FINAL REPORT

"The Roles and Functions of the Banking Sector in the Financial System of the ASEAN+3 Region"

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Executive Summary

1. General Statement

In the ASEAN+3 region banks play the key role of financial intermediary. Most financial intermediaries function through the banking sector. Households are not affluent enough to take large financial risk. (excluding Japan) Bank penetration is not so high as Japan. Though capital markets are developing rapidly, there are not a variety of investors.

Banks are shifting their targets from corporate to SMEs and consumers. SME business is growing and will be a pillar of bank revenue. Also, personal finance business is growing. Retail banking business facilitates the booming consumption and economic growth. However, evaluating credit risk of retail customers is difficult. This problem can partially be overcome if the government can provide credit enhancement for SMEs or assist developing accounting systems for SMEs.

In terms of soundness, banks are currently in good shape. Many financial reforms were made after the Asian financial crisis. Banks in the region were developed under those financial reforms. Economic growth also contributes to the soundness of banks. Maintaining the soundness is very important. It is hard to fix the problems when banks are financially weak. To maintain the soundness of banks even when the economy is slowing down, banks in the region could review the practice and experiences of developed countries.

Enhancing the competitiveness of banks is essential to the stabilization of financial systems. The integration of the ASEAN economy in 2015 (AEC) would be the driver for banks to become more strategic and more competitive. To improve efficiency, banks should expand profitable business, introduce advanced technologies and develop human resources.

Some issues still remain. Firstly, developing risk management is an important issue. Expanding credit rapidly might cause a credit bubble. Banks should learn from other countries' experiences. The government can assist banks by developing accounting system reform for SMEs or developing tax collecting systems. Secondly, consumer protection is an important issue as many kinds of financial products are sold at banks. Thirdly, strengthening the management is a critical issue. Corporate governance is weak due to shareholder composition.

Economic growth is essential to the development of the banking sector. Banks can invest in business expansion only when they are financially sound. Banks should support the real economy, should not be pursuing their own interests and away from economic growth. Excessive pursuit of profit multiplied by highly leveraged loans, tend to take the risk of over-capacity. The traditional commercial bank model will contribute to stable economic growth. The risk is mitigated in a long time. Because traditional commercial banks have raised funds in deposits, they are strong against shocks from the market.

Asian banks have an important role in supporting the economic growth of Asia. It is desirable that the banks support economic growth while maintaining their soundness.

Payment system reform is proceeding in many countries, in addition to the increase of processing capacities as the introduction of RTGS is progressing. Therefore, the risk is less likely to accumulate up to the time of settlement. The possibility of a chain-reaction collapse resulting from the settlement risk in the banking sector in Asia is relatively small.

2. Thailand

Thailand has traditionally had a bank-centric financial system and commercial banks have been playing central roles. After the Asian financial crisis in 1997, the supervisory authorities and the industry engaged in a wide range of reforms. As a result, the Thai banking sector has maintained its financial soundness and stability. However, there still remain some issues to be tackled, such as the expansion of financial access for the underserved, preparation against the anticipated regional competition, further strengthening of the management base to handle potential risks, and so on.

3. Vietnam

The Vietnamese banking sector is still in its infancy. The industry, dominated by state-owned commercial banks, mainly serves the large corporations which are usually state-owned. The banking penetration rate among individuals is a mere 10 to 20%. The banking sector has been going through various reforms in recent years, but there still remains a host of challenges that need to be addressed, including the independence of the central bank and strengthening of their supervisory capacity, as well as the strengthening of the capital base of the banks.

4. Malaysia

Thanks to the effective reforms mainly led by the authorities, Malaysia’s financial system has continued to develop. Now, it has not only a competitive and sound banking sector, but also expanding bond markets. The future tasks for the local banks are: to further improve their competitiveness, to support the acceleration of economic growth by proper financial intermediation, and to promote regional economic and financial integration by expanding their overseas business. Also, promoting the internationalization of Islamic finance is a very important target for Malaysia’s financial system.

5. Indonesia

In Indonesia, business-based micro-finance, which is different from the model of the Grameen Bank in Bangladesh, has been utilized in the whole country for over 100 years. However, there are many businesses and individuals who have no access to banks, meaning that the capital surplus of the household and corporate sectors is not being fully utilized. If this is allowed to continue, then not only will capital fail to be used effectively, but financial services will not be able to be used to help stabilize the standards of living of those at low income levels. Financial inclusion is the most important issue.

6. China

China has made progress in moving toward a more commercially - oriented financial system through different types of financial reform since the 1990s. China is a bank-based financial system, and in particular the large commercial banks, dominate almost two thirds of financial intermediation. They have not only performed well and are sound, but are also competitive in terms of market capitalization, capital and assets with banks ranking among the Top in the world. China is the only country in the ASEAN+3 that has no deposit insurance system. Also, financial liberalization is incomplete due to strict interest rate regulation and a controlled exchange rate. As a result, informal finance and off-balance sheet activities are on the rise. The future challenge is to restructure the capital market towards a more market - based system in line with Basel III.

7. Japan

Japan's banks have adopted conventional commercial bank business models, based on strong relationships with customers. While Japan's banking system is different from the models of other advanced nations, it is the most advanced in Asia. It has enabled finance to permeate throughout the country, and Japanese banks were able to realize stable profits. However, it is difficult to envisage how growth can be achieved in the years to come. Now that the economy has matured, businesses' capital demand is growing only very slowly. In the future, the market will be shrinking because Japan's population is not only aging but also decreasing in size.

Introduction

ASEAN+3's regional cooperation began when the leaders of Japan, Korea and China were invited to join the ASEAN leaders' summit in 1997. This initiative had been triggered by a strong realization on the part of Japan and other East Asian countries of the necessity for regional cooperation in the wake of the Asian financial crisis. Even though limited to economic fields, this regional cooperation spans a great many topics, such as trade, investments, technical transfer, currency and finance, and so on.

In terms of cooperation in the field of finance, at the 3rd Leaders' Summit in 1999, the need to strengthen self-help and support mechanisms in East Asia was agreed upon, and at the Second ASEAN+3 Finance Ministers' Summit in May, 2000, it was agreed that a network of bi-lateral currency swap agreements should be constructed. Then, in 2010, the Chiang Mai Initiative Multi-lateralization (CMIM) came into effect.

Also, against the backdrop of the Asian financial crisis, it was realized that the tendency of financial institutions to rely heavily on short term financing in dollars and other foreign currencies, rather than their own currencies, had been wrong, and that, in addition to curing the bank's propensity to excessive lending, bond markets needed to be developed. The hope is that this will not only correct the phenomenon a double mismatch of currency and loan maturity, where financial institutions attempt to meet domestic long term capital demand with short term US dollar denominated borrowing, but also lead to the more efficient distribution of capital among industries and businesses, due to corporate financing cost being based on market principles. In 2003, the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) established the Asian Bond Fund, implementing Asian Bond Fund 2 from 2005. Although there are already these kinds of concrete results of financial collaboration in the region, it has been limited to international finance and capital markets.

ASEAN has agreed to the establishment of the ASEAN Economic Community (AEC) in 2015. The aim is to realize a single market in terms of the real economy by 2015, and to standardize financial rules and regulations by 2020. As described above, financial collaboration in the ASEAN+3 region has already resulted in currency swap agreements and Asian Bond Fund initiatives, but the role of financial intermediation in the region is principally undertaken by the banks, and there has as yet been no debate on the integration of the banking sector. ASEAN has only just begun discussing the standardization of financial regulations by 2020. Therefore, in order to examine the role and functions of the banking sector in the ASEAN+3 region, this report has selected and compared six countries, in an attempt to clarify the current situation and issues in each case. The selected countries are Thailand, Vietnam, Malaysia, Indonesia, China and Japan. The reports have been compiled as a result of investigating prior research, statistics and other literature, as well as interviews conducted in the selected countries between October and December, 2011.

1. General Statement

1.1. Characteristics of the Banking Sector.

1.1.1. Bank-centric Financial Intermediation

In the ASEAN+3 region, banks play the central role of financial intermediary. Most financial intermediation is through the banking sector. This is because historically banks have played the major role of financial intermediaries and the capital markets are still developing. In ASEAN, only the governments and large corporations can utilize the capital markets, and most companies including SMEs depend on banks for financing.

It has been empirically observed that risk money supply does not increase until the GDP per capita exceeds a certain amount. In no country, other than Japan, do the financial assets per capita exceed 10,000 dollars. In Japan, the capital markets are well developed and have considerable trading volume. In spite of the high volume of financial assets per capita in Japan, the banks play the key role of the main financial intermediary.

To measure financial depth, the deposit to GDP ratio or the loan to GDP ratio will be useful. Before comparing the numbers, the basic numbers of each country such as GDP, population and macro savings ratio should be checked. According to the IMF data in September 2011, China is the largest in GDP, followed by Japan, Indonesia, Thailand, Malaysia and Vietnam. In terms of GDP per capita, Japan is the largest with 42,783 US dollars, Malaysia with 8,423 US dollars, Thailand with 4,992 US dollars, China with 4,382 US Dollars, Vietnam with 3,554 US dollars, and Indonesia with 2,974 US dollars.

In terms of the macro savings ratio, China is the highest with 53.4%, while Japan is the lowest with 23.8%. The other four countries are all in the 30% level. (Table 1.1.)

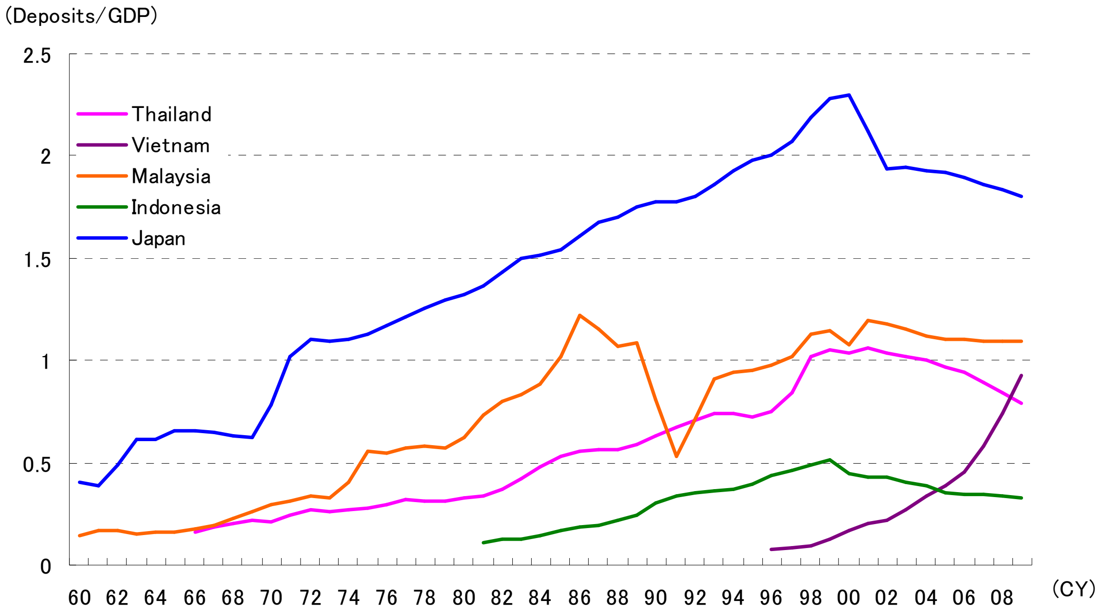
Table 1.1. GDP, Population and Gross National Savings

		Thailand	Vietnam	Malaysia	Indonesia	China	Japan
Population	(million)	63.9	88.3	28.3	237.6	1341.4	127.6
GDP	(US dollars)	318.9	103.6	238.0	706.7	5878.3	5458.8
GDP per capita	(US dollars)	4,992	3,354	8,423	2,974	4,382	42,783
Gross National Savings	(%)	30.6	34.3	32.9	33.3	53.4	23.8

Source: IMF, “World Economic Outlook Database September 2011”

According to the statistics of the World Bank in 2009, the deposit ratio to GDP of Japan is the highest at 180%, followed by Malaysia, Vietnam, and Thailand. The ratio of Indonesia is the lowest. In ASEAN countries excluding Vietnam, the deposit ratio to GDP has been decreasing gradually in recent years. However, the ratio of Vietnam is increasing rapidly. (Figure 1.1.)

Figure 1.1. Bank Deposits to GDP

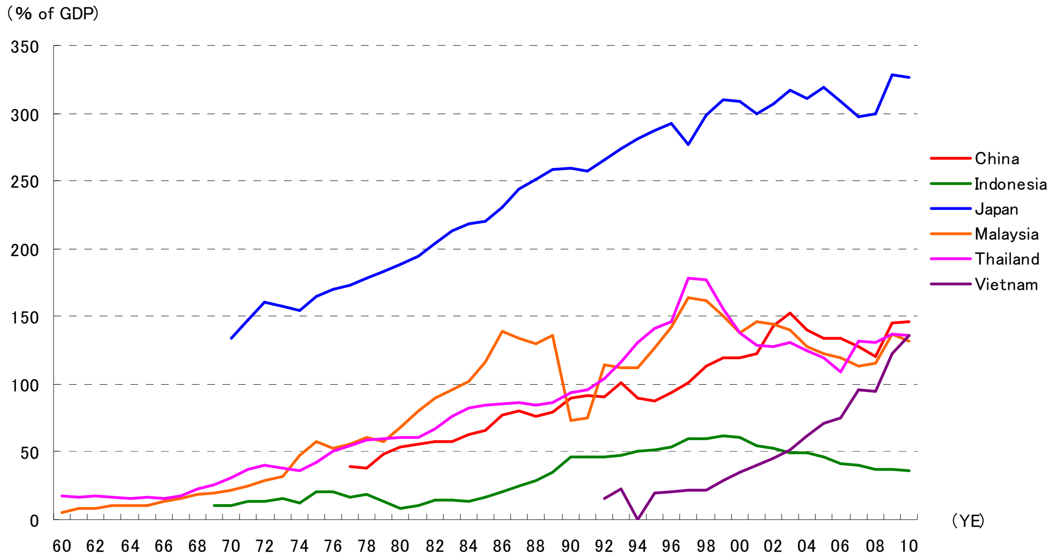


Source: World Bank

Meanwhile, the 6 countries are divided into three groups by the domestic credit to GDP ratio. Japan is the highest at over 300%. In contrast, Indonesia is the lowest at 36%. The other four countries range from 130% to 150%. Vietnam was the lowest in the 1990s but it increased rapidly in recent years to belong in the same group as Thailand or Malaysia. The background of this rapid increase of Vietnam seems to be that Vietnam is a socialist country and quite different in economic systems. Also, the size of banks has been very small in Vietnam, Thailand and Malaysia

Thailand and Malaysia at one time had expanded credit to over 150%. After the Asian financial crisis, they reduced their credit and have stable development. Indonesia also reduced its credit affected by the Asian crisis. However, the speed of the decrease was much slower than that of Thailand and Malaysia. China was not affected by the Asian financial crisis directly but the credit ratio to GDP is gradually increasing. Comparing the credit to GDP ratio in 2008 and in 2009, to measure the impact of Lehman shock, no country has a decreasing ratio. In fact, in many countries, for example Vietnam, Japan, China and Malaysia, the credit ratio to GDP increased rapidly from 2008 to 2009. (Figure 1.2.)

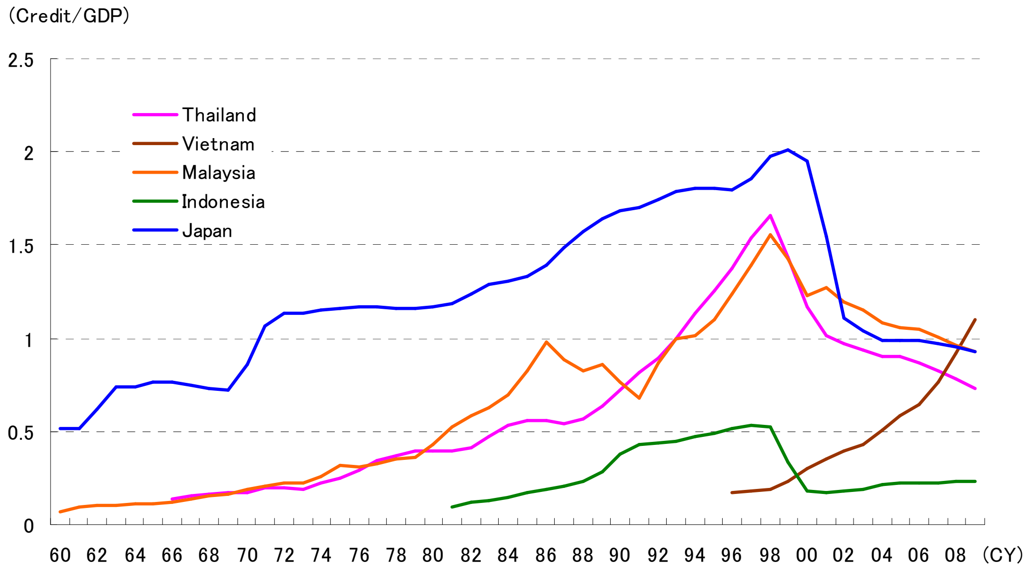
Figure 1.2. Domestic Credit Provided by Banking Sector



Source: World Bank

Also comparing the ratio of credit to the private sector by banks, Vietnam was the highest at 109%. Japan and Malaysia followed with 93%, Thailand with 73%, and Indonesia was lowest at 23% (Figure 1.3.)[1]

Figure 1.3. Private Credit by Deposit Money Banks



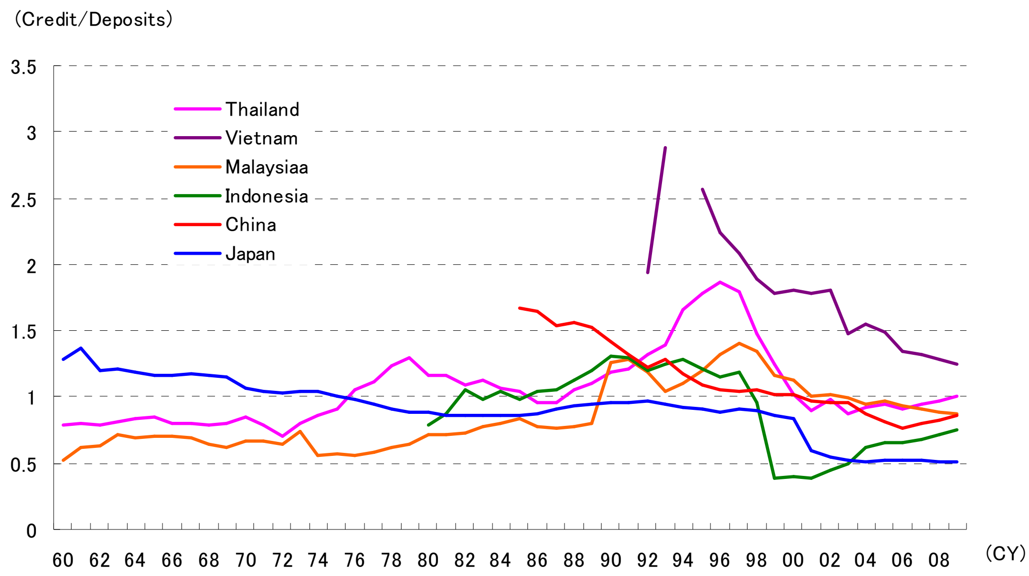
Source: World Bank

[1]The statistics of the World Bank do not include data for China.

Looking at the loans to deposits ratio , Vietnam is the highest with 125%, followed by Thailand with just above 100%, while the others are below 100%. The ratio of Japan has been low, staying around 50%.

Before the Asian financial crisis, the ratio was over 100% in Thailand, China, and Malaysia. In Thailand especially in 1996, its ratio increased to 186%. After the financial crisis, the ratios of these three countries decreased to below 100%. The ratio of Vietnam once increased to 288% in 1993, but has since decreased. The ratio of China was once above 100%, after 2004, but since its NPLs were transferred to an external company, the ratio has remained at the same level of 80%. The loans are funded by deposits in 5 countries, excluding Vietnam. The funding structure is very stable. (Figure 1.4.)

Figure 1.4. Bank Credit to Bank Deposits

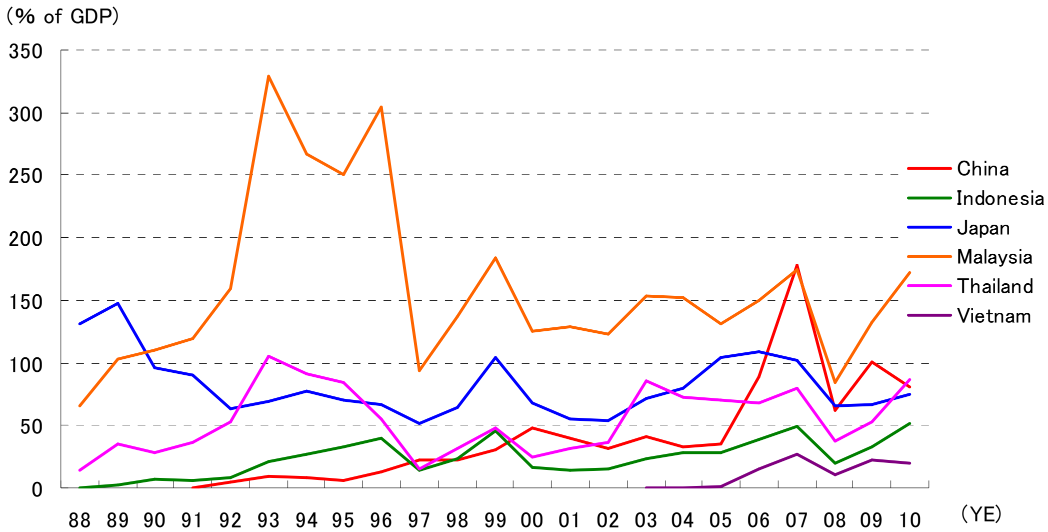


Source: World Bank

The bond market plays a complementary role to bank lending. The amount of bonds issued by the public sector is much larger than that of the private sector. The ratio of bond market capitalization to GDP of Japan is noticeably high at 172% of GDP. Malaysia and Indonesia remain at about the same level while Thailand and China are increasing. Looking at the ratio of bonds issued by the private sector to GDP, Malaysia is the highest at 60%, Japan is second at 37%, Thailand and China at 19%, and Indonesia is the lowest at 2%. Comparing bank loans with bonds, in every country, bank financial intermediation is larger than the bond markets. To develop the bond market, a variety of conditions must be fulfilled. There are many corporations which are qualified to issue bonds. The information infrastructure for disclosure is well prepared. There are some big institutional investors such as pension funds. In the region, Malaysia is relatively advanced in its bond market.

Finally, comparing the ratio of stock market capitalization to GDP, Malaysia is relatively high, but others are below 100%. (Figure 1.5.)

Figure 1.5. Market Capitalization of Listed Companies



Source: World Bank

1.1.2. Form and Size of the Banks

Although many of the countries examined have rapidly increased the scale of their banks' assets in recent years, with the exception of China and Japan, their assets are still not all that large. In the past, Japan had 13 comparatively large banks, but bank mergers in the US and Europe from the mid '90s onwards led to the expansion of the assets of the global top class banks, and Japan's world ranking slumped. However, the non-performing loan problems of the latter 1990s prompted a series of mergers and business integration, and the banks are now concentrated in three large groups. Although the scale of the assets of these megabanks qualifies them as G-SIFIs, their main business area is domestic, and they lag behind their European and US counterparts in terms of international business. Also, in terms of the type of business that they are involved in, commercial banking tends to be their business base, and margins earned from deposits and loans account for over half of their source of revenue.

China's state owned banks have by far the largest assets of banks in China, and have a nationwide network so, as China's economy has grown in recent years, the state owned banks' assets have expanded also. Chinese banks have a major presence internationally, with some of the five large commercial banks listed on the New York stock exchange, and Bank of China designated a G-SIFI. Of course, in recent years, other middle level banks have been growing strongly and the big five banks' share of business has been falling. As will be discussed later, there are many different types of financial institutions in China, and financial intermediation by financial institutions other than deposit-taking financial institutions is increasing in some sectors.

On the other hand, many of the banks in the ASEAN region are small commercial banks. The GDP of these countries are much smaller than that of China and Japan. For that reason, many of these countries have restrictions on market participation by foreign banks. However, foreign banks are not only a threat to local banks. They often outperform local banks in terms of various types of financial techniques, product development capacity and know-how, and there are many instances where local banks have been able to form business tie-ups with foreign banks and absorb technology and know-how from them. Foreign banks are restricted in terms of opening new branch offices, and there is a limit to how far they can expand and develop their businesses by themselves. Forming business tie-ups with local banks has the merit of enabling them to expand their networks.

1.1.3. Bank Penetration

The banks' ratio of deposits and lending against GDP is one index that shows the importance of bank transactions in a country's economy. Also, a variety of different indices can be used to compare what percentage of the population makes use of banks. Indices such as the number of people per thousand adults that are borrowing from a bank, or the number of people who have deposit accounts give a numerical indication of the extent of usage of banking services. Other indices show the ease of access to banking services, such as the number of banks or ATM in a given area, or for a given size of population.

Statistical constraints mean that it is not possible to compare all six countries simultaneously, but a comparison with Japan indicates that the level of bank penetration in the region is not so high as Japan. For example, the number of depositors per 1,000 adults is 7,168.98 in Japan, compared with only 1,619.94 in Malaysia and 1,119.94 in Thailand. A comparison of the number of bank branches per 100,000 adults shows that Thailand has about one third of the number in Japan, Indonesia one quarter and Vietnam only one tenth. (Table 1.2.)

Table 1.2. Financial Access

Use of banking services	Thailand	Vietnam	Malaysia	Indonesia	China('09)	Japan
Number of borrowers from commercial banks per 1,000 adults	236.98	...	284.06	274.8	...	...
Outstanding loans from commercial banks (% of GDP)	85.18	0	93.59	27.49	107.62	125.22
Number of depositors with commercial banks per 1,000 adults	1119.94	...	1619.94	...	...	7168.97
Outstanding deposits with commercial banks (% of GDP)	74.04	...	117.17	36.41	137.11	233.05

Access to banks' physical outlets	Thailand	Vietnam	Malaysia	Indonesia	China	Japan
Number of commercial bank branches per 1,000 km^2	11.59	6.96	6.18	7.71	...	103.03
Number of commercial bank branches per 100,000 adults	11.16	3.33	10.48	8.32	...	33.97
Number of ATMs per 1,000 km^2	80.68	36.87	33.12	12.39	...	...
Number of ATMs per 100,000 adults	77.69	17.64	56.18	13.37	...	...

Source: IMF, “Financial Access Survey 2010”

From this it can be seen that, with the exception of Japan, banking services are not really spreading widely amongst the populations of these countries. It may be assumed that there are still considerable sections of the population and regional areas where banking services are not yet being widely used. In other words, these countries have a considerable population of potential bank users, and by providing coverage for those populations and regions, the banking sector can well be expected to grow in the years ahead. This is because, by concentrating the small sum savings of people who cannot yet access the banks, not only will the core deposits increase, but the banks' financing capacity will also grow. Currently, many people who do not have access to formal financial services are using informal financial services.

Currently, financial inclusion programs are being implemented throughout ASEAN, in order to provide financial services to people who do not otherwise have access to them. One the use of financial services spreads among the populace, the lives of individual people will become easier and more stable. In the current situation, reasons cited for a lack of access to financial services include insufficient knowledge of finance, a reluctance to bear the burden of deposit account handling charges, and the physical remoteness of bank branches, etc. Financial inclusion programs include measures to try to overcome these causes. One such measure is to conduct educational initiatives in order to spread knowledge about finance. In addition to financial education in schools, there are also programs to encourage people to open accounts that do not require maintenance charges. Another is to leverage the widespread ownership of mobile telephones and offer services such as mobile money, mobile banking.

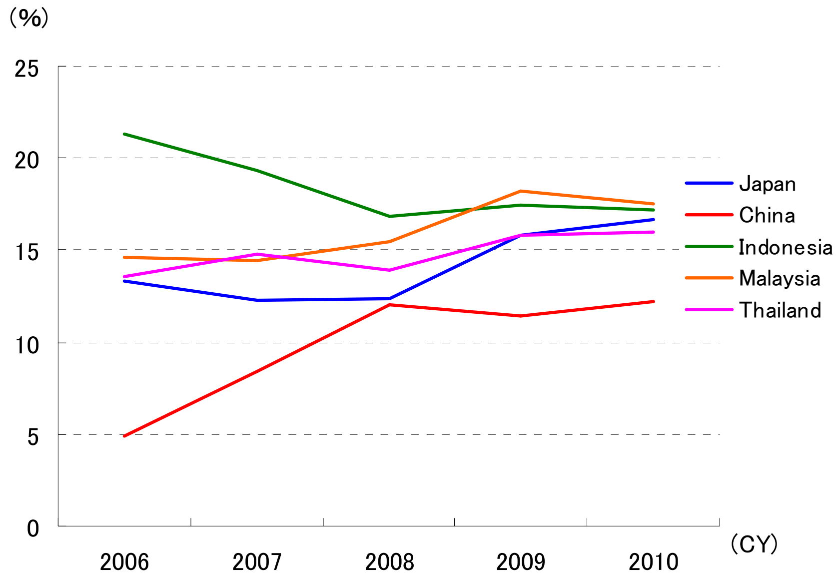
1.1.4. Bank Regulations and Soundness

Bank regulations are different among countries. However, one of the basic objectives of bank regulation is to maintain the soundness of banks and to secure the settlement networks. That is why it is prohibited to establish a bank without a license from the regulatory authorities. This is an entry barrier of the banking business. Also banks are often prohibited from doing a business other than banking so that they do not take on excessive general business risk.

To maintain the soundness of banks, the regulations of capital requirement and provision for bad debt are implemented. In terms of capital requirement, the Basel Committee regulations has essential for international banks. A concrete implementation schedule varies among countries.

Comparing regulatory capital, China was below 5% in 2006 but had improved to 11.8% in 2011. Thailand, Malaysia and Japan are improving in recent years and all three countries were above 15% in 2010. Though Indonesia is decreasing compared with 2006, it is still above 15% and maintains bank soundness. (Figure 1.6.)

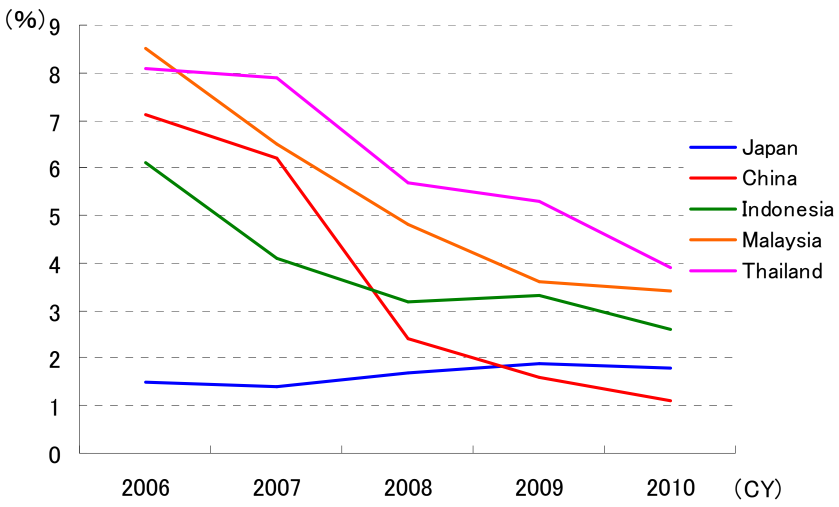
Figure 1.6. Bank Regulatory Capital to Risk-Weighted Assets



Source: IMF, “Financial Soundness Indicators”

Next, comparing the non performing loans (NPL) ratio, Japan’s number has remained steady. In 2010, the NPL ratio of Japan banks was 1.8%. Thailand, Malaysia and Indonesia are decreasing their NPL ratio. In 2010, Malaysia decreased its NPL ratio to 3.4%, and Indonesia declined to 2.6%. The NPL ratio of China was very high at 7.6% in 2006. With the disposal of non performing loans, the NPL ratio of China was drastically reduced to 1.1% in 2010. (Figure 1.7.)

Figure 1.7. Bank Nonperforming Loans to Total Loans



Sources: National authorities and IMF staff estimates.

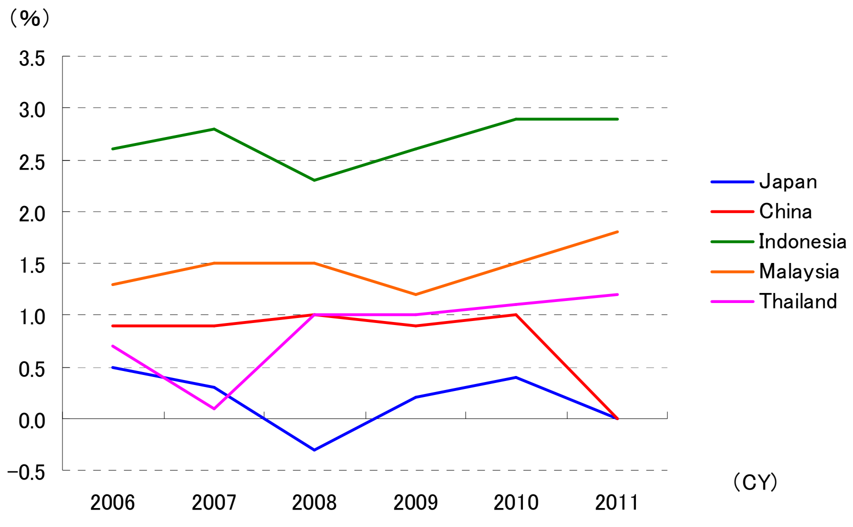
Financial regulations become liberalized as an economy develops. In China, the regulation on interest rates has not been lifted yet. The GDP of China is the second largest in the world, but there are wide gaps among regions and industries. It is difficult to liberalize interest rates under this situation. Moreover, foreign exchange is still restricted. However, the Chinese economy is growing and there are lots of opportunities for investment. To circumvent strict restrictions and regulations, financial intermediaries other than banks have been growing recently.

1.1.5. Performance of Banks

Comparing the performance of banks in each country by ROA, Indonesia is the highest. The ROA of Indonesia has been over 2% for 6 years. Malaysia, Thailand and China follow, and Japan is the lowest at 0.4% in 2010. (Figure 1.8.) In terms of ROE, Indonesia is the highest at 26% in 2010. China, Malaysia and Thailand follow and Japan is the lowest at 8.3%. (Figure 1.9.)

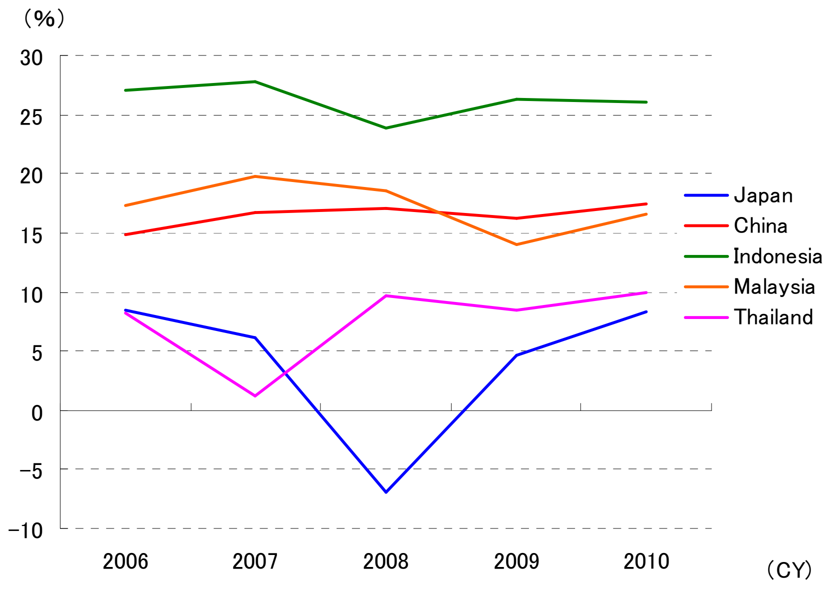
Though the ratio of bank lending to GDP of Indonesia is small, the banking business of Indonesia is the most profitable. Japanese banks grow at a sluggish pace and the profitability has been low for a long time.

Figure 1.8. Bank Return on Assets



Sources: National authorities and IMF staff estimates.

Figure 1.9. Bank Return on Equity



Sources: National authorities and IMF staff estimates.

1.2. Roles of Banking Sector

1.2.1. Sustaining Economic Growth

Banks sustain economic development by intermediating between the surplus sector (household) and the deficit sector (corporations) and by providing the settlement function which facilitates business activities. As described before, banks play the central role of financial intermediary in a region. Therefore banks play key roles in developing the economy of a region.

In terms of GDP per capita, that of Indonesia has grown to over 3,000 US dollars. Empirically it is known that the mass middle class emerges when GDP per capita exceeds 3,000 US dollars so that their increasing consumption will accelerate economic growth. Economic growth led by consumption will be sustainable because it can create a virtuous cycle. Most middle class people belong to SMEs, which employ most of the employees in a society. Therefore, banks' financial support to SMEs by lending can contribute to making middle class people better off. Also banks lending to consumers will contribute to boosting consumption. In this sense, banks' role in developing the economy is very important.

