feature became effective only in 1990, with the beginning of the transformation process proper (Table 1). The new supervisory system set up in 1990 provided for both entry and exit rules and prudential norms. There was, however, strong pressure for relatively low barriers to entry,[3] due to the idea that private ownership was to be a major pillar of the new economic system. The number of new private enterprises established in trade, services and some industries grew very rapidly at the beginning of the 1990s. However, low interest on the part of potential foreign investors and very limited domestic capital made it impossible either to privatise quickly the state-owned banks or to create strong new "generic" private banks. Privatisation, especially with the participation of foreign capital, was seen as something for the rather distant future – Poland had not been servicing her foreign debt at that time, so perceived country risk was very high. Moreover, both the macroeconomic situation and the condition of the Polish banks constituted a strong disincentive to foreign investment. Given the desire to increase the role of the private sector in banking, low initial capital requirements were the natural outcome.

Table 1

Number of commercial banks in Poland

1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
5	17	43	89	103	104	82	83	81	83	63	77	74

Source: NBP.

The number of banks in Poland grew quite substantially in that period. However, with the fears of a monopoly of the state-owned banks predominant in the minds of policymakers and the general public alike, this development was regarded as a positive one.

To summarise, we may note that the beginning of the transformation of the banking system in Poland was a period of relatively low entry barriers due to two main reasons: the need to promote the growing share of the private sector in banking and the need to increase competition among banks. The share

1 I would like to thank Marta Gołajewska and Monika Józefowska for their able research assistance.

2 The National Bank of Poland, under the old regime of the centrally planned economy, was a typical case of the so-called monobank, ie it was simultaneously an issuing authority, credit regulator and commercial bank.

3 These low barriers meant that only the minimum amount of capital needed when applying for a banking licence (in 1989 it was 0.4 million zloty) with other norms, more prudential in nature, being similar to standard requirements (eg presentation of a viable business plan, professional and moral requirements for owners and management). This capital limit was increased several times in the early 1990s, up to the equivalent of 5 million ecu in the mid-1990s. A detailed description of this period may be found in Wyczański and Gołajewska (1996).

of these private banks in the loan and deposit market went up from 1% in 1989 to 14% in 1991 and 20% in 1992. The major constraints necessitating this approach were the lack of adequate domestic capital resources and the reluctance of foreign investors to come to Poland at that time.

2. Structural changes as a result of policy reassessment

A change in this policy came only around 1992. The economic transformation, recession, the breakdown of intra-Comecon trade and other economic disturbances, coupled with the weaknesses of many new and old banks, plunged the banking system into a quasi-crisis. Its major feature was a bad loan problem that endangered a substantial number of banks – the share of non-performing loans peaked in 1993 at around 31% and only declined to 29% in 1994.[4] This led the government and the central bank to reassess the policy principles behind decisions shaping the structure of the banking system. The sheer growth in the number of banks was no longer the decisive factor in licensing and supervisory practices.

One important, and often overlooked, factor in this reassessment was the lack of any deposit guarantee facility for newly established banks.[5] However tempting it would have been to allow weak and badly managed banks to go bankrupt, one had to bear in mind the issue of future public trust in the private banking system. Hence, this consideration became another important constraint for the restructuring process.

On the other hand, around the same time internal restructuring processes under way at the state-owned banks made them more attractive for privatisation. Initial attempts to privatise these banks drew on both the existing potential of the domestic capital market and the interest of foreign investors (including public international financial institutions). However, some foreign banking institutions attracted to the growing Polish market wanted to start their operations in a different way – by creating their own branch or subsidiary.

The major reaction to all these developments materialised in a change in licensing policy. All applicants not only faced higher requirements for initial capital, but also were pressed into either participating in the privatisation of state-owned banks or taking over ailing private institutions established after 1990. This second process was intended as a means of protecting the household deposits placed with these institutions. Domestic banks looking for a faster and – at least sometimes – cheaper way to expand also used takeovers of small and weak institutions to that end.

These processes may be thought of as a first wave of consolidation within the Polish banking system. They did not bring about any major changes in concentration, or have much effect on the number of banks, but they did give rise to a novel way of introducing changes within the system.

3. The second wave of changes

After the period of rapid growth in the number of institutions and then the bad debt problems, the main feature of current developments in the banking industry in Poland is the increasing competition. Seeking a better competitive position and the possibility to lower the cost of banking activity seems to be an important incentive for domestically designed and driven mergers.

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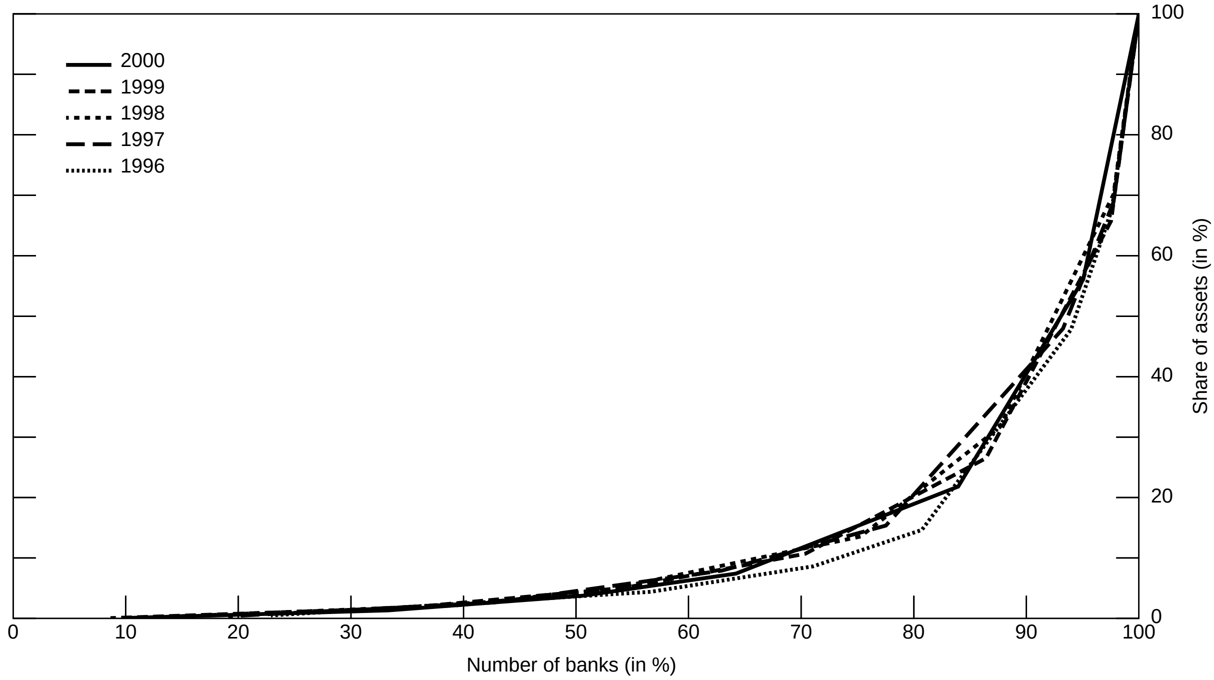
4 There is already a vast literature on the bad loan problem and the various approaches adopted in transition economies to solve it; for a brief description of the Polish approach, see various papers in Simoneti and Kawalec (1995).

5 In formal terms, the government had guaranteed deposits at all banks offering deposit services to private households before February 1989. However, in practice only old state-owned banks were covered by this facility. A formal deposit insurance system covering all banks was introduced only in 1995, but the central bank made a semi-formal commitment to guarantee household deposits at private banks according to this system’s design a couple of years earlier.

Graph 1

Concentration in the Polish banking system, 1996–2000



Some banks look for opportunities to buy weaker or troubled banks cheaply, so as to improve quickly their market share. Such processes, welcome from the point of view of enhancing stability, used to be supported by the central bank and the Bank Guarantee Fund. The former offered temporary suspension of required reserves and the latter granted long-term loans.[6] The financial assistance provided by these two institutions was of major significance in the period after the takeover of an unprofitable bank. This kind of activity is rather rare now in the case of commercial banks, but is still common within the cooperative sector of the banking system.[7]

Another process, similar to some extent, is the takeover of small niche banks by larger, though usually only medium-sized, institutions. The major reason for this is usually the perception that it is a short cut to establishing a group of services being demanded by the customers of the larger institution. The number of these cases is very limited and the approach seems to be losing its appeal.

Both processes described above can be classified as market-driven consolidation, though in the past some state-owned banks' activities in this area could be motivated by their desire to influence the government positively and therefore have more control over the privatisation processes to which they were subject.

Apart from the aforementioned takeover processes, three other types of consolidation have been observed recently. Their role in shaping the new banking landscape in Poland is increasing gradually and may prevail in the future.

The first type of consolidation occurs mainly among small and medium-sized banks. Most of them are either limited in term of geography or in the range of services they provide. Quite often in the past they established strategic alliances, offering standard services, but the increasing competition clearly shows that this is not enough to ensure their viability. Their controlling shareholders are often reluctant to lose their influence, so they are more eager to merge with banks having similar features and size. These processes concern a group of some 20 banks, where the number of completed mergers is no

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[6] These measures were not introduced automatically but required special conditions to be met.

[7] Poland had a cooperative banking sector established as far back as the 19th century, organised in a similar way to the German cooperative system. The banks involved are, however, a very minor part of the banking system in Poland (representing less than 5% of total assets), so they are not described in this paper.

more than three. I do not think that they will influence the shape of the Polish banking system very strongly, mostly because they do not constitute a substantial part of the system. However, I think this process deserves to be mentioned in a paper like this one because of its “learning value”. This type of consolidation is purely market-driven, allowing a lot of legal experience to be accumulated, and some solutions may be applied usefully for mergers among larger players.

The second type of consolidation is a specific outcome of the privatisation processes. Some foreign banks began their operations in Poland relatively early by opening branches or creating small subsidiaries. With their interest in the Polish market growing, they have chosen participation in the privatisation of relatively large state-owned banks as a means of fast expansion. Both their internal considerations, eg the parent company’s policy, and the encouragement of the banking supervisor have given impetus to these kinds of mergers.

Three mergers of this type have been completed so far: in 1999 HypoVereinsbank Polska SA was merged with Bank Przemyslowo-Handlowy SA and in 2000 Bank Austria Creditanstalt SA with Powszechny Bank Kredytowy SA and Citibank Poland with Bank Handlowy. Some other similar mergers will probably take place in the near future.

Before this kind of merger, the banks concerned usually covered different areas of activity. To simplify, foreign banks focused on corporate and trust services whereas Polish banks had a stronger presence in retail banking. Polish banks, which had usually been present on the market for longer, were much bigger in terms of assets, while foreign counterparts were quite small in this respect. There were therefore no significant changes in the market shares of merged institutions (Table 2). Polish banks’ branch networks were much more developed and their customer base was significantly larger as well. These two components provided a solid base for expansion for the “new” foreign bank. In the longer term, this type of merger may allow banks to reduce expenditure by achieving synergies. The other side to these mergers, which was well recognised by the supervisory authorities, was the elimination of unnecessary competition between banks belonging to the same investor and an increase in market transparency.