While the banking sector supports economic growth, economic growth also contributes to the growth of the banking sector. In other words, as long as economic growth continues, the banks' profits rise, enabling investment in new financial technologies and information, and the improvement of financial soundness. Therefore, along with economic growth, the banks' competitiveness has the chance to improve. This in turn enhances the banks' financing capacity and allows them to do business with new customers. In this way, economic development and the development of the banking system work in tandem to complement each other.

1.2.2. Financing for SMEs

Though the history of the development of the banking system differs from country to country, one common factor is that, as the capital markets develop, the banks' share of large corporate lending begins to fall. This is because the large corporations are then able to raise funds by issuing shares and bonds. Among the ASEAN countries in particular, having learned the hard lessons of the Asian currency crisis, large corporations began to reduce their dependence on banks and to experiment with raising funds in the corporate bond and stock markets. As a result, the banks' proportion of lending with large corporations began to dwindle and they then focused their efforts on expanding retail markets with small and medium sized enterprises (SMEs) and individuals.

If SMEs are able to grow as a result of smooth financing from the banks, sustainable economic growth can be expected. As the SMEs develop, the increases in their employees' wages give rise to the emergence of the middle tier. Then, as consumers' purchasing power grows, consumption becomes energized and economic growth accelerates.

By supplying finance, the banks can contribute to SMEs' growth, and the SMEs can also provide the banks with some benefits. First is that SMEs cannot access the capital markets, so the interest margin is greater than in transactions with large corporations. Second, until now the banks have only done business with a portion of the SMEs, leaving a large potential for growth.

Naturally, SMEs also have their own difficulties. The biggest problem is how to overcome the asymmetry of information, in other words, how to conduct risk assessment and monitoring of SMEs. Interviews have revealed that, for numerous banks, there are no suitable measures, resulting in their reluctance to do business with SMEs.

One solution is to strengthen the bank's network of branches and maintain close and personal contact with SMEs. In Indonesia, there are banks that have leveraged their networks of branches in order to develop close, intimate contact with SMEs so that they can then conduct information gathering and monitoring, and thereby establish small scale micro finance services for these SMEs on a commercial basis. However, increasing the network of branches is also a cause of rising cost for the banks, and there is a limit to the number of banks that can adopt this method.

The difficulty is the risk assessment when the first loan is granted. In Japan, the system adopted has been to gather SME transaction data in databases and to calculate risk stochastically, and from there work out the loan interest. However, this approach has not been successful because of adverse selection and a greater than anticipated number of defaults. As far as monitoring is concerned, one method is to provide convenient settlement services from the banks, concentrate the SMEs' settlement accounts in those banks, and closely monitor the movement of funds.

Also, it is very important to have portfolio management, where the size of each individual SME loan is small and the number of loans is large, and the loans can be spread across industries and regions, so that if defaults do occur, the banks can avoid having large amounts of non-performing loans occurring at one time.

One system related issue is how to promote the spread of an accounting system that is geared to the SMEs, thereby enhancing the reliability of SMEs' accounting information. Although several countries have introduced IFRS, they are difficult to apply in order to reflect the actual situation of SMEs' transactions, and it has been pointed out that they have not spread much among SMEs.

Also, since the growth of SMEs is linked to the sustainable growth of the economy overall, some governments are also considering providing complementary credit, thereby reducing the risk taken on by the banks.

1.2.3. Boosting Consumption by Consumer Credit

Expanding consumer credit as well as SME lending will contribute to economic growth. As mentioned before, after GDP per capita exceeds 3,000 US dollars, the life style of middle class people will change and they purchase consumer durables such as motorcycles, cars and home electric appliances. Consumer credit facilitates purchasing these items. Installment purchase is a kind of consumer credit suitable for such large amount purchases, where the consumer can get these items just by paying down payment. The risk management for banks in installment purchase business would be relatively easy. This is because it is clear that the money provided to a consumer was used to purchase a specific item. Banks take chattel mortgages on what the consumer purchased. However, installment purchase loan providers are not always banks.

Credit cards are another kind of consumer credit. For consumers, the availability of credit cards is much broader than installment purchase loans. For banks, credit card risk management is more difficult than with an installment purchase loan because credit card usage does not usually provide collateral. Therefore, only high-income consumers can get credit cards at an early stage of credit card business development. In Japan, even a low-income consumer can get a credit card easily because lump-sum payment for credit card debt is common and banks set the credit limit very low.

Home mortgages also contribute to consumption indirectly. When a consumer purchases a new house, the need to purchase furniture or home electric appliances usually follows. Home mortgage is a profitable business for a bank because the borrower will make a great effort to make every payment so as not to lose the home. Also, the time period of a home mortgage loan is very long.

These markets have not been explored so much and the potential growth of these consumer businesses is quite high. In consumer credit businesses, banks apply a risk premium to compensate for the expected default. The loan rate is usually higher than that of SMEs. Visiting homes or offices of debtors could be useful for screening or monitoring. In some countries, the database for personal credit information is available for credit evaluation.

1.2.4. Bond Market

A bond is the same as a bank loan because both are debt for a borrower, but it is different from a bank loan in some ways. First, bonds are suitable for long term finance. Basically, a bank cannot provide longer term loans than deposits because a bank cannot take such a large risk. By issuing bonds, the banking sector will be able to avoid such long term risk. In this way, bond markets can contribute to the development of sound bank lending to SMEs.

Second, the bond markets lures foreign investors. If the market provides liquidity, it enables investors to map out an exit strategy. If the money from foreign countries flows into the bond markets, the financial system would be stronger because in the event that market confidence is undermined, the banking lending activity would not be affected by the investors' confidence. Also, the banks can avoid double mismatch of currency risk and maturity risk.

Several Asian bond projects were promoted to develop bond markets. The Asian Bond Fund in 2003 and Asian Bond Fund 2 in 2004 were established to purchase public bonds in the region. As a result, the amount of public bonds is much larger than that of private sector bonds. It should be noted that establishing an Asian common bond market is under discussion.

The bank sector or bond markets should not be discussed only based on the efficiency with which one or the other might play the central role in the financial system. The structure should be selected in consideration of the demands of the real economy and then develop gradually. Therefore, developing the bond market should not be taken as an alternative for developing the banking sector. To make the financial system robust, the development of both bond markets and the banking sector is necessary.

1.2.5. Settlement

Banks provide payment functions. The efficiency of settlement varies greatly, depending on the structure of the country's payment systems, and it is reflected in the costs related to settlement. If each bank has a central bank account, inter-bank settlement is carried out as a transfer of funds between accounts which is more efficient. In some countries such as Japan and China, settlement through such a central bank account has been done.

If settlements are performed together several times a day, the bank needs consider just the difference between banks to prepare the exchange of funds. The cost to hold the funds is small. As the outstanding balances increases before the time of settlement, the risk of non-payment increases. By introducing the real time gross settlement (RTGS) system, which completes a settlement each time, the risks associated with increased outstanding balances can be avoided. In recent years the introduction of RTGS is progressing in the region.

Banks provide an aspect of finality in their settlement function. On the other hand, means of payment such as credit cards and electronic money are more diverse. The provider of the means of payment need not necessarily be limited to banks. With these kinds of payment, the finality is not necessarily guaranteed.

In Japan, the contactless IC card, electronic money and credit cards are being used to pay for everyday shopping. In addition, by establishing an electronically recorded monetary claims system, a new financing mechanism is taking off. The new system establishes a bill of exchange or a nominative claim. The creditor can get financing or can make a payment using electronically recorded monetary claims.

In this way, the settlement function is done through an infrastructure which provides smooth economic activities. All countries can promote the efficiency of this kind of settlement. With the development of information technology, means of payment are diversified. The environment is being put into place where non-financial services and payment features easily come together.

1.3. Reform of the Banking Systems and Issues

1.3.1. Reform of Financial Systems

Although each country has a different history of the development of its banking system, they have all worked to reform bank related regulations. Some of the reasons for this are the facts that 1) economic development brings with it an accumulation of financial assets and, in addition to financing needs, money management needs have also grown, 2) WTO accession has required countries to allow the market participation of foreign financial institutions, and 3) as economic globalization progresses, the world's financial regulations are changing to adopt market mechanisms as far as possible, and countries find that they need to adapt to these current trends.

Also, the ASEAN countries have conducted financial reform in the wake of the Asian financial crisis. Specific measures have included shifting the currency system to a floating exchange rate system, the disposal of NPLs in order to restore financial functionality, the implementation of depositor protection systems, and the enhancement of information disclosure. As a result of these measures, the banks have stopped the excessive expansion of credit and, with the exception of Vietnam and Thailand, their deposit-loan ratios are all under 100%. These banks basically work to a conventional commercial banking model, raising fund by accepting deposits and using the fund to make loans. They make very little use of securitized products. And, the fact that the Lehman Brothers collapse in 2008 did not have a great impact on the banking sector would suggest that the reforms have been successful.

In the wake of the Lehman Brothers collapse, there has been greater international debate on the strengthening of banking sector regulations, but in light of the fact that local banks in the region did not suffer any serious damage at the time of the Lehman shock, there is little enthusiasm domestically for tighter banking regulations. In fact, the banks have adopted a pro-active attitude of implementing the latest Basel Committee standards, in step with international developments regarding regulations, and working to ensure that they are not left behind in an international competitive environment. Among the ASEAN countries that were the subject of this survey, there are no banks that have been designated as globally important financial institutions, so the direct impact of tighter regulations is comparatively slight, and the banks appear content to observe international debate calmly from the sidelines. As for Japan, since the banking business model in Japan is quite different from those in Europe and the US, and since the domestic business ratio is very high, neither Japan's regulatory and supervisory authorities nor the banking industry itself were necessarily in favor of tighter regulations. In the end, with the three megabanks designated SIFI, it is likely that tighter international regulations will have a significant impact on domestic finance. With some major Chinese commercial banks listed on the New York stock exchange, China has been quite positive about adopting the new regulations, signaling China's intention to establish itself as a global financial player.

Further, in 2015 the ASEAN Economic Community is due to be established with ASEAN, with financial regulations integrated by 2020. Since the ASEAN countries are all at different levels of economic development, and the circumstances of their financial systems and financial institutions are widely different, some countries will participate in actual integration, with the others joining the integrated AEC at a later date.

The financial regulations for international banks will need to be standardized by 2020. However, there is as yet no clear schedule for these reforms. Among the member countries, it is expected that there will be mutual recognition of each other's regulations. Therefore, there is a possibility that regulations may remain in force with regard to the foreign banks of non-member countries.

Depending on their stance, some countries will see this intra-regional integration as an opportunity, others as a risk. For countries whose domestic markets have matured and whose own banks have a comparatively high level of competitiveness, the initiative will be a chance to branch out into other countries. On the other hand, for countries whose markets have still to be fully developed, rather than expanding business abroad, their priority will be the growth of their domestic markets, and there is a possibility that their local banks will face tough competition from foreign banks. Therefore, in such cases, the banks will need to improve their competitiveness before integration takes place. Further, in 2015, if economic integration at a real economic level progresses ahead of financial integration, it is believed that there will be an increase in demand for international financial services in the region.

1.3.2. Improving Competitiveness

In order to improve the banks' competitiveness, it is necessary to stabilize the financial systems. While the most competitive banks in the ASEAN region have a significant presence in their own countries, they are actually quite small in global terms. Reforms implemented in the wake of the Asian financial crisis have done much to improve the robustness of the banking system. Learning the lessons of the Asian financial crisis, much effort was expended in strengthening the banks' business foundations. While ASEAN's banks may not yet be at the same level as those in the developed economies, they have evolved massively over the last five years. If the competitive environment becomes tougher moving forward, it is expected that each bank will formulate its own differentiation strategies.

In each country it is recognized that the strengthening of the banking system is crucial to sustainable economic development, and a range of different initiatives are being implemented, depending on the level of economic development. In order to raise the banks' levels of competitiveness, issues such as increasing scale (through takeovers and mergers), introducing new technologies and developing human capital, will need to be resolved, and some countries are looking to support from major financial institutions in developed countries to help them catch up in terms of product development, technologies and personnel development.

1.3.3. Remaining Issues

Bank reform has been carried out. However, there are still some remaining issues.

Firstly, risk management needs to be strengthened. The rapid expansion of credit carries the risk of creating a credit bubble. It will be important for ASEAN countries to learn from the experience of the developed countries. Also, as the expansion of SME financing becomes an issue, it will be necessary to implement appropriate risk management. Stochastic models are not complete. In order to guarantee the accuracy of financial information, the SMEs' accounting systems need to be reformed.

Secondly, there is the issue of consumer protection. As financial deregulation progresses, the banks are able to offer a diverse range of products. Confidence in financial institutions is essential for the development of the retail finance business. Therefore, it is necessary to develop rules governing the sales of financial products, all the while confirming the consumers' understanding of the risks involved. Also, some countries have introduced systems for the rapid and low cost resolution of consumers' complaints, outside of the court system.

Third, the management of the banks needs to be strengthened. Depending on the shareholder composition, there have been cases of weak corporate governance. Also, there are cases where state owned banks tend to prioritize state owned enterprises in terms of credit supply, and the private sector is not being sufficiently supplied with capital.

1.3.4. The Development of Asian Banks

A high level of economic growth is essential for the development of the banking sector. The maintenance of the banks' financial soundness makes investment in business expansion possible. Also, the banks are supposed to be there to support the real economy, and should not be in pursuit of their own profits independent of economic growth. The excessive pursuit of profit through the use of highly leveraged financing tends to involve risk beyond the bank's capacity.

The traditional commercial banking model contributes to stable economic growth. Risk abates somewhat over an extended period of time, and because the traditional commercial banks procure their capital by accepting deposits, they are fairly resilient to market shock.

1.4. Safety Net

1.4.1. The Impact of Global Financial Crisis to Money Flow

In 2008, the global financial crisis began since the collapse of Lehman Brothers occurred. How did the money flow change in the Asian region after the crisis?

a. Intra-Regional Ratio of Bank Flows for Asia

It is not easy to get data about intra-regional bank flows within Asia. Looking at the BIS international banking statistics, there are locational banking statistics and consolidated banking statistics. And from the latter statistics[2], the numbers can be generated shown on Table 1.3. .

The consolidated banking statistics are based mainly on the country of incorporation of the reporting institutions and measure the international lending activities of banks' head offices in the reporting countries and all their offices at home and abroad, with positions between offices of the same bank being netted out. Table 1.3. shows total foreign claims vis-a-vis the ASEAN+3 countries and Hong Kong from the BIS reporting banks. In the consolidated banking statistics, the BIS reporting banks are from 30 countries. Among them, only Japan and Singapore are from the ASEAN+3 countries. Also, from Asia, Chinese Taipei, Hong Kong SAR and India are included.

It should be noted that, regarding Finland, Hong Kong, India, Luxemburg, Norway and Singapore, the reporting bank data is not shown in the BIS statistics, though the lending amounts of these banks are included in total foreign claims. Furthermore, Table 1.3. does not show the countries whose loan amount to Asia is very small, such as Brazil, Mexico, and Panama, even though their reporting bank data is shown in the BIS statistics.

For these reasons, the total of "Weight by nationality" is only 76.1%. Regarding the residual 23.9%, roughly 20% is estimated to be lent by Hong Kong and Singapore[3]. In total, the intra-regional flow ratio should be about 30%, by adding the ratio of Japan to 20%. It must be added that, among the Asian countries that are not included in

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[2] BIS, "Consolidated Banking Statistics" Table 9B: Consolidated foreign claims of reporting banks-immediate borrower basis

[3] According to the Hong Kong Monetary Authority, *Annual Report* 2010, 699 billion Hong Kong dollars, or 39.9% of Net External Claims of All Authorized Institutions was vis-a-vis the ASEAN+3 countries. If we apply this ratio to the gross lending data using locational banking statistics (because consolidated statistics for Hong Kong are not disclosed), the share of Hong Kong in total foreign claims to the ASEAN+3 countries is estimated to be about 10%.

According to the Monetary Authority of Singapore, Table1.16 of *Monthly Statistical Bulletin*, as of June 2011, 296 billion US dollars, or 43.9% of interbank and non-bank funds in the Asian Dollar Market was vis-a-vis East Asia (Hong Kong, Taiwan and the ASEAN+3 countries excluding Singapore). If we apply this ratio to the gross lending data using locational banking statistics (because consolidated statistics for Singapore are not disclosed), the share of Singapore in total foreign claims to the ASEAN+3 countries is estimated to be about 10%.

Table 9B as a reporting bank, China and South Korea should have a certain impact on the real intra-regional ratio because of their size. The impact of other countries is estimated to be at most 1% each. Care must be taken that, in the above analysis, the way of funding of each reporting bank is not considered. If the funding is dependent on the money from outside the Asian region, the ratio of intra-regional flows should be regarded as less.

Table 1.3. International Bank Lending in Asia by Bank Nationality

(June 2011) (million USD, %)

		Bank nationality							
Claims vis-a-vis	Total foreign claims	European banks	Australia	Canada	Chinese Taipei	Japan	United States	Total foreign claims/Domestic credit	Total foreign claims/GDP
All countries	32,616,178	19,663,091	640,599	958,750	213,806	2,890,397	3,167,549		
Japan	1,062,295	429,842	n.a.	n.a.	3,319	-	298,144	7.6	19.5
China	669,207	267,769	n.a.	8,388	12,195	51,859	81,772	6.9	11.4
Hong Kong SAR	635,414	387,342	14,791	3,997	16,379	76,194	60,003	127.3	283.1
Singapore	375,164	205,294	22,509	2,273	5,236	53,402	60,061	157.6	168.5
South Korea	373,546	179,241	n.a.	n.a.	3,467	44,031	97,198	32.2	36.8
Malaysia	155,176	64,291	n.a.	n.a.	1,352	11,936	20,347	43.7	65.2
Indonesia	114,924	45,967	n.a.	620	1,206	18,746	19,277	42.2	16.3
Thailand	95,771	25,399	109	n.a.	1,276	35,542	11,375	25.0	30.0
Philippines	38,223	17,894	n.a.	1,387	1,150	4,439	7,945	37.1	19.2
Vietnam	24,440	11,621	n.a.	n.a.	3,249	3,928	2,109	18.0	23.6
Brunei	4,057	2,406	n.a.	n.a.	182	n.a.	1,224	128.0	32.8
Laos	428	339	0	0	2	87	0	21.9	6.6
Cambodia	399	103	n.a.	n.a.	95	n.a.	5	13.1	3.4
Myanmar	253	202	0	0	0	0	0	12.0	0.6
Asia total	3,549,297	1,637,710	37,409	16,665	49,108	300,164	659,460	13.2	24.6
Weight by nationality	100.0	46.1	1.1	0.5	1.4	8.5	18.6		

(December 2001) (million USD, %)

		Bank nationality							
Claims vis-a-vis	Total foreign claims	European banks	Australia	Canada	Chinese Taipei	Japan	United States	Total foreign claims/Domestic credit	Total foreign claims/GDP
All countries	11,488,150	7,138,923	n.a.	337,677	n.a.	1,178,955	799,238		
Japan	553,360	294,395	n.a.	7,078	n.a.	0	57,378		13.5
China	57,510	23,691	n.a.	261	n.a.	11,539	3,802		4.3
Hong Kong SAR	268,188	164,200	n.a.	2,321	n.a.	38,445	20,148		161.0
Singapore	133,841	65,733	n.a.	2,384	n.a.	22,339	16,895		152.6
South Korea	73,157	30,338	n.a.	1,721	n.a.	10,742	16,386		14.5
Malaysia	51,429	22,147	n.a.	n.a.	n.a.	6,241	7,791		55.4
Indonesia	37,426	20,080	n.a.	644	n.a.	8,971	3,374		23.3
Thailand	42,364	16,923	n.a.	n.a.	n.a.	11,182	4,374		36.7
Philippines	22,410	11,016	n.a.	n.a.	n.a.	3,144	4,853		29.4
Vietnam	2,420	1,285	n.a.	n.a.	n.a.	286	363		7.4
Brunei	1,433	1,211	n.a.	n.a.	n.a.	n.a.	126		25.6
Laos	39	19	n.a.	n.a.	n.a.	n.a.	n.a.		2.3
Cambodia	125	100	n.a.	n.a.	n.a.	n.a.	n.a.		3.1
Myanmar	540	478	n.a.	n.a.	n.a.	27	n.a.		8.3
Asia total	1,244,242	651,616	n.a.	14,409	n.a.	112,916	135,490		18.6
Weight by nationality	100.0	52.4	n.a.	1.2	n.a.	9.1	10.9		

Source: BIS, "Consolidated Banking Statistics" Table 9B: Consolidated foreign claims of reporting banks-immediate borrower basis

b. Historical Change

When the weight by nationality is compared between December 2001 and June 2011, big changes are that the ratio of European banks dropped from 52.4% to 46.1%, and that the ratio of US banks increased from 10.9% to 18.6%. The ratio of Asian banks seems to have not changed much.

Again, the fact must be considered that, in this analysis, China and South Korea are not included as a lender. In particular, the size of Chinese banks has expanded a lot during the last decade, and this fact would surely have some impact on the analysis.

On the other hand, looking at the situation of intra-regional ratio for long-term bond investment, judging from the IMF's coordinated portfolio investment survey, the intra-regional ratio changed from 3.3% in 2001 to 3.7% in 2009 (Table 1.4.). That is not a big change, but the fact that China is not included as a source of investment would have some impact on the change of the ratio. For reference, if Japan is excluded from the source of investment, both ratios for 2001 and 2009 are 18.3%.

In summary, the intra-regional ratio of bank flows and long-term bond investments stayed stable for the last decade at around 30% and 3.5%, respectively. Judging from the quantitative measures, regional financial integration has not deepened much regarding these kinds of financial transactions. From these results, regional financial integration is still an important task for the ASEAN+3 countries.

Table 1.4. Balance of Cross-border Long-term Bond Investment in East Asia

2001 (million UD dollars)

	Source of Investment									
Recepient	Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of investment received
China	1,776	--	880	118	--	--	325	--	3,099	5,504
Hong Kong	--	95	1,254	288	28	25	920	47	2,657	15,625
Indonesia	--	--	106	40	8	3	260	--	418	1,613
Japan	4,980	1	--	75	15	5	3,606	--	8,682	169,196
South Korea	2,680	--	5,435	--	3	7	1,670	--	9,794	22,389
Malaysia	1,766	--	2,197	295	--	9	1,392	--	5,660	9,263
Philippines	1,152	--	1,347	89	41	--	577	--	3,207	8,843
Singapore	1,225	35	928	141	7	59	--	9	2,404	13,227
Thailand	530	--	748	159	21	--	500	--	1,958	3,613
Vietnam	--	--	30	15	--	--	--	--	45	101
Total	14,109	131	12,925	1,221	122	108	9,251	56	37,924	249,374
Total investment balance	85,877	687	1,004,878	5,284	551	1,641	41,960	327	1,141,205	6,430,125
Intra-regional ratio (%)	16.4	19.1	1.3	23.1	22.2	6.6	22.0	17.1	3.3	3.9

2009

	Source of Investment									
Recepient	Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of investment received
China	8,271	--	521	144	--	--	1,514	--	10,450	16,088
Hong Kong	--	90	1,390	385	100	67	3,595	184	5,810	11,312
Indonesia	203	--	1,792	166	48	--	5,298	8	7,515	24,455
Japan	3,742	--	--	212	--	7	1,992	90	6,043	218,071
South Korea	10,671	10	8,440	--	1,296	153	13,965	8,332	42,867	98,017
Malaysia	2,987	5	2,509	130	--	56	4,429	201	10,318	27,624
Philippines	651	4	1,477	56	196	--	1,246	29	3,659	17,357
Singapore	2,896	298	3,595	102	605	--	--	10	7,506	27,220
Thailand	173	--	684	74	104	18	1,226	--	2,280	5,539
Vietnam	96	--	33	2	2	--	210	--	343	1,453
Total	29,691	406	20,443	1,270	2,352	301	33,474	8,855	96,792	447,135
Total investment balance	244,908	2,615	2,224,756	25,032	6,493	3,829	120,999	12,988	2,641,620	20,471,463
Intra-regional ratio (%)	12.1	15.5	0.9	5.1	36.2	7.9	27.7	68.2	3.7	2.2

Source: IMF, "Coordinated Portfolio Investment Survey"

Notes1: China and Vietnam are not included as sources of investment because no data are available.

Notes2: The figure in the bottom right-hand corner of each table represents the world total for the balance of investment.

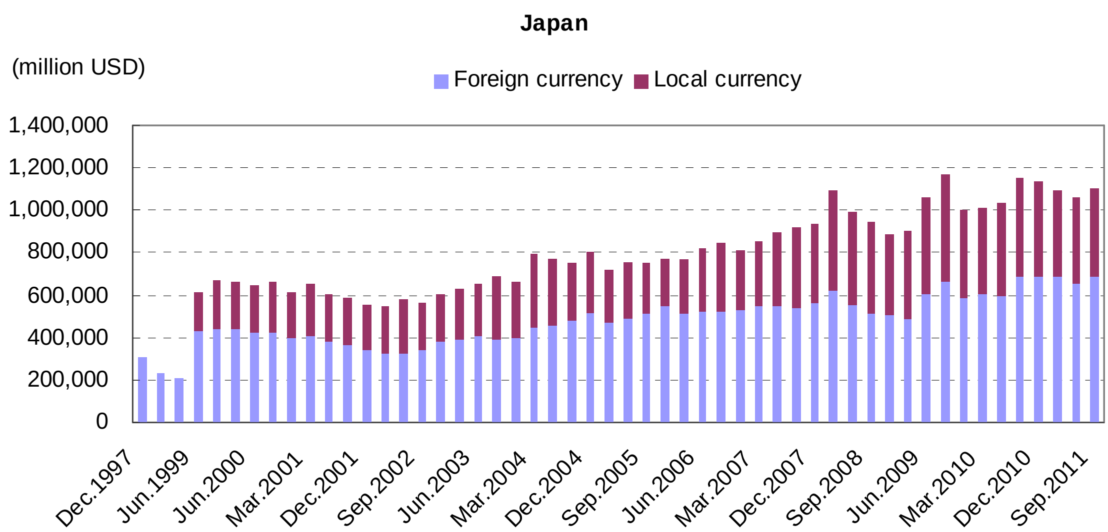
c. Importance of Foreign Claims as a Funding Source

As of June 2011, the ratio of total foreign claims to domestic credit was 13.2% for Asia as a whole in this table. The ratios for Japan and China are less than 10%. On the other hand, the ratios for South Korea and the ASEAN original member countries are more than 25%, which is rather high.

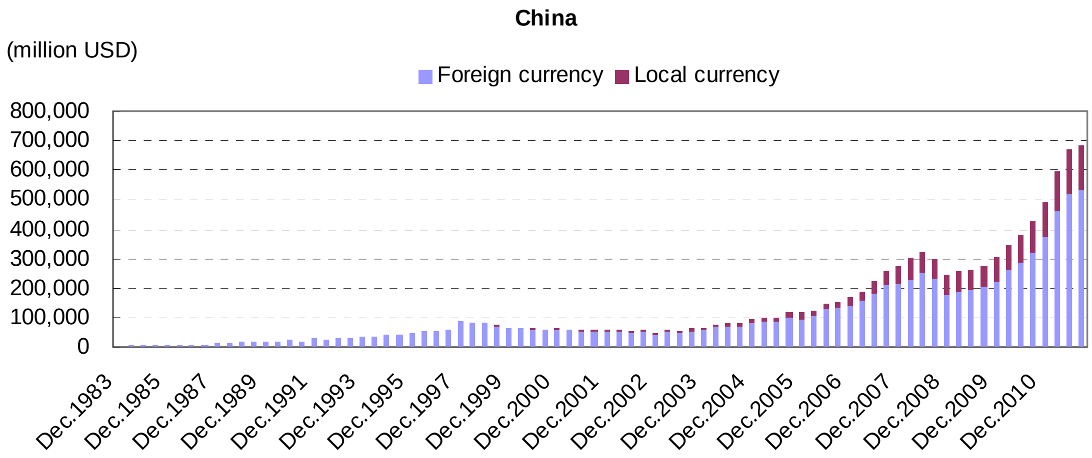
Compared with nominal GDP, total foreign claims increased from 18.6% in 2001 to 24.6% in 2011. It can be said that the situation regarding the external bank borrowings of the ASEAN+3 countries did not change a lot. However, the change is remarkable for some countries such as China (from 4.3% to 11.4%), Hong Kong (from 161.0% to 283.1%), South Korea (from 14.5% to 36.8%), and Vietnam (from 7.4% to 23.6%).

In this analysis, it must be considered that, in the consolidated banking statistics, local claims of foreign affiliates of reporting banks in local currency are included. The situation on this point varies among the countries analyzed in the following chapters (Figure 1.10.).

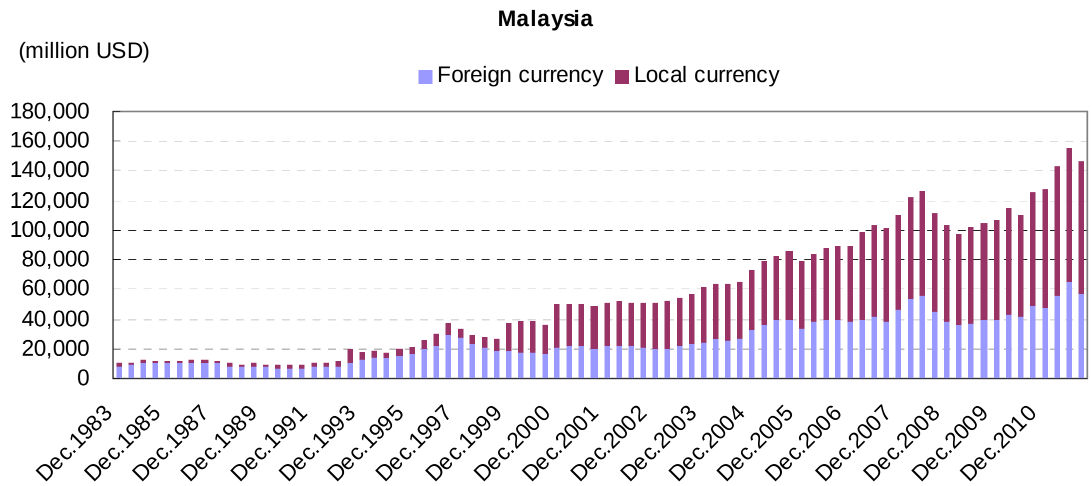
Figure 1.10. Total Foreign Claims



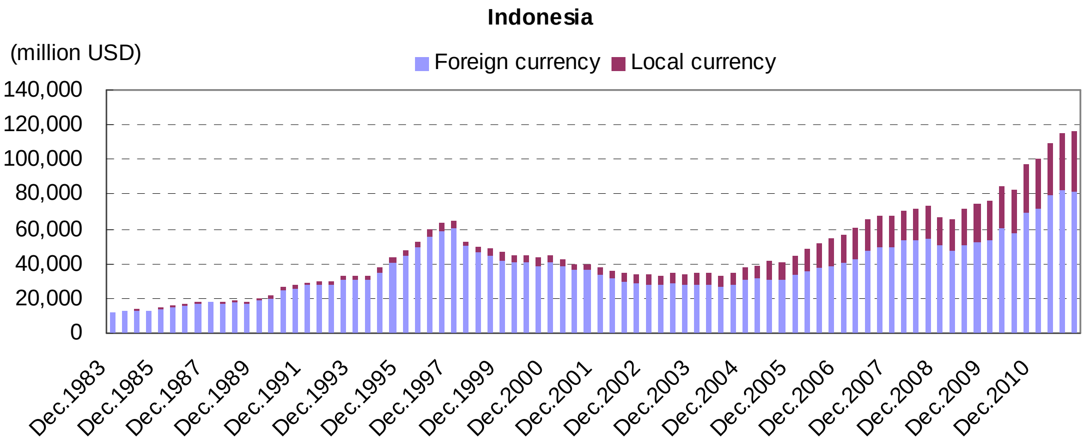
Source: BIS, “Consolidated Banking Statistics”



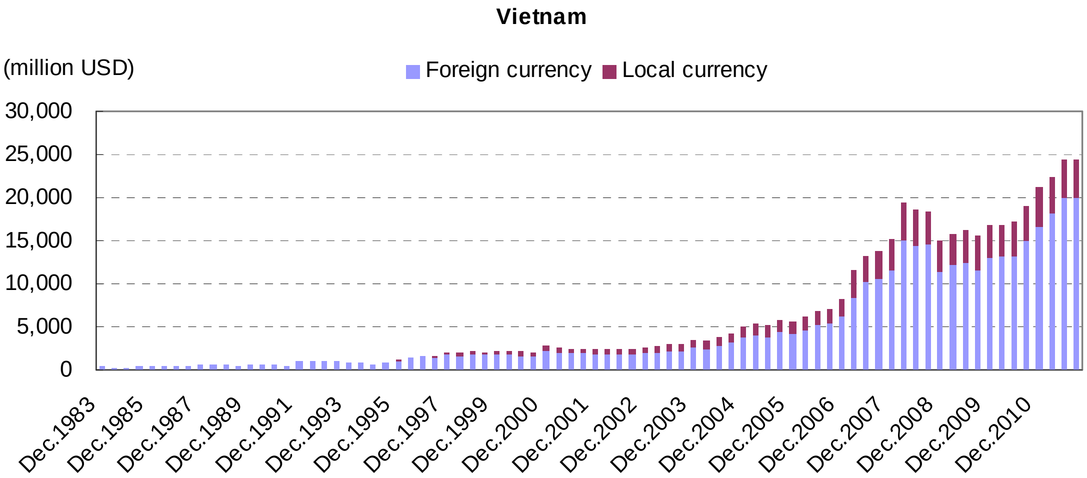
Source: BIS, “Consolidated Banking Statistics”



Source: BIS, “Consolidated Banking Statistics”



Source: BIS, “Consolidated Banking Statistics”



Source: BIS, “Consolidated Banking Statistics”

In summary, in recent years, the analyzed countries have been experiencing the increase of capital inflows by the reporting banks in various ways. These countries must pay attention to the risks involved with the increase, and think carefully about their strategies in response, such as monitoring of capital flows, introduction of capital controls, regulations for banks about their external exposures, how to introduce foreign banks to the domestic market and so on.

In this way, there is not a large change in money flow. The aim to recycle savings into investment among Asia has not been achieved yet. Asian savings will flow through to the United States, through US treasury and Composition has become a savings of Asia to the U.S. through the reflux, such as U.S. Treasury bonds, which are reinvested to Asia via the U.S. and European financial institutions. Those funds have been reinvested to Asia via the U.S. and European financial institutions.

It is difficult to solve this problem only by banking system reform. ASEAN +3 countries make dollar denominated export in high ratio. There is a structure dollar funds are accumulated naturally. Especially, ASEAN countries were transformed as to increase foreign reserves by lessons learned from the Asian financial crisis in 1997. The foreign reserves increased considerably. There is no destination other than US Treasury for investment of massive dollar assets. As long as current account surpluses in Asian countries, capital composition to reflux in the United States will not change. Therefore, in order to recycle savings into investment in Asia, the settlement currency problem should be considered as well as financial reforms such as capital markets reforms and banking sector reforms.

1.4.2. Deposit Insurance and Establishing Bankruptcy Process

Learning the lessons from the Asian financial crisis, ASEAN countries are working to develop their deposit insurance provision. Although the amount of deposit protected by insurance differs from country to country, deposit insurance has already been implemented in Thailand, Vietnam, Malaysia and Indonesia. Therefore, even if a bank fails, deposits are protected to a greater or lesser extent and there is only a very slight possibility of turmoil such as a run on the bank. However, in China the deposit insurance system has not been introduced yet. Japan had deposit insurance from an early stage and, in the wake of Japan's financial crisis in the late 1990s, the system for disposing of failed banks was also enhanced, and the deposit insurance mechanism plays that role. Also, in addition to deposit insurance systems, some countries are progressing with the development of their own early corrective measures and bankruptcy disposal systems. Further, in the event that a bank has insufficient liquidity, in many countries the central bank will supply liquidity as the lender of last resort.

Currently, while there is some concern over a slight rise in the NPL ratio in Vietnam, the region's banks are generally in good financial soundness. China's state owned banks used to have very large amounts of NPLs, but they were disposed of by transferring them to other companies. Also, in the last two years China's banks have increased their reserve allowance and their NPL ratios are falling.

As described above, settlement systems are being reformed in all of the examined countries and, in addition to increased handling capacity, the introduction of RTGS is advancing. Therefore, there is less likelihood of risk accumulating up until the point of settlement. Given the foregoing, it would seem comparatively unlikely that there would be any chance of chain-reaction bank failures resulting from banking sector settlement risk in Asia.

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2. Thailand

2.1. Characteristics of the Banking Sector

2.1.1. Domestic Economic Situation and Industrial Structure

a. Economic Trends

The Kingdom of Thailand has been a constitutional monarchy since 1932. Under the parliamentary democracy (a bicameral National Assembly comprised of a House of Representatives elected by popular vote, and a Senate appointed by the King upon recommendation of the Prime Minister), the administrative power is vested in the Cabinet which consists of the Prime Minister and other ministers of state. The Cabinet is constituted by one Prime Minister and not more than 35 other Ministers who were appointed by the king. The administrative organization of the central government consists of the Office of the Prime Minister and 19 Ministries. Thai kings exercise executive powers through the cabinet, and judicial powers through the law courts. While not directly involved in political management, the King exerts a strong moral influence on carefully selected issues.