Table 2

Market share in terms of assets, before and after merger

	Before merger		After merger	
	Market share (%)	**Ranking**	**Market share (%)**	**Ranking**
Bank Przemyslowo-Handlowy SA	4.2	7	4.5	7
HypoVereinsbank Polska SA	0.4	31		
Powszechny Bank Kredytowy SA	5.1	3	5.7	5
Bank Austria Creditanstalt	0.6	24		
Bank Handlowy SA	5.0	4	7.6[1]	3[1]
Citibank Poland SA	2.6	13		
Bank Slaski SA	4.3	7	5.8[1]	4[1]
ING branch	1.5	16		

[1] Hypothetically, December 2000. Source: NBP.

In a certain sense, then, the government (in a broad sense) played a role in pushing forward this kind of consolidation, but at the same time there are also efficiency advantages. In my opinion, an unambiguous classification of these types of developments into government- or market-driven consolidation is impossible.

The last important kind of consolidation process in the Polish banking system is the domestic manifestation of the global M&A phenomenon. Most global banks maintain some presence in the Polish banking market, so whenever any consolidation occurs among them, it soon affects their subsidiaries in Poland. A major example, as yet incomplete, is the merger between Bank Austria Creditanstalt and Hypovereinsbank. Both banks are strategic investors in large Polish banks, and their Polish subsidiaries are now in the initial stage of negotiations on how to organise their future activities in Poland. There is a strong probability that this type of consolidation will continue to be important in the near future.

Table 3

Ownership structure of the Polish banking system (% of net assets)

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
All commercial banks, *of which*	93	95	95	95	95	96	96	96
• banks with majority state ownership	80	76	68	67	49	46	24	23
- directly state-owned	76	71	63	51	38	37	22	21
• banks with majority private ownership	13	19	27	29	46	50	72	73
- domestic	10	15	23	15	31	33	25	3
- foreign	3	3	4	14	15	17	47	70
Cooperative banks	7	5	5	5	5	4	4	4

Source: NBP.

BOX: Case study of a bank merger

A separate example of a bank merger in Poland is the case of Bank Pekao SA. It was created from a former specialised bank and three regional banks spun off from the NBP. The legal basis for this merger was a special act passed by parliament in 1996 to promote mergers between state-owned banks. In September 1996 shares of the three banks owned by the State Treasury were used as an instrument for increasing the capital of Bank Pekao SA. This led to the creation of the Group of the Bank Pekao SA. After a few years all group members merged into a single entity under the brand name of Pekao SA.

All the banks chosen to participate in this merger offered a wide range of services and were recognised as universal banks, though Pekao SA operated nationally while the other three banks were regionally anchored. At the same time they had certain areas of individual specialisation, so that the group's activity was not totally overlapping.

The final result of this process is Pekao SA becoming the largest bank in Poland in terms of assets (approximately 20%). However, the almost concurrent privatisation of this bank (partially through the domestic capital market) with a large foreign bank coming in as a major strategic investor makes it currently impossible to identify the role of this government-driven merger in the further development of Bank Pekao SA.

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The Russian banking sector in 2000

Vladimir Goryunov

1. Macroeconomic background

Russia's economy recorded its strongest growth for many years in 2000; real GDP expanded by almost 8%, over twice the growth rate of 1999, which had itself been a strong year. Industrial production expanded by 9% and there was a surge in investment, which increased by 18% compared with only 5% in 1999.

Notwithstanding the rapid growth in domestic demand, the balance of payments continued to strengthen, aided by higher oil prices. The trade balance over January-September 2000 was US$ 45 billion, compared with US$ 23 billion in 1999.

While inflation remained high, it also showed an improving trend. The consumer price index decelerated from 37% in 1999 to 20% in 2000 and the producer price index from 67% to 32%.

2. Development of the banking sector

This relatively healthy macroeconomic background facilitated the decision in 2000 to clean up the banking system.

The banking system expanded rapidly in 2000, with aggregate assets growing by 47%. This was quite widely spread, with assets rising in three quarters of active banks. In real terms assets were back to 90% of pre-crisis levels and now represent 34% of GDP, a slightly larger proportion than before the crisis. Funds raised by banks increased by 55% as public confidence in the banking system increased. Within this total, the proportion raised from enterprises increased slightly to 39%, while that from households was steady at around 23% (Table 2).

The proportion of loans in the balance sheet rose but they still account for less than half of assets (Table 2). Increasingly loans are being made to corporations (Table 1) and carry 100% risk weights (Table 3).

Table 1

Banks' loan portfolio (%)

	End-1998	End-1999	End-2000
Government	4.6	4.8	1.6
Banks	13.2	14.3	10.8
Households	4.4	4.2	4.5
Corporates	76.4	74.8	81.9
Other	1.5	1.8	1.2

Table 2

Composition of assets, liabilities and capital (%)

	End-1998	End-1999	End-2000
Assets[1]			
Deposits with central bank	0.5	0.2	0.9
Interbank deposits and loans	9.3	11.1	9.0
Total loans	38.2	38.7	42.1
Government securities	17.5	14.0	13.9
Total securities	20.6	17.2	16.4
Other assets	31.5	32.8	31.6
Liabilities			
Liabilities to central bank	0.9	1.1	0.6
Interbank liabilities	21.7	13.2	9.1
Household deposits	22.4	22.8	22.9
Enterprise deposits	33.9	37.6	39.0
Other liabilities	21.1	25.4	28.4
Capital			
Registered (statutory) capital	65.8	79.1	79.3
Reserves and funds	62.8	40.0	32.7
Accumulated profits	– 28.5	– 19.1	– 12.0

[1] After deduction of reserves.

Table 3

Banks' risk-weighted assets

	End-1998	End-1998	End-1999	End-2000
Total:	371.4	710.0	856.0	1,340.9
of which:				
• *with 2% risk weight*	*0.2*	*0.4*	*0.9*	*0.9*
• *with 10% risk weight*	*0.8*	*17.2*	*23.1*	*30.8*
• *with 20% risk weight*	*9.4*	*29.4*	*59.5*	*73.1*
• *with 70% risk weight*	*21.4*	*21.6*	*48.0*	*76.0*
• *with 100% risk weight*	*381.3*	*547.9*	*724.5*	*1,160.1*

There was a further contraction in the volume of interbank loans taken by Russian banks in the international financial market. The share of foreign currency denominated assets declined from 49% to 42% during the course of the year, reflecting the continued slowdown in inflation and the rate of rouble devaluation.

Table 4

Banks' foreign assets and liabilities

	End-1998	End-1999	End-2000
Foreign assets as a percentage of total assets	56	49	42
Foreign liabilities as a percentage of total liabilities	47	38	33
Difference (percentage points)	9	11	9

As banks concentrated more on lending, the relative importance of their operations in the foreign exchange market declined (Table 5).

Table 5

Banks' income and expenses (%)

	1998	1999	2000
Income			
Interest received on loans	11.7	9.1	11.4
Interest on securities	11.1	6.7	8.0
Income from foreign exchange operations	64.6	63.8	40.1
Dividends	0.6	0.0	0.0
Fines, penalties and forfeits	0.4	0.3	0.2
Other income	11.6	20.0	40.2
of which:			
Transfers from reserves	*7.2*	*13.3*	*33.5*
Commissions received	*2.3*	*2.4*	*2.9*
Expenses			
Interest paid on loans	2.2	1.2	0.9
Interest paid to legal entities	3.5	1.8	2.2
Interest paid to persons	6.5	6.5	6.0
Expenses on operations in securities	10.4	2.9	2.7
Expenses on operations in foreign exchange	54.1	59.9	39.8
Operating expenses	2.5	2.3	3.3
Fines, penalties and forfeits	0.2	0.1	0.1
Other expenses	20.6	25.2	45.1
of which:			
Transfers to reserves	*12.2*	*17.9*	*37.6*
Commissions paid	*0.4*	*0.3*	*0.3*

At the same time, the banks became better capitalised. Almost all banks were profitable, with the sector as a whole making a profit of 17 billion roubles, compared with a loss of 4 billion in 1999. This reduced the accumulated losses in the banking sector (Table 2) and helped the banking sector's aggregate capital to increase by 71% to 287 billion roubles during 2000. In real terms this brought capital back to 85% of its pre-crisis level. For the sector as a whole, the capital adequacy ratio is well in excess of the required 8%. The share of overdue loans declined from 6.5% to under 4% over the course of the year (Table 6).

Table 6

Structure of the loan portfolio

	End-1998	End-1999	End-2000
Standard	75.4	78.8	87.2
Substandard	7.2	7.8	5.1
Doubtful	6.0	2.7	2.5
Irrecoverable	11.3	10.7	5.2

Since the crisis, 250 bank licences have been revoked, although only 33 of these were revoked in 2000. Financially stable banks now account for 88% of financial institutions. Personal loans continue to account for only a small share of banking assets (about 2%). Despite a small reduction in the number of bank branches, due to licence revocations, the provision of banking services to outlying regions has improved markedly.

3. Factors relevant to systemic instability

There remain many risks in the Russian banking system. Some of these arise from factors outside the banking system such as the slow pace of restructuring in the economy, low incomes, high taxes and the low creditworthiness of many borrowers. They are exacerbated by weak management within banks, including poor risk assessment and a reliance on short-term liabilities. The banks are not very transparent and are not trusted by much of the population. The state infrastructure has not helped. There are big risks caused by the legal system, which has shown weak support for creditors. Legal environments of banking supervision should be improved.

There remain many small banks (Table 7). About 80% of banks have less than US$ 5 million in capital and half of them have less than US$ 1 million. The quality of this capital is also questionable.

Table 7

Number of financial institutions

	1998	1999	2000
Active credit institutions	1,476	1,349	1,311
of which:			
Banks	*1,447*	*1,315*	*1,274*
Non-banks	*29*	*34*	*37*

4. State and foreign-owned banks

The government has a majority holding in 23 credit institutions, which together account for about a third of total assets. The main state-owned banks are Sberbank, which alone accounts for a quarter of banking assets and has three quarters of household deposits, and Vneshtorgbank. Many of the state-owned banks cannot make loans of over US$ 100,000. It has proved very hard to sell these banks to either domestic investors or foreign banks. Many are likely to remain state-owned for a considerable period. (In part this reflects Russia’s history; it had a command economy for five generations whereas central Europe had one for only two generations.)

In the cities foreign banks have an increasing influence. Their overall market share is now approaching 10%. There are no obstacles to the entry of major foreign banks as it is realised they can bring significant benefits, such as introducing new technology and sophisticated financial instruments and techniques, helping train domestic bankers and increasing competitive pressures. However, it is realised that further improvements to the legal system will be needed to attract more foreign banks to Russia.

Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry

Jammaz Al-Suhaimi

1. Introduction

This paper traces aspects of consolidation, competition and systemic stability through half a century of evolution of the Saudi banking system. The banking system is characterised by strength, stability and resilience supported by consistency in government policies and strong banking supervision.