Thailand had relatively stable political and social conditions for a long period. But after the collapse of the Thaksin regime in 2006, the confrontation intensified between “the National United Front of Democracy Against Dictatorship (UDD, Red Shirts)” - which supports former Prime Minister Thaksin - and “the People's Alliance for Democracy (PAD, Yellow Shirts)” - which criticizes and rallies against Thaksin and his policy. In the background, there is the deep-rooted social problem of the economic gap between urban and rural areas.

According to the National Economic and Social Development Board (NESDB), Thailand's Gross Domestic Product (GDP) growth rate was 7.8% and GDP at current prices was 10,104.8 billion baht, with per capita income of 150,117 baht in 2010 (according to the International Monetary Fund (IMF) statistics, $318.8 billion and $4,992, respectively).

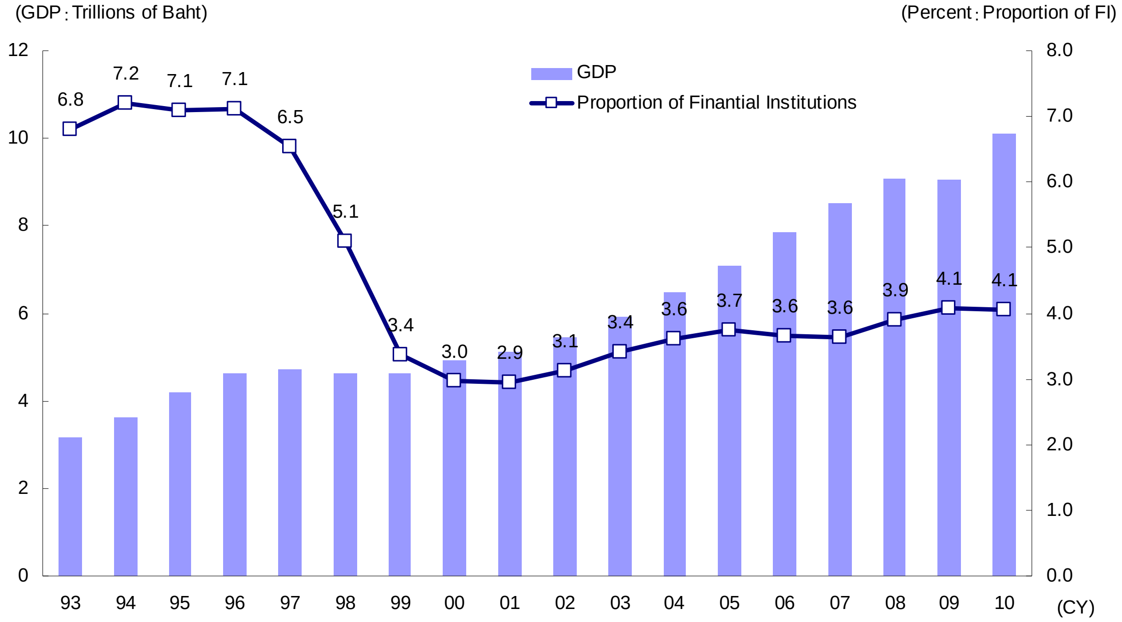
When Thailand’s economic growth is viewed in terms of its nominal GDP growth, from 60 billion baht ($2.8 billion at contemporary exchange rates) in 1960, it expanded by 168 times over the subsequent 50 years. In particular, the Thai economy has continued to grow at double digit speed since the latter half of the 1980s, and part of the background to that has been the fact that the great volume of direct investment flowing into Thailand from Japanese firms, NIEs, and Europe and the US has been the driving force of high levels of economic growth. Whereas countries like Japan and Korea basically put priority in the allocation of domestic savings into investment in heavy industry, Thailand achieved its economic growth by promoting foreign capital-led industrialization, thus overcoming production technology difficulties and capital procurement restrictions.

Further, as a result of the liberalization of finance and capital transactions in the 1990s, huge volumes of capital began to flow into Thailand from abroad, and the growth in domestic credit fueled consumption expansion. Of course, a large part of that capital was in the form of short term financing and, since a considerable proportion of that was diverted towards such as real estate investment, a bubble economy developed. Due to concerns over the future of the Thai economy, foreign capital started to withdraw from Thailand. This brought with high volume baht selling by speculators, forcing the shift to a floating exchange rate system. Currency prices crashed and the Asian financial crisis of 1997 followed. In the wake of the financial crisis, the Thai economy suffered a serious setback and its financial systems were in turmoil. The economic growth rate in 1997 fell to minus 1.4%, and then plunged to minus 10.5% in 1998.

Subsequently, the economy was restructured with the support of international organizations like the IMF and the World Bank, and by the early 2000s was averaging 5% growth per annum. However, from May 2008 onwards, anti-government demonstrators became more active, leading to a situation of political instability, which in turn damaged consumption and investment sentiment and had a severe impact on tourism. Further, in the wake of the global financial crisis that was triggered by the collapse of Lehman Brothers, Europe and US-destined export growth fell drastically and the economy entered a period of stagnation. Thailand's real economic growth rate fell from 5.0% in 2007 to 2.5% in 2008, and switched to negative growth at minus 2.3% in 2009. The latter half of 2009 saw a rapid recovery in private consumption and foreign demand, and the real economic growth rate for Q4 2009 switched back to positive growth at 5.9%. From 2010, against the backdrop of recoil inventory growth following the compression of the previous year, and flourishing plant and equipment investment, the economy has continued to expand and growth has recovered to 7.8% (Figure 2.1.).

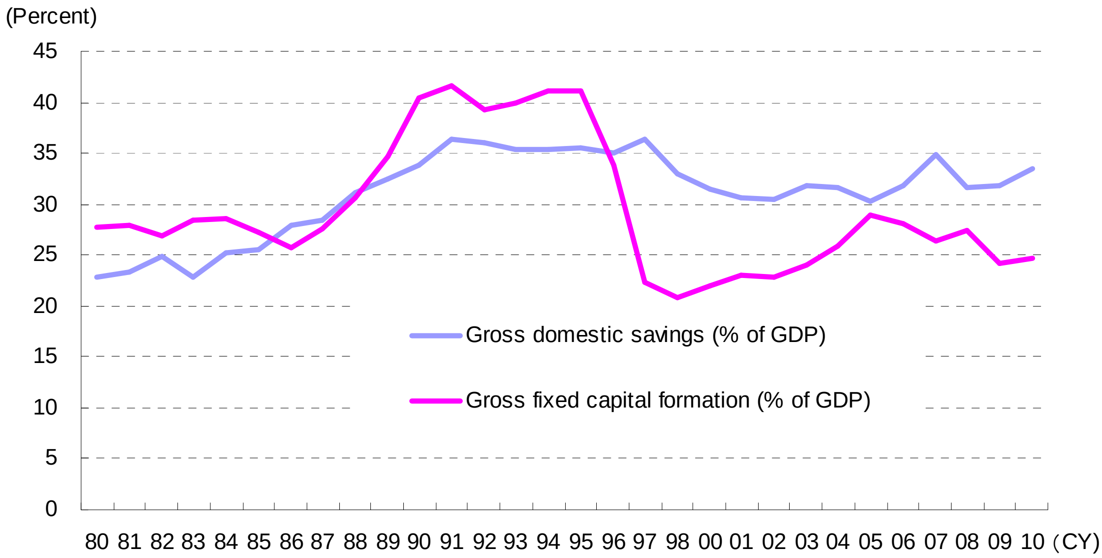
So, although the Thai economy passed through several stages of change, it has been able to maintain comparatively healthy economic growth. However, the economy suffered a body blow from the widespread flooding that occurred in 2011, with major industrial sites flooded one after the other, and factories were forced to suspend operations. In consideration of the effects of flood damages, the Bank of Thailand (BOT) has revised its GDP growth rate forecast for 2011 downwards by a significant degree, from 4.1% (July forecast) to 2.6% (October forecast).

Figure 2.1. Gross Domestic Product at Current Market Prices



Source: National Economic and Social Development Board

Figure 2.2. IS Balance

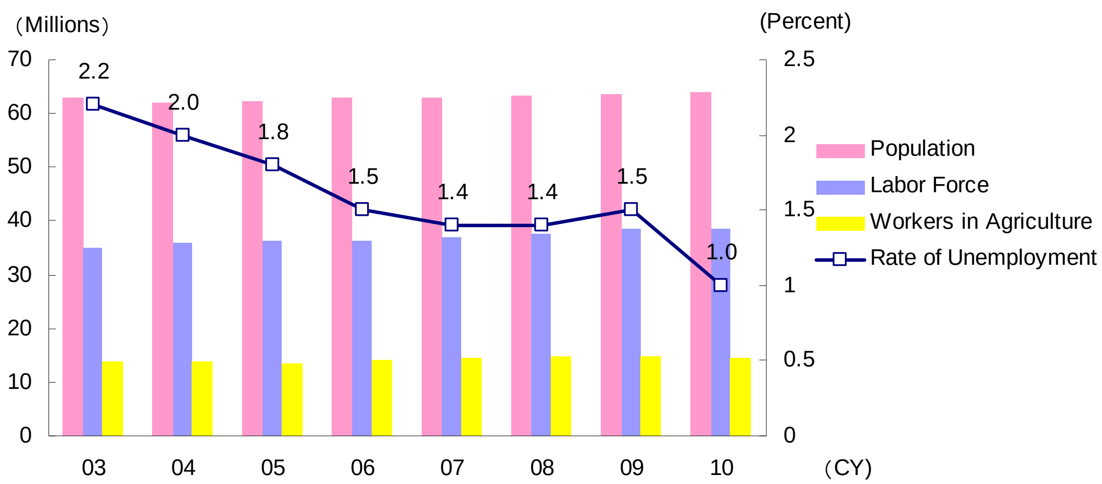


Source: World Bank

Examination of the balance between investments and savings in Thailand shows that, up until the Asian financial crisis, as Thailand's economy developed, savings and investments both grew. In particular, as the economy began to overheat in the '90s, domestic investments were well in excess of domestic savings. However, after the Asian financial crisis, domestic investments dropped suddenly and Thailand switched from being an excess investment economy to an excess savings economy. Subsequently, though domestic investments began to show signs of recovery by 2005, Thailand's economic structure continues to be characterized by excess savings and a current account surplus. Currently, domestic savings as s percentage of GDP are growing in the 30% range and domestic investments in the upper 20% range (Figure 2.2.).

Thailand's population at the end of 2010 stood at 63.88 million (according to the BOT), with around one third of the population concentrated in the central region, centered around Bangkok city (population: 5.7 million). According to the international statistics compiled by the U.S. Census Bureau, the Thai population stood at 66.33 million in 2010 and is expected to peak in 2034 at 71.46 million, decreasing from then on. Further, the productive population, aged between 15 and 60, will peak in 2014, with Thailand expected to become an ageing society from then on. Thailand's labor force population (aged 15 or over: the BOT) was 38.64 million at the end of 2010, with 38.04 million employed workers (excluding seasonal laborers). Of those employed, 14.55 million, or 38.2%, workers in agriculture, forestry and fisheries. The number of unemployed is 400,000, and the unemployment rate 1.0% (Figure 2.3.).

Figure 2.3. Populations and Employment



Source: Department of Provincial Administration, National Statistical Office and National Economic & Social Development Board

b. Thailand's Industrial Structure

Looking at Thailand's industrial structure in terms of real GDP, it can be seen that, from the 1950s, as the weight of the primary industries (agriculture, forestry and fisheries) has declined, industrialization has advanced and the weight of the secondary industries (such as manufacturing) is increasing. In particular, as the yen grew in strength from the latter half of the 1980s, Japanese manufacturers began to increase the speed at which they transferred production operations overseas. Also, at that time, the Thai government began to introduce investment incentives more aggressively, encouraging many Japanese firms to invest in Thailand and accelerating the pace of industrialization. Further, in terms of sub-classifications within the manufacturing sector, in the 15 year span between 1994 and 2009, automobiles, IT equipment, machinery, and chemical products all took on greater weight, whereas textiles, clothing, and leather goods saw their weight decline. From these data it can be deduced that export oriented processing and assembly industries have been the drivers of the Thai economy.

As a result of the growth of manufacturing, the weight of agriculture, which had accounted for around 25% of GDP in 1970, fell to 12% in 2010. However, even today agriculture accounts for roughly 40% of workers, and agriculture remains a major industry in terms of its working population. Meanwhile, the percentage of the working population working in manufacturing increased from approximately 14% to around 17% over the last ten years, and manufacturing accounts for 89% of export value and 36% of GDP.

Within the international division of labor, Thailand imports raw materials and capital goods, processes these and turns them into products, or exports them to other countries as intermediate materials. In 2009, the global financial crisis caused demand to slow among the industrialized economies, such as the US and Europe, which were major export destinations, and this led to a drastic fall in export volume. In 2010, thanks to economic stimulus measures implemented around the world, exports were able to recover to levels higher than those of 2008. Thailand's exports for the whole of 2010 were worth $193.7 billion, 28.5% up on the previous year, with imports at $179.6 billion, up 36.8% on the previous year, leaving a trade surplus of $14 billion and a current account surplus of $14.8 billion.

The major export items (2010) were computers (including parts and components), automobiles (including parts and components), electronic printed circuit boards and so on. Major import items were crude oil and agricultural machinery (including parts and components), electrical machinery (including parts and components), and chemicals. Thailand's main partners, for both exports and imports, are Japan, other ASEAN countries, China, the US and EU.

2.1.2. Overview of Financial System

a. The Changing Thai Financial System

Before the Second World War, foreign banks dominated the Thai financial market, principally through currency issuance and trade finance. The full scale construction of the Thai financial system began in 1942 with the establishment of the BOT. The Commercial Banking Act was established in 1945, and at that time many of the financial institutions that went on to become today's major local commercial banks were founded. Then, in 1962, the revised Commercial Banking Act introduced tougher restrictions which made the establishment of new commercial banks more difficult and led to the local major commercial banks' monopolization of the market.

In the decade between 1970 and 1980, Thailand adopted one of the more prudent stances among ASEAN countries with regard to financial deregulation, such as maintaining strict controls on interest rate. The real liberalization of interest rates only got underway when the reform of the financial system started in the late 1980s. In 1990, Thailand accepted the obligations of Article VIII of the Articles of Agreement of the IMF, speeding up the process of liberalization of foreign exchange and capital transactions. In 1993, the offshore market "Bangkok International Banking Facility (BIBF)" was established. Part of the reason behind this move was Thailand's attempt to establish itself as a financial center within Indochina. To that end, tax benefits were introduced so that BIBF would be able to compete with other financial centers in the region. Although BIBF was able to handle not only "out – out" transactions (between non-residents) but also "out – in" transactions (inward capital investment in Thailand by foreign investors), large volumes of capital flooded into Thai markets from overseas and resulted in a bubble economy, which was one contributory factor that triggered the currency and financial crises.

In the wake of the Asian financial crisis, many Thai financial organizations were forced into business failure. The Thai government accepted the support and guidance of the IMF and the World Bank, and began working on financial and corporate structural reform. Examples of major reform initiatives included management intervention and the injection of public funds to support vulnerable banks, the restructuring of the banking sector and the reform of regulatory and supervisory frameworks, and so on. As regards the capital markets, the Public Limited Companies (PLC) Act was revised and guidelines were drafted by the Stock Exchange of Thailand (SET) and the Securities and Exchange Commission (SEC). Over-dependence on indirect financing and the fragility of the financial system has been recognized as one of the factors that contributed to the Asian financial crisis. In order to address that problem, Thailand is attempting to reinforce the banks' structures and to vitalize raising funds through direct financing, such as the issuance of corporate bonds and stocks.

b. Direct and Indirect Financing

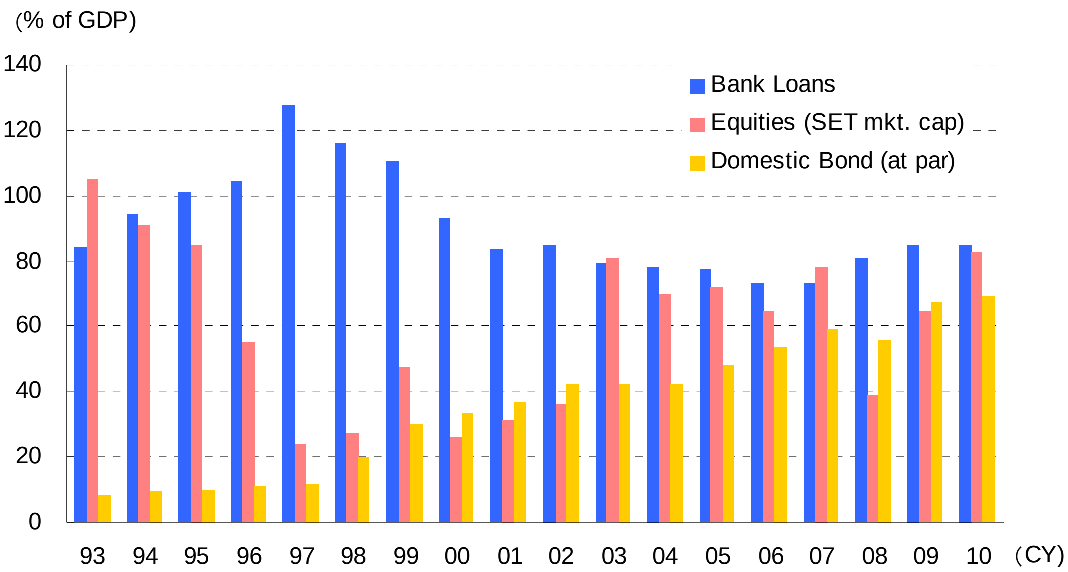
As with other south-east Asian countries, Thailand's financial system was traditionally bank-centric. The history of capital markets is relatively short, and the Stock Exchange was only opened in 1975, with the Stock Exchange Commission (SEC) established in a supervisory capacity in 1992. In terms of the bond market, because the Thai government had adopted the policy of balanced finance, in the early 1990s there was no issuance of national bonds that might have served as benchmarks.

However, the Asian financial crisis of 1997 delivered a significant shock to

Thailand's indirect financial system. As part of the process of reconstruction of the financial system that followed the Asian financial crisis, the banking sector, the principal focus of indirect financing, and its affiliate financial companies underwent rationalization and reorganization. Non-performing loans (NPLs) were sold off to asset management companies, and a large scale credit squeeze followed. As a result, although the NPL ratio did fall, the banks' lending activities contracted rapidly. The deterioration of the real economy triggered a credit crunch among the financial organizations, and this in turn caused the real economy to deteriorate further, thus engendering a vicious cycle.

Under these circumstances, it became more and more clear that there was a need to shift from a predominantly indirect finance-centric system to one that balanced indirect finance with direct finance, thereby diversifying the financing methods available to the corporate sector and dispersing some of the risk that had been concentrated on the banks into the market. And so, through initiatives like the Thai Capital Market Master Plan, the work of developing the stock market and the bond market proceeded.

Figure 2.4. Size of Thai Financial Market



Source: Thai Bond Market Association

With the expansion of the issuing of government bonds as part of measures to clear NPLs, and the shift of large companies towards the corporate bond markets away from the tight credit of the banks, bond issuance has been expanding at a steady pace. In 1995, on the eve of the Asian financial crisis, the bank loan ratio to GDP was 100.9%, equities 85.0% and bonds 10.1%. In 2010, those figures were 85.0% for bank loans, 82.5% for equities, and 68.9% for bonds (Figure 2.4.). At first glance, these figures may be interpreted that a shift is occurring from indirect finance to direct finance. However, the number of listed companies in the stock market has stayed more or less unchanged, with very few new companies being listed. Also, only a limited number of companies can actually issue bonds, and corporate bonds account for only about a fifth of the bond market, so the reality is that the market is not yet being fully utilized by the corporate sector as a means of procuring capital.

c. Flow of Funds Structure

According to the NESDB's flow of funds account, the total value of both the surplus and deficit of funds began to increase from the end of the 1980s and, after peaking between 1999 and 2000, suddenly crashed, and has been recovering on track since 2006.

In terms of individual sectors, the household sector is generally a supplier of funds and the private non-financial corporate sector and government sector are borrowers. Of course, in the 1980s the household sector's surplus and the private non-financial corporate sector's deficit were more or less the same scale, but in the 1990s the private non-financial corporate sector's deficit growth outstripped that of the household sector's surplus, and the difference was mainly made up by foreign capital. It is believed that part of the background to this was that, in the early 1990s, financial deregulation, capital transaction liberalization, and the establishment of BIBF, etc., led to a great volume of capital flowing into Thailand from the foreign sector. After a period of adjustment in the wake of the Asian financial crisis, the household sector again became the supplier of capital, while the private non-financial corporate sector, and the government and foreign sectors were the borrowers. Also, the fact that the household sector became a deficit sector in 2009 is believed to be due to the increase in housing loan debt (Figure 2.5.)[4].

Next, in terms of fund management in the household sector, examination of financial product component ratios shows that, though there may be fluctuations depending on the economic environment of a particular year, overall the cash and bank deposit ratio is large (Figure 2.6.). The share of cash and bank deposits has grown especially in the wake of the Asian financial crisis and the global financial crisis. On the other hand, investment in securities grew about 20% between the late 1980s and the mid 1990s. Though it did dip momentarily during the Asian financial crisis, securities investment is growing again at around 20%, following the economic recovery. Although investment in bonds has improved in comparison with the situation pre-1990, investment in corporate bonds in particular is very low. As regards the funding in the household sector, the main sources are short and long term loans, housing loans

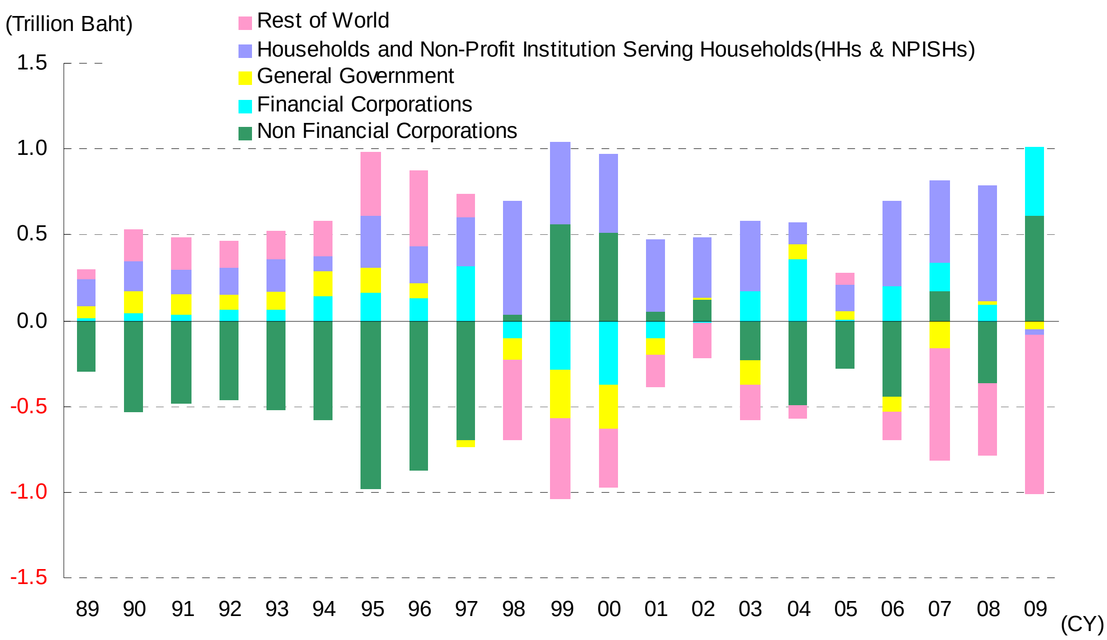
[4] National Economic and Social Development Board. *Flow-of-Funds Accounts of Thailand 2005-2009.* 2011

(mortgages) and installment payments, with funds borrowed mainly from banks and non-bank financial institutions (Figure 2.7.).

On the other hand, as regards the private corporate sector, the main source of funding was the foreign sector prior to the Asian financial crisis. Since the Asian financial crisis, the flow of funds from the foreign sector has continued to be deficient. Although there are fluctuations in the fund management volume of the private corporate sector from year to year, the trend in recent years has been for diversification into bonds, loans, cash deposits and securities, and the use of government bonds and treasury bills in particular is increasing (Figure 2.8.). Funding tends to focus on borrowing, securities and bonds, with funds being borrowed from commercial banks or Special Financial Institutions (SFIs) (Figure 2.9.)[5].

From the foregoing, it can be seen that Thailand's financial system is bank-centric, with a flow of funds structure characterized by intermediation by private sector financial organizations.

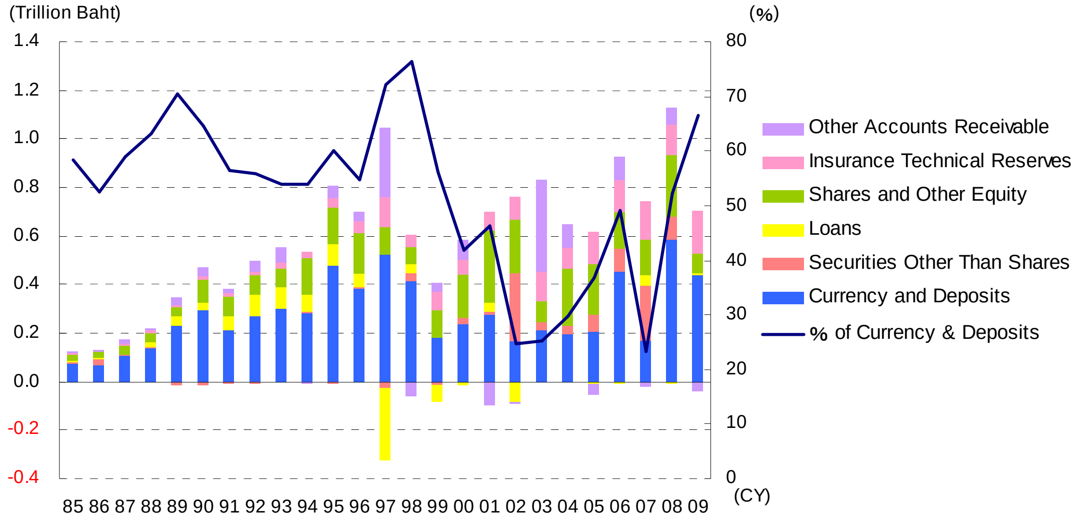
Figure 2.5. Financial Assets and Liabilities by Sector



Source: National Economic and Social Development Board

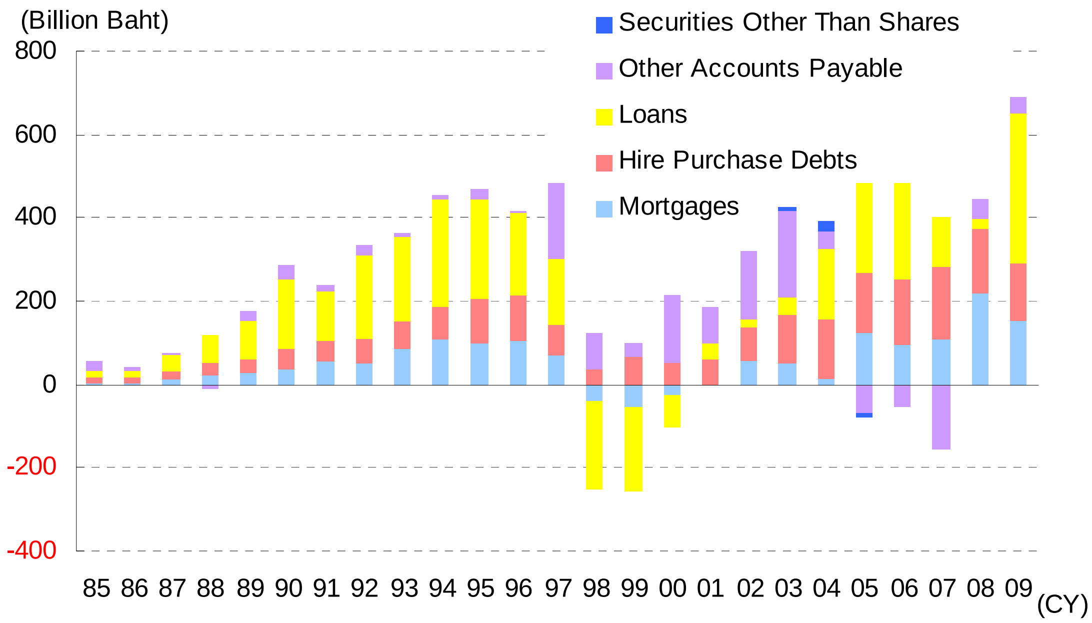
[5] National Economic and Social Development Board. *Flow of Funds.* April 2011

Figure 2.6. Net Acquisition of Financial Assets
: Households and Non-Profit Institution Serving Households



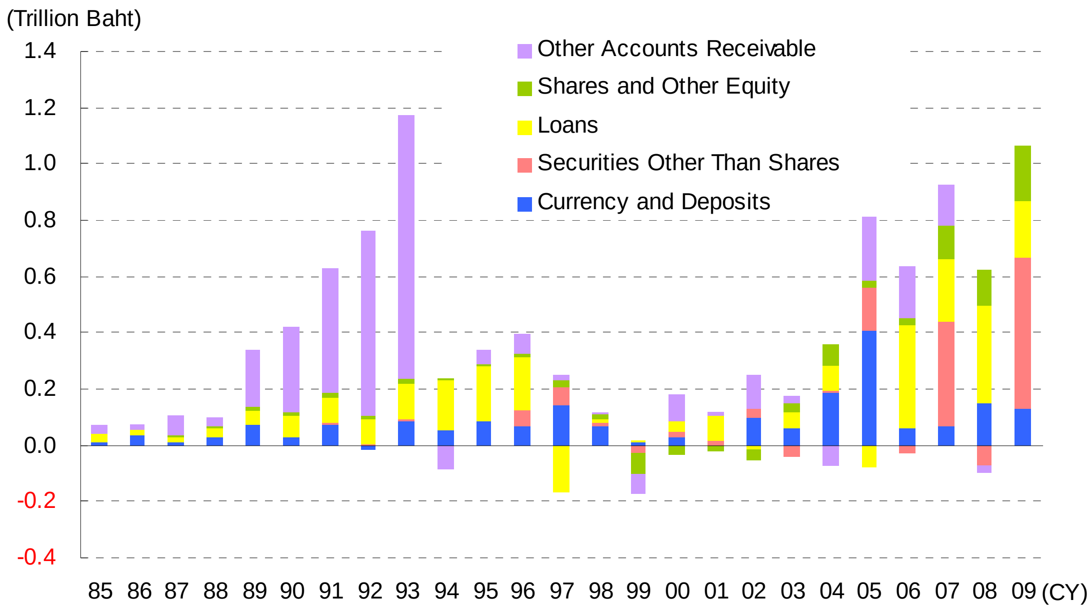
Source: National Economic and Social Development Board

Figure 2.7. Net Liabilities: Households and Non-Profit Institution Serving Households



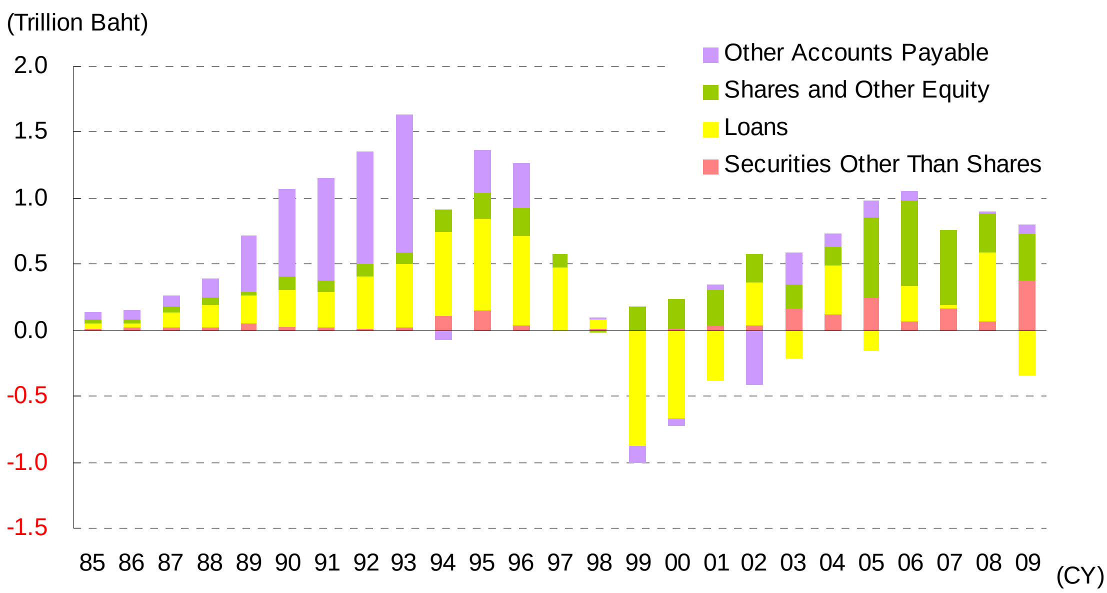
Source: National Economic and Social Development Board

Figure 2.8. Net Acquisition of Financial Assets: Non-financial Corporations



Source: National Economic and Social Development Board

Figure 2.9. Net Liabilities: Non-financial Corporations



Source: National Economic and Social Development Board

d. Outline of Thai Capital Markets

i) Stock Market

Thailand's modern stock market system has a short history compared with other capitalist countries. The first stock exchange was established in 1962, as a limited partnership by a private group. The group later became a limited company and changed its name to the "Bangkok Stock Exchange Co., Ltd. (BSE)" in 1963. Despite its well-intended foundation, the BSE was rather inactive. In addition to the Thai economy being at an immature stage, because of a lack of official government support and a limited investor understanding of the equity market, trading value was very poor. The BSE finally ceased operations in the early 1970s.

Despite the failure of the BSE, the concept of an orderly, officially supported stock market in Thailand had by then attracted considerable attention. In this regard, the Second National Economic and Social Development Plan (1967-1971) proposed, for the first time, a plan for the establishment of such a market, with appropriate facilities and procedures for securities trading.

In 1969, as recommended by the World Bank, the Thai government carried out the capital market development plan supported by Professor Sidney M. Robbins from Columbia University. In 1975, "The Securities Exchange of Thailand (SET)" was established under "the Securities Exchange of Thailand Act B.E. 2517 (A.D. 1974)". On January 1, 1991, its name was formally changed to "the Stock Exchange of Thailand (SET)".

Full-scale growth of the stock market in Thailand was in the latter half of the 1980s when the Thai economy was growing rapidly, and the Thai government proceeded with financial deregulation. The fundamental framework of regulation and the supervision of the present capital market were formed through reform in the early 1990s. In order to correspond to a rapid growth of the stock market, "the Securities and Exchange Act" and "Public Limited Companies (PLC) Act" were amended in 1992, and PLCs were approved to list on SET and offer for sale newly issued shares to the public under the law. The Securities and Exchange Commission (SEC) and the office (Office of SEC : OSEC) were established in 1992. The SEC performs the functions of the capital market supervisory agency with the status of an independent state agency.

However, the Asian financial crisis occurred in 1997 and the trading volume and value of the stock market contracted rapidly. Stock prices at the end of 1997 fell by 55% from the previous year, and it was one fifth of the peak price. In order to maintain trade volume, the delisting standard was eased temporarily to continue the listing of companies which were implementing debt restructuring. In addition, the varieties and scope of securities were expanded.

After the Asian financial crisis, the Thai government tackled capital market reform under the supervision and support of the IMF and the World Bank. In 2001, the government decided on "the Thai Capital Market Master Plan" in order to strengthen the capital market functions and enhance market supervision. In the first phase (2002 - 2005), the plan focused on six strategic pillars: 1) promoting good corporate governance; 2) enlarging the investor base; 3) increasing the number and the diversification of financial market instruments; 4) strengthening intermediary institutions; 5) enhancing the efficiency of the infrastructure to reduce transaction costs; and 6) reforming the structure of the supervision system. For example, listed companies have to establish an audit committee including an external board member, in order to strengthen corporate governance.

The second phase of the plan covering the period 2006 - 2010 was released in February 2006. The plan focused on 1) expanding the equity market by increasing the number of domestic institutional investors so they hold at least 20% of total equity on the exchange, resulting in an institutional to retail investor ratio of 40:60; 2) growing the size of the fixed income market by increasing supplies (both government and corporate securities) and promoting investment by individual investors using tax incentives; 3) developing derivative instruments as hedging tools for market players and investors; 4) strengthening the capacity and financial stability of market intermediaries by increasing their capital requirements, encouraging more revenue diversification, and gradually liberalizing brokerage fees; 5) promoting good corporate governance practices of listed companies; 6) enhancing the financial literacy of domestic investors; and 7) reemphasizing the role of regulatory agencies in developing the market in addition to regulating it.

The third phase of the plan was "the Capital Market Development Master Plan (2010 - 2014). It consists of eight key policy components, each time-bounded: 1) abolishing the monopoly and improving the competitiveness of the Thai stock exchange, 2) liberalizing the securities business to promote market efficiency, 3) going through legal reform, 4) streamlining the tax system related to financial products, 5) developing financial products including those that help mitigate risk such as interest rate derivatives, 6) establishing a national savings fund, 7) developing a culture of investment and savings, and 8) developing the domestic bond market.

In 1999, "the Market for Alternative Investment (mai)" was established as a stock market for small and medium-sized enterprises. The mai's purpose is to create new fund-raising opportunities for innovative businesses with high potential growth as well as to provide a greater range of investment alternatives. In 2004, the Thailand Futures Exchange, a market for derivative products, was founded.