2. Growth and consolidation

The genesis of the banking system

The modern banking system in Saudi Arabia has its roots in the creation in October 1952 of the Saudi Arabian Monetary Agency (SAMA) with primary responsibility for monetary stability. Prior to this, branches of a few foreign banks and some local money changers provided all financial services to meet the needs of the trading community and pilgrims. By 1952, the inflow of royalties from increasing production and demand for oil had contributed to a sharp rise in government revenues and expenditures. As this gave a boost to the domestic economy, the demand for financial services rose sharply. The government encouraged a competitive banking environment by allowing new domestic and foreign banks in Saudi Arabia. SAMA's creation was followed by the licensing of more branches of foreign banks including Banque du Caire, Banque du Liban et d'Outremer and First National City Bank of New York. Some domestic banks were also licensed. The National Commercial Bank was licensed in 1953, and Riyad Bank started operation in 1957 and Bank Al-Watany in January 1958. Following banking problems in 1960, Riyad Bank took over the operations of Al-Watany and the government acquired 38% of the shares in the bank. In 1966, a new Banking Control Law giving SAMA broad regulatory powers was promulgated and a few more foreign banks were licensed.

Consolidation of the banking industry in the 1970s

The 1970s were a period of rapid expansion of the banking system to keep pace with the significant rise in government revenues and expenditures and the financing of major infrastructure and industrial projects. There was tremendous growth in the commercial banks, with the total assets increasing 35 times from SAR 2.7 billion in 1970 to SAR 93 billion and deposits increasing over 40 times from SAR 1.6 billion to SAR 68 billion. The demand for commercial credit lagged the increasing liquidity available in the banking system and low-cost medium- to long-term credit was easily available from the government lending institutions. Consequently, the foreign assets of the commercial banks grew rapidly from 11% of total assets in 1977 to 45% at the end of 1980. By 1980, there were 12 banks in operation; three were branches of foreign banks and seven had substantial foreign ownership and management. The total number of bank branches had risen to 247 and covered almost the entire country.

Notwithstanding this growth, significant gaps remained in the provision of banking and financial services. Some of the key gaps were: small businesses with limited access to credit; chequing facilities limited to cash withdrawals; foreign currency transfers only available through money changers; no consumer loans and facilities for small savers; antiquated banking procedures; non-existent computer technology; and a regionally based clearing house. A major deficiency was the dependence of banks on foreign expatriates. Thus by 1980, Saudi banks and Saudi authorities had a number of deficiencies to rectify.

The trials and tribulations of the 1980s

The 1980s were a tumultuous and testing period for the Saudi banking system. In line with the tremendous increase in government revenues during 1979-81 and subsequent slow down in 1982-86, the Kingdom's commercial banks saw rapid expansion followed by a difficult period of adjustment, deterioration in asset quality and retrenchment. As oil prices tumbled from the all-time high in 1981 and continued to decline for the next five years, the resultant economic slowdown put significant pressure on the quality of banks' assets. Government revenues, which had risen to SAR 333 billion by 1981, started a rapid decline and dropped to just SAR 74 billion by 1987. Credit to the private sector, which had increased over 500% during the period 1976-81, grew only at an annual rate of less than 4% per year over the next five years. Over 20% of loans were non-performing by 1986. Banks' profits suffered significantly and loan loss provisions and loan write-offs mounted. By 1988 most banks had made sufficient provisions for doubtful debts and the average provision for the banking system had risen to over 12% of total loans.

In terms of bank mergers and restructuring there were three major events in the 1980s. First, the United Saudi Commercial Bank was formed in 1983, to take over the branches of three remaining foreign banks, namely United Bank of Pakistan, Bank Melli Iran and Banque du Liban et d'Outremer. This completed the process of conversion of foreign bank branches into strong joint venture banks involving foreign and Saudi shareholders. Also, in 1984 Saudi Investment Bank was given a full commercial licence and in 1988 a licence was granted to Al-Rajhi Banking and Investment Corporation to convert the Al-Rajhi family's money changing business into a fully-fledged commercial bank. With these developments, by 1990 the Saudi banking system had 12 commercial banks, of which nine had substantial foreign ownership. By 1990, the number of bank branches had reached 1,036 and total employees had also risen significantly from 11,000 in 1980 to about 25,000. Another aspect of expansion was the opening of overseas branches of major Saudi banks in the United Kingdom, Bahrain, Beirut and Turkey.

The difficulties of the mid-1980s led to a significant increase in banks' capital with the encouragement of SAMA. During the period 1988-93, seven of the 12 Saudi Banks increased their capital through new share flotation. As a result, the capital and reserves for the banking system had doubled from SAR 15 billion at end-1988 to SAR 30 billion by end-1993.

The economic boom and growth of banking in the 1990s

Following the resolution of the Gulf crisis in 1991, there was a mini boom in the economy. During 1991 there was a massive surge of about 20% in the deposits of the banking system. Banks' domestic loans and advances grew 90% in 1990-95 and all other banking indicators, such as rates of return on equity and assets, continued to be very strong with many banks posting record profits. Despite difficult international conditions, the banks continued to show solid and stable growth and strong profitability during the second half of the 1990s. The trend towards increasing the banks' capital base continued and three Saudi banks went to the market during 1993-97. The capitalisation objectives were largely achieved and, with a risk/asset ratio of over 20% at end of 2000, Saudi banks are now highly capitalised by international standards (Table 1).

Table 1

Saudi banking system

	1980	1990	1998
Assets (in US$ billion)	21	69	109
Number of banks	10	12	11
Concentration (share of top five banks)	80	76	75
Number of staff (in thousands)	11	25	22
Branches	247	1,011	1,236
Return on assets (%)	1.9	1.4	1.7
Simple capital ratio	6.1	7.2	10.4

The restructuring of the banking system continued with the 1997 merger of United Saudi Commercial Bank and Saudi Cairo Bank into United Saudi Bank. In 1999, United Saudi Bank merged with Saudi American Bank to form the third largest bank in the Kingdom. This consolidation of Saudi banks is primarily driven by shareholders who wish to maximise share values and believe that size matters. The trend towards mergers may continue as banks may require more capital to invest in technology, in new products and services and in risk management systems.

Participation of foreign banks in the banking system

As described earlier, foreign bank presence in Saudi Arabia dates from the very beginning of the banking system. The government had always encouraged foreign banks to open branches within the Kingdom and consequently, by 1975, 10 international banks with 23 branches were established. However, with the Second Five-Year Plan, commencing in 1976, the government promoted a policy of converting foreign banks' branches into publicly traded companies with the participation of Saudi nationals. This policy had a number of objectives. The incorporation and floatation of these banks encouraged broad-based public participation in the banking industry and also contributed greatly to the development of a stock market in the Kingdom. Also it promoted banking activities and the formation of banking habits among the population. By encouraging foreign banks to take large shareholdings in the newly incorporated banks and by offering them management contracts, the foreign partners' position was strengthened. They could not only exercise significant management control but could also benefit from national treatment as accorded to banks fully owned by Saudis. During the 1980s and 1990s the participation of foreign banks and foreign shareholders remained substantially unchanged. However, there was some dilution of foreign participation as a result of disinvestment or due to the mergers and consolidation of joint venture banks noted earlier. The joint foreign-Saudi owned banks had assets of SAR 218 billion at end-1998, just over half of the total.

Today, the Saudi banking system is preparing for a likely increase in the number of foreign banks, as a result of the decision of the Gulf Cooperation Council governments to permit reciprocal opening of their banking markets. In this connection, Gulf International Bank of Bahrain was granted a licence to open a branch in Saudi Arabia in September 2000. Furthermore, general and specific criteria have been developed for assessing the application of new foreign banks. By March 2001, eight of the 11 banks had substantial foreign participation. The government has encouraged foreign bank presence to promote trade, investment and economic relations and to attract expertise and technology.

3. Competition

Along with sustained growth and systemic stability, a major policy of the Saudi government has been to encourage and maintain a healthy competitive environment so that the customers are able to access a broad range of banking and financial services in an efficient and cost-effective manner. This focus on ensuring a high level of customer service and multiplicity of choice has been reflected in a number of policy decisions made during the past half century.

In the early years, the government encouraged customer service by permitting a number of foreign banks to open branches in the Kingdom and also licensed domestic banks for competition. The government was selective and licensed foreign banks from different parts of the world, with varying management cultures, systems and technologies. This diversity was conducive to broadening the choices available and creating a dynamic and competitive environment. The variety in foreign presence has been maintained over time as investors representing many countries still have a considerable stake in the Saudi banking system.

SAMA has always supported and encouraged the acceptance of the universal banking model for banks in Saudi Arabia. Consequently, Saudi banks have become the primary financial institutions for provision of all banking and financial services. This policy was to ensure systemic stability in that banks were managed by fit and proper persons and enjoyed sound capital positions. It was also to promote healthy competition as banks were able to devote sufficient funds and qualified human resources to providing a broad range of financial services, including fund management, stock brokerage, investment advice and non-interest banking. More recently, banks have been distributing life and other insurance products to their customers and investing in leasing companies. These initiatives have promoted a very competitive environment in the domestic market.

These developments need to be seen from the perspective of a fundamental government policy of freedom of movement of capital whereby customers are free to access financial services from any institution or market. This ensures that Saudi banks are constantly challenged to compete with other foreign and regional banks and financial institutions. This competition is particularly vigorous in the corporate and private banking sectors, where customers can normally choose from all domestic and international banks and financial institutions. To promote a level playing field, SAMA has also ensured that all domestic banks have equal access to the basic financial infrastructure for developing their products and services. SAMA took a leadership role in establishing all payment and settlement systems in the country, to provide a strong technical infrastructure in which banks can build their own proprietary payment systems. Also, to access these central payment systems, all banks are compelled to invest in new technologies.

4. Systemic stability

The early years

The first banking problems faced by Saudi Arabia in 1960 also led to the first merger of two domestic banks. Riyad Bank and Al-Watany Bank, which had commenced operations in 1957 and 1958 respectively, faced serious liquidity problems arising from mismanagement and improper loans by board members in both banks. By 1960, Bank Al-Watany was technically insolvent and was unable to settle the claims of local depositors. SAMA liquidated the bank and merged its operations with Riyad Bank. By 1961, SAMA required Riyad Bank to reorganise and, on behalf of the government, acquired 38% of its shares. These events tested the government's resolve to defend the stability of a nascent banking system. The government not only took action requiring mergers but also came in strongly as a shareholder to prevent a bank failure. This sent a clear signal that the Saudi authorities wanted to maintain and support a strong, stable and credible banking system.

These early banking difficulties led to a new Banking Control Law in 1966, which gave SAMA broad supervisory powers to license and regulate all banks. Banks were required to meet stringent capital adequacy, liquidity and reserve requirements as well as lending ratios. A system of on-site and off-site prudential supervision was introduced and SAMA strengthened its supervisory capabilities.

The systemic challenges of the 1980s

In 1982, SAMA faced another supervisory challenge when irregularities appeared in the operations of Saudi Cairo Bank. Two senior managers were involved in unauthorised trading in bullion, and the bank had concealed accumulated losses that exceeded its share capital. SAMA took legal action against the managers and required the bank to issue new shares and double its capital in 1986. The increase was taken up entirely by the Public Investment Fund, which in this case acted not only as an "investor of last resort" but also helped the bank with liquidity and restored it to a healthy position.

The systemic challenge faced by the Saudi banking system due to the precipitous drop in oil prices in 1982 has been detailed earlier. As oil prices tumbled and the economy slid into a long slowdown, bank profits suffered, the asset quality deteriorated and non-performing loans increased. SAMA, with the help of other Saudi authorities, took a number of steps to strengthen the banks. These included retention of capital reserves, tax write-offs for loan provisions, extension of the tax holiday for foreign investors, encouragement of bank recapitalisation, provision of liquidity through repos, and investment in new technologies.

The threat of the Gulf crisis

By the beginning of the 1990s the Saudi banking system had largely recovered from the difficulties of the mid-1980's. Banks had expanded their branch network, introduced stronger management methods and new technologies, raised new capital, improved their profitability and set aside large provisions for doubtful accounts. However, the invasion of Kuwait by Iraq in August 1990 fully tested the strength of the banking system and SAMA's capability as a central bank and a banking supervisor. The crisis affected the monetary situation profoundly. Customer withdrawals of domestic deposits during the first week of August 1990 were 11% of total customer deposits. These were largely converted into foreign currency and transferred abroad. By September 1990, the pressure had eased. SAMA had ensured the availability of foreign currency to meet customer demands by providing more liquidity through repo arrangements and placing foreign currency deposits with banks.

A strong supervisory framework has banks well positioned for the new millennium

The sustained long-term growth and development of the Saudi banking system has been supported by a strong and comprehensive system of banking supervision. Since the 1960s, SAMA has enjoyed broad regulatory powers for licensing banks, approving their activities and taking prompt corrective action when required. It has powers to promulgate rules, regulations and guidelines to banks in all areas, including capital adequacy, liquidity, lending limits, and credit and market risk. Also, it has powers to conduct both on-site and off-site supervision. SAMA has a dual role of providing central payment and settlement services to banks and overseeing these systems. SAMA also acts as a regulator of the stock market. Over the years, these broad supervisory powers have been used effectively to ensure that the Saudi banking system continues to enjoy a high reputation for soundness and stability in the international financial markets. Looking ahead, enhancing systemic stability for the banking system continues to be a primary goal of Saudi authorities in general, and SAMA in particular.

While the history of the Saudi banking system has reflected the ups and downs of the oil market, the global economy and the geopolitical events, it has been able to maintain a stable and steady course. Saudi Arabia has been able to avoid a systemic banking crisis such as those faced by many countries in the last two decades. As Saudi Arabia enters the new millennium, technology, deregulation and globalisation are forces affecting its banking system. However, Saudi banks are well positioned to meet the challenges from a more open, liberal and competitive environment around the world, in the Gulf region and in Saudi Arabia.

An approach to the consideration of bank merger issues by regulators: a South African case

Gill Marcus

1. Introduction

An aspect of banking policy that recently received a great deal of attention in South Africa is the issue of bank mergers, and the regulator's approach to considering whether to allow a merger to proceed.

This paper describes the approach taken by the Registrar of Banks in considering a recent application by a "big four" bank to make a hostile acquisition of another "big four" bank. From the outset, many complex issues were at stake. Therefore, a fairly formal decision-making process, and a normative framework of factors to be considered, was developed. It is intended that this approach will be used, adapted where appropriate, for such cases in future.

2. Background

2.1 Overview of banking supervision in South Africa

Until 1986, the Department of Finance supervised banks in South Africa. This duty was then transferred to the South African Reserve Bank (SARB). In 1990, the approach of the SARB's Bank Supervision Department was revised, and the Banks Act rewritten, to support a modern risk-based approach to the supervision of banks. This approach, as continually refined, has served the banking system well. An independent assessment of the SARB's compliance with the Core Principles for Effective Banking Supervision in 1998, as well as a subsequent IMF Article 4 consultation, confirmed that the approach was appropriate to the country's circumstances. A recent Financial Sector Assessment Programme investigation resulted in further refinements to the supervisory process and supporting legislation. These refinements made the SARB fully compliant with the minimum standards set out in the Core Principles.

2.2 The South African banking sector

The South African banking sector, and for that matter the whole corporate sector, is still highly concentrated as a result of the years of economic isolation during the 1980s. Approximately 60 banks are registered in South Africa, but the largest four have approximately 70% of the assets, and own the bulk of the retail banking system. The others are mainly small niche banks, focusing on specific activities, regions or communities.

The "big four" South African banks have always invested heavily in information technology (IT), and their systems are as sophisticated as those in much more developed countries. This has increased the availability of information in the markets and has led to a substantial expansion in cross-border transactions. Technological developments have also facilitated the design of complex new financial instruments, which have provided innovative ways of hedging against risks. But most importantly, IT is seen as a major strategic competitive factor, since it forms the basis for South African banks' drive to improve cost efficiencies.

A related development has been the liberalisation and modernisation of financial markets. South Africa has adopted a clearly defined policy of actively participating in globalisation, and has implemented a number of economic policies to facilitate this process. Deregulating the exchanges, phasing out exchange controls, restructuring the capital market to provide for more specialised trading in equities, bonds and derivatives, upgrading the national payment, clearing and settlement system, and more active participation in multinational economic cooperation have all helped integrate South Africa into the global financial markets. Foreign banks are largely free of restrictions. Some 10 foreign banks operate in South Africa, and a further 60 have representative offices. The large banks also have significant operations and interests in several major foreign markets.

However, a large proportion of the population is not served by the "formal" banking system. In pursuing cost efficiencies, the main banks have left a vacuum of access to basic banking services in mostly rural areas and primarily among the poorest of the population. So far, formal government institutions, such as the Post Bank or Land Bank, have been unable to fill the gap. An informal, but largely unregulated and fairly exploitive, microfinance industry has developed. Recent moves to regulate this industry are, however, showing some promise. Nevertheless, pressure is mounting for the banking system to play a bigger role in resolving the problem of access to finance by, specifically, small, medium-sized and micro enterprises and potential sub-economic homeowners. Legislation may be promulgated soon, in order somehow to "compel" banks to undertake more developmental investment.

2.3 Overview of legal requirements relating to bank mergers and acquisitions

The Banks Act, 1990, requires the consent of the Minister of Finance, after consultation with the Competition Commission, in approving a merger between two banks. Before permission is granted, the act requires that the Registrar of Banks or the Minister, as the case may be, is satisfied that the proposed acquisition of shares will not be contrary to the interests of the general public, the bank concerned, its depositors or the controlling company concerned.

The Supreme Court of Appeal recently ruled that the Registrar of Banks and the Minister of Finance are responsible for regulating and judging bank takeovers and mergers. Subsequent proposed amendments to the Competition Act after the merger application, however, give the Registrar of Banks and the Competition Commission concurrent jurisdiction with regard to share acquisitions in banks and banking mergers or takeovers.

3. Description of the proposed merger case

3.1 The application and rationale

Bank A, through its associates, already held 26% of the issued shares in Bank B, and wished ultimately to acquire all of the issued shares. Bank A announced it would make an offer to the shareholders of Bank B once the permission of the Minister of Finance had been obtained.

The overriding reason put forward by Bank A for the merger was to create a fundamentally better banking group, for the benefit of South Africa and all stakeholders. The merged bank would have a stronger capital structure and a reduced risk profile. By eliminating duplicated costs, it would have a stronger free cashflow, allowing it to accelerate the development of state of the art IT.

Furthermore, they argued the merger would create a regional bank with sufficient scale and efficiency to compete with international banks. This would enhance trade across South Africa, whilst also contributing to the enhancement of African banking and the development of the Southern African Development Community.

Bank A argued that the merger was unlikely to reduce competition substantially, since the banks operated in the financial services industry generally, rather than just the retail banking market. It also asserted that globalisation, facilitated by IT developments, meant that South African banks effectively competed with other financial service providers worldwide.

Bank A also argued that the proposed merger had substantial public interest benefits, in that the merged entity's lower cost base would enable it to extend banking services to the underbanked and provide black economic empowerment opportunities.

3.2 The defence presented

Bank B responded by citing recent research showing that the majority of bank mergers had not delivered the promised benefits. A Deloitte & Touche report had concluded that “most mergers simply have not delivered the benefits that were promised” and in particular struck problems integrating IT systems. BNP/Paribas had underperformed its peers by 26% since its merger announcement. A review of the five largest US bank mergers in 1997 and 1998 had indicated that estimated earnings for two years after completion were substantially below initial expectations. Another South African bank had experienced a falling market share, reduced revenues and higher cost to income ratios after merger. Furthermore, empirical research had demonstrated that bigger was not better; in the United States between 1988 and 1997 the 10 largest banks had a lower than average return on assets. Furthermore, implementation risks were high as there was no experience of such large-scale integration, especially of IT systems, which could take up to six years.

They argued South African domestic banking was already concentrated, since the four large banks dominated the retail, small business and large corporate markets. Comparable mergers would not be allowed in Australia and Canada. They argued the merger would vastly increase systemic risk and concentration.

They rejected the argument that the merged bank would have an increased global profile as emotive and illogical, pointing out it would be only number 144 in the world in terms of assets, and argued European-style regional expansion was not relevant to South African banks.

Bank B also rejected the public interest argument. Its existing mass market strategy would be jeopardised by a competitor with no appetite or experience in this regard. There would be a permanent loss of 10,000 to 15,000 jobs, primarily at the clerical and the branch level, probably within 12 months, mostly from previously disadvantaged communities, which could not be handled by attrition.

4. The process of forming a recommendation

The process followed in analysing the issues and making a recommendation to the Minister involved:

- review of international bank merger practice;
- research of merger and acquisition considerations as they apply to banks;
- fact-finding discussions with the banks concerned;
- consultation with other domestic and international regulators;
- workshops to refine policy and other considerations;
- consultation with the Competition Commission;
- consultation with the Governor and Deputy Governors of the SARB;
- preparation of documentation.

Owing to the importance of the decision, and the apparent balance of the considerations for and against, an attempt was made to quantify the many complex and abstract issues. A list of 47 considerations, structured under six main headings, was considered by a panel of the management of the SARB’s Bank Supervision Department, including the analysts of the banks concerned. The SARB’s Internal Audit Department organised workshops and prepared background material for the panel. Each consideration was discussed, evaluated and scored in terms of the impact of the proposed merger.

As the questions were somewhat abstract, there was an element of judgement and subjectivity involved in answering. However, to limit this, independent, anonymous “voting” was conducted on each detailed question. The range of possible answers to each question was limited to:

– 2 – significant adverse impact;

– 1 – some adverse impact;

0 – no impact;

+ 1 – some positive impact;

+ 2 – significant positive impact.