As of the end of December 2010, the SET had 474 listed companies and the total value of market capitalization was 8.3 trillion baht. The mai also had 66 companies with a stock market capitalization of 55,100 million baht. In 2010, there were a total of 11 new listed companies (excluding BTS Group Holding PCL, through a backdoor listing), 4 of SET and 7 of mai. The number of SET member securities companies is 38. In recent years, Internet trading is expanding. The number of SET securities companies providing Internet trading services is 27 and dealing volume via Internet occupies about one fourth of the total amount.

In terms of investor composition in the Thai stock market, the ratio of individual investors was 76% in 2003 and fell to 54% in 2008 caused by the expansion of investment by domestic institutional investors and foreign investors. However, foreign investors flew out of the country due to the effects of Lehman Shock and subsequent world financial crisis. The investment ratio of foreign investors was 29.1% in 2008 and decreased to 18.4% in 2010. Instead of foreign investors, the domestic institutional investors increased their investments, and as a result, the ratio of domestic investors in 2010 increased to 62%.

The benefits of listing on the SET are 1) tax incentives, 2) diversification of financing method, and 3) improvement in recognition and credit. In terms of tax incentives, 1) for the company which proceeds to list their securities on the SET, the corporate income tax rate is reduced from 30% to 25%, and 20% for those which proceed to list their shares on the mai for three consecutive years. 2) There is a reduction of the corporate income tax rate to 20% for the first 20 million baht for a company already listed on the mai, and 25% for the first 300 million baht for a company already listed on the SET. Furthermore, a listed company entitled to this tax incentive must not be granted a tax reduction under Royal Decree No. 467 (as amended by R.D. 474). Besides, the preferential taxation to listing companies was extended for three years till the end of 2012.

When one looks at the trend of the number of listing companies in 2004, the number recovered to the pre-crisis peak level, but it has remained steady in recent years. At present in Thailand, the stock market is not fully exploited by many companies for financing.

ii) Bond market

Since the beginning of the 1990s, the demand for funds to invest in the construction of large-sized infrastructure such as traffic, electric power, telecommunication and industrial property was backed by high economic growth. However, before 1992 the issuance of corporate bonds was limited to public companies and companies listed on the SET. As a result, private companies were overly dependent on loans from banks for financing. In order to fill the need for funding, the government implemented the further development of the bond market.

For promoting utilization of the primary bond market, the Securities Exchange Act and Public Limited Companies Act were revised in 1992, which allowed public and private companies, listed and non-listed, to issue bonds. Furthermore, the Thai Rating Information Service (TRIS) was founded as the first Thai rating agency in 1993 with the support of the BOT and technical support of Standard and Poor's. Companies which issue bonds must be rated by TRSI.

With regard to development of the secondary market, the Bond Dealers Club (BDC) was established by the Association of Securities Companies (ASCO) in 1994 as a secondary market for bond trading, adding more liquidity to debt instruments. As an independent organization, the function of the BDC was strengthened in 1997. It was reorganized to become the Thailand Bond Dealing Center (TBDC), and all the debentures can be traded and accounts settled now on-line.

However, the Thai bond market didn't function well at raising funds. The underdevelopment of the Thai bond market can be attributed to the fiscal restraint policy of the government. Thai government was working to reduce debt by prepayment of government bonds, for example, and had little incentive or need to issue any regular or substantial amount of government bonds. Therefore the government had not issued any bonds between 1988 and 1996. The resulting limited supply of government bonds inhibited the development of a risk-free benchmark against which private issuers could price their bonds, and made it difficult to develop the corporate bond market. Prior to the Asian financial crisis, while bank loans and the stock market filled a large portion of the Thai financial system, the bond market was limited and rarely used for financing by private companies. The total amount of outstanding bonds at the end of 1996 accounted for only 11.2% of GDP and 10.8% of bank loans.

The Thai bond market has grown significantly in recent years after the 1997 crisis which had brought massive problems of NPLs and a credit crunch. The Thai government had to support the distressed financial institutions with 500 billion baht in government bonds issued through the Financial Institutions Development Fund (FIDF) to recapitalize the banking sector. State enterprises and corporations also had to issue bonds instead of borrowing money from banks for restructuring their debts and funding for new projects.

To support restructuring and recapitalization of financial institutions, the government issued bonds in 1998 for the first time in the decade. The total amount of government bonds issued under this program was 500 billion baht and this has opened a new era for the Thai bond market. The government has continued to issue bonds since then with the primary objective to finance the budget deficit resulted from the crisis.

As the importance of the bond market development was widely recognized after the Asian financial crisis, "the Domestic Bond Market Development Committee" was set up in 1998 to promote the development of the domestic bond market by the Ministry of Finance, the BOT, the SEC, the TBDC and commercial banks. They also decided upon a "Domestic Bond Market Development Master Plan". Under the plan, eight task forces were installed to analyze the market and discuss reform measures.

As part of enhancing the secondary market, the Bond Electronic Exchange (BEX) was established by SET to enhance efficiency in bond transactions in 2003. "The Thai Bond Market Association (Thai BMA)" was also established in 2005 as a self-regulatory organization for the fair and efficient operation of the bond market and to be an information center for the Thai bond market. It also plays functional roles on market development, market convention and standards and is the bond pricing agency for the industry.

According to the Thai BMA's annual report, the outstanding value of the Thai BMA registered bonds amounted to 6,755.64 billion baht as of December 2010, an increase of 15% from 2009. They consisted of 2,523.16 billion baht (37.3%) of government bonds, 2,411.73 billion baht (35.7%) of State Agency bonds, 1,103.64 billion baht (16.3%) of long-term corporate bonds, 501.78 billion baht (7.4%) of State Owned Enterprise bonds, 85.66 billion baht (1.3%) of commercial paper, 71.71 billion baht (1.1%) of T-Bills and 57.96 billion baht (0.9%) of foreign bonds.

The largest portion of long-term corporate bonds outstanding was in the energy & utilities (26%) sector, followed by banking (20%), construction materials (11%), property development (10%), financial and securities (9%), transportation and logistics (6%), information and communication technology (4%), and others (14%). In terms of credit rating, the majority of corporate bonds are A-rated bonds, accounting for 920.40 billion baht or 83% of the total outstanding value. The remaining 17% consisted of 101.15 billion baht of B-rated bonds (9%) and 82.08 billion baht of non-rated (8%) bonds.

e. Types of Financial Organizations

i) Commercial Banks

According to the BOT, the banking sector can be classified into 4 categories in Thailand. They are 1) commercial banks, 2) retail banks, 3) foreign bank branches, and 4) special financial institutions (SFIs) owned by the government.

The BOT allows only two types of financial institutions to mobilize public savings. Those financial institutions have to fill the following requirements to obtain a license as a bank.

<u>A: Commercial banks</u> for qualified and well capitalized financial institutions. Such commercial banks may provide financial services to all groups of customers and carry out virtually all types of financial transactions, except insurance underwriting and brokering, and the trading and underwriting of equity securities. The minimum capital requirement is currently placed at 5,000 million baht of tier-1 capital.

<u>B: Retail banks</u> for qualified financial institutions with much smaller capital requirement. Retail banks may offer basic financial services to all types of customers, with the limitation that they may only provide credit, or other similar transactions, to retail customers and SMEs. They may provide virtually all types of financial transactions with the same exceptions as commercial banks, and are not allowed to conduct business related to foreign exchange (unless permitted by the Minister of Finance), and derivatives products (unless for risk-hedging of their own portfolios). The minimum capital requirement is 250 million baht of tier-1 capital.

The BOT also established two types of foreign bank licenses.

<u>A: Full branch</u>, enjoying the same scope of business as Thai commercial banks but with only one branch. The foreign bank branch must maintain assets in Thailand in the amount no less than 3,000 million baht, in accordance with the types, procedures

and conditions as prescribed by the Minister of Finance, from the day it begins its operation.

B: Subsidiary, enjoying the same scope of business as Thai commercial banks and are allowed to open four branches in addition to one head office – one branch and one head office in the Bangkok metropolitan area, and the remaining three outside the Bangkok metropolitan area. The subsidiary must have paid-up registered capital in the amount of no less than 4,000 million baht from the day it begins operation.

New policies enable foreign banks which currently operate a branch in Thailand to apply to convert such a branch into a subsidiary, which can have a maximum of 20 branches and 20 off-premise ATMs, without limitation on location. The MOF has approved the notification which will come into effect on December 15, 2011. The foreign bank branch can submit application to convert into a subsidiary between January 4, 2012 and December 28, 2012[6].

The Thai banking sector including commercial banks, retail banks, finance companies, credit fonciers and SFIs is regulated under "the Financial Institution Business Act" which was established in 2008 (Table 2.1.)[7]. Securities companies under the Securities Exchange Act, non-bank financial institutions (NBFI) not mobilizing deposits, are exempt from this law.

Businesses of commercial banks, finance companies, and credit fonciers can be undertaken only by a public limited company with a license from the Minister of MOF with the advice of the BOT. Also a foreign commercial bank may establish a branch to undertake the commercial banking business in Thailand upon obtaining a license from the Minister with the advice of the BOT.

In Thailand, Special Financial Institutions (SFIs) are established to supplement commercial bank functions and roles that take a negative stand against providing financial services to rural areas or niche markets, lower income segments, because those segments are considered unprofitable. There are 8 SFIs as follows;

1) Government Saving Bank (GSB)
2) Bank for Agriculture and Agricultural Cooperatives (BAAC)
3) Government Housing Bank (GHB)
4) Export–Import Bank of Thailand (EXIM-Bank)
5) Small and Medium Enterprise Development Bank of Thailand (SME Bank)
6) Islamic Bank of Thailand (ISBT)
7) Secondary Mortgage Corporation (SMC)

[6] Bank of Thailand. "Policy Guideline Permitting Foreign Banks to Establish a Subsidiary in Thailand." http://www.bot.or.th/Thai/PressAndSpeeches/Press/News2554/n5854e.pdf
[7] Bank of Thailand. "Financial Institution Business Act B.E. 2551."
http://www.bot.or.th/English/LawsAndRegulations/DocLib_EngLaw/Law_E24_Institution_Sep2011.pdf

8) Thai Credit Guarantee Corporation (TCG)

ii) Finance Companies

Thai finance companies are a unique type of non-bank financial organization. They were established in the late 1960s as a result of the tightening of restrictions on commercial banks as part of the Commercial Banking Act, enacted in 1962. The Finance Company Act was enacted in 1972, enabling finance companies to engage in banking and securities business activities, other than deposit taking and foreign exchange transactions.

Finance companies differ from commercial banks in that they issue promissory notes for the funds that are deposited with them, rather than deposit certificates, to procure funds and make loans to individuals and entrepreneurs. One reason behind the growth of Thai finance companies is that they have not been subject to the same tight restrictions as the commercial banks. Also, since foreign banks were not allowed any new operations until 1989, they were involved in Thai financial markets by investing in the finance companies. However, the fact that the finance companies were generally not so strict as the commercial banks when it came to vetting often led to financial instability (such as the public relief bailouts applied during the financial instability of the late 1970s and the economic depression of the early 1980s). At the peak of the public relief process, over 200 companies were consolidated, with many of them coming under the control of commercial banks. Of the 91 finance companies that existed before the 1997 order to suspend operations, 75 were affiliated with commercial banks.

Before the Asian financial crisis, although the finance companies did play some role in complementing the commercial banks' loans to the manufacturing industry, they did tend to make loans to high risk sectors, such as construction and real estate. So after the Asian financial crisis they were left holding a huge amount of NPLs. The finance companies' total loans were worth 1,488.2 billion baht in 1996, but by 2000 had dwindled to about a tenth of that size, 147.3 billion baht. Finance company bankruptcies were also a significant business shock to their parent commercial banks, and in the process of disposing of failed financial institutions in the wake of the Asian financial crisis, almost all of them were liquidated and restructured. Prior to the Asian financial crisis, there were 91 finance companies in Thailand, of which 56 were ordered to close in 1997, reducing the number to 35. Currently, there are three finance companies left, two of which are Thai and one foreign.

iii) Credit Foncier Companies

Credit foncier (landed credit) companies specialize in real estate loans. Their main financing method is the issuance of long term promissory notes, and they specialize in financing real estate (land and buildings) purchases. In 1990 there were

18 credit foncier companies in Thailand. This number fell to 12 in 1997 and there are now only three left.

The authorities' stance is one of gradually widening the scope of business of the commercial banks (to full service banks), while moving towards abolishing the finance companies and credit foncier companies in the future, merging them with the commercial banks. Today's retail banks originated from finance companies and credit foncier companies, and the government is also pushing to convert them into commercial banks.

iv) Other Financial Institutions

In Thailand non-bank financial institutions (NBFI) are defined as finance intermediaries that do not accept deposits, and to which the Financial Institutions Business Act does not apply. NBFI include credit card companies, personal loan companies, e-money card companies, lease companies, hire purchase companies, factoring agencies and so on. Other non-bank financial institutions include securities companies, asset management companies, investment trust management companies, insurance companies, post offices, agricultural cooperatives, savings cooperatives, pension funds, social security funds, money changers and pawnshops.

The credit card and personal credit businesses of non-bank financial institutions are controlled by the MOF and the BOT. According to the BOT, there are 11 non-bank companies whose businesses include credit card operations (as of August 2011). Also, there are 25 companies under the BOT supervision which provide personal loan services.

v) Informal Finance

Small and medium sized enterprises (SMEs) that are not able to enjoy the benefits of formal finance and government finance make use of pawnshops, moneylenders, chit funds and other forms of informal finance on a regular basis. In agricultural communities in particular, even today, the money needed to purchase seedlings, fertilizer, farm equipment, etc., is often borrowed from a broker or a landlord. Purchases of consumer goods also are often made through credit purchase, which is dependent on local merchants.

For this reason, government authorities are trying to educate people about finance, as well as promoting the offering of microfinance services, so that those who are currently using informal finance that charge high interest rates will be able to use formal financial services.

Table 2.1. Financial Institutions in Thailand and Related Regulators and Laws

Institution	Regulator	Related Law
The Bank of Thailand	Ministry of Finance	Bank of Thailand Act B.E.2485 and amended
Commercial Banks	Bank of Thailand	Financial Institutions Businesses Act B.E.2551
Foreign Bank branches		
Foreign Bank Subsidiaries		
Retail Banks		
Finance Companies	Bank of Thailand	Financial Institutions Businesses Act B.E.2551
Credit Foncier Companies		
Asset Management Companies	Ministry of Finance/ Bank of Thailand	Emergency Decree on the Asset Management Company B.E.2541
Money Changers	Ministry of Finance/ Bank of Thailand	Exchange Control Act, B.E.2485
Securities Companies	Securities and Exchange Commission	The Securities and Exchange Act, B.E.2535
Mutual Fund Management Companies		
Life Insurance Companies	Ministry of Finance/ Office of Insurance Commission	Life Insurance Act, B.E.2535 and amended
Agricultural Cooperatives	The Department of Cooperatives Promotion and the Department of Cooperative Auditing, Ministry of Agriculture and Cooperatives	Cooperative Act, B.E.2511 and amended
Savings Cooperatives		
Provident Fund	Securities and Exchange Commission	Provident Fund Act, B.E. 2530
Social Security Fund	Ministry of Labor	Social Security Act, B.E.2533
Pawnshops	Ministry of Interior	Pawnshop Act, B.E.2505 and amended

Source: Bank of Thailand

2.1.3. Structure of the Banking Sector

a. Historical Background

The history of commercial banking in Thailand starts with the opening of the Bangkok branch of the Hong Kong and Shanghai Banking Corporation in 1888. Thus, the first commercial bank to do business in Thailand was a foreign bank. Local banks owned by the locals have their origin in the "Book Club", founded in 1904 by the Finance Minister, a brother of the King (approved by the King as a bank in 1907 and later becoming Siam Commercial Bank), but it was foreign banks that were the hub of currency issuance and trade finance, and virtually dominated Thailand's financial markets. The majority of local commercial banks were set up after the 1940s, and many of them were established by exporters of products such as rice and timber, who had amassed large amounts of capital pre-1930. The enactment of the Bank of Thailand Act in 1942 and the Commercial Banking Act in 1945, at long last provided the framework for a legal system and governmental monitoring to cover the Thai banking sector.

In order to reinforce the local banks, the BOT amended the Commercial Banking Act in 1962, tightening the restrictions imposed on market entry by foreign banks. This meant that, in principle, with the exception of offices and branches that were already open in Thailand, foreign banks were restricted to one bank in Thailand, and one office per bank. Further, there was a condition of reciprocity, in that the other country must already have permitted a Thai commercial bank to do business there. For about 30 years after that, no new banks were allowed to be established, and this included Thai banks.

However, the Asian financial crisis of 1997 impacted the Thai economy and its financial system deeply. The financial institutions were left holding massive amounts of NPLs, and of the 15 commercial banks in Thailand at the time, six banks needed injections of public funds and other types of intervention, including nationalization[8]. Then, in an effort to attract foreign capital in order to recapitalize the banks, the foreign capital investment limit (25%) which applied to financial institutions (banks and finance companies) was lifted for a period of ten years, and four banks were bought out by foreign financial institutions[9].

Subsequently, eventually breaking free of the effects of the Asian financial crisis, the profitability of the financial institutions was restored through a series of structural adjustments, including the enactment of the Financial Sector Master Plan (Phase I) in 2004, the rationalization of problem financial institutions, the relaxation of restrictions on foreign capital participation, the conversion of finance companies into commercial banks, and the strengthening of the financial health of financial institutions based on the new Basel Accord. Then, IBF, which had been one of the causes of the currency crisis, was gradually scaled back and finally closed in 2006. In addition, the One Presence policy was implemented. This stipulated that, in each financial conglomerate, there could only be one financial institution (bank or finance company) that could accept private sector deposits. This structural reform had the effect of reducing the number and types of financial institutions. Thus, although the financial system appeared to have changed outwardly, the presence of the local top level banks was still strong, and there had not been much real change to the basic structure.

Meanwhile the trend of banking realignment still continues. The Government sold off state-owned shares of the local commercial banks to the private sector or foreign

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[8] In 1998 the Bangkok Bank of Commerce (BBC), Bangkok Metropolitan Bank, Siam City Bank, Laem Thong Bank, and Union Bank were all nationalized, followed by the Nakornthon Bank in 1999. Of these, BBC was closed and Laem Thong was absorbed by Radhanasin Bank, which was formed to inherit the blue chip assets of 56 failed finance companies. Union Bank merged with Krungthai Thanakit, a finance company belonging to the Krung Thai Bank group, and became Bank Thai.

[9] The four local banks taken over at that time were Asia Bank (bought by the Dutch ABN Amro Bank in 1998, sold to Development Bank of Singapore (DBS) in 2004, merged with UOB Radhanasin (UOB Thai) in 2005), Thai Danu Bank (merged with DBS in 1998 and TMB in 2004), Nakornthon Bank (bought by the UK's Standard Chartered Bank in 1999), and Radhanasin Bank (bought by Singapore's UOB in 1999, merged with Asia Bank (UOBT) in 2005).

banks; Bank Thai was sold to CIMB Bank of Thailand in 2009, ACL bank was sold to ICBC Bank of Thailand, and Siam City Bank was sold to Thanachart Bank in2010.

b. Regulatory Environment

In comparison with other Asian countries, the regeneration of Thailand's financial institutions in the wake of the Asian financial crisis of 1997 was rather slow. One reason for this was the inadequacy of the financial supervisory function and market regulations.

The old Bank of Thailand Act, enacted in 1942, stipulated that "The general supervision of the affairs of the Bank of Thailand is vested in the (Finance) Minister" (Section 14), and "The Governor and the Deputy Governor shall be appointed or removed from office by the Crown, upon the recommendation of the Cabinet" (Section 19), with the effect that the BOT lacked independence as a financial institution. Then, the Bank of Thailand Act was revised, in an attempt to strengthen the BOT's supervisory mechanisms and the independence of its financial policies. Specifically, the central bank's objectives of "monetary stability, financial institution system stability and payment systems stability" were clarified. The Act also stipulated the selection of the Governor by a selective committee and the approval of this selection by the Cabinet. The Act also secures the independence of the Governor from the MOF, stipulating that the Governor's term of office is to be five years (with one re-election possible), and that the Governor may only be removed from office by the Cabinet, and with clear statements of the reasons for the removal. In addition, replacing the earlier overall supervisory powers of the MOF, the supervisory powers of the BOT were strengthened and specific Committee and/or Boards were set up to monitor each specific area within the BOT, thus decentralizing supervisory powers.

Also, the laws covering banks, etc., had been separated into "the Commercial Banking Act" and "the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business", but these were merged under "the Financial Institutions Business Act of 2008," strengthening the BOT's powers to supervise and monitor the banking sector. Specifically, the commercial banks' capital equity ratios were stipulated and, in the event that a bank's capital equity ratio falls below 8.5%, the BOT was granted the rights to issue a correction order, to conduct financial inspection and to impose penalties.

Further, the enactment of the Deposit Protection Agency Act has enabled the gradual shift from the earlier system of guaranteeing total deposits through the Financial Institutions Development Fund (FIDF) to one of partial guarantee, and has promoted financial discipline in the market.

As regards supervisory institutions for financial organizations other than commercial banks, the stock exchange and securities companies, etc., are supervised by the Securities and Exchange Commission, and insurance companies and the like by the

Insurance Commission (newly established in 2007 as an independent organization to replace the Insurance Bureau of the Ministry of Commerce).

Regulation concerning the banking sector in Thailand is as follows;

i) Basel II and Capital Adequacy Requirement

Capital adequacy requirements started at the end of 2008. Any Thai commercial bank must have sufficient capital cushion under Basel II's Pillar I to cover credit risk, market risk and operation risk, where this capital adequacy ratio (CAR) must be at least 8.5% of the total risk-weighted assets (RWA) of a specific bank and at least 4.25% of Tier 1 capital to its RWA.

In addition, foreign bank branches must hold at least 7.5% of its RWA and must also hold capital under Section 32 of "the Financial Institution Business Act"[10]. Such capital requirement becomes the first line of defense against a bank run in critical times, as capital cushions are supposed to cover the unexpected losses of banks and be used as tools for crisis prevention and risk mitigation.

In 2010, the average CAR of Thai commercial banks was 16.2%, with the ratio of Tier 1 capital of 12.5%.

ii) Single Lending Limit

1) The amount of money in which a financial institution, except a retail bank, grants credits to, makes investments in the business of, or undertakes contingent liabilities or credit-like transactions with any person or several persons in any project or for the same purpose, at the end of any one day shall not exceed 25% of the capital funds of such financial institution.

2) The amount of money in which a retail bank grants credits to, makes investment in the business of, or undertakes contingent liabilities or credit-like transactions with any person or several persons in any project or for the same purpose, at the end of any one day shall not exceed 11% of the capital funds of such retail bank. The ratio of transactions of which a retail bank can engage with each type of counter party shall be in accordance with the following. 1) Granting credits, making investment, or undertaking contingent liabilities or credit-like transactions with each retail customer shall not exceed 1% of the capital fund. 2) Granting credits, making investment, or undertaking contingent liabilities or credit-like transactions with each SME shall not exceed 10% of the capital fund.

In a case where a person holds, directly or indirectly, 20% or more of the total shares sold in a company, it is assumed that such company is related to such person,

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[10] Bank of Thailand. "Financial Institution Business Act B.E. 2551."
http://www.bot.or.th/English/LawsAndRegulations/DocLib_EngLaw/Law_E24_Institution_Sep2011.pdf

unless it can be proven otherwise[11].

iii) Maintenance of Assets by Branches of Foreign Banks

Assets to be maintained by branches of foreign banks shall be as follows: 1) Deposits with the BOT, Thai government securities, bonds issued by the BOT, bonds issued by the Financial Institutions Development Fund, and debt instruments issued by the Deposit Protection Agency; 2) Shares, debentures, or debt instruments issued by the Bank for Agriculture and Agricultural Cooperatives; 3) Debentures, bonds, or debt instruments issued by the MOF or guaranteed by the MOF in respect of both principles and interests; 4) Debentures, bonds, or debt instruments issued by state organizations or state enterprises established under specific laws or other state enterprises approved by the BOT; 5) Deposits at state organizations or state enterprises established under specific laws or other state enterprises approved by the BOT; 6) Unit trusts where the proceeds from the issuances of such unit trusts are used for investing in assets under Clause 1) to 5)[12].

iv) Guidelines on Investing in Financial Institutions

Financial institutions shall not hold or possess shares, directly or indirectly, in a company more than the following specified ratios:

1) 20% of financial institutions' capital funds in case of aggregated investment
2) 5% of financial institutions' capital funds in case of investment in each individual company
3) 10% of the company's shares sold

The calculation of ratios mentioned above should include the shares held by financial institutions' related parties. In the case of branches of foreign banks, the calculation should include shares of companies registered in Thailand held by the head office or other oversea branches[13].

v) Individual and Aggregate Currency Limit

The onshore FX market in Thailand is closely monitored by the BOT. First, onshore commercial banks are required by the BOT to limit their net FX positions in any one currency to no more than 15% of capital (individual currency limit) and also to maintain a net overall FX position across all foreign currencies of no more than 20% of capital (aggregate currency limit) at the end of each day[14].

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[11] Bank of Thailand. "Supervisory Guidelines on Large Exposure (Single Lending Limit)." http://www2.bot.or.th/fipcs/Documents/FPG/2551/EngPDF/25510325.pdf

[12] Bank of Thailand. "Regulation on the Counting of Assets that Branches of Foreign Commercial Banks shall Maintain as Capital." http://www2.bot.or.th/fipcs/Documents/FPG/2551/EngPDF/25510561.pdf

[13] Bank of Thailand. "Guidelines on Making Investment of Financial Institutions." http://www2.bot.or.th/fipcs/Documents/FPG/2551/EngPDF/25510327.pdf

[14] Jacob Gyntelberg, Mico Loretan, Tientip Subhanij and Eric Chan. "Private information, stock

vi) Maintenance of Liquid Assets (Reserve Requirement)

Commercial banks are required to maintain liquid assets for reserves on the average over a fortnightly period (starting on a Wednesday and ending on a second Tuesday thereafter) with carry-over provisions using the previous period's average level of commercial banks' deposits/liabilities as the base.

Banks have to maintain the required reserves by qualifying assets such as deposits with the BOT or unencumbered Thai government securities and so on. The amount of reserves shall be no less than 6% of the following deposits and borrowings of each bank. The reserve base comprises 1) total of all types of deposits; 2) total of foreign borrowings with maturity within one year from the borrowing date, and total of foreign borrowings that shall be repayable or may be recalled within one year from the borrowing date, with the exception of borrowings under the criteria or conditions prescribed by the BOT; 3) total borrowings with embedded financial derivatives[15].

vii) Loan to Value Ratio

Mortgage lending by financial institutions recently became more competitive as seen by an increasing number of loans with the loan-to-value (LTV) ratio higher than 90 per cent. This reflected the easing of credit standards and had the potential to heighten the risks to financial system stability. To reduce such risks, the BOT imposed a preventive measure to reduce incentives of financial institutions in lending at high LTVs by increasing the risk-weighted assets required for such loans with property prices below 10 million baht per unit. From January 1, 2011, bank loans must be limited to 90% of a home's value for condominium units, and low-rise housing loan-to-value (LTV) ratios are capped at 95% from January 1, 2012.

For larger loans, banks must increase risk weighting to between 75% and 100% of the loan value. At present, the risk weighting is set by the BOT for the property sector at 35%. Risk weightings are used to calculate the minimum amount of capital required to support lending. The higher the risk, the greater the capital that is required by banks leading, which increases overall costs, and leads to higher interest rates[16].

In addition, the BOT sets and conducts monetary policy as well as focuses on three points as monetary policy target; curbing inflation while attaining price stability and economic growth. In order to achieve these objectives, the BOT sets the policies regarding interest rates, reserve rates and open market operations.

In April 2000, the BOT launched the Monetary Policy Committee (MPC) for

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markets, and exchange rates." BIS Papers No 52, Page 194, http://www.bis.org/publ/bppdf/bispap52g.pdf

[15] Bank of Thailand. "Prescription on the Maintenance of Liquid Assets by Commercial Banks." http://www2.bot.or.th/fipcs/Documents/FPG/2549/EngPDF/25490126.pdf

[16] Bank of Thailand. "Inflation Report January 2011." Page 50 http://www.bot.or.th/English/MonetaryPolicy/Inflation/DocL_IR_E2011/5Chapter4_E030211.pdf

discussing and determining monetary policies. The MPC's responsibilities include 1) determining a target for monetary policy, in conjunction with the MOF and the Cabinet; 2) setting a policy framework for exchange rate management under an exchange rate arrangement as determined under the Currency Act; 3) setting the necessary measures to ensure consistency with the targets and policy frameworks in 1) and 2), and following up on these measures to ensure efficiency. The MPC has published the Inflation Report on a quarterly basis to emphasize transparency and accountability in the policymaking process since July 2000. In addition, the BOT has adopted inflation targeting since May 2000 and shows the posture of openness and transparency of its policy decision making process to the financial market. At present, the MPC considers that an inflation target for core inflation (excluding perishable food and energy) of 0.5% - 3.0% per annum is appropriate for the Thai economy.

The BOT is implementing policy for not only controlling inflation and sustaining stable economic growth but also promoting the improvement of competitiveness of the Thai financial sector. The BOT established "the Financial Sector Master Plan (FSMP)" with the MOF in 2004. The plan was a long-term reform program and aimed to improve efficiency, stability and competition within the financial sector as well as to construct a highly transparent and fair financial market, and to provide financial access to all the public. With the first phase of the FSMP completed in 2009, the BOT and the MOF released a new plan "the Financial Sector Master Plan phase II" in 2009 for the next step. The new plan focuses on reducing system-wide operating costs, promoting competition and financial access, and strengthening financial infrastructure (FSMP will be described hereinafter in detail).

c. Competition

Commercial banks are the main players in the Thai banking sector. As of the end of December 2010, the total assets of commercial banks and branches of foreign banks were worth 11,745.9 billion baht, with a loan total of 7,076.7 billion baht, and deposits of 7,365.5 billion baht. The local commercial banks' share of total assets was 85%, and 93% each of both the credit balance and deposit balance.

Prior to the Asian financial crisis, there were almost 180 financial institutions, which had dwindled to just 37 as of January 2012. As mentioned above, this has come about because, since the Asian financial crisis, there has been an ongoing rationalization of financial institutions, through financial reform programs such as the Financial Sector Master Plan. As of January 2012, there are 14 local commercial banks (Thai corporations) and one retail bank (Table 2.2.).

Table 2.2. Number of Financial Institutions by Type

Institution	Jan 1997	Jan 2012
Commercial Banks	31	31
Locally incorporated	15	14 (*1)
Foreign bank branches	16	15
Retail banks	-	1 (*2)
Subsidiaries	-	1
Finance companies	91	3
Credit foncier companies	12	3
IBFs	42	-
Total	176	37

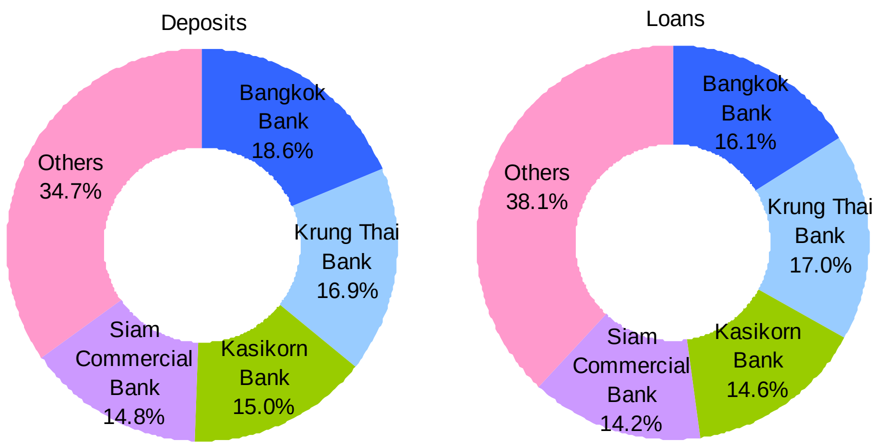
Source: Bank of Thailand

Note1: Siam City Bank was merged with Thanachart Bank on October 1, 2010.

Note2: Land and House Bank upgraded to commercial bank from retail bank in December 19, 2011.

The commercial banks can be further divided into two types: 1) Thai capitalized commercial banks and 2) foreign capitalized commercial banks. One long standing feature of the Thai banking sector is the fact that the major local commercial banks have a virtual monopoly of both deposits and lending. At the end of December 2010, the top four banks accounted for 65.3% of the deposit total and 61.9% of the loan total (Figure 2.10.). One reason that the Thai banking market became such an oligopoly is that, when the Commercial Banking Act was revised in 1962, no new Thai or foreign banks were allowed to be opened. A lineup of 15 local banks and 14 foreign banks was maintained until 1997. Additionally, bank restructuring in the wake of the Asian financial crisis has further increased the market's oligopolistic structure.

Figure 2.10. Outstanding of Deposits and Loans



Source: Bangkok Bank "Commercial Banks in Thailand 2011"

Note: as of December 31, 2010

Many Thai local commercial banks have their origin in the family businesses of ethnic Chinese as well as other Thai major companies. Bangkok Bank was founded by the Sophonpanich family (Chin family, Teochew), KasikornBank was founded by the Lamsam family (Ung Family, Hakka), and Bank of Ayudhya was founded by the Ratanarak family (Li family, Teochew)[17].

Among the foreign capitalized commercial banks are Standard Chartered Bank (99.83% owned by Standard Chartered Bank of the UK), UOB Thai (99.66% owned by UOB of Singapore), CIMB Thai (93.15% owned by CIMB Bank of Malaysia), and ICBC (97.7% owned by ICBC of China)[18]. These are called hybrid banks.

As regards foreign bank branch offices, as of November 2011, there are a total of 15 banks with full branch status, allowing them to provide full banking services: three Japanese, eight European and US, and four Asian. Given the great number of Japanese companies doing business in Thailand, and the scale of their economic activity, there are three Japanese banks which have large presences in Thailand. As of December 2010, the three Japanese banks' share of the total loans made by foreign bank branches in Thailand were, 27.0% for The Bank of Tokyo-Mitsubishi UFJ, 21.2% for Mizuho Corporate Bank, and 20.7% for Sumitomo Mitsui Banking Corporation. These are the top three foreign bank branches in the country, and together the three Japanese banks account for 68.9% of the foreign bank business. Even when compared against local commercial banks, the three Japanese banks loan totals compare with those of the middle level banks.

Of course, the foreign banks' share of the banking sector's total assets is only 14.6%, deposits 6.7% and loans 7.1%. Although the foreign banks are allowed to do the same range of business as the local commercial banks, they are limited in the number of branches that they can open, and the Thai banking sector may be said to be a restricted competitive market.

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[17] When the Asian financial crisis occurred, there were 15 commercial banks in Thailand. They could be divided by the ownership form. 12 banks (including local banks) were owned by Chinese families, one bank made the Bureau of the Crown Property the major shareholder, one was closely-linked to the military, and one was held by the Thai government.

Some commercial banks owned by Chinese families disappeared after the subsequent injection of public funds, liquidation and reorganization. Also, families' shares of stock and participation in management have been diluted by recapitalization, etc..

According to Shuto [2007], the proportion of family-owned banks' assets to total assets of commercial banks declined to 7.89% in 2003, from 80% in 1996, and the ownership structure of the commercial banks had changed dramatically. (Megumi Shuto "Governance Issues in Corporate Sector and Financial Sector - before and after the Asian Financial Crisis-" *International Affairs* No. 563, The Japan Institute of International Affairs)

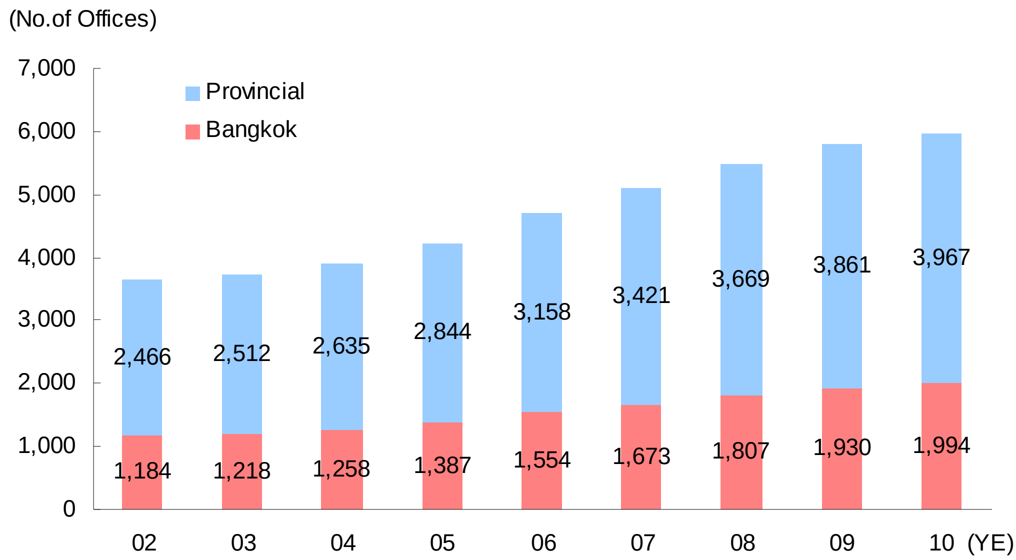
[18] In order for foreign banks to gain the right to do business in Thailand, they must obtain permission from the Financial Supervisory Authority, the same as local commercial banks. Foreign capital participation in commercial banks used to be capped at 25%, in principle, but with the promulgation of the Financial Institutions Business Act in February, 2008, the limit on foreign capital participation in banking was raised from 25% to 49%, conditional upon the approval of the BOT. Also, with the special approval of the MOF, foreign capitalization may exceed 49% (but this is limited to investment for the purposes of stabilizing the business of a financial institution).

In Thailand, there are no regional banks that have established their bases in rural areas, and the commercial banks that have nationwide networks of branches do business not only in the cities but provide capital management and procurement services in local areas also. It should be remembered, though, that many of the large corporations that are the principal customers of the commercial banks are situated in the cities, and this has meant that most branch offices have tended to be concentrated in city areas. In recent years, the government has promoted policies to decentralize industry out into rural areas, developing industrial sites in locations far from the Bangkok metropolitan area, and encouraging foreign companies to locate their factories there.

For instance, Ayutthaya is the center of Thailand's electrical and electronics industry. Most of the country's major automobile assembly plants and parts suppliers are located in Rayong and Chonburi. Chonburi is also the center of Thailand’s petrochemical industry.

Along with the industrial concentration of mainly foreign companies in these rural industrial sites, commercial banks have begun to open more branch offices in these locations. In addition, when the BOT grants permission to a commercial bank to open a new branch office, the condition is that for every new branch opened in the Bangkok metropolitan area, the commercial bank must open another two or three branches in rural areas, and this has encouraged the spread of branch offices in rural areas (Figure 2.11.).

Figure 2.11. Number of Domestic Offices of Thai Commercial Banks



Source: Bangkok Bank “Commercial Banks in Thailand”

Thai commercial banks see the number of branch offices as an important element of competitive strength and each one of them is working hard to increase the number of their branches. As a result, the number of branch offices is increasing every year. Among the top tier, Siam Commercial Bank has a network of 1,019 branches, Krung Thai Bank 962 branches, Bangkok Bank 935 branches, and Kasikorn Bank 826 branches (all as of the end of December 2010).

d. Earnings

In 2010, the recovery of the world and domestic economies played a leading role in the expansion of the loans and deposits of commercial banks in Thailand. Along with the economic recovery, consumer confidence and demand for loans improved. As a result, total loan amount at the end of 2010 expanded by 11.3%, compared to a 1.8% contraction in 2009, and loan growth outpaced deposit growth effected by a slight tightening on liquidity in the banking system.

Affected by the global economic and financial crisis stemming from Lehman Shock, corporate loans decreased by 5.0% from the previous year and SME loans decreased 6.9%. Rebounding from the economic downturn in 2010, both corporate loans and SME loans showed a V-shaped recovery. The amount of corporate loans outstanding at the end of 2010 was 5,298.1 billion baht (constituting 71.3% of total loans), and increased by 9.0% from 2009. This strong growth was in line with the economic expansion which resulted in higher demand for fixed investment and working capital from both large corporations and SMEs. SME loans (constituting 52.0% of corporate loans) grew by 7.4%, in contrast with a 6.9% contraction last year.

The amount of consumer loans outstanding was 2,129.4 billion baht at the end of 2010, which accounted for 28.7% of total loans. Consumer loans accelerated from last year driven by the economic recovery and government stimulus policies that boosted consumer confidence and private consumption. At the end of 2010, consumer loans expanded by 17.7%, up from 8.0% in 2009. Especially car loans, housing loans and personal loans had increased.

To meet this strong loan growth, commercial banks collected funds via deposits and Bills of Exchange (B/E)[19] and deposits grew by 5.2% in 2010 in contrast to a 0.5% contraction the previous year. Also B/E proportion of total liabilities rose from 7.6% in 2009 to 9.6%. Combining deposits and B/E, the funds mobilized rose by 8.3% from 2009. However, the growth of deposits and B/E was outpaced by that of loans, and liquidity in the banking system tightened. The ratio of loans to deposits increased 100% in the Q4 2010, and the ratio of loans to deposits plus B/E edged up to 88.3% (in Q4 2009, they were 94.4% and 85.8%, respectively) (Figure 2.12.).

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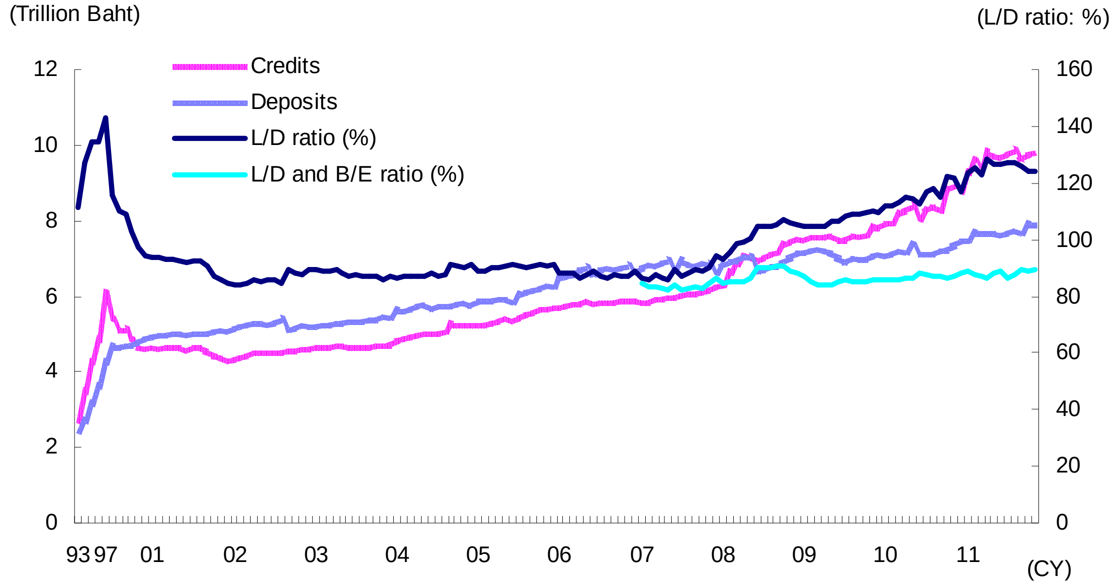
[19] Some depositors switched their savings to B/E that offered higher return because they are not subject to contribution to the Deposit Protection Agency (DPA).

Figure 2.12. Commercial Banks' Loans, Deposits and L/D Ratio



Source: Bank of Thailand

The banking sector in 2010 recorded operating profits of 213.3 billion baht (185.0 billion baht in 2009), with an increase of 15.4%, and net profit of 123.0 billion baht (92.0 billion baht in 2009), up by 34.5% from the previous year. Major profits came from higher net interest income and non-interest income, as well as lower cost of provisioning from better asset quality. While net interest margin (NIM) dropped slightly to 2.8% from 2.9% last year, return on assets (ROA) rose to 1.1% from 0.9%. Operating efficiency (operating expense /total income) improved to 54.8% from 56.4% in previous year. The banking sector's capital base strengthened as a result of profit and capital increase, and thereby, the ratio of capital-to-risk assets (BIS ratio) in 2010 rose to 16.2%, with the ratio of Tier 1 capital of 12.5%, both exceeding the required levels (CAR 8.5%, Tier 1 4.5%).

The disposition of gross non-performing loans (NPLs) is proceeding consistently. With the help of superior performance, NPLs of the banking sector decreased 63.5 billion baht from 2009 and amounted to 312.6 billion baht at the end of 2010. The ratios of gross NPLs and net NPLs to total loans also declined to 3.6% and 1.9%, respectively. Gross NPLs of corporate loans were 265.4 billion baht and declined by 56.8 billion baht from 2009. Gross NPLs of corporate loans mainly consists of manufacturing (44.6%), commerce (15.7%) and real estate sectors (14.1%), accounting for three quarters of the total corporate NPLs. The NPL ratio of corporate loans dropped to 4.0%, from 5.3% as a result of the decline in NPL in almost all sectors of both large corporate loans and SME loans.

NPLs for consumer loans also decreased and amounted to 47.2 billion baht. The ratio of consumer NPLs to total loans declined from 3.1% to 2.3%, with the decline in

NPLs observable in all categories of consumer loans.

Moreover, special mentioned loans (delinquent loans or loans overdue 1 month but not more than 3 months) declined to 232.2 billion baht, thereby the proportion of total loans dropped from 3.2% in 2009 to 2.6% in 2010.

2.2. Roles of the Banking Sector

2.2.1. Recent Changes and Trends in the Business Environment

The Asian financial crisis and subsequent financial reforms prompted a reform of the business model of Thai commercial banks. Before the Asian financial crisis, the greater part of Thai commercial banks' earnings came from lending operations. Income from interest in the period from 1992 to 1996 accounted for close to 90% of the banks' total revenue. In addition, even though the banks' profit profiles and loan portfolio bias tended to favor transactions with large corporations, they suffered the effects of economic deceleration in the wake of the Asian financial crisis. The failures of big corporations with large debts, albeit few in number, constituted a serious shock for the business operations of the commercial banks, both in terms of capital and profit.

Therefore, since the currency crisis, Thai local commercial banks have been attempting to expand their retail businesses and diversify their profit profiles. The percentage of commercial bank loans accounted for by personal loans was 13% in 1998, rising to 21% by 2006 and 28.7% in 2010. Also, the percentage of profit accounted for by non-interest income averaged 10% between 1992 and 1996, rising to an average of 22% between 2002 and 2006, and reaching 26% in 2010.

Since the Asian financial crisis, the commercial banks have been concentrating their efforts on customer segmentation and cross selling. Although there had been almost no sign of any such activity before the crisis, as competition focusing on the retail sector intensifies, there has been a growing need to expand the customer base and to shift towards a customer-centric business model that includes cross selling and the ability to respond swiftly to customer needs. Some banks are developing CRM platforms that enable them to respond to the needs of different customer segments.

Changes are also beginning to appear in the distribution channels. In terms of the channels through which services are delivered to the customer, the commercial banks are not only focusing on the usual branch offices, but are also concentrating on the development of in-store branches, sub-branches, ATMs, and Internet and mobile banking services.

Further, an important development in recent years has been the strengthening of risk management. Before the Asian financial crisis there was decentralization of empowerment, and customer acquisition and loan approval, with the exception of very large accounts (up to 10 million baht), were left to the discretion of branch office and area managers. Though large account loans required the approval of the board of directors, in reality there was often not enough time spent on credit risk analysis at the head office. However, since the Asian financial crisis, almost all banks have made a clear division of roles, with the branches responsible for customer development and retention, and loan vetting and approval being a head office function. Also, the banks are working to clarify the vetting processes between the branches and head offices, secure checks and balances functionality, and enhance the specialization of different departments. Further, each commercial bank has set up its own risk management committee, responsible for establishing credit risk policy and monitoring risk. Some banks are also implementing credit scoring systems, internal ratings systems, and credit portfolio models.

Meanwhile, on the corporate side, the financing structure is also undergoing changes. In Thailand, as with other south-east Asian countries, firms have relied to a large extent on indirect financing from banks. However, the Asian financial crisis spurred Thai listed companies, especially those in manufacturing, to try to convert their capital structures from a debt dependent model to a capital dependent model. The reasons behind this include 1) the effects of the banks' business control restriction measures[20], which began in 1999, 2) bond market development and the accompanying lower costs, and 3) a surplus of cash in hand, among others.

Faced with these circumstances, the larger banks, which have traditionally focused on transactions with large corporations, are now beginning to turn more of their attention and energy to the small and medium sized enterprises (SMEs) and retail sector that have usually been the specialty of the middle and lower ranking banks, many of which were formerly finance companies. In addition, government-run SFIs, the GSB, SME Bank, BAAC and others are also expanding their dealings in these fields and, while the commercial banks' share of corporate financing has dropped below 50%, that of the SFIs has risen from 9% to 14%[21]. Additionally, foreign banks are also very

[20] The measures referred to in 1) are restrictions that require three conditions to be met before a corporate loan can be approved: the loan must be i) 50% or less of the shareholders' equity of the borrowing company, ii) 25% or less of total debt, and iii) 5% or less of Tier 1 capital. The bank's business control restriction put a limit to corporations' borrowing from banks. In the wake of the currency crisis, the financial institutions had to go through balance sheet adjustment and adopted a cautious stance with regard to corporate loans. It is thought that, as a result, large corporations are switching to raising funds in capital markets, as a means of making up for the decline in conventional loans.

With regard to the cost of financing referred to in 2), in terms of Thai commercial banks' prime rates (as of October 2011), the average MOR (Minimum Overdraft Rate) is 7.50%, the average MLR (Minimum Lending Rate) 7.25%, and the average MRR (Minimum Retail Rate) 8.0%, against which the yield on corporate bonds announced by TBMA is around 4 to 5% (as of November 15th, 2011). The higher a company's credit rating, the more advantageous it has become for them to raise funds in the capital markets. In addition, the implementation of tax breaks for companies listed on the mai market of the second section of the SET is encouraging companies to make use of the capital markets.

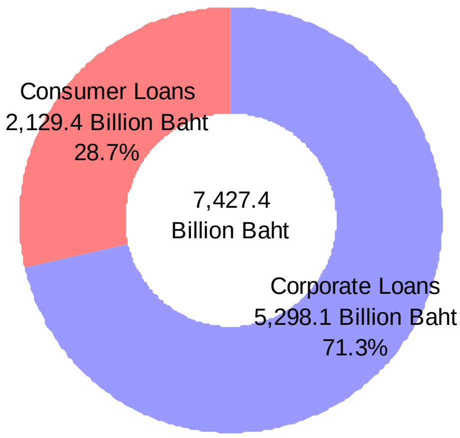
As regards the surplus of cash in hand referred to in 3), examination of the Flow of Funds shows that, although there are fluctuations in individual years, recently not only the household sector but also the corporate sector are enjoying capital surpluses, while the government sector suffers a capital deficit.

[21] Tientip Subhanij & Wanvimol Sawangngoenyuang "Competition in the Banking Sector: Any Gain

active. Banks like HSBC and Citibank, which have been restricted to opening a single general branch in Thailand, are nevertheless working to strengthen their presence in the credit card and other retail markets. Also, in an attempt to increase market share of the retail sector, there are examples of tie-ups between local commercial banks and foreign non-bank enterprises. In 2007, Bank of Ayudhya accepted a 33% stake purchase by GE Capital and integrated the financial subsidiaries of both organizations and put them under the banking group, and is working to strengthen its credit card and personal finance businesses.

In this way, non-bank entities are also involved in Thailand's financial sector, and fierce competition to win blue chip customers and retail sector market share is spreading. The commercial banks' loan total was 7,427.4 billion baht, boosted by robust economic performance, and up 11.3%, year on year. Of this total, some 5,298.1 billion baht (up 9%, year on year) was for corporate loans and 2,129.4 billion baht for personal loans (Figure 2.13.).

Figure 2.13. Structure of Total Loan



Source: Bank of Thailand "Supervision Report 2010"
Note: as of December 2010

2.2.2. Financial Services for the Corporate Sector

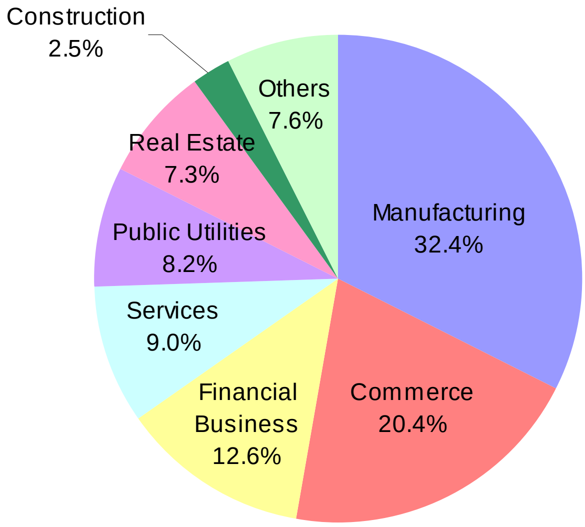
a. Overview of Financial Services for the Corporate Sector

Although the use of capital markets, mainly by large corporations, is increasing, there are only a limited number of firms that are ranked high enough to make use of capital markets, and for most businesses the main method of financing is still borrowing from financial institutions. According to TBMA, corporate borrowing at the end of 2010 totaled 8,591.4 billion baht, equivalent to 85% of GDP, and higher than the figure for the total value of stock capitalization (82.5%) and the domestic bond market (68.9%).

over the Past Decade?" Focused and Quick (FAQ) Issue 17, Bank of Thailand, January 10, 2011 http://www.bot.or.th/Thai/EconomicConditions/Publication/FAQ_documents/FAQ_17.pdf

In terms of loans outstanding by industry in December 2010, those that went to manufacturing had the largest share, accounting for 32.4%, followed by commerce (20.4%), financial business (12.6%), and services (9.0%) (Figure 2.14.).

Figure 2.14. Structure of Corporate Loans



Source: Bank of Thailand "Supervision Report 2010"

Note: as of December 2010

In Thailand, when a company receives a loan from a local commercial bank, it usually offers real estate or the like as collateral. In the case of foreign companies, the parent company is often required to become a guarantor.

The lending facilities for different funding needs are:

1) <u>Short term funds</u>: Funds required for the purchase of raw materials or to pay salaries, etc., and due to be repaid within a year. Loan forms are overdraft and promissory notes. Promissory notes are generally issued for a period of one week to six months.
2) <u>Mid to long term funds</u>: Loans for the construction of new factories and investment in equipments, and for long term operating capital required for the company's stable cash flow, of which the term exceeds one year. Loan forms are notes receivable or loan on deeds. Loans are available for up to around 15 years, but the majority is from between five to seven years.
3) <u>Invoice acquisition</u>: From the perspective of increasing corporate capital liquidity, there are many local financial institutions that operate a system of providing companies with capital by purchasing their invoices. The system can be used by companies that have no collateral, but there are conditions, such as 1) the invoices must be from a large corporation with strong credit capability, 2) the

invoiced company must agree to the purchase, and 3) should the invoiced company default on its obligation due to bankruptcy, etc., the company that brought in the invoice is responsible for repayment. Invoice acquisition is mainly carried out by bank affiliated companies.

4) Lease transactions: The Financial Sector Master Plan allowed the commercial banks to participate in factoring, leasing and hire purchase. Therefore, some commercial banks have established leasing subsidiaries and factoring subsidiaries to handle these businesses. In Thailand, automobile operating leases are becoming very well known, and the basic form is finance leasing. In finance leasing, instead of directly lending the user the capital to purchase equipment, the lease company makes the purchase on behalf of the user and then makes a long term lease of the equipment to the customer. The basic features of the setup are that 1) the lease company, in principle, has no responsibility for the functionality, etc., of the equipment, 2) it applies to general movable property and the user may select the items as they wish, 3) the customer may not terminate the lease before its expiry, and 4) any repairs are the responsibility of the user. The benefits to the user are that 1) they can get the same effects as with a long term fixed rate loan, and 2) users who do not have ready cash can also purchase equipment.

Moreover, each commercial bank sets its own prime rate for corporate loans, which is used as a reference for determining the lending rate to individual corporations. For example, each financial institution sets its spread in accordance with the credit capability of the borrowing company, so the rate would be MOR (Minimum Overdraft Rate) + spread for overdrafts, or MLR (Minimum lending Rate) + spread in the case of promissory notes and loan on deeds. In the case of foreign banks' loans to foreign corporations, BIBOR (Bangkok Interbank Offered Rate) and THBFIX (Thai Baht Interest Rate Fixing) are used.

b. Overview of Corporate Loan Assessment

When financial institutions conduct a loan assessment, they concentrate on the "three Cs", 1) Credit history, 2) Collateral, and 3) Concrete Plan.

As regards credit history, the company's repayment history is scrutinized, including any personal loans taken out by company management and directors. Also, in the case of newly established companies, the business results for the first two or three years need to be made available.

In terms of collateral, the main focus is any land or buildings owned by the company or its management, though production plant and equipment, deposits, government bonds and shares, may be presented as collateral.

In addition to collateral, in principle, the company's management, are often asked to be guarantors. The life insurance policies of management and directors may also be considered complementary collateral. Although the government and SFIs are trying to make it possible to present intellectual property and inventory, as collateral, this is still not widely accepted. Collateral is assessed in term of 1) its market value and 2) the price officially announced by the Department of Lands. The collateral assessment rate is generally 80% of the appraised value in the case of land, and around 70% in the case of buildings. There are systems for the granting of unsecured loans and loans in excess of the collateral assessment value, but there are restrictions, such as limits on the amount that can be borrowed (10 million baht for unsecured loans, and around 40 million baht for unsecured portions of loans in excess of the collateral assessment value), and extra interest.

When applying for a loan, it is necessary to present the company's business plan, in order to demonstrate repayment capacity. In addition to a business plan describing the business environment of the industry to which the company belongs, SWOT analysis, business and marketing strategies, it is also necessary to provide financial plans, showing the business prospects for the next three to five years, predicted earnings and cash flow, etc.

c. Relationships between Banks and Companies

The relationships between businesses and the commercial banks are not all that close. In other words, when companies become larger, they become more able to raise funds in the capital markets, and when it comes to dealing with the commercial banks, rather than thinking about a long term relationship, the focus tends to be on the rate of interest and other terms. Therefore, while a particular bank may be a company's main bank, the relationship is not secured by strong connections, and the company may in fact switch banks according to the conditions it can get.

The current situation of corporate finance in Thailand today is that it is a buyer's market, favoring the borrower. Many of the local commercial banks are prepared to offer very attractive interest rates and other conditions in order to maintain their relationship with the most profitable customers, or to win transactions with Japanese companies. Some of these banks are in such haste to win contracts that in some cases there are no signs of proper investigation into the company's business result and business trends, or of sufficient market survey.

In the case of SMEs, however, there is a strong relationship with the bank that they do business with. As far as the SMEs are concerned, the best way to ensure smooth and stable financing is to make sure that the bank understands the company's business and business conditions. In that sense, many entrepreneurs value their relationship with their bank. Of course, there are almost no cases of banks being so closely involved with customer companies that they send staff to the company's board of directors or as financial officers, or investing in the company.

2.2.3. Financing for Small and Medium Sized Enterprises (SMEs)

According to the Ministry of Industry, the definition of a SME in Thailand is a company in the manufacturing or service industries, employing 51 or more employees, up to a maximum of 200, with fixed assets of over 50 million baht, up to a maximum of 200 million baht. Such SMEs account for 99.6% of companies in Thailand, and 77.9% of the employed population. As such, they play an important role in the Thai economy[22].

As bank financing for large corporations wanes due to the use of capital markets, financing for SMEs is becoming an important business for the commercial banks. As of the end of 2010, corporate loans were worth 5,298.1 billion baht, of which 52% was accounted for by loans to SMEs, an increase of 7.4% on the previous year.

In order to expand their business with SMEs, local commercial banks are opening SME business centers and other outlets, apart from ordinary branch offices. The kinds of services that they provide to SMEs, besides loan transactions, include the kinds of functionality expected from a bank, such as business management advice, support in developing business overseas, M&A mediation, management of entrepreneurs' personal assets and business succession. The SME business centers aim to deliver one stop destination to provide a wide range of services for SMEs, through their relationship managers.

This does not mean to say that all SMEs are able to obtain loans from the banks smoothly. The commercial banks tend to focus on excellent middle sized companies with a certain level of business pedigree, good business performance and real estate or other form of collateral. Many of the commercial banks are trying to make their underwriting processes more efficient and to shift away from collateral dependent loans (collateral based loan) to loans that are sensitive to cash flow (cash flow based loan), and are introducing their own credit scoring systems, not only for retail loans, but also for SME financing. Nevertheless, the reality is that real estate collateral and personal guarantees, life insurance policies, etc., are still sought as credit enhancement. Small businesses that have not been in business long lack sufficient business performance results and do not have suitable collateral. Also, their accounting systems, financial information and business plans are often not sufficiently developed to satisfy loan conditions. Since these small businesses cannot get information and advice from the banks, they do not recognize the merits of obtaining banking services. This also prevents small businesses to use banks.

SMEs account for 37.1% of GDP (2010), and this ratio is decreasing year by year. Also, the banks' loans to small businesses peaked at 35% in 2006, shrinking to 25% by

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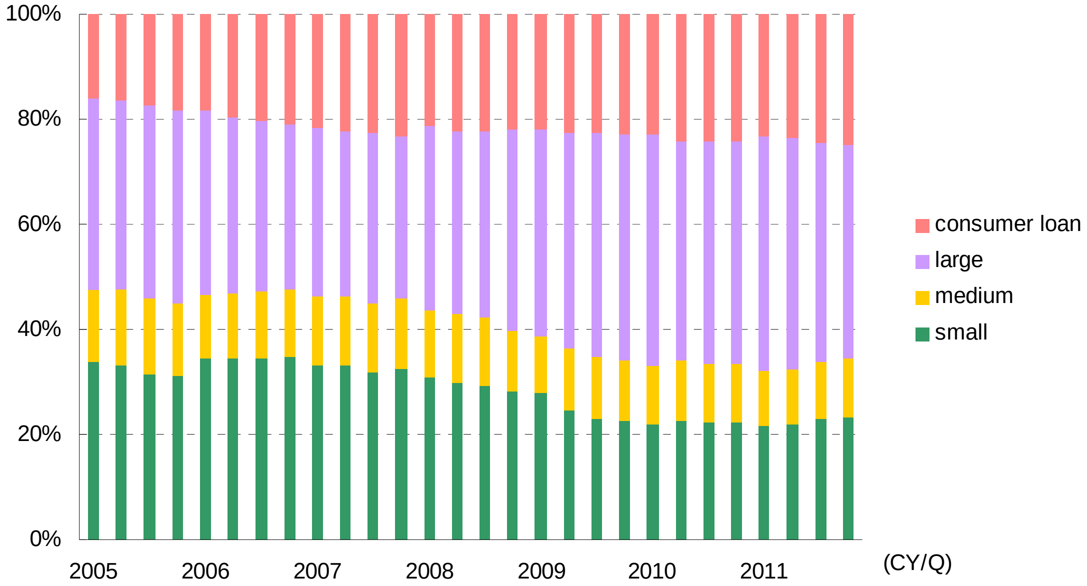
[22] Office of the Small and Medium Enterprises Promotion. *The White Paper on Small and Medium Enterprises Of Thailand in 2010 and Trends 2011.*
http://eng.sme.go.th/SiteCollectionDocuments/White%20Paper%20on%20SMEs/White%20Paper%20on%20SMEs%202010%20and%20Trends%202011/Executive-Summary-Eng.pdf

2010 (Figure 2.15.)[23]. The fact is that it is not easy for SMEs to obtain financing, and because of this they suffer from a lack of capital and are often unable to demonstrate their full potential, and this is one reason that hinders their growth.

Therefore, the government is currently working on beefing up the collateral laws in order to enable SMEs to utilize non-real estate assets, accounts receivable and intangible assets, as loan collateral. Further, the government has set up SFIs whose main purpose will be to provide capital to SMEs and farmers who find it difficult to get loans from commercial banks.

Figure 2.15. Composition of Bank Loans



Source: Bank of Thailand

a. Government Savings Bank (GSB)

The Government Savings Bank (GSB) specializes in collecting small savings and the Bank makes great efforts to collect savings from small depositors. The GSB also has been fostering financial literacy of the Thai people.

The GSB has its roots in 1913 when King Rama VI set up the Savings Office. The office was later transferred to the Post and Telegraph Department and its assets and liabilities were taken over by the newly created GSB in 1947, under the Government Savings Bank Act B.E. 2489 (1946).

In 1998, the government issued a Royal Decree on the Modification of the GSB's Functions (No. 2) B.E. 2541 (1998) to allow the expansion of the GSB's operations to accommodate the development of financial instruments and businesses as well as the

[23] Tientip Subhanij. "Financial access of SMEs: the road to inclusive growth." Jan. 3, 2011, Bank of Thailand, http://www.bot.or.th/Thai/EconomicConditions/Publication/FAQ_documents/FAQ_16.pdf

emergence of recent financial innovations. In response to this, the GSB is engaged in diversification of its business, customer segments, services, financial instruments and so on.

The GSB set up its vision and mission as follows[24]:

Our Vision (Year 2012-2016): To be a secure financial institution for savings, and for national economic, social and environmental development with the leading role in supporting the grassroots economy, having management with efficiency and good governance.

Our Mission: To be an institution for investment and development, to be an institution that promotes the grassroots economy, to be a savings institution, to be an institution with social and environmental responsibility

Under this vision and mission, the GSB provides loans for SMEs and entrepreneurs as well as individual loans. According to the GSB's Annual Report, SME loans increased 14,295 million baht or 41.5% from 2009 year-end and account for 12.9 % of the total loans. The GSB also takes the lead in supporting the grassroots economy, offering microfinance service through its nationwide branch network to enhance the opportunities for people in remote areas to have access to formal financial services. The bank has an extensive network of offices throughout the country. At present, the GSB is a juristic person and state enterprise which operates as a financial institution guaranteed by the government under the supervision of the MOF. As of the end of 2010, the GSB had in place 692 branches, 201 sub-branches and service units, 62 mobile service vans and 2,332 ATMs all over the country.

b. Small and Medium Sized Enterprise Development Bank of Thailand (SME Bank)

Thailand's commercial banks have not been very positive with regard to providing finance for SMEs. Also, the fact that many SMEs do not have sufficient collateral or deposits is another reason they find it difficult to obtain loans from private sector banks. As a result, there are frequent cases where businesses have to resort to informal finance and, in the end up, find it very difficult to stay in business. Small and Medium Enterprise Development Bank of Thailand (SME Bank) is an SFI that was set up under the provisions of the Small and Medium Enterprise Development Bank of Thailand Act in 2002 in order to address this kind of problem.

SME Bank not only provides a range of loans for SMEs, such as loans for working capital and for investments in plant and equipment, but also implements a variety of characteristic programs. For example, the One Tambon (village) One Product financing program was launched in 2003, in order to encourage business startups in farming communities and expand sales domestically and abroad. Efforts are also underway to implement Asset Capitalization Programs that will enable borrowers'

[24] GSB's web site: http://www.gsb.or.th/about/mission-en.php

tangible and intangible assets to be assessed and used as loan collateral. Further, SME Bank's role is not only to provide financing to SMEs, but also to act as a business advisor, with the aim of developing a society in which the spirit of entrepreneurship is firmly rooted.

Naturally, SME Bank's assets are much smaller than those of the commercial banks, and its offices and professional staff are limited in number, so it has not been able to give full rein to its expected functions[25]. For this reason, the criticism has been leveled that, in order to use up their budget from the government, SME Bank often lent to companies that did not qualify for loans from commercial banks, ending up with a raft of NPLs. In 2008, the NPL ratio reached 50%. Subsequently, although the work of disposing of NPLs has progressed, the value of SME Bank's NPLs at the end of 2010 was 16,509.63 million baht, and the non-performing loan ratio was 20.31% (37.16% in the previous year), which is extremely high when compared against the commercial banks. In terms of P/L, after losses of 1,065 million baht in 2007 and 2,708 million baht in 2008, SME Bank finally achieved a 131 million baht profit in 2009 (and a 128 million baht profit in 2010).

Approved loans in 2010 totaled 58,826.3 million baht, of which loans for government projects (Government Loans[26]) accounted for 41,908 million baht, or 71.24%. As of end 2010, the loan total was 81,286.5 million baht.

c. The Bank for Agriculture and Agricultural Cooperatives (BAAC)

The Bank for Agriculture and Agricultural Cooperatives (BAAC) was established in 1966 as a state enterprise under the jurisdiction of the MOF. The BAAC took over the function of the Bank for Cooperatives (BAC). The BAC was set up in 1947 and played a central role in rural finance. However, the BAC had no power to provide credit to farmers directly, and it was replaced by the BAAC.

In 1992, the BAAC was permitted to provide agriculture-related financing by amendment of the BAAC Act. Moreover, BAAC came to be able to provide not only agriculture-related financing but also non-agricultural financing due to the revision of the Act in 1999.

Today the BAAC is one of the largest financial institutions in Thailand and serves most farmers in the country directly through group and individual loans or through loans to farmer associations and cooperatives. At the end of 2010, a total of 6.247 million farm families had access to the BAAC services. Of these, 4.61 million families were extended direct credit services on an individual basis, while 1.63 million families

[25] As of the end of 2010, the average total corporate equity among the 14 commercial banks was 72,023 million baht. In comparison, SME Bank's total corporate equity was 5,889 million baht. And, whereas the commercial banks have on average 422 branches nationwide, SME Bank has only 110.

[26] Government Loans refer to the loan plans where SME Bank has financially supported companies affected by the recent global financial crisis, especially targeting SMEs, and SMEs without access to a funding source.

were members of agricultural cooperatives and 7 thousand were members of farmers' associations.

At the end of 2010, the BAAC recorded an outstanding deposits balance of 726,573 million baht and outstanding credits (outstanding loans) totaled 577,591 million baht. Of these, 515,786 million baht (89.3%) was credit provided to individual farmers; 35,479 million baht (6.1%) was provided to agricultural cooperatives; 119 million baht (0.02%) to farmers' associations; 2,843 million baht (0.5%) to government secured loan projects, and 23,364 million baht (4.0%) to other types of borrowers.

Most farmers are the users of BAAC, and BAAC is a vital presence as a financial method for farmers who need money for agricultural production and/or agricultural related investment. After 1997's financial crisis, the share of BAAC in rural finance has been increasing.

d. Thai Credit Guarantee Corporation (TCG)

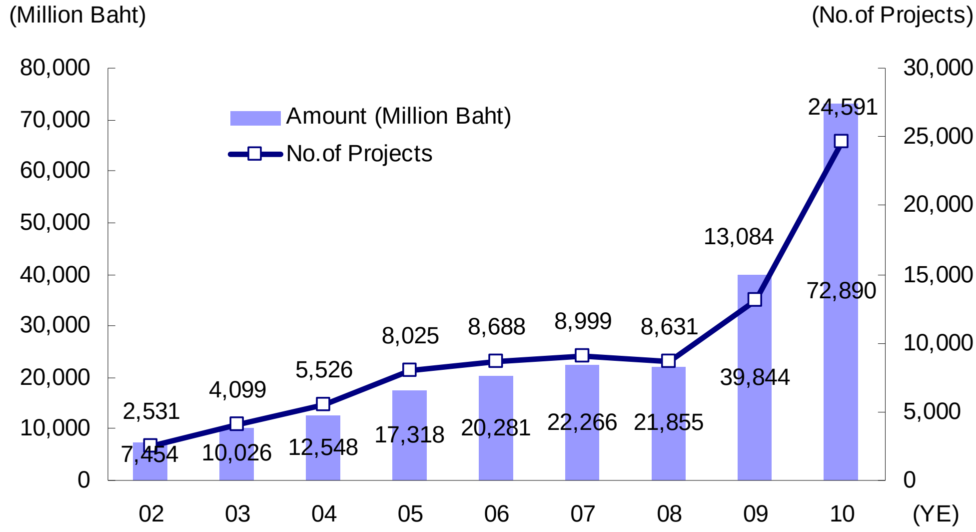
Thai Credit Guarantee Corporation (TCG, or Small Business Credit Guarantee Corporation: SBCG) is a state-owned specialized financial institution under the supervision of the MOF. TCG was established in 1991 under the Small Industry Credit Guarantee Corporation Act 1991 to take over all the business and operations of the Small Industry Credit Guarantee Fund set up in 1985. TCG is modeled after the SME Credit Guarantee Programs in Japan. TCG was established to provide support to SMEs through guarantee service for the SMEs that have potential but lack collateral security in order to enable them to acquire the required amounts of loans from financial institutions and, at the same time, enhance the financial institutions' confidence in credit expansion which will benefit overall economic development.

Although the start-up capital was 400 million baht, it was not enough to expand its guarantee business. Therefore, the MOF boosted the capital bases of TCG in several steps and at present, TCG's total registered capital is 6,839,946,700 baht, of which 6,702,473,000 baht is paid-up.

TCG's operating results in 2010 recorded total credit guarantee approval of 42,585.177 million baht going to 13,346 projects. Total outstanding guarantee commitments amounted to 72,890 million baht for 24,591 projects (Figure 2.16.).

After SME Bank launching in 2002, TCG has been expanding its guarantee approval steadily both in number of projects and amount.

Figure 2.16. Guarantees Outstanding at the End of Year



Source: TCG Annual Report

2.2.4. Retail Finance

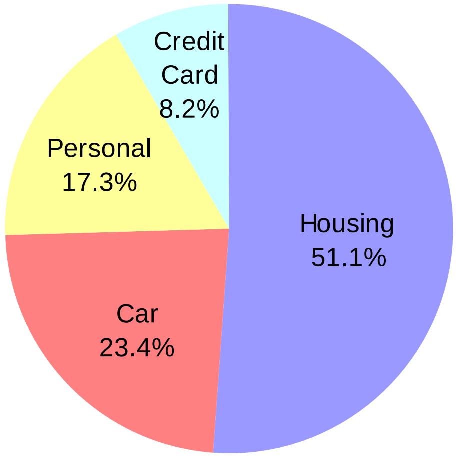
a. Consumer Credit Trends

Since the Asian financial crisis, bank borrowing by big companies in manufacturing and other industries has dwindled, so the commercial banks are concentrating more into the retail sector, providing loans for SME and individual consumers. In particular, the individual (household) sector is gaining an ever stronger presence as a borrower of bank funds, rather than simply the provider of funds to be loaned to the corporate sector.