The voting process used the commercially available “Option Finder System”, a combination of software and interactive wireless keypads used to improve group communications in face to face meetings. During the course of the meeting, facilitators posed questions or statements relating to each consideration to the participants, which were projected onto a large screen. The participants voted by pressing the keypad number of the response that matched their opinion. The software processed the keypad responses and, instantly, produced a graph of the results. The graph was projected for all to see, and outliers were discussed and resolved by revoting if necessary. The system provided a full audit trail of responses and ensured voting integrity at all times. This process made it possible to quantify the multitude of issues into a value for each category and, after account had been taken of relative weightings, into a single value, indicating a bias for or against allowing the merger. These averages were then used to guide the Registrar in assessing whether the proposed acquisition would be contrary to the various interests stated in the Banks Act.

The advantages of this approach were:

- *Anonymity* - the keypads allowed participating experts to respond anonymously, thereby encouraging more honest and accurate responses, and greater focus on content and outcomes.
- *Productivity* - more was accomplished, in a shorter time, because of the structured nature of the workshops and the comprehensive framework of considerations.
- *Democracy of input* - every participating expert was given a keypad and could register his or her opinion; not just the participants who spoke more or who had the most “power”. The graph of this input provided the basis for further discussion and decision-making.

It is stressed that the process followed did not change a judgmental decision into an objective one, but helped to structure the considerations and to break down the decision into manageable parts. Particularly the weightings of strategic issues could easily affect the outcome of the model. Ultimately, after due consideration of the objective factors and analysis, the decision remained a judgment call, informed by the process, but not solely determined thereby.

5. Normative overview of merger issues

5.1 Objectives of regulation

Regulatory authorities worldwide have three main objectives, that is to ensure that:

- banks are safe and sound;
- banks’ customers have faith and confidence in their banks; and
- banks operate efficiently and effectively.

Every country has its own instruments, contained in legislation and regulations, to achieve this. The international community of bank regulators has developed a wealth of knowledge, culminating in guidelines known as the Core Principles for Effective Banking Supervision. These comprise 25 basic principles that need to be in place for a supervisory system to be effective, and they relate to:

- preconditions for effective banking supervision - Principle 1;
- licensing and structure - Principles 2 to 5;
- prudential regulations and requirements - Principles 6 to 15;
- methods of ongoing banking supervision - Principles 16 to 20;
- information requirements - Principle 21;
- formal powers of supervisors - Principle 22;

- cross-border banking - Principles 23 to 25.

The environment in which banks operate underwent globalisation long before other industries. Banks, in performing their pivotal role in the economy, influence the repo rate, participate in the payment system and influence the international banking scene through the international payment system. It is therefore a further regulatory objective to cherish the national financial system jealously, in order to retain its systemic strength. A balance must be struck between, on the one hand, serving the national market and, on the other hand, the interest in competing internationally.

The international role of the South African financial system is to:

- be a reliable member of the international financial community, engendering confidence in investors;
- form a liaison with international financial systems;
- play a leading role in Africa; and
- lead by example in the East and Southern Africa Banking Supervisors' Group.

Not only must the robustness of the South African financial system be safeguarded, it must be enhanced and be an export product. Against this background, and being conscious of the principles applicable to competition, the regulator must adjudicate an application without falling into the trap of taking a commercial decision on behalf of the parties concerned. Although competition considerations are certainly in the interest of depositors, that interest may have to yield, under appropriate circumstances, to the regulatory objectives set out above.

Furthermore, in considering a merger application, a number of regulatory principles have to be taken into account. With regard to the shareholding structure, a bank must pay appropriate regard to the interest of its depositors. Therefore, no single shareholder (or group) should be in a position to exercise undue influence over the policies and operations of a bank. The shareholding structure should not be a source of weakness and should minimise the risk of contagion from non-bank activities conducted by shareholders in other entities within the conglomerate. Banking groups vary widely in terms of structure, range of activities and complexity. This could complicate the effective supervision of banks within such groups. Furthermore, users of banking services must be able to make a proper assessment of the banking group's activities and risk profile. The principle that the regulator does not create wealth, but is intent on protecting wealth, must prevail.

5.2 Review of international best practice

The experience in nine countries was reviewed. The number of bank mergers has increased significantly during the past two decades and creates the impression that "big is beautiful". Although there are some hostile takeover bids, most mergers are by agreement.

Some key observations were:

- Although bank regulators play an important role in the process of approving a merger, competition considerations would appear to be regarded as more important.
- European mergers and acquisitions surged during 1999 as European monetary union heightened competition and forced banks to seek ways to cut costs and to increase market share. Governments in many European countries welcomed the process of consolidation in their banking sectors and, in some cases, even urged their banks to merge as a way of creating formidable national champions and improving the international competitiveness of their banking sectors.
- Consolidation of the Japanese banking system was due mainly to an effort to restructure a struggling industry.
- Regulators and competition bodies in countries such as Australia and Canada maintain a tough stance on mergers. The Australian authorities maintain the "four pillar" policy in order to prevent a merger of any two or more of the big four banks. In Canada, two proposed mergers were recently refused, mainly because of an unacceptable concentration of economic power. The United States, with much less concentration, is reconsidering existing policy standards.

- Hostile bids are generally not well received by governments, regulators and competition agencies. Although the French government was in favour of a recently proposed three-way merger, it stated that the merger could take place only by agreement and in an ordered way. In Italy, the central bank has a strong aversion to hostile bids.
- The UBS/SBC merger in Switzerland had to be approved by two thirds of the shareholders, the Swiss regulators, the European Commission and the US Federal Reserve Board.
- In some cases, approval is granted for a merger to go ahead subject to certain conditions, for example in Australia, Switzerland and the United States.
- The international movement towards the consolidation of banking systems has held promise for more efficient, better diversified banks, with more intense competition in local markets. In many cases, especially when acquirers paid a reasonable price and managed the resulting post-merger organisational problems effectively, this promise has certainly come true. There is, however, accumulating evidence in surveys and empirical research that the promise has not always been fulfilled for retail customers in local banking markets. In many cases, neither greater efficiency nor substantial improvements in diversification appear to have been realised, and bank profitability has fallen in 12 countries, despite the recent wave of consolidation. There is also some evidence of less, instead of more, competition resulting from the process of consolidation.

Drawing on this international experience, the following principles emerged:

- There should always be sound and rational reasons for mergers. Reasons for seeking to increase size should always relate to the generally accepted standards for performance, such as revenue growth, lower costs, return on equity and assets, customer loyalty and dividend yield. The potential for rapid improvement in one or more of these measures must always be present, and a merger should be carried through to the point at which the benefits are realised.
- The potentially negative effects or disadvantages should be considered and managed carefully if it is decided to go ahead with a merger.
- A merger between two or more banks should not only be to the advantage of the institutions involved, but should also promote the soundness and stability of the banking sector (or, at least, not harm it) and should develop along the lines of national economic interests.
- Stability considerations relating to safeguarding the economy from potential shocks caused by systemic problems in the banking system are important. Since sound banks ensure a sound banking system, there is a close relationship between stability and safety considerations. The stability considerations focus more on the robustness of the system and its ability to deal with a bank failure without instability spreading to other banks and damaging the economy. Stability can either be enhanced or harmed by a merger.
- An efficient structure in the banking system would promote free competition and, therefore, efficient resource allocation. Again, a merger can either improve the efficiency of the structure, or harm it.
- The purpose of regulation is to address externalities and market imperfections, and, in a sense, regulation is a “public good”. More specifically, public interest considerations, such as changes in cost structures, can be affected by a merger.
- The interests of the bank or bank controlling company concerned should be considered. The Banks Act requires that a merger not be contrary to the interests of the bank concerned or of its controlling company. A merger can affect, for instance, a bank’s market niche and, thereby, the sustainability of its profits.
- A further set of considerations is of a more abstract nature, such as considerations relating to an industry’s present positioning in the international context. It is conceivable that permission for a merger might be based on one such strategic issue alone, following the judgement of the regulator, rather than on hard facts.

6. Framework of the relevant considerations

6.1 Introduction

A combination of the normal objectives of the regulation of banks, international best practice and the requirements of the Banks Act leads to the emergence of a framework of six categories of consideration that would be pertinent to any bank mergers. The framework can be said to be as follows:

6.2 Safety considerations

Safety considerations relate to the soundness of banks and the protection of depositors.

Ability to create a top-class management team

Management of banks should be fit and proper, competent, properly skilled and prudent. It is within this context that the management of a merged entity should be viewed. In particular, the ability of executive management to build and mould a management team that is able to lead the merged organisation through the painful process of merging IT systems, business lines and products, cultures and people is of critical importance. In this regard, the management of the merged entity needs to have the ability not only to identify the integration risks at an early stage, but to "bed down" the merger in the shortest possible time.

In addition to the above, the management of a bank must at all times place the interests of the organisation and its depositors before their own interests and should at all times act in the best interests of depositors, regardless of the demands of shareholders and other stakeholders.

Probability of a bank failure

The regulatory authority needs to consider whether the chance of failure in the merged entity is greater or less than the possibility of failure in either one or both of the stand alone entities. While research has generally indicated that the chance of failure of a large merged entity is less than the chance of failure of two smaller entities, when a large bank runs into financial difficulties, the impact is usually much greater.

Ability of authorities to assist with problems

In most banking systems, the authorities are faced with the "too big to be allowed to fail" problem. Should one or more big banks have problems, the authorities may be "compelled" to provide assistance to such banks, to avoid devastating damage to the entire banking system.

Moral pressure on authorities for forbearance

If the result of a banking merger is the creation of a very large bank, added pressure for forbearance (being "soft", instead of making more painful, but possibly more correct, decisions) may be placed on the relevant authorities. In many banking systems worldwide, such "regulatory capture" is a key concern of regulators.

Effectiveness of moral suasion by authorities

In a highly concentrated banking sector, the effectiveness of moral suasion (pressure on banks to agree to do something that they are not compelled to do by legislation) by the central bank and/or the regulatory authorities can be reduced. The sheer size and power of a very large bank would make it more difficult for the authorities to exercise moral suasion over it.

Capital adequacy and the ability to raise capital in the future

An important requirement for any bank is that it should have adequate capital to meet both its regulatory requirements and its own internal requirements, taking into account its risk profile. The capital that a bank holds should be permanent, of high quality and readily available to absorb losses. Furthermore, it is important for a bank to have in place adequate plans to ensure that it can raise sufficient capital to meet future growth.

When considering the merger of two or more banks, the regulator needs to be comfortable that the capital base of the merged entity will be sufficient to meet the objectives stated above.

Shareholding structure and the role of major shareholders in the merged entity

A regulatory authority ideally wishes to see a shareholding structure that not only has a diversified spread of shareholders, but which also has one or two key shareholders that would be available to support the bank in times of need. Of importance, however, is that, preferably, no shareholder should have the ability to exert an overwhelming influence over a bank.

In addition, the shareholding structure should be transparent and allow the regulatory authority to supervise the banking group effectively, on both a solo and a consolidated basis.

Overall risk profile of the merged entity

The authorities need to consider whether the overall risk profile of a merged bank would over time stay within acceptable boundaries and be capable of being managed properly. Common reasons for the risk profile of the merged entity possibly being higher, especially initially, include failure of control systems, lack of management focus and poor understanding of “adopted” risks. If it is clear that the risk profile of the merged entity would increase to unacceptable levels and that the management of the merged entity would not have the ability to manage the process, the regulatory authority should stop the merger.