Part of the background to the increase in borrowing by the individual sector is that, as the Thai economy has grown and incomes have risen, the individual consumer's ability to repay has increased, the appetite for housing and other durable consumer goods has grown, the use of credit cards has become widespread, and the financial institutions are reinforcing their consumer loan businesses. Also, as more and more finance companies and credit foncier companies were promoted to commercial banks as part of the Financial Sector Master Plan, they were able to get involved in automobile loans and hire purchase, and this boosted the growth of the retail sector.

There are both secured personal loans and unsecured personal loans. Secured personal loans are mainly housing loans, but there are also loans for which automobiles (against which there is no outstanding loan balance), may be offered as collateral. As regards the purposes of the loans, there are some that are made for specific purposes, such as the purchase of products or services, and others that have no specific purpose (Figure 2.17.). As regards loan methods, there are loans on deeds and overdrafts. In recent years, there has been a rapid increase in the volume of installment (hire purchase) loans.

Figure 2.17. Structure of Consumer Loan



Source: Bank of Thailand "Supervision Report 2010"

Note: as of December 2010

In order to provide support to the retail sector, the Thai Banker's Association and Government Housing Bank merged their customer information resources and established the Thai Credit Bureau as a new credit bureau. Additionally, a credit scoring system was introduced for retail loans, and the BOT issued a set of guidelines in January 2005.

Further, as the volume of consumer loans grew, the BOT introduced new regulations pertaining to personal loans in July, 2005, in order to protect consumers. These regulations applied not only to the commercial banks, but also to non-bank operations that had been outside the scope of the BOT supervision.

According to the BOT[27], key issues of regulation on consumer loans[28] were as follows:

1) Commercial banks and finance companies can operate personal loans under supervision[29] without seeking permission from the MOF. Non-financial institution operators, however, must obtain such permission and must have a registered capital and a paid-up capital of not less than 50 million baht.

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[27] The Bank of Thailand. *Supervision Report 2005.* http://www.bot.or.th/Thai/FinancialInstitutions/New_Publications/KeyDevFI/Supervision/Documents/SupervisionReport2005.pdf

[28] Consumer loan means a loan to any individual not for the purpose of business. Such loans include housing loans, credit card loans, and personal loans.

[29] A personal loan under supervision means an unsecured loan extended to a person without specific purpose or for the purpose of acquiring goods or services unrelated to the person's business. Such loans include loans from hire purchase and leasing for goods that operators sell outside their ordinary business, except for automobiles and motorcycles.

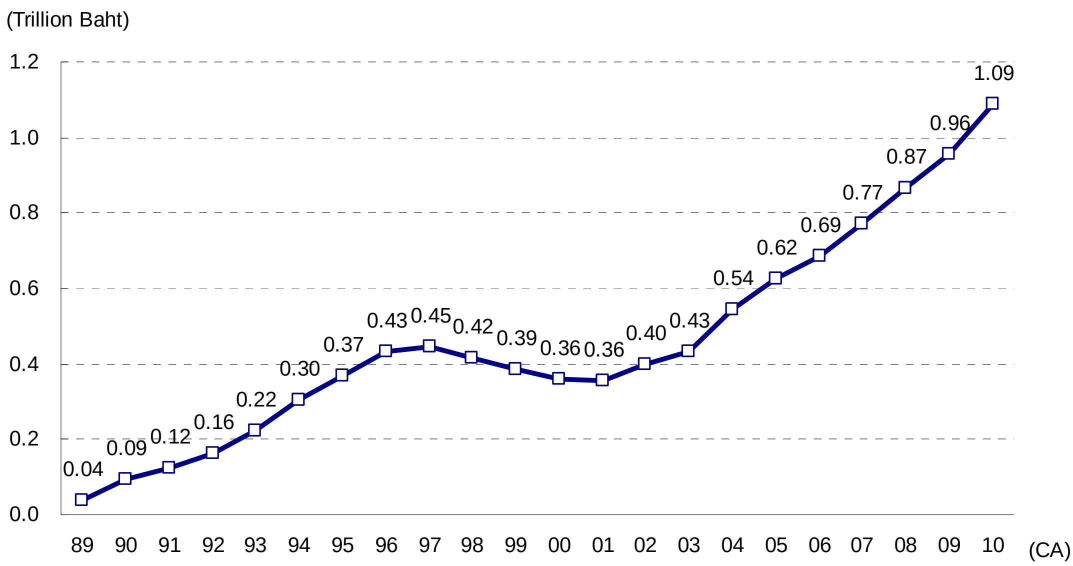
2) The line of credit of personal loans under supervision is limited to no more than 5 times each customer's average monthly income. The aggregate of interest rates, fines, service fees, and other operating fees of personal loan under supervision must not exceed 28% per annum (effective rate).
3) For consumer loans, commercial banks and finance companies must disclose the interest, lending rate, service charge, fees, and other expenses related to loans at all premises and on their website. In addition, for consumer loans and personal loans under supervision, only actual and reasonable expense items specified by the BOT may be charged.

b. Housing Loans

Housing loans are a major product in the commercial banks' retail sector. As of the end of December 2010, housing loans totaled 1.09 trillion baht, accounting for 51.1% of total consumer loans, and have made a rapid recovery after a temporary dip in the wake of the Asian financial crisis (Figure 2.18.).

The big four local banks (Bangkok, Kasikorn, Siam Commercial, and Krung Thai) which have major shares in deposits and loans also dominate the housing loan market. Among the foreign banks, UOB and Standard Chartered are expending resources in this sector, but their scale is small compared to the local commercial banks, in terms of the scale of their branch office networks and loan volumes. Meanwhile, Citibank and HSBC, which concentrate on retail services, such as credit cards, are not focusing very much on housing loans.

Figure 2.18. Personal Housing Credit Outstanding

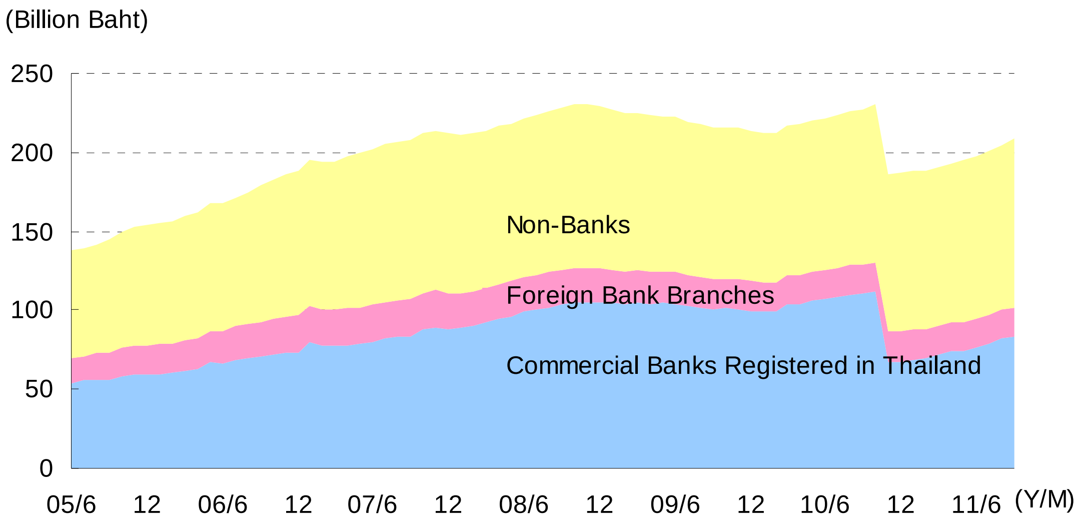


Source: Bank of Thailand

c. Personal Loans

According to the BOT statistics, unsecured personal loans were worth 187,491 million baht at the end of 2010. Of that, the commercial banks loaned 67,826 million baht, branches of foreign banks 18,956 million baht, and non-bank institutions 100,709 million baht (Figure 2.19.).

Figure 2.19. Personal Loans under Supervision Outstanding



Source: Bank of Thailand[30]

Personal loans may be for non-specific purposes, or specific purposes (education, marriage, medical treatment, etc.) and product purchases. Loans for product purchases cover a wide range: automobiles, motorbikes, PCs, televisions, and mobile phones. Purchasing these products with using loans is very popular among the consumers. Automobile loans account for 23.4% of personal consumer loans, after housing loans. Automobile sales in Thailand were up 17.5% in Q1 2011, on year to year comparison. Automobile purchases are increasing, particularly in farming communities, and this is thought to be due to the availability of easier automobile purchase loans from the commercial banks, in addition to the increase in incomes. Interest rates, penalties and commission, on personal loans are limited to a total of 28% per annum, from the perspective of consumer protection, as mentioned above.

The interest rate on installment (hire purchase) loans depends on the product,

[30] Personal loans under supervision refers to uncollateralized personal loans, installment purchases (hire purchases), and leasing loans on goods of which the licensed lenders are usually not in the business of selling.

Excluded from this category are loans for installment purchases and leasing of automobiles and motorcycles, loans for education, loans for working abroad, loans for medical care and loans pertaining to employee benefits under an agreement between the employers and the lenders.

such as automobiles and motorbikes. Competition is tough, with some companies offering 0% interest on products where the competition is the most severe. Installment loans are, in the main, offered by commercial banks, automobile manufacturers' and other retailers' captive finance companies or other finance companies. Installment loans can be repaid month by month at convenience stores (7-Eleven) or by bank transfer and many people make their payments while they are shopping. Some banks use mobile phone SMS to remind their customers just prior to the payment date.

d. Credit Cards

According to the BOT, the credit card market comprises 15.08 million accounts with usage worth 206.7 billion baht, an average of approximately 14,000 baht per user (according to the BOT survey at end September, 2011), of which the commercial banks issued 7.79 million cards (51.7%), and non-bank credit card companies 7.29 million (48.3%) (Figure 2.20.).

Credit cards can be used in a wide variety of arenas, such as gasoline stations, supermarkets, restaurants, etc. Credit cards were used to spend a total of 1,052 billion baht in 2010, of which 748 billion baht was for shopping and 304 billion baht for cash withdrawals and other purposes, with shopping accounting for over 70% of credit card use. Credit card users are thought to have three or four credit cards each. Credit cards account for 8.2% of consumer loans.

In Thailand, there are many kinds of financiers in the credit card market, Thai and foreign, bank and non-bank. Major operators include local commercial banks like Krung Thai Bank, Siam Commercial Bank and Kasikorn Bank, and Japanese retailers such as Aeon Thana Sinsap Thailand. The commercial bank credit card sector generally targets high income customers, while non-bank and other credit card companies are mainly used by mid to low income earners. Foreign banks are only allowed to have a single branch in Thailand so that, even if they do issue credit cards, they cannot offer nationwide settlement of accounts. However, Citibank is performing well in such an environment. The reason is that Citibank was the first to offer credit cards in Thailand, and therefore has a strong brand image, and also stole the march on other companies in offering a bonus points system.

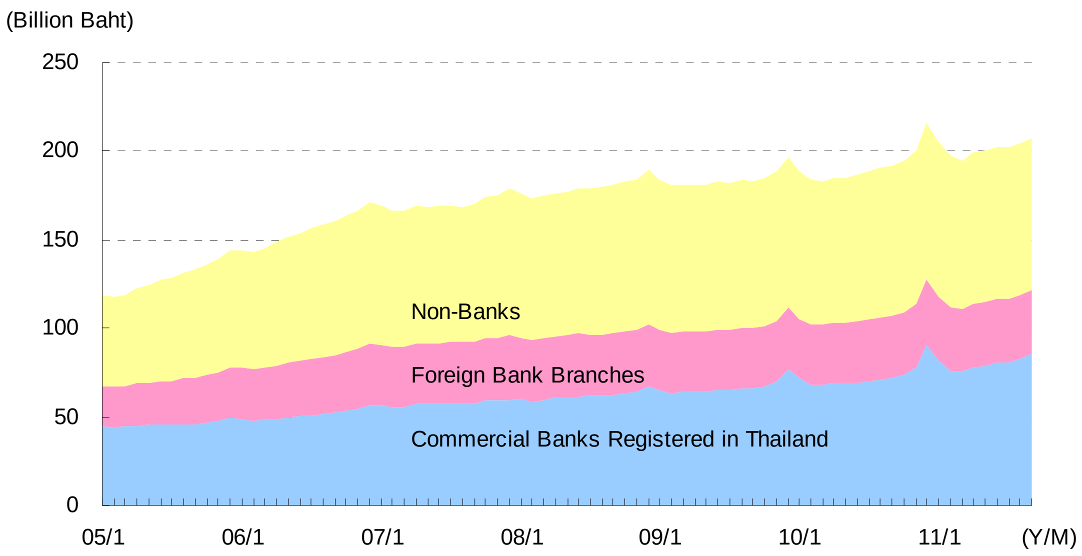
In Thailand, at the end of 2000, the BOT made changes to the regulations on credit card issuance, lowering the minimum age (from 22 to 20) and the minimum monthly wage (20,000 baht to 15,000 baht). Also, from January 2002, credit card issuers were allowed to set their own minimum monthly wage limit. The banks began to relax their conditions for issuing credit cards, such as minimum income, age and monthly payments, as well as offer very low interest rates and a range of free services to attract customers. As a result, there was a dramatic increase in the number of credit card bankruptcies. In November 2002, new credit card business restrictions re-introduced income limits (no cards to be issued to those earning less than 15,000 baht per month, or 180,000 baht per year). This meant that only about 10% of the working population qualified for credit cards, and led to a saturated market and intensified competition among card issuers to win customers.

Credit card companies set up booths in hypermarkets and shopping malls and conduct aggressive promotional activities, and try to secure their customer base with co-branded cards in supermarkets and gas stations. For Thais, having a credit card is evidence of a certain level of income and has become something of a status symbol.

Credit card interest rates have an upper limit of 20%.

Concerning debit cards, the number has increased rapidly, growing by approximately four times between 2004 and 2009. According to the BOT, debit cards by the end of 2010 totaled 34.13 million, and the cards can be used in approximately 250,000 shops. These cards are used almost totally for cash withdrawals and ATM payments and transfers. Their use for store purchases is very limited, compared to that of credit cards. The average monthly purchases paid by credit cards amount to 3,764 baht, whereas the monthly average for debit cards is 74 baht.

Figure 2.20. Credit Card Outstanding



Source: Bank of Thailand

e. Wealth Management

The foreign banks and their branches, such as HSBC, Citibank, Standard Chartered, are putting effort into providing wealth management and private banking services. Thailand's economic activity is fiercely concentrated in and around Bangkok, and almost all of the potential customers of these kinds of services reside there. Having a limited network of branches is not much of a restriction in this business sector. However, in Thailand, the outward investment in securities by residents has not been deregulated, so it can be assumed that there is only limited demand from the middle class.

Also, the BOT tightly restricts the development and offering of structured financial products so, as far as the local commercial banks are concerned, providing special financial products to a limited wealthy class involves time and cost, and is not very profitable. For that reason, many of the wealthy use the private banking services of foreign financial institutions based abroad such as Singapore. Most of the local commercial banks, until now, have not really put much effort into providing private banking and wealth management services.

f. Micro-finance

According to a 2007 BOT survey, 83% of the population has access to the financial services provided by the formal financial sector. The remainder has no access to financial services and must depend on informal finance or non-structured sources. With regard to borrowing, in particular, only 43% of the population is able to borrow from the formal financial sector. Among them, only 31% are able to borrow from commercial banks and SFIs. The proportion of households not making any use of financial services is 9.6%, around 6.5 million people.

Some of the reasons given that low income earners do not use banks include the fact that they do not know how to apply for loans, or that even if they do, they know they will be turned down and are therefore unwilling to use them, or that they have no collateral or do not want to be bothered with complicated procedures.

The BOT introduced new guidelines in 2011, to encourage commercial banks to provide microfinance for individuals and businesses that fail to meet the minimum income requirements for loans. Micro-financing covers unsecured loans of up to 200,000 baht, with an annual interest of 28%.

2.2.5. Credit Information System

The first attempt to establish a credit data center was made by the BOT more than 50 years ago in 1961. The Thai Banker's Association (TBA) and the BOT discussed modalities for a credit bureau to collect and exchange the credit data of commercial banks' customers to reduce risk and prevent damages. Then the BOT started the central credit registration in 1964.

The Asian financial crisis caused serious NPL problems in the banking system and provided the impetus for the enhancement of the credit information system. In 1998, the Deputy Minister of Finance who controlled and monitored the Government Housing Bank (GHB) appointed the GHB to be the main office to establish the credit data center. Meanwhile, the BOT proclaimed a policy for the TBA to set up a credit data center. As a result, establishment of a credit data center was divided into 2 sections: one was Thai Credit Bureau established by the GHB and the other was Central Information Services set up by the BOT and the TBA. Both credit bureaus were established with the same objective: collect credit data of bank customers to reduce risk, increase the efficiency of loan businesses and prevent the adverse affects of NPL problems on the economic and financial system.

Both bureaus started their operations in 2002, before the Credit Information Business Act came into effect in later 2002. The law was not well designed and became very onerous in some respects where a small mistake on the use of the information and breach in data security and procedure can be punishable by jail terms and/or fines for the individual who breached the law including management. Both bureaus' business was put at risk since operations were affected with the overly stringent law and members, board of directors and management of both bureaus resigned en masse for fear of law penalties. Hence both bureaus suspended operation for 3 months during the second quarter of 2003 and asked the credit information protection committee to clarify the law. Representatives from the World Bank, the US Consumer Data Industry Association (CDIA) and the US credit bureau experts met with Thai officials and conducted a series of roundtable discussions to share the US and international experience on credit bureaus. Thus, the law was amended in 2006 and 2008.

In 2005, Central Credit Information Services merged with Thai Credit Bureau and changed its name to National Credit Bureau (NCB). The merging greatly benefited both former credit bureaus and their stakeholders in many ways. Financial institutions which were members of both bureaus were able to report as well as obtain information from one bureau, which contributed to more efficient operations. This would facilitate, as well as lower the cost of, the loan requesting process, resulting in time and cost-saving for borrowers.

The NCB collects and warehouses debt and debt service records provided by its member financial institutions. As of February 2011, the NCB provides consumer and commercial credit reports to 72 members. It has information on approximately 62 million consumer accounts involving 19 million account owners. In 2010, the NCB handled 16.1 million credit inquiries, or more than 1 million per month. Members are required to pay a monthly fee of 50,000 baht. The cost of each inquiry by a member is 12 baht for a consumer report and 100 baht for a commercial report.

2.2.6. Payment and Settlement System

a. Payment Systems

i) BAHTNET

BAHTNET (Bank of Thailand Automated High value Transfer Network) is a real time gross settlement (RTGS) system which is used for settling large value funds transfers between financial institutions or other organizations maintaining deposit accounts at the BOT. BAHTNET started to provide its electronic payment service in 1995. The BOT developed BAHTNET in order to reduce inter-institutional settlement risk, create fast and secured payment service, and act as the main financial infrastructure for real time gross settlement between institutions. Major services provided by BAHTNET include inter-bank transfers, third-person transfers, inter-bank messaging services, foreign exchange trading, inter-bank lending, internal funds transfers, securities purchases, and government bond purchases.

In December 2001, a newly designed BAHTNET system (so-called "BAHTNET 2") began operation. BAHTNET 2 added the service of government securities trading through Delivery Versus Payment (DVP) and capabilities of host-to-host connection with members' computer systems so as to be able to transfer funds directly by straight trough processing (STP). Until then, the majority of government bonds were issued in bearer form and settled physically at the BOT, and payment was made by check. As a result, a one-day gap existed between securities settlement and funds payment. The new system of BAHTNET 2 has been modified by using the SWIFT network as the main interface to enable STP and to be consistent with international practice.

At the end of 2010, there were 66 BAHTNET participating institutions, consisting of 17 commercial banks registered in Thailand, 15 foreign bank branches, 11 finance and securities companies, 14 SFIs and 9 departments of the BOT. In 2010, there were 2,323,258 BAHTNET transactions recorded (15.9% increase over the previous year) and the total value of these transactions stood at 654.6 trillion baht (an increase of 33.7% over the previous year).

ii) Check Clearing System

In Thailand, the inter-bank check clearing system consists of the electronic check clearing system (ECS) for Bangkok and vicinity, the provincial check clearing system for other provinces, and the bill for collection (B/C) system for inter-provincial clearing.

The ECS became operational in 1996. It is operated by the electronic check clearing house (ECH) of the BOT and used in the Bangkok metropolitan area. The ECS was developed in order to improve the accuracy and efficiency of check clearing services and to reduce the check collection time period. Member Institutions connect online with the ECS located at the BOT's ECH. The check data will be sent online to the ECS by the headquarters of the sending bank and the physical checks will be sent to ECH by 7.00 p.m. in the same day for sorting and cross-checking with the check data received earlier.

For other provinces, the provincial check clearing system (PCS) is operated under the membership of the BOT and commercial banks. The capability of PCS has been upgraded to speed up and improve the efficiency of provincial check clearing, to reduce the cost and risk associated with check payments and to facilitate cash management for member banks. The check clearing center at Phuket was first upgraded in September 1997, and the program has since been expanded to all provinces. Whereas originally the BOT representatives at the provincial treasuries performed interbank settlements, now these operations are centralized through the BAHTNET system.

B/C is the clearing procedure for checks, drafts, bills of exchange, and promissory notes in cases where a collection branch and a paying branch are located in different clearing areas.

In 2010, the volume of check usage (including inter-bank and intra-bank checks) totaled 114.6 million checks (declining by 7.0% from the previous year) and the total value of check usage was 51.7 trillion baht (down 7.8% from the previous year). The total number of inter-bank checks stood at 75.1 million checks (0.3% increase over the previous year), equivalent to the total value of 33,780 billion baht (increasing 0.6% from 2009).

The BOT has introduced the imaged check clearing and archive system (ICAS); a system that uses an image of a check instead of a physical check in the inter-bank clearing process and serves as an electronic archive center for check data and images. The system will improve the efficiency of the clearing system. ICAS was launched in Bangkok and vicinity in May 2011, and the BOT expects its coverage to be extended nation-wide in 2012.

iii) Retail Funds Transfer

The BOT developed and operated the bulk payment system, an off-line retail funds transfer called "Media Clearing", during the late 1990s and early 2000s. Media Clearing provided 2 types of funds transfer services; credit transfer, by which to conduct transfers from a customer's account to another customer's account with another bank (used for payments of salaries, pensions, dividends, interests, and other items), and debit transfer, by which to conduct transfers by debiting a customer's pre-arranged account (used for payments of public utility charges, insurance premiums, credit card bills and loan repayments). The system was enhanced to transfer data via on-line web technology in 2000 and was renamed "System for Managing Automated Retail Funds Transfer; SMART" in July, 2002. In October 2007, the BOT transferred this service into private hands, National ITMX (NITMX)[31].

NITMX supports all kinds of electronic payments and funds transfer through various channels including ATMs, bank counters, internet, phone and mobile channels. It provides two kinds of services, single payment system and bulk payment system. Single payment system is an inter-bank service provided for clients to carry out single transactions such as withdrawal or funds transfer via ATM machines or bank counters. The service has real-time processing and consists of 4 service types. Bulk payment system is an inter-bank service providing for payment or funds transfer in small

[31] National ITMX was originally founded under the name ATM Pool Company Limited in 1993 with its shares held by Thai commercial banks. Subsequently, on July 8, 2005, the company was renamed National ITMX Company Limited to expand and extend the scope of the company's business and products.

amounts but high volume that have an exact due date. It consists of 3 service types.

ITMX bulk payment system stood at 24.7 million transactions in 2010, with a total value of 1,080.6 billion baht - increasing from the previous year by 18.2% and 24.5%, respectively.

NITMX has established partnership with foreign payment systems in the 4 other ASEAN countries consisted of Malaysia, Indonesia, Singapore and the Philippines. The project aims to develop an intra-regional retail payment system infrastructure to support the increasing trade and investment in the region, thereby improving its competitiveness within the global economic environment.

NITMX started a cross-border ATM link to Malaysia via MEPS in 2006. The cross-border linkage will be also extended to Singapore, Indonesia and the Philippines, respectively. This service offers participating banks' customers the convenience of making cash withdrawals and balance inquiries via ATMs in the various member countries. In the near future, NITMX will also provide funds transfer via ATMs.

iv) e-Money

The provision of e-Money services can be categorized into 2 types: card-based (value stored on a card) and network-based (value stored in a system). As of the end of 2010, there were 17 e-Money operators under the BOT's supervision. From the aspect of supervision, there are 2 types of e-Money operators. One is e-Money services for the purchase of goods and services from many service providers at the outlets which are part of the same sales and distribution system. At the end of 2010, there were 5 non-bank e-Money service providers. The other is e-Money services for the purchase of goods and services from many service providers with no restrictions on outlets and sales and distribution systems. There were 12 bank and non-bank e-Money service providers. For example, "OK Cash" card is a product launched by Payment Solution, and it can be used at more than 250 thousand affiliated stores, such as department stores, restaurants and movie theatres.

At the end of 2010, the number of e-Money transactions was 221.5 million (an increase of 115.0% compared with the previous year), with a total value of 17.7 billion baht (increasing 68.2% from last year). Such development reflects the growing popularity of e-Money as well as an increase in the number of legally registered service providers. There were 11.5 million cards or accounts in the system.

b. Securities Settlement System

After the 1997 currency crisis, the Thai government accelerated the reform of securities settlement systems to achieve the financial stability and improve the bond market.

Thailand Securities Depository (TSD) was established in November 1994 as a wholly owned subsidiary of the SET, in order to provide financial institutions and securities companies with clearing and settlement services for shares and corporate bonds. TSD also operates as a central depository and registrar of traded stocks and corporate bonds which if dematerialized, are deposited through institution depository members at the TSD and ownership is transferred by an electronic book-entry system.

In September 2000, TSD started DVP settlement of corporate bonds by linking to BAHTNET instead of settlement by check. Moreover, the depository of public debt securities has been moved from the BOT to TSD for efficiency and centralization of the securities settlement system, in accordance with the second Thai bond market development plan (2005-2014). Thus, the CCP (Central Counterparty) and CSD (Central Securities Depository) functions are integrated within TSD.

c. Payment Systems Roadmap

The BOT has drawn up a payment systems roadmap (principally by the payment system committee (PSC)) to be used as a policy framework for the country's payment systems development. In the past, the PSC formulated and implemented two payment systems roadmaps: "The Payment Systems Roadmap 2004" and "The Payment Systems Roadmap 2010".

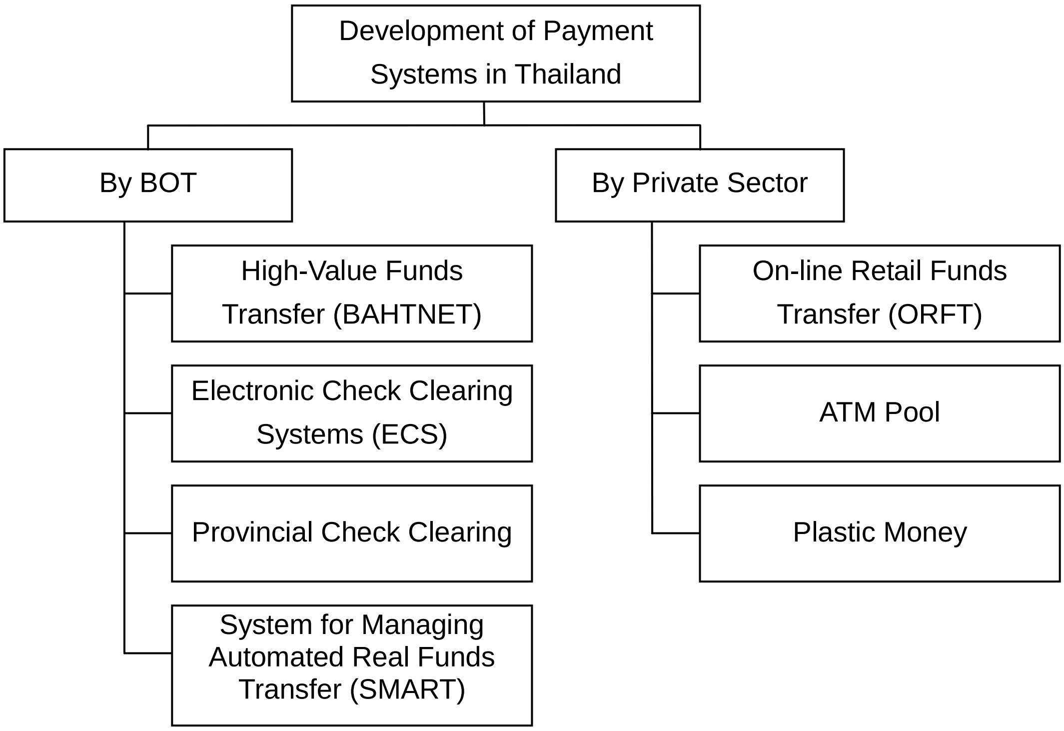
The Roadmap 2004 was implemented between 2002 and 2004 and focused on the establishment of the necessary foundations for advancement of Thailand's payment systems. The main plans under the Roadmap included: 1) establishing a platform for cooperation among service providers, 2) compiling national payment systems statistics, 3) drafting necessary laws to regulate the payment systems, 4) setting the payment systems infrastructure and standards, and 5) fostering cross-border payment systems linkages.

The Roadmap 2010 was aimed at establishing cooperation among public and private entities to foster greater usage of electronic payments and transfers by offering efficient, safe and fair services. Specifically, 1) promoting electronic payment services that appeal to "consumer" users and promoting electronic payment services that appeal to "corporate" users; 2) improving efficiency and reducing risk in the payment system; and 3) increasing linkages regionally and internationally.

In this regard, the BOT decided to develop a payment message standard that complies with ISO 20022 for 6 types of payment system services, namely direct credit, direct debit, check direct, ITMX bulk payment, high-value fund transfers through BAHTNET, and international payment.

The new roadmap (the Payment Systems Roadmap 2014 (2011-2014)) will be endorsed by the PSC and released before long.

Figure 2.21. Development of Payment Systems in Thailand



Source: Bank of Thailand

2.3. Banking Sector System Reform and Issues

2.3.1. Background to Financial Reform

In 1997, a financial crisis in Thailand triggered the Asian financial crisis. The background to this was that Thailand had set up an offshore market called BIBF, into which large volumes of short term capital (mainly dollar denominated) flowed from abroad via the banks. This capital was then loaned as baht denominated long term capital to the domestic real estate sector. As a result, bank and corporate balance sheets were mismatched in terms of currency (dollar ↔ baht) and terms (short ↔ long)

In addition to this, there were structural problems with the domestic financial system in that there was an over-dependence on the banking sector as the means of corporate finance. Deregulation in the banking sector at that time meant that, although there were serious problems with loan risk management, there were no alternative methods of fund management, resulting in an excess of loans made to the real estate sector. This resulted in a bubble which, when it burst, forced banks into a credit crunch in order to dispose of non-performing loans and adjust their balance sheets. This, in turn, had a serious impact on the financing if businesses and the crisis deepened.

Thailand then implemented wide ranging financial reform, managed and supported by the IMF and the World Bank. Specifically, there were three stages of reform, "financial crisis management policies" implemented in order to prevent both the chain collapse of financial institutions due to insufficient liquidity, and the paralysis of the financial system; "bank restructuring polices" implemented as the basic platform from which to strengthen capital equity and dispose of NPLs; and "financial system reorganization" in order to stabilize and rationalize the financial system.

The first stage of financial crisis management policies was, when many finance companies suffered from insufficient liquidity in 1997. In August of that year, the BOT responded by implementing measures to guarantee the total deposits of the financial institutions, including the commercial banks, and began the radical disposal of failing financial institutions. In the second stage, bank restructuring, the MOF and the BOT announced "the comprehensive financial sector restructuring package for economic recovery" in August 1998. This incorporated a scheme to increase and strengthen the capital equity of the commercial banks using public funds, and the disposal of NPLs speeded up. As the third stage, finance related laws, comprising the revised Bank of Thailand Act, the Financial Institutions Business Act and the Deposit Protection Agency Act, were approved by Parliament, advancing the reorganization of the Thai financial system.

2.3.2. Financial Sector Master Plan

The BOT released the "Financial Sector Master Plan (FSMP)" in January 2004, which was jointly compiled with MOF. The FSMP aimed "to improve efficiency, stability and competition within the financial institution system and to broaden accessibility of financial services to all potential users". The BOT set 3 points as the vision of the FSMP;

1) Provide financial services to all potential, economically viable, users whereby users should have access to basic financial products and services at the appropriate pricing.
2) Develop a competitive, efficient, stable, and balanced financial system, capable of servicing both sophisticated and unsophisticated users.
3) Ensure fairness and protection for customers whereby financial institutions must abide by good corporate governance standards, and consumers receive adequate information and advice from various financial institutions to make informed investment decisions.

Hence, the BOT promoted the following measures to realize the above three visions.

1) Measures to Provide Financial Service to All Economically Viable Users

A: Promoting grass-roots financial services for low-income households to reduce remaining financial gaps

B: Transforming the BAAC into a rural development bank

C: Encouraging existing financial institutions to increase the level of financial services to low-income households

2) Measures to Develop a Competitive, Efficient, Stable and Balanced Financial System

A: Rationalizing the structure and roles of financial institutions to better meet customer demand

B: Streamlining rules and regulations

3) Measures to Improve Consumer Protection

As for rationalizing the structure of the financial sector, the BOT approves only 2 types of financial institutions that can operate a banking business in Thailand; they are commercial banks and retail banks. Commercial banks offer a full range of financial services to all groups of customers (except insurance underwriting as well as brokering, trading and underwriting of equity securities) and retail banks offer financial services for SMEs and low-income customers, subject to lending limits per customer. Therefore, finance companies and credit fonciers were encouraged to upgrade to retail or commercial banks. The supervisory authorities are aiming to develop a universal banking system centered on commercial banks.

Moreover, the BOT introduced the "One presence policy". The policy aimed to reduce unnecessary duplication, remove loopholes, and increase the economy of scale within the financial institutions system. Under the "One presence policy", one financial group is permitted to have only one form of depositary institution (institutions which mobilize funding from individuals). Thus, for commercial banks, it became hard to retain finance companies and credit fonciers as their subsidiaries, as well as to have a license for IBF (International Banking Facilities), and they had to merge, close or sell those subsidiaries.

Concerning foreign banks, they are categorized into two types; "branch status" and "subsidiary status". Stand-alone IBFs were required to submit a plan to apply for full branch status or have a viable plan to merge with another finance or credit foncier company to become a subsidiary. As a result, IBF was abolished in 2006.

In terms of the expansion of financial service users, the plan placed emphasis on low-income households, SMEs and farmers as the beneficiaries of financial services. For promoting financial services to the underserved users (who are excluded from the benefits of financial liberalization and/or globalization), retail banks were added to the category of commercial banks to provide financial services to low-income households and SMEs. Additionally, the plan included the following proposals; to support community financial organizations, to upgrade the BAAC into a fully-fledged rural development bank (not achieved as of 2011), and to encourage and support commercial banks in addressing low-income households and SMEs. Under these proposals, authorities applied lower risk weights for loans that cater to SMEs and/or retail consumers[32].

The business model of commercial banks in Thailand has changed dramatically along with a series of financial system reforms. Interest income accounted for nearly 90% of banks' total income on average between 1992 and 1996, declining to 78% during 2002-2006. On the contrary, the non-interest income to total income ratio of Thai banks averaged 22% during 2002-2006, up from 10% during 1992-1996[33]. The loan-deposit ratio also decreased sharply from 100% to 80%[34].

Because of the reduced demand for corporate loans with the development of a capital market, Thai commercial banks focus now on retail business.

Prior to the Asian financial crisis, branch managers had discretion in deposit and lending. After the crisis, most banks adopted a system where the main role of branches is to find and maintain customers, leaving credit review and approval to the headquarters. They are also changing their business style to a customer-centric architecture where customer needs come first. They also promote the use of new technologies such as ICT in banking business.

2.3.3. Financial Sector Master Plan Phase II

The BOT and the MOF jointly proposed the Financial Sector Master Plan Phase II (FSMP Phase II) which was approved by the Cabinet in 2009. FSMP Phase II is a mid-term plan to be implemented during 2010 - 2014 and follows the FSMP Phase I which was implemented between 2004 and 2008. The main policies and measures of the FSMP Phase II can be grouped into 3 key pillars as follows;

- Pillar 1 Reduce system-wide operating cost: to reduce cost arising from regulations, legacy NPL and NPA
- Pillar 2 Promote competition and financial access: Liberalization of branch networks, expansion of business scope, upgrade of retail banks to commercial banks, expansion of foreign bank branches, relaxing of entry of new service providers
- Pillar 3 Strengthen financial infrastructure: Enhancement of the capability and tools for risk management of financial institutions, strengthening of the IT infrastructure and capacity, and enhancement of the capacity of human resources.

In terms of promoting competition, measures would be implemented in 3 phases as

[32] For example, the risk-weights assigned to fully collateralized credits extended for dwelling houses of indivisuals - not exceeding three million baht, and account for no more than 0.2 of the total amount of loans within the same category - is 35% down from 50%. For credit extended to SMEs in the amount not exceeding 50 million baht or no more than 0.2 of the total amount of loans within the same category, the risk-weight is 75%.
[33] Don Nakornthab. "Thai Commercial Banks One Decade after the Crisis: Assessment of Risk to Financial Stability." Bank of Thailand, July 2007
[34] Sukanya Wattanawarintr. "New Development of Thai Banking Sector after Asia Financial Crisis." Kyushu University

follows:

Phase 1 (2010 - 2011) emphasized strengthening and enhancing the efficiency of current financial institutions. This was achieved by promoting mergers, expanding of business scopes, reducing system-wide operating costs, facilitating qualified retail banks to upgrade to commercial banks, and increasing the number of branches for foreign bank branches.