Level of risk during the integration process

During a merger process, the overall risk profile of the merged entity will usually increase, because of the integration risk and the complexity of the rationalisation process. These risks increase in relation to the size of the merging entities and the circumstances surrounding the merger, in particular whether the merger is friendly or hostile. Furthermore, management would in all likelihood become more inwardly focused as it meets the challenges of integration.

It is also possible that the bank proposing the merger or takeover could seriously underestimate the risks associated with the integration process, further increasing the inherent risk.

Appropriateness and effectiveness of the existing regulatory and supervisory process

At any given time, the regulatory authority needs to ensure that the existing regulatory and supervisory processes and practices are adequate to cater for the complexities of the individual banks operating in the banking system and of the banking system as a whole. In addition, the banking regulator needs to ensure that the risks flowing from a complex group are well understood by the regulatory authority itself and that the risk management processes adopted by the complex group are adequate. When a merger results in a large complex banking group, the regulatory authority needs to give close consideration to its current practices, to ensure that the banking system will not be placed at risk and that the regulatory authority can effectively supervise the new merged entity.

Effectiveness of corporate governance

Effective corporate governance is always an aspect that is closely monitored by the regulatory authority. Consideration should always be given to the possibility that corporate governance, in particular internal control systems, will be less effective during a protracted merger, since the persons responsible for governance and control will be focusing on strategic issues relating to the merger. Another consideration is the possibility that a new owner would be inclined to use its influence to override sound corporate governance processes to “get things done”, especially in a hostile situation.

Finally, if the merged entity is large, it is more difficult in practice to manage and control corporate governance throughout the organisation.

Ability to retain key staff at critical times

The success or failure of any merger depends upon the ability of management and staff in key positions to implement the necessary changes in order to ensure a smooth transition to a new organisation.

6.3 Stability considerations

Stability considerations have to do with the protection of the economy from potential shocks caused by systemic problems in the banking system. (As sound banks make for a sound system, there is a close relationship between this category and the previous one.) Stability considerations focus on the robustness of the system and its ability to deal with a bank failure without such a failure spreading to other banks and damaging the economy. Stability can be either enhanced or reduced by a merger.

Confidence in the banking system

Banks, although stringently regulated, are prone to runs. This is because they are known to be highly geared. Confidence is therefore crucial for banks to attract and retain deposits. This holds more for small banks than for larger banks, which are less exposed to this vulnerability. It could therefore be said that larger banks enhance the confidence of the public.

On the other hand, the responsibility of the management of a large bank is more onerous, particularly to ensure effectiveness, containment of costs and adequate control systems. The demands of modern times bring pressure to bear on banks to take on risks in order to be more competitive, particularly in the international arena. In the local arena, the same applies, albeit on a lesser scale. Since a single management error in a large bank can affect the entire banking system, it is also possible that a bank that is considered to be too big by the public could reduce confidence in the banking system, especially among foreign observers.

Concentration of systemic risk

All banks, however well their risks are managed, have the same inherent flaw in their balance sheets - their liabilities are certain and short-term whereas their assets are uncertain in value and long-term. This “sameness” of banks results in a high tendency for known problems in one bank to spread rapidly to other banks and to the whole banking system if the problems are not checked. Such “systemic risk” is the worst fear of any bank regulator, and any factor that can impact thereon should be considered carefully. Although a larger bank does not imply more systemic risk, there is a possibility that a small number of very large banks would impact on the ability of regulators to “check” a systemic problem.

Level of moral hazard among management

Because of the importance of banks to the economy, their inherent fragility, and hence the need for confidence in the system to be maintained, central banks would usually consider extending assistance to banks with short-term liquidity problems. Governments have also been known to assist failing banks (those with more than just liquidity problems) or their depositors, in order to avoid even more costly damage to the system. This “implied guarantee” tends to make bank management risk-prone, rather than risk-averse, because of the presumption that there is likely to be “lender of last resort” assistance.

Central banks and governments always have the prerogative of letting a bank fail without assistance. The bigger the bank, however, the fewer alternatives the authorities have but to assist it, owing to the possibility of widespread hardship and irreparable damage.

Extent of adverse selection by consumers

A consumer of banking products would normally avoid risk by dealing only with banks that (in the consumer’s opinion) have appropriate risk profiles. The lack of reliable information about a bank's risk profile, however, combined with the fact that consumers also rely on the “implied guarantee” described above, means that there is every chance of consumers deliberately selecting the riskiest banks (in pursuit of higher returns). Such “adverse selection” undermines the effectiveness of market discipline and the importance of the “buyer beware” principle as part of the regulatory system.

Ability of authorities to stem a systemic crisis

The authorities have only limited instruments and resources to assist a bank, or worse many banks simultaneously, in order to prevent a systemic crisis. The bigger the bank, the more difficult it would be to implement rapidly an effective measure, owing to the increase in the scope of the problem.

Social cost of failure

It is an economic tenet that the social cost of a bank failure exceeds the private costs. It is one reason for the existence of regulation. The statement has three aspects. First, the “indirect” cost to the taxpayer of a failed bank, plus the losses of deposits not reimbursed, can easily exceed the losses of shareholders, who are the real risk takers; this is not equitable. Second, and more importantly, the damage caused in the form of a loss of confidence in the banking system may never be fully recovered. Third, if the problem becomes systemic, the cost to the fiscus of resolving the ensuing crisis could easily exceed 10% of GDP. The latter two aspects can cripple the entire economy of a country.

Ability to return to the status quo if necessary

Mergers are for all practical purposes irreversible, and can usually not be undone without damage if they do not turn out in the way that the parties had intended. Hostile mergers have a higher risk of failing in this regard, which is why jurisdictions usually do not allow hostile bank mergers. A factor to consider in very large mergers is that the change affects the entire structure of the banking system. Such irreversible change to the banking system, even if driven by market forces, may be just too risky to allow, simply because all the implications cannot be foreseen. The risks are often too high, because they may impact on the stability of the system.

Capacity to conduct orderly consolidation among smaller banks

In a merger between large banks, there are clearly many operational risks that have to be managed during the integration process. In addition to the management and staff of the two banks involved, there will be a focus on other resources of the banking system, notably the regulator, analysts, rating agencies and the auditing profession, during the merger. It should be borne in mind that any other structural changes being contemplated, such as a change in the supervisory approach or a regulator-induced restructure of the banking sector, would also be at risk. (Note: The new capital framework is an example, as are the many banking sector restructures that have recently taken place in emerging economies).

Possibility of mass management walkout if hostility is not resolved

An important potential source of operational and continuity problems is a loss of key staff. The risk is exacerbated if the merger is not friendly.

6.4 Efficiency considerations

An efficient structure in the banking system would promote free competition and, therefore, more efficient resource allocation. Again, a merger can either improve or harm the efficiency of the structure.

Level of competition between banks

When two large banks (both having a large market share) merge, one of the key considerations will be the impact on the level of competition between the banks. In such a merger, one should consider how the merged entity can influence the prices, products and quality of service in the banking sector. One must also consider the impact that the merger will have on the financial sector.

The H-index ranges from 1 (for a monopoly) to 1/n, when there are many banks in an industry. In a competitive system, 1/n tends towards 0. For South Africa, which currently has some 60 banks, the adjusted index had improved to 0.15, from a level of 0.16 in 1996. A comparison of H-indices for different countries shows that South Africa belongs to a group of countries with a relatively high level of concentration, including Finland (0.33), New Zealand (0.18), Israel (0.22), Ireland (0.17), Denmark (0.20), Sweden (0.18) and the Netherlands (0.19). If the proposed merger had succeeded, the index would have increased, leaving South Africa with a highly concentrated banking sector in terms of world standards.

As indicated in an appendix to the original report on the proposed merger under discussion and in a submission of the Competition Commission, several international thresholds were crossed. When the Australian and Canadian thresholds were applied to the proposed merger, the Australian thresholds were crossed on four out of a possible 10 occasions, whereas the stricter Canadian thresholds were crossed on eight out of a possible 10 occasions.

Level of innovation

It is a well known risk that the practical implementation of merger strategies tends to lead management to focus inwardly on the implementation process, thus facing the risk of losing the innovative touch.

In addition, the loss of a competitor, which is a direct result of a merger, means that there may be less need to innovate, with possibly less research and development spending and, consequently, less long-term sustainability.

Availability of sound banking skills in the marketplace

The possibility of a merger resulting in a better management team, the risks during integration, and potential losses of key staff have all been discussed above. A related consideration is the impact that the merger may have on the market for competent banking and management skills. In a mature market, the impact may be negligible. In a market with little depth, however, the marketplace could be flooded with skills, causing widespread mobility and disruption.

Ability to control input costs

Sound and rational reasons for mergers should always exist. Reasons for seeking to increase size should always relate to the generally accepted standards for performance, such as revenue growth, lower costs, return on equity and on assets, customer loyalty and dividend yield. The potential for rapid improvement in one or more of these measures must always be present, and a merger should be carried through to the point at which the benefits are realised.

A merger should not be contrary to the interests of the banks concerned, for instance their ability to control costs. One of the objectives of regulation is efficient and effective operation of banks. Therefore, returns of scale, scope and efficiency are all factors to be considered.

According to one school of thought, the most important factor to be considered is the cost efficiency versus margin ratio of the banks before and after a merger.

According to this thinking, cost efficiency will be such an important competitive aspect in the globalised banking system that a proven ability to enhance cost efficiency substantially through a merger must be the most compelling argument. More correctly, if the merged bank will reduce both margins and the cost to income ratio, there should be a strong bias towards letting the merger proceed.

Effectiveness of IT architecture

IT systems should be able to provide management information that is accurate, timely and relevant to managing a bank's risks. IT is most probably the biggest risk if not properly planned and managed. For example, there could be a lack of management information, an increased possibility of fraud and incorrect measurement of risk, since manual intervention is required until proper IT systems are in place.

A bank’s systems should also be able to serve the needs of its customers adequately and contribute to a sound internal control environment.

Ability to compete with foreign banks

A proposed merger between banks should not be considered only in a domestic context. The spate of mergers in Europe provides ample evidence that regional and international competitiveness is also considered to be a powerful motivator for bank mergers.

Ability to maintain morale, motivation and commitment of staff

In a service industry such as banking, motivation of staff is a key factor in ensuring that efficiency is maintained. In a hostile merger, the regulator must assess the impact that the hostility factor will have on the morale, motivation and commitment of staff. In addition, in any merger, the issue of different corporate cultures arises.

Ability to maintain credit/deposit lines in the sum of the parts

In any merger, it is important to consider the impact that the possible decrease in credit/deposit lines will have on the merged entity.

6.5 Public interest considerations

The purpose of regulation is to address externalities and market imperfections, and, in this sense, regulation is a public good. More specifically, public interest considerations can be affected by a merger.

Range of product lines available to consumers

A merger of banks should potentially be in the public interest, for instance as regards service considerations. The proposed merger should therefore ultimately add some depth to the local banking sector and make a worthwhile contribution to banking services and the banking industry in a particular country.

A frequent factor in motivating mergers is the possibility of scope efficiencies. The pursuit of these efficiencies often results in the product lines of the two entities being rationalised, with consequent cost benefits, since a single delivery system is used to sell a “better” (bigger) range of products. This often increases the options that consumers have and enhances the utility of these options.

In some cases, however, rationalising product lines may work against the public interest. This would be the case if a product line that is less profitable, but which serves a public need, were to be discontinued by the new management.

Ease of access to basic banking services by the public

Economies of scale are fairly likely to improve after a merger. Larger transaction volumes and larger asset positions, through a rationalised delivery system, mean that unit costs can be reduced. Provided such cost reductions are passed on to the consumer, this may be regarded as a public interest benefit.

Ability to address black empowerment and the underbanked

In particular cases, a merger could be the catalyst for a fundamental shift in social uplift and redistribution of ownership and wealth.

Ability to maintain service levels during integration

The possibility of operational problems during the integration process has been considered above. A possible result of a merger integration process, even if there are no significant operational problems, is the tendency for a deterioration in service quality levels to customers. The complexity of unifying cultures, working methods and systems, combined with possible motivational problems, may result in frequent errors causing customer inconvenience. The existence of an “excuse” that can be used to absolve responsibility can further exacerbate the problem.

Spread of ownership in the banking industry

A widespread ownership of banks has the potential benefit of reducing the possibility of abuse by owners of banks, for instance, the owners using the bank to fund other activities. On the other hand, the absence of a large shareholder means that the regulator will find it more difficult to identify a party with sufficient interest to stand by the bank in times of difficulty. A merger can often be the vehicle for a major shift in the ownership spread, and regulators need to consider the possible impact in the context of each merger.

Ability of the merged entity to abuse market power

A bank merger can easily result in a substantial increase in the market power of a bank. Despite a merger often being motivated on grounds of economies of scale and cost containment, shareholder interests also drive mergers, and the cost savings may not always be passed on to customers. In addition, the possibility exists that the increased market power might be abused by the merged entity, raising costs to customers to unacceptable levels.

Ability to ensure fair treatment of all stakeholders

In any merger, there is a possibility of passive resistance from the staff of the banks concerned. People are averse to change, especially if they feel they cannot really be part of the change process. When staff organise and offer overt resistance, for instance by organising and participating in demonstrations to protest against the merger, such polarisation can be unhealthy. It is possible that staff may feel, or indeed be, victimised afterwards. In general, the process of unification and rationalisation will affect staff, and there may be many pitfalls, including cases of inequitable treatment of staff. In addition, rationalisation of suppliers can result in unfair treatment.

6.6 Interest of the bank or controlling company concerned

The Banks Act requires that a merger not be contrary to the interests of the bank concerned or of its controlling company. A merger, for instance, can affect a bank's market niche and, thereby, its sustainability.

Ability to maintain market share and profitability

A major consideration in examining a merger of two major players in the banking sector is the ability of the merged entity to maintain market share and profitability.

One should also consider whether, given the characteristics of the two banks in question, the merged entity will result in a better bank.

Possibility of subtle sabotage owing to hostility

A major consideration when a hostile takeover is under consideration is the increased risk of sabotage or lack of cooperation (active or passive) related specifically to the hostile nature of such transactions. When banks are involved, regulatory authorities should carefully consider the potential impact thereof on the banking sector, the stability of the financial system and the economy of the country at large.

Relationship of the merged entity with unions

An important consideration relating to proposed takeover transactions, especially as regards two key players in the banking sector, is relations with relevant trade unions, since these unions play an important role in the labour market and the economy as a whole.

6.7 Strategic issues

This last set of considerations is of a more abstract nature, for instance relating to an industry's present positioning in the international context. It is conceivable that a merger might be permissible based on any one such strategic issue alone, and based on the intuition of the regulator, rather than on hard facts.

Harmony with the Competition Commission and public opinion

Worldwide, the objectives of bank regulators and competition authorities coincide in two respects - both have the efficiency of the system and fairness to consumers at heart. Whether or not the bank regulator has final jurisdiction, there should obviously be very good reasons for the bank regulator's decision to differ from that of the competition authority.

In addition, bank mergers often become fairly emotive subjects among the general public, who often have stronger than usual views on whether or not a transaction would be good for the economy. Although it is not implied that the regulator should be influenced unduly by public opinion, it should be remembered that sound, understandable reasons will have to exist and be explained if the decision goes against prevailing public opinion.

Use of opportunity for a pre-emptive strike

Several recent mergers, especially in Europe, have had an element of urgency, even desperation, in that the parties involved seem to believe that the opportunities for achieving the benefits of a merger are diminishing rapidly. The bank regulator should never precipitate a trend by allowing a merger that, although it may be in the interest of the system, is not market-driven. Nor should the regulator be an artificial stumbling block if the time for a merger is ripe, but there is uncertainty about whether or not the merger is good for the system.

Consistency with international trends

The reasons for mergers internationally have been discussed, as have the problems often associated therewith. Although no two countries are exactly alike, the dangers of being the "odd one out" should be kept in mind. If the international trend is clearly one of mergers, then care should be taken to understand fully the reasons for a merger not being permitted.

On the other hand, the international trend may be only fleeting, since the pendulum has a tendency to swing through in such matters. "Big is beautiful" can easily make way for another strategy as the underlying nature of banking changes.

Presumption that market forces should prevail

A key consideration at this strategic level is how important is the presumption that market forces should prevail unless intervention is unavoidable. A tenet of bank regulation is that it should be unobtrusive and low-cost, and that it should be limited to addressing market imperfections. The trend in international thinking about regulation is towards increasing adherence to this principle.

Clarity of policy for future mergers

The banking system, in order to work effectively, requires from the regulator, first, certainty. Whatever the decision on a proposed merger, the regulator should always seek to provide some insight into policy, which would bring a measure of certainty to the market.

Ability to manage fallout if the merger is halted

In any merger situation, the mere announcement of an intention creates expectations, which, if the merger does not go ahead, may result in unforeseen implications. Consideration should at least be given to what these implications may be, and how to mitigate their impact.

Level of reliance on a single dominant shareholder to act in the interests of the banking system

Banking regulation, unless it is so intensive that it may constrain free enterprise, usually relies in part on trust between the regulator and the owners and management of banks. In a merger situation, the trust relationship can often change. Consideration should therefore be given to whether it would be possible to rely on the owners and management of the new entity to the same extent as before.

7. Conclusion

It is clear from the discussion in this document that the decision either to allow or to disallow a merger is not easy. The arguments for and against this particular proposed merger both had validity. The process followed assisted the decision by adopting a generally acceptable structure of normative considerations and quantifying the views of a panel of experienced bank supervisors on each issue.

As is usual, however, with such abstract issues, a final judgement had to be made. In terms of the Banks Act, the Registrar of Banks had to apply his mind, and make a recommendation to the Minister of Finance. Because the Registrar is accountable to the Governor of the SARB, his recommendation was made in consultation with the SARB.

The Registrar was very conscious that the international trend towards globalisation and the resultant need for more efficient banks constituted strong arguments for regulators not to impede the ability of the market to decide on the ownership of a bank, provided that the owners met the criteria set out in the legislation.

The Registrar was also aware that, if the shareholders were not allowed to consolidate their investment in banks, this would beg the question where natural growth in the banking system would arise. The perception in the market might be that a “four pillar” approach was being applied. If this was not carefully managed, it could imply that efficiencies in the banking system were not regarded as the prime consideration in takeovers. Such a perception could lead to price fixing amongst the players and, thereby, to an inefficient market.

Notwithstanding the above, there needed to be very compelling reasons of an imminent stability nature for the regulator of banks to permit a merger that the competition authorities believed should be prohibited.

The eventual outcome of the above-mentioned process was a recommendation to the Minister of Finance by the Registrar, in agreement with the Competition Commission, not to allow the hostile takeover. Subsequently, both of the banking institutions have repositioned themselves in the market and their share prices have recovered to previous levels after being seriously affected by the intended hostile takeover.

Finally, it has to be emphasised that the considerations in Section 6 were developed and applied in a South African context. Therefore, they might not be applicable to all possible mergers. The Bank Supervision Department of the SARB, however, believes that these considerations cover the most important areas for review when a merger is assessed.

The banking industry in Thailand: competition, consolidation and systemic stability

Tarisa Watanagase

1. Forces for change

In Thailand, the recent financial crisis was not only brought about by factors related to the economic cycle but also exacerbated by structural weaknesses in the system. A significant cause of the crisis was the massive capital inflows into the economy without effective management mechanisms. Some examples of the weak initial conditions are ineffective corporate governance, inadequate supervision and regulation, and insufficient or in some cases inaccurate disclosure which resulted in lax credit policies in banks and other financial institutions and misuse of funds in the corporate sector.

Thailand initiated its financial liberalisation efforts in the early 1990s. The first step was the acceptance of Article VIII of the International Monetary Fund's Articles of Agreement, followed by a series of deregulatory measures in the financial system. Market opening of the financial system ensued with the establishment of the Bangkok International Banking Facilities (BIBFs) in 1993, which coincided with the global trend of surges in capital flows to the emerging market economies. In July 1997, Thailand faced the worst economic and financial crisis in its recent history. In retrospect, the crisis was closely linked to the premature financial liberalisation and market opening.

Owing to the liberalisation policy and the swiftness of capital mobility in the integrated financial system, business has access to overseas funds at relatively low cost and allocated such funds for rapid expansion and other purposes; a process which was in general not subject to adequate monitoring and control. It cannot be denied that liberalisation at a time when the underlying economic strength and infrastructure were not yet well instituted posed threats to both the host country and the global market place because of the potential for contagion and systemic impacts. The following subsections list some major infrastructure components that were absent at the outbreak of the recent crisis and what has been done in order to prevent future crises.

1.1 Inadequate information system

While information on foreign borrowing through the banking system was monitored, inadequate information on non-bank private corporate foreign debt resulted in an incomplete aggregate picture of the country's foreign liabilities. Data on sectoral allocation of credits did not show any signs of over-extension to the property or real estate sectors, and in fact funds seemed to be properly allocated to the "productive" sectors. Direct lending to the property sector or real estate businesses was consistently below 5% of total lending.

However, it became apparent after the crisis that these so-called productive sectors, such as exporters, had used their BIBF proceeds to invest heavily in the property and real estate sectors, thus turning the entire business group into NPLs overnight as the baht depreciated.

Another area of information deficiency was demand and supply in the property market. During the bubble economy period, the real estate industry grew rapidly. However, developers were not fully aware until much later that supply was considerably outgrowing demand.

Systems for collecting necessary data are now in place. Thailand became the 21st country to meet the specifications of the Special Data Dissemination Standard, established in May 1996 by the International Monetary Fund to enhance the quality, integrity, availability and timeliness of comprehensive economic and financial statistics. Moreover, Thailand is in the process of enacting the Credit Bureau Act so that banks can disclose both personal and corporate loan information about borrowers without seeking the borrower's consent.