Phase 2 (2012 - 2013) would step up competition in the system by gradually relaxing rules and regulations of foreign financial institutions. In this regard, existing foreign bank branches and subsidiaries would be able to apply for new subsidiary status with more branches. Moreover, new service providers would be introduced under a restricted license. The types of financial institutions that fall under this category of licenses might include microfinance, trust banks, investment banks and Islamic banks.

Phase 3 (2014) follows the implementation of measures under Phases 1 and 2, and other conditions, in which regulatory authority might consider further new licenses.

Moreover, existing commercial banks are recommended to provide better services to micro businesses and low-income individuals, by setting up an internal unit of microfinance, building partnership with other microfinance operators, and utilization of ICT.

2.3.4. Issues Left Unsolved by Financial System Reform

a. Improving the Financing for SMEs

In order to realize the sustainable growth of the Thai economy, the nurturing of SMEs, which account for 90% of Thai firms, is an important policy issue, both from the perspective of improving industrial competitiveness and of developing the supporting industries. However, financing for SMEs in Thailand is not yet at a sufficient level. The commercial banks, which are the main source of financing, maintain a negative stance on the idea. Some of the reasons behind this are the fact that 1) there is insufficient information for satisfactory loan assessment, 2) there are not enough specialists to support SMEs financing, 3) the SMEs accounting systems are not sufficiently developed, and 4) the SFIs are not yet functioning at full capacity.

i) Reliability of Financial Statements

The Thai accounting system used to be based on the US GAAP (Generally Accepted Accounting Principles in the United States), but in the wake of the 1997 Asian financial crisis, the IMF demanded that the system be overhauled and conform to international standards. So, in 2000, accounting standards were revised across the board, and Thailand adopted accounting standards "Thai Account Standard (TAS)" that conformed to international accounting standards, known as IFRS (International Financial Reporting Standards). In Thailand, all public limited companies must conform to TAS, regardless of whether they are listed or unlisted, or of their size. Also, all public limited companies must present copies of their financial documents, accompanied by the audit certificate of a certified public accountant, to the Accounting Office of the Ministry of Commerce's Department of Business Development (former Department of Commercial Registration), or, to the provincial commercial office for rural areas, within five months of the accounts settlement date. The submitted documents also need to include the name of the Thai certified public accountant and their license number.

It must be noted, however, that many SMEs are said to be producing three sets of financial documents, 1) those for registration with the Ministry of Commerce, 2) those for presentation to the tax office, and 3) the real ones. The details of these documents cannot be relied upon fully, so the banks are not really getting sufficient information to allow them to conduct assessment. Also, since there are many family businesses, with close ties among management, accountants and certified accountants, it is assumed that there are many instances of systematic accounting manipulation. Many SMEs have their accounting done by an external agency, and since the Accounting Act allows tax declarations to be submitted by an auditor (certified public accountant) on behalf of the company, as well as keeping the company's books, irregular accounting and accounts manipulation are said to be rife. There is also the problem that it is often difficult for entrepreneurs to pick up on problems with their own company's accounts and management.

Thus, it has been pointed out that issues regarding the reliability of SMEs' financial reports and accounting systems are one factor that hinders the SMEs' financing from commercial banks.

ii) Training of Certified Public Accountants, SME Management Consultants, and Other Specialists

In order to facilitate SMEs' bank transactions, it is necessary to improve the reliability of Thai companies' financial reports and to enhance the quality of management of SMEs, and to improve the system of certified public accountants that supports this, and to foster the development of specialists such as accountants and SME management consultants.

In Thailand, there are about 2 million or more SMEs. Meanwhile, there are around 9,000 certified public accountants, clearly not enough. The Thai accounting system's auditing procedures and administrative procedures are overly strict. In addition, each certified public accountant is responsible for too many companies, so account auditing can take a very long time. There was actually one certified public accountant who had signed off on 20,000 audits, a clearly impossible task, and was later disqualified.

Also, there is no qualification system like the Japanese Certified Public Tax Accountant, and though there is a system of audit by "Tax Auditors" belonging to the

Thai Revenue Department, the system is restricted to limited partnership companies with a maximum capital of 5 million baht, maximum total assets of 30 million baht and maximum annual revenue of 30 million baht.

There are different qualification requirements[35] for accounting staff depending on the size of the company's assets and the industry and type of business, but the lack of bookkeeping tests and accounting schools means that the level of bookkeeping is generally fairly low, and accounting staff cannot be considered to be of a very high level either.

As mentioned above, in order to improve the quality of SMEs' financial reporting, the revamping of the systems for certified public accountants and tax accountants, as well as the training and development of SMEs' accounting staff and enhancement of management awareness are all important issues.

Additionally, it is important to have experts that can provide business management support to SMEs. Since the Asian financial crisis of 1997, with Japan's help, the Ministry of Industry (MOI) has been at the center of an attempt to implement a system similar to the Japanese SME management consultant qualification, in order to provide business support and advice for SMEs. To date, around 450 SME management consultants have been trained, but the reality is that the plan is not being utilized very much[36]. One reason for this is the use of double and triple bookkeeping by SME's accountants, and companies are unwilling to show these to outsiders. In addition, reduced budgets also have an effect, and it has been pointed out that the number of SME management consultants is dwindling. There is a need to spread the SME management consultant system further, in order to provide SMEs with business diagnosis opportunities, and to expand the opportunities for utilization of the scheme.

iii) The Development and Provision of Financial and Accounting Systems for SMEs and the

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[35] According to Section Four of the 2000 notification of the Department of Commercial Registration (currently the Department of Business Development) regarding the qualifications and conditions of company accounting staff, depending on the size of the company's assets and earnings, accounting staff must have a diploma or higher vocational certificate in accounting, or in some cases must have at least a bachelor's degree in accounting.

[36] According to JICA (Japan International Cooperation Agency), JICA's activities with regard to the training of SME management consultants in Thailand thus far have involved sending professional experts (1998 to 2002) to assist in the implementation of a SME management consultant training system, sending senior volunteers (1999 to 2002) and conducting the development survey "Study on Development of Consulting Services to Promote SME Cluster and Regional Development in the Kingdom of Thailand" (2004 to 2005) and, with the cooperation of JICA and other Japanese agencies, some 450 consultants have been trained. Subsequent to these initiatives, however, there was little progress in having these qualifications certified and recognized. Neither was there much progress in linking finance and diagnosis, as is the case with business innovation in Japan, and there are currently no more than 110 consultants active as members of the Enterprise Diagnosis Association. Almost all consultants are based in Bangkok, and where consultants are required in rural areas, they are sent out from Bangkok. Also, as regards SME management consultants in other regions, there are about ten consultants based in Chen Mai, and their length of training is about one third of that of consultants in Bangkok, so the quantity and quality of the work they are able to do is much lower than that available in Bangkok. (http://www2.jica.go.jp/ja/evaluation/pdf/2008_0800118_1_s.pdf)

Self Employed

All companies in Thailand must be audited by a certified public accountant and their audited financial documents registered. However, Thailand's accounting standards assume conformity with international accounting standards, and it is extremely difficult to apply these to SMEs as well as large companies. It may be said that the lack of an accounting system for SMEs is causing a heavy workload for certified public accountants (greater numbers of companies to deal with per CPA), and is hindering the implementation of fair audits and speedy procedures. For that reason, it is believed that there should be some demarcation of accounting standards for large companies and SMEs, and that SMEs-specific accounting standards should be introduced. To that end, FAP (Federation of Accounting Professions) has enacted and announced Accounting Standards for Non Publicly Accountable Entity in Thailand, applicable from the business year starting January 1, 2011.

iv) Review of SFIs' SMEs Financing Functionality

In Thailand, it must be acknowledged that, although SFIs were set up in order to improve the funding situation for SMEs, the reality is that they are not being fully utilized by the SMEs.

SME Bank's capital scale is small and it is limited in terms of its funding methods, network of branches and numbers of professional staff, etc., so that it cannot give full rein to the functionality expected of it. For this reason, as mentioned above, its NPL ratio is extremely high in comparison to those of the commercial banks.

Also, it has been claimed that TCG is inconvenient for SMEs and commercial banks to use. Unlike Japan's National Federation of Credit Guarantee Corporations, TCG does not have representation in all provinces and regions in the country, but only has branch offices to cover very wide, general areas. Also, it has been pointed out that there is insufficient linkage with branches and business centers which function as liaison points for transactions with SMEs, and that credit information and assessment capabilities are insufficient, and that since its guarantee rate is set at 50% in most cases (although there are some exceptions), it lacks incentives for the banks to make use of it. For these reasons, very few of the commercial banks are making use of the credit guarantee system for finance for SMEs, and it is used for no more than a small percentage of SMEs loans.

In addition to the SFIs' lack of capital, assessment capability and branch offices, the fact that government policy changes with the administration of the time means that there is a lack of consistency, and that it is difficult to implement policies for the promotion of SMEs from a long term perspective.

In order to promote the use of the SMEs services offered by both of these institutions, it will be necessary to strengthen collaboration with private sector commercial banks. Specifically, rather than simply competing directly with the private sector financial institutions in terms of loans, SME Bank should also be enhancing its ability to complement the work of the private sector financial institutions, for example, agency loans, guarantee services, and the securitization of finances receivables. Similarly, with regard to TCG, there is a need to study incentive measures in order to encourage use by private sector financial institutions.

Additionally, it has been suggested that, in order to ease the asymmetrical nature of information in the SMEs, the creation of a credit information database should be studied.

b. Taxation System

In Thailand a corporate income tax of 30%, in principle, is levied on businesses (however, some listed small and medium sized enterprises pay a lower tax rate). In addition, with a few exceptions, when Thai corporations make payments, they have to draft their own withholding tax forms and deduct the appropriate corporate tax and income tax and declare the month's withholding tax by the 7th day of the next month. Thus, there is a lot of work related to withholding tax. Also, there are many troublesome tax procedures, such as VAT (value added tax, applicable to the sales of commodities and offering of services within Thailand, and imported commodities and services) declaration that has to be made every month.

Therefore, with more intra-regional exchange of human resources and capital within AEC (ASEAN Economic Community), many feel that having a high taxation rate in comparison with countries like Singapore, Hong Kong and Malaysia will be a regional competitive disadvantage. With the coming of AEC, if a regional headquarter is to be attracted into Thailand, many feel that there will need to be discussion of what kind of taxation system the country should have.

c. Greater Access to Financial Services

Thailand remains a bank-based economy where most business sectors and citizens obtain funds (working capital) and financial services from commercial banks. According to the World Bank Report ("Financial Access 2010"), Thai people relatively have access to financial services compared with neighboring countries: 1.4 bank accounts are held per adult[37].

A survey in 2007 by BOT and the NSO found that 90.4% of households had access to financial services; 83.65% were served by the formal sector, while the remaining 16.35% were served by the semi-formal and informal sectors. The proportion of households served by commercial banks and bank-like institutions such as finance companies and credit fonciers was 62.93%. The proportion of those who were not

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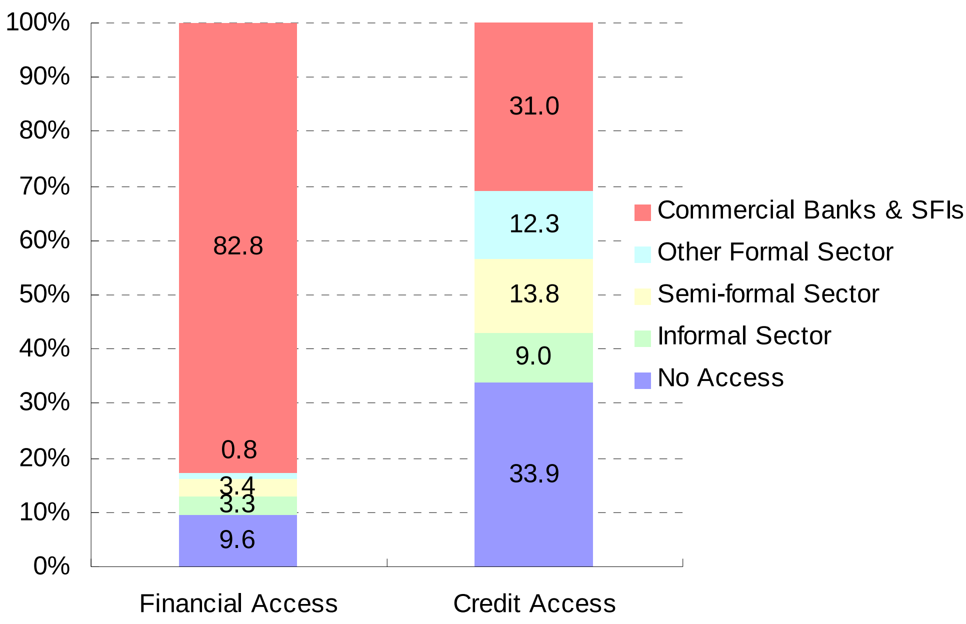
[37] The Consultative Group to Assist the Poor/The World Bank Group. *Financial Access 2010 - The State of Financial Inclusion Through the Crisis.* September 2010
http://www.cgap.org/gm/document-1.9.46570/FA_2010_Financial_Access_2010_Rev.pdf

served by the aforementioned institutions but were served by SFIs was 19.88%. Moreover, only 9.61% of both the country's households and SMEs did not have access to financial services. However the majority of lower-income households relied mainly on SFIs (such as the GSB and the BAAC), the semi-formal sector (i.e. cooperatives, credit unions etc.) and the informal sector (such as self-savings groups and moneylenders)[38].

Although the number of households without access to any financial services is on the decrease and consist of a relatively small proportion of the population, the survey found that 22.58% of Thai households still relied on semi-formal and informal sector's financing. Moreover, a much larger proportion (33.93% of households) did not have access to credit from any financial institution (Figure 2.22.). In summary, despite a relatively high proportion of households having access to financial services, they did not use these services to secure loans or other credit products[39].

Figure 2.22. Households Financial Access



Source: NSO-BOT, Household Socio-economic Survey, Q4 2006

The kinds of people who need microfinance in Thailand include those in family businesses, such as the self-employed and smallholding farmers, entrepreneurs without much business experience, and low income earners without regular, fixed sources of income. Since they do not have sufficient income or collateral to be able to avail

[38] Wajeetip Pongpech. "Using survey data to design financial inclusion policy - Thailand's case." The Bank of Thailand, AFI Global Policy Forum, 14 September 2009

[39] Tientip Subhanij. "Household sector and monetary policy implications: Thailand's recent experience" June 2009, the Bank of Thailand Discussion Paper

themselves of the services of formal financial institutions, such as commercial banks, SFIs and non-bank companies, they must resort to informal financial services. However, since informal financial services generally come with high interest rates, low income earners and farmers who borrow from them find repayment difficult and, having virtually no cash leeway, find it difficult to secure funds for further growth.

If these groups could be assured access to financial services, this would promote a level of cash independence and business growth among low income earners and contribute significantly to the growth of a sustainable economy in Thailand.

Therefore, Thailand needs to educate and nurture financial institutions that can specialize in microfinance, and increase the numbers of financial service providers and diversify the range of available products. These kinds of financial services might be provided by, in addition to SFIs and commercial banks, NPOs, NGOs, foundations, funds and other organizations. However, under the current Thai finance regulations, in order to become a provider of microfinance services, a financial institution license is required. But these organizations mentioned above are not financial institutions. Therefore, they would need to find some way of obtaining a non-bank license. The problem here, however, is that non-bank organizations cannot collect deposits. This means that they would not be able to use the business model of collecting funds and then lending these to low income earners, farmers and other entrepreneurs.

In order to promote microfinance and expand access to financial services, a first step would be to widen the range of services offered by existing financial institutions. Currently, however, the SFIs are working on microfinance backed by government funds so, from the commercial banks' perspective, getting involved in microfinance brings risk and high costs and unfair competition with SFIs. It will be necessary to provide some kind of motivation for the existing financial institutions to get involved more positively in microfinance. One other necessary step will be to review the regulations, that are currently preventing institutions and organizations that would like to provide microfinance services.

In addition, work must be done to widen financial education for those groups who have until now been unable to use or access financial services, and to promote consumer protection.

d. Facing Intra-Regional Competition in ASEAN

Many of Thailand's local commercial banks feel that their first priority is to provide financial services to domestic markets and companies. Therefore, even when these banks open up branches overseas, their aim is to support their customer Thai companies as they expand their businesses in those countries, and they are not pro-actively trying to develop their own business overseas. Additionally, many of the current financial regulations are protective of Thai financial institutions, and restrictive of foreign capitalized financial institutions, such as limiting their branch offices, so that they cannot develop their businesses under the same conditions as Thai capitalized local banks.

Meanwhile, looking ahead to the deregulation[40] of the region's markets with the establishment of AEC in 2015, banks in Malaysia and Singapore are getting ready to switch from being local banks targeting domestic markets to being regional banks targeting the whole ASEAN region. In comparison, Thailand is trying to prioritize the regional deregulation of the capital markets and, with regard to the banking market, to hold off on deregulation until 2020, in consideration of the possible impact on the economy and society.

Many in financial circles fear that, in the future, when Thai companies try to grow their businesses within the region, local Thai commercial banks, having prioritized the domestic market, will be unable to provide a sufficient level of service in comparison with the regional banks of Malaysia and Singapore, and that when intra-regional financial competition begins in earnest, local commercial banks and financial institutions will have neither the size nor the strength to compete with other countries in the region.

2.4. Banks' Financial Soundness and Safety Net

2.4.1. Structure and Current Situation

a. Deposit Protection Agency

Since August 1997, the full amount of principal and interest of deposits would be repaid by the Financial Institutions Development Fund (FIDF) in the case where a bank collapsed (so-called blanket deposits guarantee system). For individual cases, customers could file a complaint to the BOT.

Since the soundness of Thailand's financial system has been restored after the 1997 financial crisis, "Deposit Protection Agency Act 2008" was enacted in August 2008 and the Deposit Protection Agency (DPA) was established under the Act. The DPA is the new organization to be responsible for deposit guarantee and the full guarantee scheme is gradually being shifted to a partial one, and eventually the cap would be reduced to 1 million baht per depositor, per financial institution. (Consequently, the role of FIDF to guarantee depositor came to an end and now FIDF's main mission is focusing on managing assets and liabilities to liquidation and finally closes down the operation).

The DPA provides protection to domestic deposits denominated in Thai Baht, namely current accounts, savings accounts, term accounts or other similar feature

[40] AEC is an initiative that aims at regional economic integration by 2015 by deregulating 1) goods, 2) services, 3) skilled labor, 4) investments, and 5) capital.

accounts under different titles[41]. The insured deposits exclude deposits in the Non-Resident Baht Account which is the account opened for special purposes according to the Exchange Control Act, deposits embedded with derivatives, interbank deposits and deposits of SFIs. Membership in the DPA is compulsory for commercial banks, finance companies and credit foncier companies in Thailand. Extension of coverage to other financial institutions such as SFIs established under special laws can be made by promulgation of Royal Decree.

Member financial institutions are obliged to remit premiums to the DPA twice a year, within the last working day of June and December. The calculation was based on the monthly average amount of deposits of the prior 6-months. The premium rate is 0.4 percent per annum based on total insured deposits. From 2010 onwards, the daily average amount of deposits is exercised in calculation of the premium. At the end of 2010, the Deposit Protection Fund amounted to 52,103 million baht.

At first, the protection limit was planned to be gradually reduced over a 4-year period (from 2009 to 2012) as follows; reduction from whole amount to 100 million baht in 2009 (the 2nd year), to 50 million baht in 2010 (the 3rd year), to 10 million baht in 2011 (the 4th year), and lastly stand at 1 million baht in 2012 to protect small depositors. However, the financial crisis that started in the US in the latter half of 2008 adversely affected the Thai economic and financial positions. Therefore the Thai government decided to extend the period of blanket guarantee for two more years (until 10 August 2011) and to increase the coverage of the fourth year from 11 August 2011 to 10 August 2012, to 50 million baht (Table 2.3.).

The DPA is empowered to request the financial institutions to submit any information and report. However, to avoid duplication of data reported by the financial institutions, the DPA and the BOT agreed to exchange information with each other. The DPA will act as liquidator in case financial institutions fail or close.

Table 2.3. Time Schedule of Deposit Guarantee Reduction

Year	Period	Guarantee/Owner of Account/Bank
1	August 11, 2008 – August 10, 2009	All Deposits
2	August 11, 2009 – August 10, 2010	All Deposits
3	August 11, 2010 – August 10, 2011	All Deposits
4	August 11, 2011 – August 10, 2012	Not over 50 million Baht
5	August 11, 2012 - onwards	Not over 1 million Baht

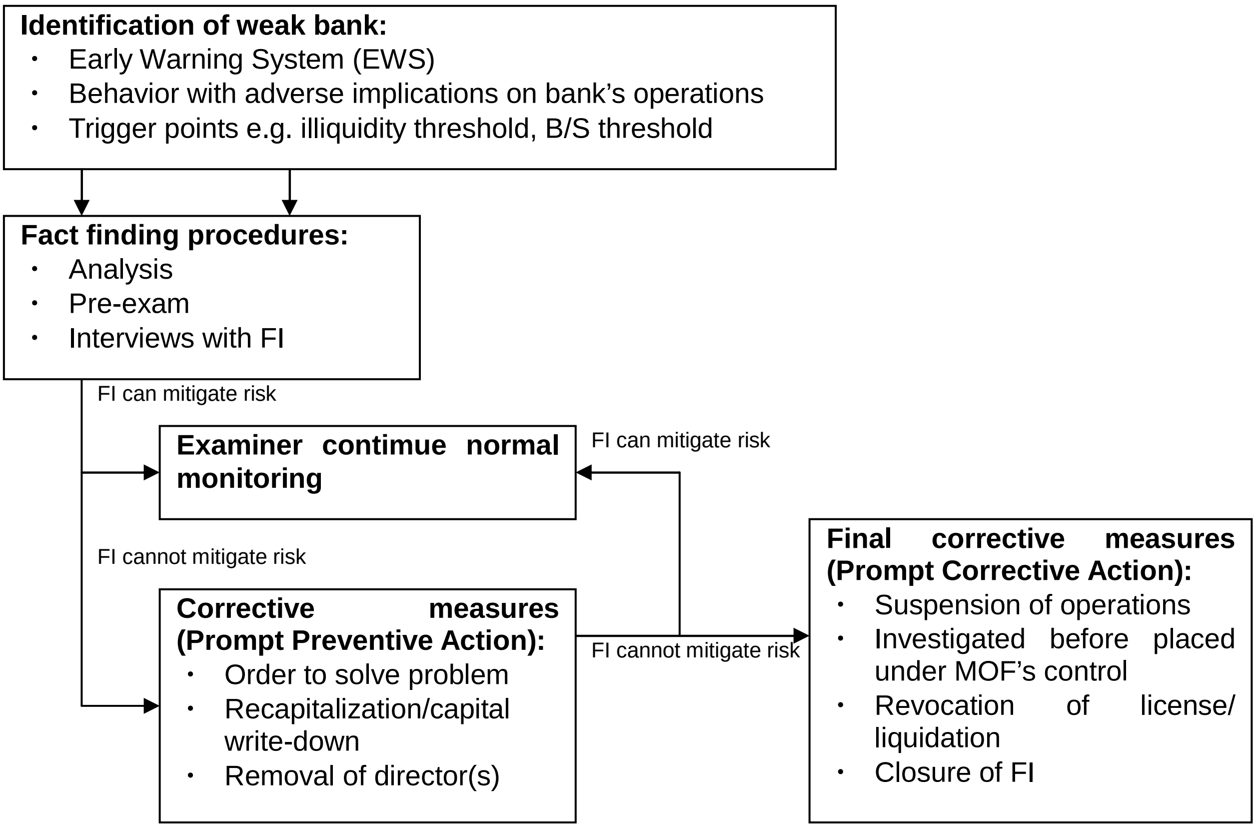
Source: DPA

[41] Bill of Exchange (B/E) is excluded from insured deposits. Thus commercial banks are increasing fund mobilization via B/E by offering B/E with higher interest rate than baht-denominated deposits.

b. Prompt Preventive Action (PPA) and Prompt Corrective Action (PCA)

CAR requirement are the principles of prompt preventive action (PPA) and prompt corrective action (PCA). PPA will be imposed on banks whose CAR is between 8.5%-9.5% and banks will be subject to a thorough examination on its risk, management and integrity of business conduct. Then, the bank must submit a clear action plan which will be evaluated on a quarterly basis. As for the PCA, the authority is granted to the BOT under Section 97 of the current regulatory statue. The possible actions include the suspension of certain or all businesses and recapitalization requirement for a bank whose CAR falls below 8.5% but is not lower than 5.5%. If the CAR is between 2.5%-5 %, then the BOT will either intervene or initiate mergers with other banks. Finally, if CAR is below 2.5 percent, then the bank must be closed (Figure 2.22.).

Figure 2.23. Measures to be Taken When Financial Institutions Encounter Problems



Source: Dr. Tarisa Watanagade "Thailand: Institutional Aspects of Bank Insolvency" Bank of Thailand

c. Outline of Bankruptcy Disposal System

The old Thai Bankruptcy Act 1940 had many problems, such as the fact that it focused on liquidation of the failed company and contained no provision for reconstruction, so companies that might have been capable of reconstruction were forced into bankruptcy. In the wake of the Asian financial crisis of 1997, and with the management and support of the IMF and the World Bank, the bankruptcy laws were reorganized to allow for the efficient liquidation of those failed businesses that had no prospect of rehabilitation, and the reconstruction of those with the potential to continue their businesses. Subsequently, the revised Bankruptcy Act (1998, 1999) was introduced, centering on the introduction of procedures for corporate reorganization, and the establishment of bankruptcy courts specializing in the handling of bankruptcy cases.

Additionally, the BOT-driven Framework for Corporate Debt Restructuring (the so-called Bangkok Approach), was introduced. This framework required the creditors to accept a temporary suspension of debt collection, as well as offer new funds during the enactment period of the corporate restructuring plan. Also, the Corporate Debt Restructuring Advisory Committee (CDRAC) was formed under the auspices of the BOT. CDRAC acted as an intermediary – adjuster in cases of voluntary liquidation, based on the Bangkok Approach. Of course, the BOT-led CDRAC had no legal authority, and was only effective where the creditor was a financial institution, and it is not reckoned to have been significantly effective. With the steady progress of the disposal of NPLs, CDRAC formally ended in October, 2006.

Also, in order to buy up the assets of financial institutions and other organizations that failed in the wake of the Asian financial crisis, Asset Management Companies (AMC) were set up under the provisions of the 1997 Emergency Decree on the Asset Management Company (revised in 1998). However, since the AMC did not have any legal binding power, though NPLs were transferred from the banks, there was almost no progress made in their disposal. Then, in 2001, the Thai Asset Management Company (TAMC) was founded. TAMC was granted the right of foreclosure without judicial procedure, and at long last the work of NPLs disposal could go ahead. TAMC formally finished its business in June, 2011.

Further, the usual procedure of the disposal of a failed financial institution is not to create a new bridging bank, but to divide the financial institution's assets into sound and non-performing, and transfer the NPLs to an AMC and then use public funds to reorganize the institution and eventually sell it off to another financial institution.

2.4.2. Impact of the Global Financial Crisis and Response to Tougher International Regulations

In the wake of the Asian financial crisis, a tougher set of regulations and supervision were imposed to the Thai financial sector, with the BOT at the center. Therefore, when the global financial crisis hit in 2008, triggered by the Lehman Brothers' collapse, Thai local commercial banks had almost no sub-prime related assets, so the impact on the Thai financial system was minimal. Unlike European and US financial institutions, there were no Thai commercial banks that faced operating difficulties as a direct cause.

However, the economic deceleration in Europe and the US has had a deep impact on the export dependent Thai economy. According to an NESDB announcement, Thai's real GDP growth rate in the fourth quarter of 2008, was minus 4.3%, compared to the same period in the previous year, the first negative growth since the first quarter of 1999 (minus 0.2%), after the Asian financial crisis.

Under such circumstances, the global financial crisis has affected on Thailand's financial policies. One was the postponement of the deposit protection system. Out of consideration of the effect of the global financial crisis on Thai economic and financial markets, the implementation of the system was put back by two years. Another was the response to the new framework of capital equity ratio regulations. Although none of the local Thai commercial banks qualify as SFIs subject to tighter international regulations, the BOT's policy is to pursue Basel III. Third is the review of the accounting systems related to financial products. Since the financial crisis, G20 has been asking for a review of IAS 39, and revision is ongoing within IASB. Thailand's accounting standards conform to international standards, and will therefore need to adapt to any review of IAS 39.

It is thought that changes to capital equity ratios and accounting standards regulations will likely mean a new cost burden for Thailand's local commercial banks.

2.4.3. Issues and Risks

The Thai banking sector may be said to have kept its sound financial health and stability due to the process of the drastic bank restructuring that followed the Asian financial crisis, tighter regulation and supervision and the development of a variety of systems, as well as the support of a healthy domestic economy.

Of course, there are risk factors, such as political unrest, global economic deceleration, and flood damages.

First, there is still political discord between the People's Alliance for Democracy (PAD, the Yellow Shirts) and the United Front for Democracy Against Dictatorship (UDD, the Red Shirts). The respective parties that look to these groups for their support base have promoted crowd pleasing policies as part of their election strategies, in order to win political power. For example, the Yingluck administration, formed in August 2011, promised to raise the minimum (daily) wage to 300 baht. However, this has met with fierce opposition from industrial circles, citing fears of damage to Thailand's competitive strength. The implementation of such populist policies is feared likely to worsen the budget deficit and push up commodity prices.

Second is the fear that, if the European debt crisis causes the global economy to decelerate once more, the export dependent Thai economy may well suffer serious damage. In addition to the slowing of exports that will follow deterioration in the real economy, it is thought that stronger risk avoidance sentiment among European and US financial institutions will result in a withdrawal of capital (leading to falling exchange rates and stock prices, rising import prices and increased difficulty in procuring dollar capital, etc.). Already, the Federation of Thai Industries and others are reporting that the impact of the European and US economic crisis is beginning to make itself felt in the export industry.

Third, widespread flooding has hurt the Thai economy. The flooding of industrial sites has caused disruption in supply chains, leading to suspension and reduction in manufacturing production. The prolonged flooding and the spread of damage even into Bangkok has affected consumption and tourism. In addition, the lack of coordination among jurisdictional authorities and the government's poor crisis management capabilities were exposed, and there has been a growing loss of confidence in the Thai government, not only among the people but also foreign companies doing business in Thailand.

It needs to be remembered that Thailand's balance of current account is still in the black, and that the foreign currency reserve is healthy. Also, the progress of intra-regional financial cooperation since the Asian financial crisis has meant that there is very little possibility of any serious economic damage resulting from an outflow of capital. And, given that the various social infrastructures and legal systems as well as living conditions have already been established, and that there is a high quality labor force, Thailand has a high reputation among foreign companies to do business in. Therefore, while there are risk factors, it is difficult to imagine any drastic changes in the domestic situation, or economic or financial conditions. Nevertheless, it would be considered prudent to continue to keep an eye on the domestic situation and trends in international financial markets.

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3. Vietnam

3.1. Characteristics of the Banking Sector

3.1.1. Outline of the Vietnamese Economy

a. Basic Facts

Vietnam is a one-party communist state. It is densely populated with 87 million people, ranking third among the ASEAN countries after Indonesia (240 million) and the Philippines (93 million, all 2010 figures by the World Bank). The population is expected to hit 100 million by 2030, according to UN projections. It has a young population: 53% of the people being under 30 years old (2009).

Since the enactment of "doi moi" (renovation) in 1986, the country has been going through structural reforms to shift itself to a market economy while opening itself up to international trade and investment. In recent years, Vietnam has become a popular low-cost destination for foreign companies pursuing the "China plus one" strategy, where companies establish factories not only in China but also in other countries in an attempt to disperse risks. This is reflected in the continuous surge in foreign direct investment (FDI) inflows into the country.

Vietnam has been one of the world's fastest growing economies in the world: the real GDP growth rate averaged 7.2% during 2000 and 2011, the third highest after China (10.3%) and India (7.4%). In spite of this, the size of the economy, in nominal GDP terms, was a mere US$103 billion in 2010, still one of the smallest in the ASEAN region.

Looking into the GDP by sectors, industry/construction had the largest share at 41%, while services and agriculture/forestry/fishing were 38% and 21%, respectively. However, employment in agriculture/forestry/fishing accounted for 49%, more than twice that of the industry/construction sector at 22%. This reflects the fact that despite the steady urbanization of the country, 70% of the population resides in rural areas.

In 2009 the per capita income surpassed US$1,000, meaning that Vietnam joined the ranks of "lower-middle-income" countries from the previous status of "low-income" countries by World Bank definitions. Within the ASEAN region, Vietnam shares this "lower-middle-income" standing with Indonesia ($2,580 in 2010), the Philippines ($2,050), and Lao PDR ($1,010).

Both the fiscal and current account balances are in the red, the fiscal deficit being 6.6% of nominal GDP (2009) and the current account deficit being 4.0% (2010). The fiscal deficit has surged recently due to the stimulus measures taken by the government to cope with the 2008 global financial crisis. In contrast, the current account deficit has been persisting for years, as the country's domestic demand has long exceeded supply due to supply bottle-necks, resulting in the reliance on imports. Vietnam finances the current account deficit mainly through foreign direct investments (FDI), remittance from overseas workers, and official development assistance (ODA).

Vietnam unofficially adopts a crawling peg with the US dollar for its exchange rate, and commercial banks can set their own exchange rates within a designated band. There has been constant devaluation of the Vietnamese Dong (VND) for an extended period of time, as the current account deficit and more recently, high inflation, have been putting downward pressure on the currency. The VND usually trades lower in the black market.

The most pressing challenge the country faces today is the soaring double-digit inflation. Consumer prices surged by 11.8% year-on-year in December 2010, and accelerated even further in 2011, peaking at 23.0% in August. Since then they have calmed somewhat, but as of February 2012 they were still 16.4%, the highest in the ASEAN region. In order to tame inflation, the government has been pursuing tight monetary and fiscal policies and what is more, has shifted its priorities from pushing for growth to focusing more on macroeconomic stability. It remains to be seen if the government can stick to this policy shift despite pressures from numerous sources to weaken its grip.

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b. Business Environment

One of the key policies set up by the government to transform the country to a market economy is equitization of the state-owned enterprises (SOEs). Equitization is a process of converting an SOE into a joint-stock company or a limited liability company. It is not equal to privatization as the government may keep some or all of the shares. Even after equitization, an enterprise is categorized as state-owned if the government holds 51% or more of the shares in the enterprise. SOEs have decreased in number from about 12,000 when the equitization started in the late 1980s, to 3,400 in 2009. For the past four years, though, the equitization drive has stalled due to unfavorable stock market conditions.

There are currently 249,000 enterprises in Vietnam, which means that SOEs account for a meager 1.3%. However, SOEs still play a central role in the economy, while enjoying privileges not given to private enterprises. SOEs are mostly large in size and dominate strategically important industries such as oil, electricity, transportation and telecoms. In contrast, most of the private enterprises are small- and medium-sized enterprises (SMEs), defined as employing fewer than 300 employees. Of all the SOEs, 33% employed more than 300 people, while the percentage of non-state enterprises employing more than 300 people was a mere 1%. Actually, 58% of the non-state enterprises employed less than 10 people.

Notwithstanding their disadvantages, private enterprises have grown to be significant players in various industries, usually operating in areas that do not compete directly with SOEs, and are now the engines of economic growth in the country. Meanwhile, the increasing number of SOEs that converted into private enterprises boosted both the sales and profits of the private sector. As a consequence, between the years 2000 and 2008, net turnover of non-state enterprises increased by 15 times, while profits before taxes swelled by 18 times. The equivalent figures for SOEs were 3 times and 4 times, respectively.

3.1.2. Overview of the Financial System

a. Savings and Investments

It is difficult to get hold of an accurate figure of the flow of funds among economic sectors in Vietnam due to insufficient statistical data. A rough picture is that strong investments by both the government and corporate sectors, which is not fully covered by savings by the household sector, results in an economy that relies on foreign savings. State organizations including the government and state-owned enterprises (SOEs) are the largest investors with a 38% stake in 2010. This share has been in gradual decline in the past decade, but nonetheless is still disproportionately high compared to other ASEAN countries. The share of non-state entities in investment is 36% while that of foreign invested sectors is 26%. There has been a remarkable surge in the share of foreign invested sectors, reflecting high foreign direct investments into the country.

The savings-investment gap has been widening since the mid-2000s, from 5.3% in 2005 to 11.9% in 2010, resulting in further reliance on foreign funds. This widening has occurred because the increase in savings has not kept up with the rapid expansion of gross capital formation brought on by the foreign investments. Actually, domestic savings as a percentage of nominal GDP have gone down in the past five years. High inflation and the depreciation of the VND are responsible for this. A more fundamental issue is that households have not yet been fully integrated into the financial system. This is true especially in rural areas. The 2006 Rural Household Survey revealed that 54% of the households in rural areas had some kind of savings, but only 17% had savings in financial forms including cash hoarded under the mattresses and savings kept in bank accounts. The remainder was physical assets such as cattle, land, gold and jewelry[42]. Even for the total population including people residing in urban areas, it is estimated that only about 10 - 20% have bank accounts. This is due to the underdevelopment of banks as well as the low income levels of the households.

b. Outline of the Financial Sector

Vietnam's financial sector is still in its infancy. It was just 24 years ago, in 1988, when financial reform put an end to the monobank system, where the State Bank of Vietnam(SBV) had functioned as both central bank and commercial bank. Also, it was not until 1990 that private banks were allowed to be established in the country. The

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[42] Newman, Carol, Finn Tarp, Katleen Van den Broeck, Chu Tien Quang, and Luu Duc Khai. "Household Savings in Vietnam: Insights from a 2006 Rural Household Survey," *Vietnam Economic Management Review.* Volume3, Number 1. 2008. p.35-36.

capital markets have an even shorter history, as can be acknowledged by the fact that the nation's first stock exchange, the Ho Chi Minh Stock Exchange, was established just 12 years ago, in 2000. Considering these matters, it is no wonder that for the year 2010 the World Economic Forum ranked Vietnam 46th out of 57 countries for financial development[43].