1.2 Inability to utilise policy instruments, particularly the exchange rate

Rigidity in the exchange rate system, and the lack of political will to tighten fiscal policy in the midst of an overheating economy, sent a warning signal worldwide of the unsustainability of the country's economic situation. Pressure was also put on monetary policy, which was further constrained by its inability to act autonomously. The high interest rate policy, in turn, encouraged further foreign capital inflows, exacerbating the already overheated economy.

Under a basket-peg exchange rate regime and volatile global capital flows, little room was available for independent monetary policy. Defending or abandoning the exchange rate peg was a difficult policy dilemma. In fact, before the float, the real effective exchange rate had appreciated in line with the US dollar. However, whether and to what extent it was overvalued was controversial, as it depends on the "equilibrium" real effective exchange rate. If one takes the period when the current account was in equilibrium, say in 1990, as the benchmark, there was an overvaluation of 8% at most at the time of the float. However, recognising the loss in competitiveness and structural changes since 1990, such a benchmark would have been too simplistic. Nevertheless, it was felt that tampering with the exchange rate system (eg band widening) under the circumstance of intense speculative pressure and ebbing domestic confidence would have resulted in a wholesale run on the baht and prompted an immediate currency crisis. The Bank of Thailand, even with substantial foreign reserves, would not have been able to stabilise the exchange rate, given the much larger unhedged foreign currency debts of Thai corporations, which would have rushed to close their exposure on the first signs of any weakening commitment to a stable exchange rate. The decision was made to protect the exchange rate system as long as possible in order to buy time for the authorities to tackle fundamental problems in the economy and the financial sector without having to face a simultaneous currency crisis.

Such a policy decision was premised on the rationale that a devaluation of the baht would have done more harm than good for the following reasons:

- High import content of Thai export products implied that there would be only limited gains in export competitiveness.
- Large losses on unhedged foreign currency debt would result in a high number of corporate bankruptcies, leading to unemployment and consequent social problems.
- Financial institutions' asset quality would be further impaired due to weakened corporate sector.
- Inflationary pressure would intensify through higher import costs and wage demands.
- Higher interest rates to contain inflation would make it even more difficult for weak financial institutions to recover.

On 2 July 1997, however, Thailand's exchange rate system was changed to a managed float, whereby the value of the baht is determined by market forces.

1.3 Outdated legal framework

Another factor contributing to the difficult pre-crisis environment was the outdated legal and regulatory framework. The foreclosure law involved lengthy procedures that did not allow financial institutions to sell, foreclose or dispose of bad debts to stop losses. This law, as well as the bankruptcy law, has now been amended to expedite legal procedures. The new laws, especially the bankruptcy law, also facilitate the settling of cases in court as well as provide opportunities for both creditors and debtors to rehabilitate the debts for mutual benefits.

At the same time, the new Financial Institutions Act has been drafted and is currently before parliament. It will pave the way for Thai supervisors to improve their approaches in response to the changing financial environment. The draft law broadens the scope of commercial banks' financial activities by allowing them to form financial conglomerates, empowers the Bank of Thailand to apply consolidated supervision and encourages the practice of good governance. Not only can market discipline impose strong incentives on banks to conduct their business in a safe, sound and efficient manner, but it can also encourage them to allocate efficiently resources and maintain a strong cushion against future losses. Since reliable and timely information enables all stakeholders to make effective assessments, the Bank of Thailand has required financial institutions to disclose specified information following the accounting standards, which are in line with international standards.

1.4 Inexperienced risk management and poor governance of financial institutions and corporations

Banks' lending practices were largely collateral-based. Less attention was paid to cash flow or analyses of project feasibility. With the property and stock price boom, financial institutions did not expend resources on valuing the underlying collateral. Banks were also under pressure from shareholders to take on risky investments in return for potential profits that would allow attractive dividend payments. This, in turn, made them less vigilant in monitoring and taking appropriate actions against borrowers once they showed signs of financial deterioration. Unfortunately, the real estate and stock market booms overshadowed the growing risks inherent in the system.

Before 1997, a number of Thai corporations had taken advantage of cheap foreign funds and the pegged exchange rate to borrow heavily from abroad. Many of them neither had foreign currency income, nor adequately hedged positions. When the exchange rate regime changed to the managed float system, many found their foreign liabilities had approximately doubled.

Risk management has become an essential component of the financial sector as financial institutions compete in an environment of increased risk and larger and more liquid financial markets. The Bank of Thailand organised a risk management symposium to promote a broader understanding of the risks involved in the finance and banking sector as well as stimulate concerted action to develop and strengthen prudential standards towards risk management for the stability of the Thai financial system.

1.5 Lax supervision

Prudential regulations, especially in the area of loan classification and provisioning, were inadequate. The skills required for on-site examination, and off-site supervision using a risk-based approach, were lacking. This, coupled with the absence of proper credit risk analysis, led to financial structures that were inherently fragile. To make matters worse, the weak standard of transparency and disclosure in private financial institutions also brought on a sense of mistrust. Banks did not have good internal control systems in place, while their managers had not been made more accountable.

As such, the component of market discipline can indirectly assist in reinforcing supervisory efforts in promoting risk management in banks and the financial system, since it adds pressure for financial institutions to manage themselves in a safe and sound manner. Effective market discipline requires reliable and timely information that enables all stakeholders to make effective assessments.

To address concerns about transparency and disclosure, the Bank of Thailand has required financial institutions to disclose necessary information along the same lines as the accounting standards. In addition, they must disclose their NPLs and related lending on a monthly basis. The Bank of Thailand has also changed the emphasis of its supervision to be more focused on risk and less on verification of transactions. Examiners are specialised through effective examination planning and scoping to suit the size and activities of financial institutions and to concentrate on areas that expose the financial institutions to the greatest degree of risk. An Examiners' School and examiner commissioning process have been established.

In addition, the Bank of Thailand has put forth various measures to improve governance, including:

- Limiting a bank's lending to related companies to no more than 50% of shareholders' equity or 25% of the company's total liabilities or 5% of the bank's Tier 1 capital, whichever is lowest.
- Restricting a bank's lending to related companies where cross-directorship exists. Where directors or senior executives of the bank also hold directorships and own shares exceeding 1% of paid-up capital of the related companies, lending to these companies is prohibited.
- Prohibiting senior executives and directors of a bank from holding directorships in more than three companies.
- Prescribing minimum requirements for procedures for granting credit, investing in securities, undertaking contingent liabilities for any person, and selling assets.

Furthermore, the Bank of Thailand has established a working group, with the participation of the banking industry, to map out guidelines for the Thai financial sector on the practice of good governance in line with international best practices. Preliminary recommendations include:

- Encouraging or requiring financial institutions to establish committees such as an audit committee, nomination committee and compensation committee.
- Encouraging or requiring financial institutions to have independent directors as the key component of the board and committees to form independent views on business policy issues and monitoring of the institution.

2. State banks: privatisation

2.1 Current development

The economic crisis in Asia in 1997 was the starting point for many countries in this region to lay down measures to solve financial sector problems. Giving foreign financial institutions an opportunity to invest in this region by, for example, forming business alliances with domestic financial institutions or buying financial institutions intervened by the government allows major international financial institutions to play an essential role in Asia.

During the crisis, seven Thai banks were intervened and taken into state ownership. In 1998, one bank was closed, and bad assets were transferred to an asset management company (AMC), due to the large losses. One was fully acquired by a state-owned bank. One was merged with a bank while another was merged with another financial institution. The main purpose of intervention is to strengthen financial institutions by merging them or selling them to the private sector through open competitive bidding processes to ensure fair competition and transparency. Consequently, two intervened banks were privatised in 1999 while the resolution of the other two banks was expected to be completed by the end of 2000. In addition, the authority aims to decrease gradually its stake in the remaining two banks in the medium term.

2.2 Deposit guarantee

While a deposit insurance scheme has not been implemented in Thailand, the Financial Institution Development Fund (FIDF) has provided blanket insurance to depositors and creditors of the closed banks, finance companies and credit fonciers in full amount.

For purchasers of state-owned banks, the FIDF guaranteed to compensate losses from NPLs through yield maintenance and gain-/loss-sharing schemes.

2.3 Transaction structure

In most cases, the FIDF is offering two distinct support packages to potential buyers:

(a) Loss sharing

Under this structure, the FIDF will enter into a Loss Sharing Agreement with the bank. The FIDF will thereby agree to reimburse the bank for a specified percentage of losses on covered NPLs and for the cost of holding covered NPLs on its balance sheet. Loss sharing will cover only loans above a certain size which are NPLs as of the date of closure and no more than 15% of remaining loans which become NPLs within six months of the date of closure. The loss-sharing agreement will establish two loss-sharing percentages, two loss-sharing thresholds and the initial reserve (representing the proportion of the specified losses to be borne by the FIDF).

Under the loss-sharing agreement, the FIDF will only share the losses above the first threshold. Bidders must specify the first and second loss-sharing percentages as part of the bids.

(b) AMC with loss sharing

This option is similar to pure loss sharing as described above. The key difference is that specified NPLs will be transferred to an AMC, which is owned by the FIDF. There will then be a loss sharing agreement between the Bank and the AMC.

3. Domestic mergers

In a number of countries, mergers take place in order to create synergy, reduce costs and increase the competitive edge of the merged institutions. In the case of Thailand, recent mergers were the consequences of problem bank resolution and the policy to reduce the number of smaller financial institutions. Any five or more finance companies, finance and securities companies and credit foncier companies can merge to form a restricted-licence bank, which will be further upgraded to a fully-fledged bank at a later stage.

4. Entry of foreign banks

From 1993 the Bank of Thailand authorised the establishment of the Bangkok International Banking Facilities (BIBFs) which allowed greater diversification of service providers through new international entrants. In addition, it enabled domestic banks to diversify their business towards international banking intermediation by obtaining offshore funds to lend to either the domestic market (out-in) or to the international market (out-out).

Since BIBFs are not allowed to take domestic deposits, they are subject to fewer regulations than commercial banks. For instance, BIBFs are not required to observe a minimum capital adequacy ratio. BIBFs also carry a lower corporate tax rate of 10%, as opposed to 30% in the case of banks. However, current policy does not allow new entry of foreign banks through BIBFs or full-licensed branches. Rather, foreign investors that have sound financial standing and high potential to help strengthen local financial institutions are allowed to hold more than 49% of the shares. With the relaxation of the regulation on foreign participation, five local banks out of a total of 13 banks are now majority-owned by foreign institutions.

Before the 1997 financial crisis, the domestic banks dominated the retail market through their extensive branch networks and their close relationship with local customers. Foreign banks, on the other hand, focused their businesses on wholesale customers. Nevertheless, the role of foreign banks will change significantly now that they have acquired majority shares in domestic banks. Access to retail customers is now possible. These foreign-owned banks are offering diversified financial services to their retail customers. With their experience and know-how, their shares in the retail market are expected to rise. However, this is hard to confirm, as reform of the Thai banking system is still at an early stage.