Vietnam's financial sector is a bank-based system, as is typical in a country during the early stages of financial development. Banking has been expanding rapidly, thanks to far-reaching reforms by the government to modernize the system as well as strong financing needs from enterprises reflecting high economic growth. The speed with which banking networks have expanded recently is remarkable, as banks rushed to set up branches and ATMs across the country. As a result, the last decade has seen a financial deepening of the Vietnamese economy, as can be witnessed from the ratio of M2 to nominal GDP going up from 50.5% in 2000 to 140.8% in 2010. Similarly, domestic credit provided by banks has expanded from 35.1% of nominal GDP in 2000 to 135.8% in 2010. (Figure 3.1.) In fact, there is no denying an over-extension of credit in recent years.

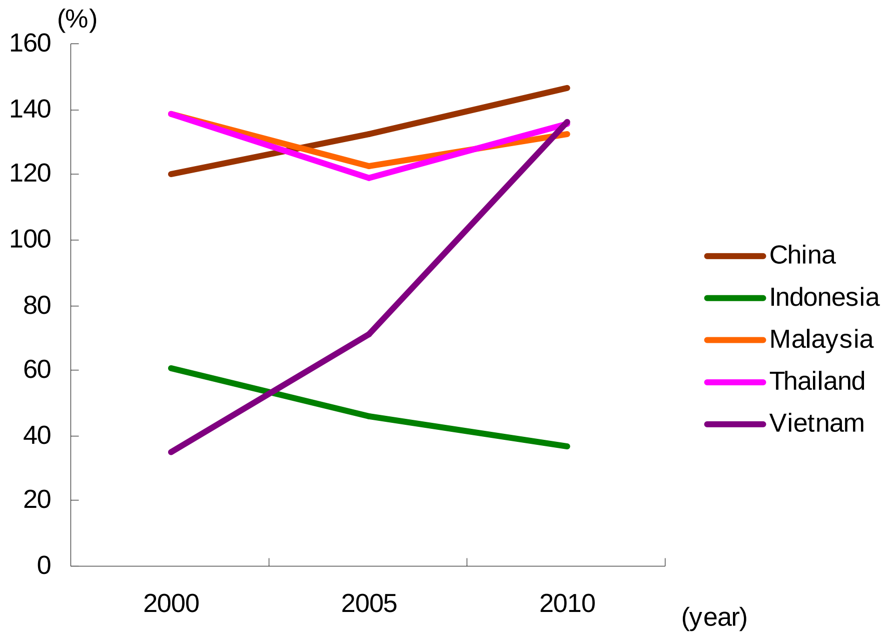
Contrary to the banking sector, capital markets remain fairly small. The equity market in Vietnam grew in line with the equitization of state-owned enterprises that started in 1992. Before the two formal stock exchanges were established, the Ho Chi Minh Stock Exchange in 2000 and the Hanoi Stock Exchange in 2005, transactions were done through informal negotiations and over the counter. The short period between 2006 and 2007 witnessed a stock market bubble where speculative money flooded into the two exchanges, but ever since the burst of the bubble in 2008 the market has remained stagnant. The weak stock market has been hindering the development of the formal market, allowing the informal market to predominate. The securities traded informally are poor in transparency as they are not subject to disclosure or listing requirements, thus making investing in them risky. Stock market capitalization has grown from a nearly non-existent 0.4% of nominal GDP in 2003 to 27.5% in 2007 during the peak of the stock market bubble, falling to 19.2% in 2010. This present level is one of the lowest in the ASEAN region.

The local currency bond market has also seen rapid growth, but nonetheless the amount of bonds outstanding in December 2011 was still US$16.9 billion, or 15.6% of nominal GDP, again one of the lowest in the region. What is more, government bonds dominate the market by 90%, with an outstanding of $15.3 billion. In contrast, corporate bonds outstanding amount to a mere $1.5 billion[44]. An insufficient legal framework for bond trading, no standard for credit rating, and low market liquidity due to the lack of market makers, are some of the many reasons for the underdevelopment. Recent issues such as high inflation, depreciation of the currency, and the surging

[43] World Economic Forum. *Financial Development Report 2010.* December 2010. p.12.
[44] Asia Bond Monitor. *AsianBondsOnline*. (http://asianbondsonline.adb.org/index.php)

current account and fiscal deficits are also hindering bond market growth.

Figure 3.1. Domestic Credit Provided by the Banking Sector



Source: World Bank

Note: % of nominal GDP

c. Outline of the Banking Sector

Vietnam has about 100 banks. Under the supervision of the State Bank of Vietnam (SBV), there are 5 state-owned commercial banks (SOCBs), 1 development bank, 1 social policy bank, 37 joint stock banks (JSBs), 5 joint venture banks between Vietnamese and foreign partners, 48 branches of foreign banks, and 5 wholly foreign-invested banks. The development bank (Vietnam Development Bank) and social policy bank (Vietnam Bank for Social Policies) are both policy banks 100% owned by the government. The SBV also supervises 1 People's Central Credit Fund under which 998 People's Credit Funds operate, as well as nonbank credit institutions consisting of 17 finance companies and 13 leasing companies. (Table 3.1.)

Among these various types of credit institutions, SOCBs and JSBs serve as the two pillars of the banking system. People's credit funds, a network of cooperative credit institutions that cater to the rural areas to improve the accessibility of banking services, are large in number but only account for about 1% of both overall deposits and loans in the country. Due to insufficient information, the profitability of the banking sector as a whole is difficult to assess, but SOCBs and the large JSBs seem to enjoy high growth in their profits.

Table 3.1. Credit Institutions in Vietnam

banks	**State-Owned Commercial Banks (SOCBs)** 5 banks Vietnam Bank for Agriculture and Rural Development (Agribank) Joint Stock Commercial Bank for Foreign Trade of Vietnam (Vietcombank) Vietnam Joint Stock Bank for Industry and Trade (Vietinbank) Bank for Investment and Development of Vietnam (BIDV) Housing Bank of Mekong Delta (MHB)	commercial banks
banks	**Development Bank** Vietnam Development Bank	policy banks
banks	**Social Policy Bank** Vietnam Bank for Social Policies	policy banks
banks	**Joint Stock Banks (JSBs)** 37 banks, including Asia Joint Stock Commercial Bank (ACB) Viet Nam Technological and Joint Stock Commercial Bank (Techcombank) Sai Gon Thuong Tin Joint Stock Commercial Bank (Sacombank) Export-Import Joint Stock Commercial Bank (Eximbank) Maritime Joint Stock Bank (MSB)	commercial banks
banks	**Joint Venture Banks** 5 banks	commercial banks
banks	**Foreign Bank Branches** 48 branches	commercial banks
banks	**Wholly Foreign-invested Banks** 5 banks HSBC ANZ Standard Chartered Bank Shinhan Bank Hong Leong Bank	commercial banks
cooperative credit institutions	**People's Credit Fund System** People's Central Credit Fund People's Credit Funds 998 funds	
nonbank credit institutions	**Finance Companies** 17 companies	
nonbank credit institutions	**Leasing Companies** 13 companies	

Source: State Bank of Vietnam et al.

Notwithstanding the prevalence of SOCBs and JSBs, informal banking still plays an important role in the banking sector, especially for individuals and household enterprises in rural areas. This is due to the fact that banks in Vietnam have basically been corporate lenders, and historically have not offered sufficient credit to individuals and household enterprises. Issues on information asymmetry, as well as comparatively low income in rural areas, also cause the banks to be reluctant to lend to these customers. There exist three major microfinance institutions, namely the state-owned Vietnam Bank for Agriculture and Rural Development (Agribank), Vietnam Bank for Social Policies, and the People's Credit Funds, but their loans are not enough to cover all the financial needs of individuals and household enterprises.

The informal financial sector consists of money lenders and cooperative societies, as well as family members and friends. One estimate points out that 50% of total credit among the poor and low income people is supplied by these sources[45]. Informal lending had been on a gradual decline with the penetration of banking services, but it seems to be gaining force again recently, as banks are curbing loans following tighter credit policies imposed by the SBV.

3.1.3. Structure of the Banking Sector

a. Regulatory Framework

The State Bank of Vietnam (SBV), the central bank, is the single regulator of banks and nonbank credit institutions. It has the authority to grant and revoke licenses to or from credit institutions, monitor and supervise banking activities, control credit activities, and handle all violations. It is a ministerial agency of the government, not an independent entity. There still exist obstacles that hinder full autonomy of the SBVs, even though progress has been made under the new State Bank of Vietnam Law promulgated in 2010.

In 2008, the National Financial Supervisory Commission (NFSC) was established to supervise the whole financial market including banking, insurance, and securities, as well as coordinate multiple-sector supervision. Before that, each industry was supervised solely by individual agencies: other than the SBV supervising the banks, the Insurance Supervisory Department of the Ministry of Finance supervised the insurance and re-insurance companies, while the State Securities Commission under the Ministry of Finance was responsible for the supervision of securities companies and fund management companies. However, due to its weak legal status and insufficient power, the NSFC has not been playing an active role, and has limited presence in the supervision of the financial markets.

The banking sector in Vietnam is governed by the Law on Credit Institutions, the Law on the State Bank of Vietnam, and accompanying decrees, circulars and decisions

[45] Biallas, Margarete and Kien Dam. "Vietnam Financial Sector Diagnostic 2008." International Finance Corporation, August 2008. p.7.

by the government. The Law on Credit Institutions, a new version enacted in 2010, governs the organization and operation of credit institutions, foreign bank branches, representative offices of foreign credit institutions, and other foreign organizations engaged in banking activities.

Interest rates had been gradually liberalized, the final step being the liberalization of VND denominated lending rates by credit institutions in 2002. However, the SBV re-imposed interest rate ceilings in 2008, which have continued until now while the rates have gone through several changes.

Banks may participate, through subsidiaries or affiliated companies, in non-banking activities such as securities underwriting and trading, financial leasing, and insurance. In fact, many of the large banks, in an attempt to become financial conglomerates, have subsidiaries that engage in various activities including non-life insurance, securities, and asset management.

The SBV requires credit institutions to adhere to safety ratios such as the minimum capital adequacy ratio (CAR, 9%), the maximum credit exposure to a single borrower over its equity (15%), the minimum ratio of total current assets over total current liabilities (15%), the maximum ratio of credit extension against mobilized capital[46] (80% for banks and 85% for non-bank credit institutions), and the maximum ratio of short-term funds that credit institutions can utilize for their medium- and long-term loans (30%).

b. SOCBs

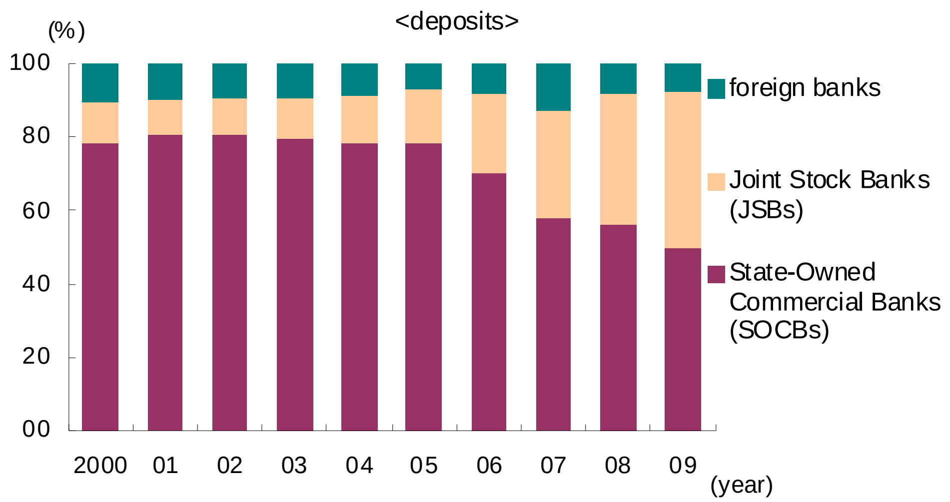
State-owned commercial banks (SOCBs) consist of Vietnam Bank for Agriculture and Rural Development (Agribank), Joint Stock Commercial Bank for Foreign Trade of Vietnam (Vietcombank), Vietnam Joint Stock Bank for Industry and Trade (Vietinbank), Bank for Investment and Development of Vietnam (BIDV), and Housing Bank of Mekong Delta (MHB). SOCBs dominate the banking sector, although their influence has been receding in recent years as the JSBs increased their presence. The shares of deposits and loans by SOCBs in 2009 were 50% and 54%, respectively, down from 78% and 72% in 2000. (Figure 3.2.) Previously, as oligopolies with little competition, SOCBs enjoyed fairly stable relationships with their customers which were mostly state owned enterprises (SOEs). However, this has changed as the SOEs decreased in number through equitization and consolidation, while the number of private firms increased remarkably, forcing SOCBs to seek beyond SOEs as customers. As a result, loans toward private firms now surpass loans to SOEs for all the SOCBs.

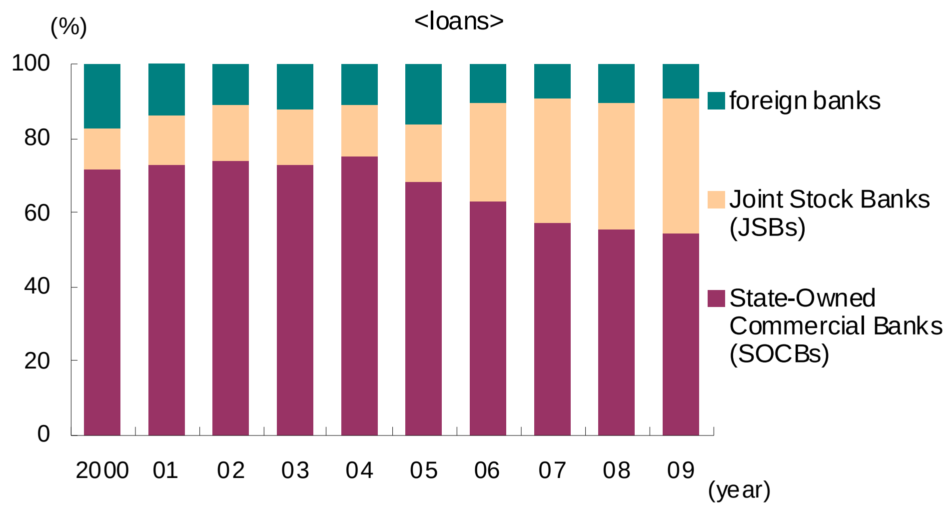
As being SOEs themselves, SOCBs were also subject to equitization, with the aim of enhancing the effectiveness and competitive strength of these banks. Of the five SOCBs, Vietcombank, Vietinbank and MHB completed their equitization in the years

[46] Mobilized capital consists of cash deposits, borrowed capital from domestic and foreign credit institutions, funds raised though the issuance of valuable paper, and borrowed capital from the SBV.

2007, 2008, and 2011, respectively, while BIDV is at present going through the equitization process which is expected to be completed by the first quarter of 2012. However, they remain state-owned even after equitization, as the government retains the majority of shares at all four banks. At the time of equitization, the government retained 91% of the stake of Vietcombank while it retained 89% of Vieinbank. In September, Japan's Mizuho Financial Group announced that it was acquiring a 15% stake in Vietcombank for US$567 million, possibly the largest ever inbound acquisition in Vietnam. Even after the Mizuho acquisition is completed in the first quarter of 2012, the government will still retain 76% of Vietcombank. In the meantime, Agribank converted to a single-member limited liability company entirely owned by the government in 2011.

Figure 3.2. Market Share of Credit Institutions in Vietnam





Source: State Bank of Vietnam et al.

c. JSBs

Joint stock banks (JSBs) are much smaller in size than the SOCBs; the largest in terms of assets is Asia Joint Stock Commercial Bank (ACB) with VND 264 trillion (US$13 billion[47]), but this is still half the amount compared to Agribank, the largest of the SOCBs with assets of VND 524 trillion (US$25 billion, September 2011 figures). (Figure 3.3.) However, JSBs have been growing rapidly and grabbing market share from SOCBs. In 2009, JSBs had a market share of 43% in terms of deposits and 37% in terms of loans. This is a great improvement from the 11% share in both deposits and loans in 2000. (Figure 3.2.)

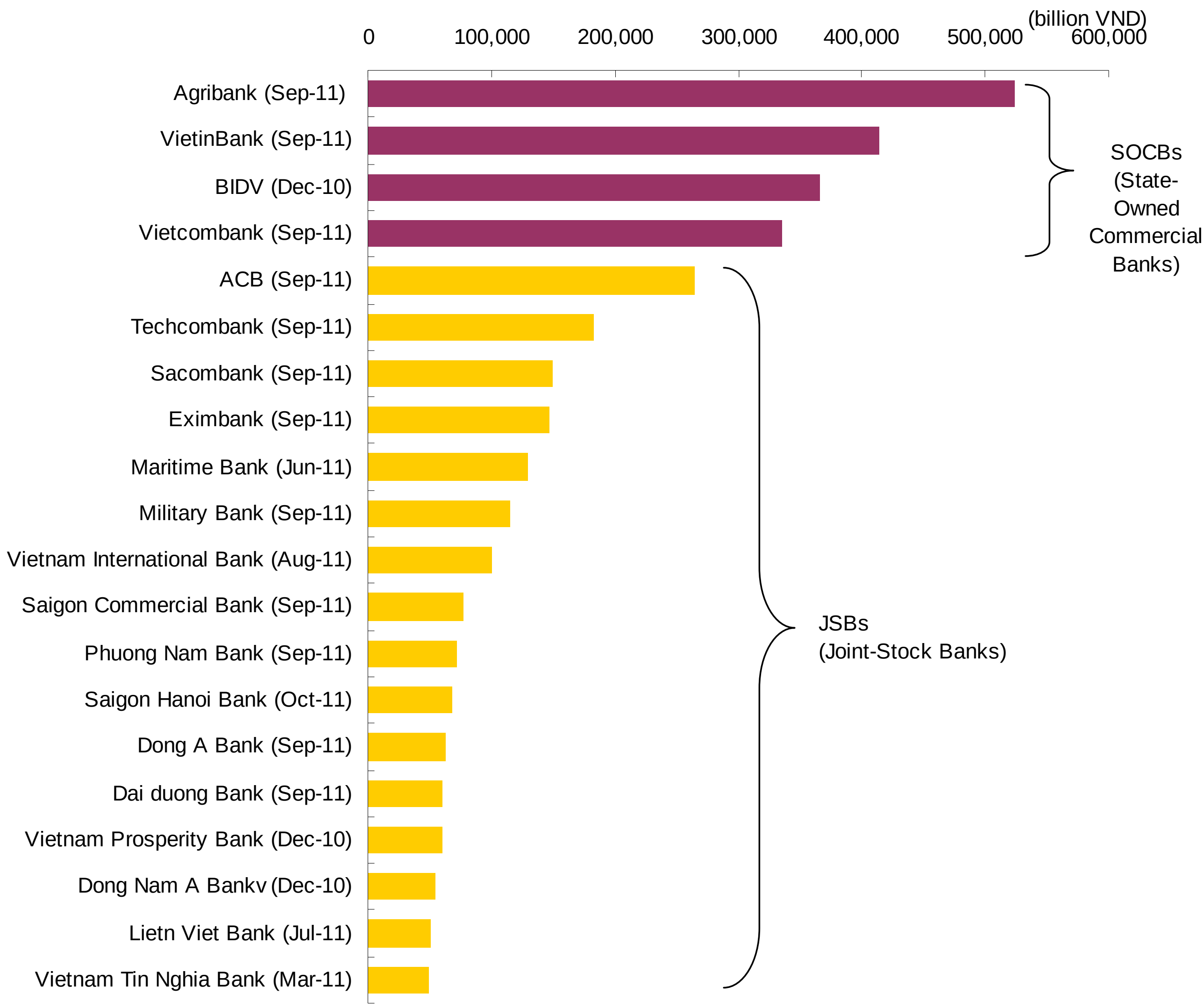
Many of the JSBs were established after 1990 when new rules liberalized entry into banking. They mostly started as small entities, concentrating on the niche market of catering to private enterprises that were usually small-and medium-sized, as there was little room to gain access to SOEs which generally had strong ties with SOCBs. From them emerged several banks that are now industry leaders, such as ACB, Viet Nam Technological and Joint Stock Commercial Bank (Techcombank), Sai Gon Thuong Tin Joint Stock Commercial Bank (Sacombank), Export-Import Joint Stock Commercial Bank (Eximbank), and Maritime Joint Stock Bank (MSB). These banks compete with each other fiercely, as well as with Vietcombank and Vieinbank, the two powerful SOCBs. They aim to become financial conglomerates in the future.

On the other hand, some of the smaller JSBs lack sufficient capital as well as proper management resources. Governor Nguyen Van Binh of the SVB, during a session at the 13th National Assembly on November 13, 2011, said that of the 37 JSBs which currently operated in Vietnam, 8 small ones were "unhealthy"[48]. He did not elaborate on the specific names of the 8 banks, but it is rumored that many of them used to be rural banks that transformed to urban banks in the years 2006 and 2007. These small banks have extended loans at a rapid pace without appropriate risk control, during the years of expansionary monetary policy. As a result, it is assumed that these banks are now suffering from high nonperforming loans (NPLs) and insufficient capitalization buffers. They pose a threat to the soundness of the banking system, and need to be restructured in some way or other.

[47] In this report the interbank average exchange rate of US$1=VND 20,828 as of February 10, 2012 (posted on the State Bank of Vietnam website) is used for the conversion from VND to USD.

[48] The State Bank of Vietnam. "SBV Governor Nguyen Van Binh takes floor at NA question-and-answer session." (What's new). November 25, 2011. (http://www.sbv.gov.vn/)

Figure 3.3. Total Assets of Major Commercial Banks in Vietnam



Source: Reuters. "Vietnam Banks' Assets, Registered Capital." November 16, 2011.

d. Foreign Banks

The Vietnamese banking sector has gradually opened up its doors to foreign investments in accordance with the country's commitments that it made when becoming a member of the World Trade Organization (WTO) in 2007. Foreign banks that wish to operate in Vietnam can now choose from three options: set up a branch or representative office, form a wholly-owned bank, or establish a joint venture bank with local commercial banks. The five 100% foreign-owned banks are HSBC, ANZ, Standard Chartered Bank, Shinhan Bank (South Korea) and Hong Leong Bank (Malaysia).

Foreign banks accounted for 8% of deposits and 9% of loans in 2009. They especially play an important role in providing loans and trade finance to foreign-invested enterprises, as well as offering sophisticated products and services in corporate finance and foreign exchange areas to domestic enterprises that operate globally. Some have been expanding to the retail banking arena, a trend that may speed up given that foreign banks have been allowed to provide the same banking services as Vietnamese banks since January 2011.

One of the drivers of banking reform in Vietnam has been the competition from foreign banks. The SBV recognized that it was important to strengthen the local banks so that they could retain market share even after the foreign banks gain equal footing with the local banks in terms of regulation.

3.1.4. Strategic Foreign Investors

On the one hand, foreign banks have acted as competitors to the Vietnamese banks, but on the other hand, they have become partners, as there has been a rush among Vietnamese banks in inviting foreign banks as "strategic investors". A foreign investor with sufficient capital and managerial capacities can become a strategic investor of a local bank in which it will assist the bank to improve its technology, products and management. The government caps total foreign ownership in a domestic bank at 30%, and within this limit a single foreign financial institution's ownership of a domestic bank is capped at 10% while the cap for all other foreign investors' ownership is 5%. However, foreign investors that become strategic investors are allowed to own up to 15%, and with special approval from the prime minister, the cap can go up further to 20%.

12 Vietnamese banks now have foreign banks as strategic investors. (Table 3.2.) By becoming strategic investors, foreign banks can obtain knowledge and know-how of the local practices without setting up their own branch networks, while profiting from the rapidly growing market.

The advantages that the local banks have gained may be larger. Of course the greatest advantage is to receive the much-needed capital contributions. Other than that, all the banks with strategic investors that were interviewed pointed out various positive results including the improvement in credit risk assessment, strengthening of internal controls, and the reinforcement of a credit culture. These are realized because after becoming strategic investors, the foreign partners send staff to the local bank to share their know-how and technologies, as well as contribute in employee-training programs.

One bank has invited 30 staff members from its strategic partner, spread out over various sections such as retail banking and risk management. Another bank mentioned that it had a five year contract with its strategic investor in a knowledge transfer project, and it was able to absorb know-how in market risk, credit risk, and operational risk management, as well as develop a centralized system for credit appraisal and approval. Yet another bank was able to launch a wealth advisory service for its mass-affluent individual customers, a fairly new service in Vietnam, with the help of its strategic investor.

A strategic investor can also contribute to the improvement in corporate governance. One bank, a SOCB, mentioned that the presence of a strategic investor prompted them to treat all their customers with the same criteria, whether it was a SOE or a non-SOE.

Table 3.2. Investment by Foreign Banks in Vietnamese Banks

Vietnamese Bank	Investor	Nationality of Investor	Stake Acquired
Vietnam International Bank (VIB)	Commonwealth Bank of Australia	Australia	20%
Technological & Commercial Bank (Techcombank)	HSBC	UK	20%
An Binh Bank (ABBank)	Malayan Banking Bhd (Maybank)	Malaysia	20%
Dong Nam A Bank (SeABank)	Societe Generale	France	20%
Phuong Dong Bank (Oricombank)	BNP Paribas	France	20%
Phuong Nam Bank (Southern Bank)	United Overseas Bank	Singapore	19.9%
Bank for Foreign Trade (Vietcombank)	Mizuho Corporate Bank	Japan	15%
Asia Commercial Bank (ACB)	Standard Chartered	UK	15%
Export Import Bank (Eximbank)	Sumitomo Mitsui Financial Group (SMFG)	Japan	15.13%
Vietnam Prosperity Bank (VPBank)	Overseas Chinese Banking Corp	Singapore	14.88%
Sai Gon Thuong Tin Bank (Sacombank)	ANZ	Australia	10%
Hanoi Building Bank (Habubank)	Deutsche Bank	Germany	10%

Source: Reuters. "Vietnam Banks' Assets, Registered Capital." November 16, 2011.
Note: Based on announcements.

3.2. Roles of the Banking Sector

3.2.1. Recent Changes in Banking Environment and Industry Developments

a. Banking Reforms

One of the most important issues of the government is to strengthen the banking sector. In a country like Vietnam that has an underdeveloped capital market, the economy must rely on banks to collect capital which will be sent efficiently to areas that are most in need. This is especially true as the communist government is pursuing a shift to a market economy where the private sector is responsible for capital allocations.

A strong and healthy banking sector is also important to avoid the so-called "middle-income trap." This is a situation that middle-income countries tend to fall into, where they lose out in competition from both low income countries with low-priced products as well as advanced economies with highly value-added products, resulting in prolonged periods of stagnant growth and not being able to move on to the next stage of development. Vietnam has just reached "lower-middle-income" status and therefore still has some way to go before it needs to start worrying about this trap. The country nonetheless needs to focus on maintaining macroeconomic stability and sustainability, while investing more on infrastructure and further strengthening the private sector, in order to avoid the trap in the future. Finance plays a critical role in addressing all these challenges, bringing about the importance of banking reform.

Strengthening the banking sector is also an imminent issue with the increasing presence of foreign banks. As mentioned earlier, Vietnam's commitment under WTO has opened up the banking sector to foreign players including global banks with strong capital bases and attractive products. Therefore, enhancing the competitiveness of the domestic banks has become crucial to keep them from being forced out of the market.

The government has undertaken various reforms to strengthen the banking sector. Equitization of the SOCBs is one of the key areas. Another is strengthening the capital base of the banks. The weak capital base has been frequently pointed out as one of the most serious problems in the banking industry. In an attempt to address this issue, the SBV implemented stricter rules on capital requirements.

First of all, it increased the minimum nominal amount of capital the banks were required to hold. In the decree issued in November 2006[49], the SBV announced that all commercial banks must hold at least VND 3 trillion (US$144 million) in chartered capital by the end of 2010, a substantial increase from the prior minimum of VND 70 billion (US$3 million). The deadline was extended by one year to the end of 2011, as it became obvious that quite a few banks were not able to meet the deadline. But since then these banks have been rushing to increase their capital, and most of them have completed their requirements by the new deadline.

Secondly, the SBV raised the minimum capital adequacy ratio (CAR), which measures total capital as a percentage of risk weighted assets, from 8% to 9% in May 2010, effective October 2010[50]. However, Vietnam still adheres to Basel I based standards.

These new rules on stricter capital requirements are also expected to become triggers of consolidation, in which the smaller banks that cannot meet the requirements would be motivated to merge with others.

Besides these measures, the government has been working on improving the banking infrastructure such as upgrading the interbank payment system, the financial

[49] Decree No.141/2006/ND-CP.

[50] Circular No.13/2010/TT-NHNN.

safety net, and credit information center. These are necessary for banks to operate in a smooth manner.

Raising the banking penetration rate is also important to make full use of domestic savings for economic development. In an attempt to integrate banks into the daily lives of the people, the government has started paying their employees through bank accounts instead of handing out cash. In this way, employees will need to open bank accounts to receive their salaries, and routine withdrawal of money from their accounts is expected to familiarize them with banking in general. At the end of 2009, 46% of state government employees were paid in this way. This method of paying salaries through bank accounts has been spreading among many private businesses as well, since it is convenient for both employers and employees, contributing to the formalization of savings.

b. Recent Banking Regulations

The government is at present working on curbing credit growth in the country. Bank loans have been growing by more than 20% per annum since 1999, peaking at 53.9% in 2007, but are still surging in double-digits since then. This resulted in domestic credit by the banking sector reaching 135.8% of nominal GDP in 2010, as mentioned earlier. This ratio is not necessarily out of line with other countries in the ASEAN region: in Malaysia it is 132.2% and in Thailand 135.5%. What is of concern is that Vietnam reached this level in such a short period. (Figure 3.1.)

During the stock market bubble in 2006 - 2007, it is believed that a significant portion of bank credit went into speculative investments in equity. However, even after the burst of the bubble, credit kept on expanding, mainly to corporations and real estate investments. The flood of credit, in addition to prompting inflationary pressures, has been raising concerns about underwriting standards of the banks: that a certain portion of the loans were made without strict scrutiny, and would end up in non-performing loans (NPLs). Another concern is that corporations, with easy money in hand, have used the funds ineffectively such as investing in non-core areas, not contributing to the much-needed increase in productivity of the economy.

In an effort to tame this over-extension of credit, the SBV has been ordering the banks to restrict overall credit growth to be within a certain range. For the year 2011, it capped the growth rate at 20% compared to the previous year for total loans and 16% for lending to non-productive sectors, including real estate.

It also imposed a cap on interest rates at 6% per annum for VND deposits that were non-term or less than one month, and 14% for VND deposits of one month or more, as well as capping the interest rate at 2% for US dollar deposits. The caps are intended to make it difficult for banks to collect deposits, and thus curb lending, as banks in Vietnam rely heavily on deposits to fund their loans.

As discussed later, the interest rate caps were first imposed in December 2010, but were breached by many banks until September 2011 when the SBV started to strictly enforce the rules. This resulted in a shift in deposits from small to large institutions, as people preferred to deposit their money at large institutions that were presumably safer than their smaller peers, if the interest rates were the same. Small banks are particularly reliant on deposits to satisfy their funding needs, but they usually have smaller networks than their larger peers and so have to depend on high interest rates to attract deposits. The cap weakened this tactic and as a consequence, small banks have been suffering from liquidity difficulties. Recent rumors are that some banks are again breaching the interest rate caps.

3.2.2. Corporate Banking

a. Main Features

Corporate banking plays a dominant role in the Vietnamese banking system. Banks historically have been corporate lenders, and even after diversification to other fields such as small- and medium-sized enterprises (SMEs) and retail, lending to corporations remains the pillar for profits at most of the banks.

Although corporate banking is in principle relationship-based, banks have been experimenting with implementing objective tools in the management of the loans. Some banks use in-house scoring systems for underwriting and monitoring the loans. For the scoring system of one bank that was interviewed, 40% of the score was based on financial aspects and the remaining 60% on non-financial aspects, such as ownership of the company, management, experience in the business, and market share.

A large chunk of the demand for corporate banking comes from SOEs, as many of the large corporations in Vietnam are state-owned. As discussed previously, SOEs have been going through equitization since 1992, resulting in a substantial decrease in the number. However, equitization has taken place mostly in fairly small SOEs. The ones that are considered to be strategically important for the country, which are usually large in size, have been excluded from the equitization plans.

SOCBs had historically been the main lenders to SOEs. As mentioned earlier, the two entities have maintained close ties with each other, even after formal policy lending from SOCBs to SOEs had ceased. There also persists informal government intervention in commercial lending decisions of SOCBs, including those concerning SOE lendings, albeit to a much smaller degree than in the past. SOEs are regarded as being lower in risk given the government's stake. As a result, SOEs still have fairly easy access to credit, being able to enjoy numerous privileges not given to private enterprises.

Favorable treatments towards SOEs are said to have crowded out credit to private enterprises, bringing adverse implications for the development of the private sector. What is worse, many of the SOEs have low or negative profits, reflecting inefficient operations. The default of Vietnam Shipbuilding Industry Group (Vinashin) in

December 2010 on a US$ 600 million syndicated loan highlighted the inefficiency, poor corporate governance and lack of transparency of the SOEs. This is why credit allocation in favor of SOEs is considered to have a negative effect on the domestic economy as a whole.

b. Recent Issues

In addition to curbing over-extension of credit to the corporations, the government is tackling the problem of investment in banks by SOEs. In an attempt to strengthen the SOEs to become internationally recognized companies, the government consolidated several enterprises to form economic groups. There are at present 12 of them, large in size and involved in key areas such as oil, construction, electricity and telecom. These economic groups as well as large non-financial SOEs invested in JSBs and finance companies, mainly during the period of lax money in 2007 and 2008, as they sought to broaden their business to non-core areas to become conglomerates, as well as to gain quick returns. The Ministry of Finance reported that total investments outside their core businesses reached over VND 21,800 billion (US$1 billion), of which VND 10,128 billion (US$0.5 billion) was invested in banks. This is a sizable amount, when considering that total chartered capital of the 37 JSBs is VND 158 trillion (US$7.5 billion).

This brought about concerns that the banks and finance companies would provide easy credit to the economic groups without sufficient underwriting procedures, and any losses would be covered by additional funding, thus undermining the health of the banking sector. The government, acknowledging such dangers as well, later on prohibited these companies to invest in the financial sector, while it required those that had already made investments to unwind them. The government recently reiterated this policy, but it will take some time before the divestiture of the investments is completed.

3.2.3. SME Banking

a. Main Features

Small- and medium-sized enterprise (SME) lending is one of the fastest growing areas in banking, reflecting the rapid expansion of SMEs in the country. The Enterprise Law in 2000 eliminated numerous regulations that had acted as barriers to start private businesses, and since then there has been a remarkable increase in the number of establishments. Most of them are small in size, as they are usually fairly newly established and serve in areas that the large SOEs had not had a grip on. They nonetheless have become important engines to the growth of the economy as well as major sources of generating new jobs. Since the pie of SME businesses is growing rapidly, there have emerged various opportunities for banks to build business relationships with them.

JSBs used to be the dominant lenders to SMEs, but in recent years SOCBs have been entering this area, competing with JSBs to lure SME customers.

As discussed previously, credit is still allocated disproportionately to SOEs. There is no denying that SMEs are able to gain access to credit much more easily than in the past, due to higher competition among the banks, but obstacles still remain. According to the Enterprise Surveys by the World Bank (2009), the top constraint to SMEs' business in Vietnam was "access to finance", as pointed out by 24.7% of the respondents, exceeding the 19.3% that chose "practices of competitors in the informal sector" and the 13.3% that chose "transportation"[51]. A different survey by the Ministry of Planning and Investment revealed that just one-third of Vietnamese SMEs could receive loans from banks[52]. The SMEs that do not have access to bank loans must therefore finance their activities out of reinvested earnings or through informal loans.

b. Obstacles to SME Lending

Other than the dominance of SOEs, a major hurdle to SME lending is the persistence of information asymmetry problems. Although information asymmetry is prevalent in SMEs anywhere around the world, it is especially strong in Vietnam: insufficient accounting and auditing practices result in the lack of transparency and accuracy of their financial information. Many SMEs do not maintain financial records that adhere to a complete accounting system, while independent auditing is still not the norm. One bank mentioned that it was common for SMEs to have one book for tax purposes and another to show to the banks. Weakness in the institutional framework such as underdeveloped bankruptcy procedures also discourages banks to lend to SMEs.

Information asymmetry brings about a cautious approach in the banks' underwriting procedures of SME loans. They are usually cumbersome and require various documentations. Banks are also watchful for early warning signals after giving out the loans. One bank that was interviewed mentioned that their branch staff either phoned or visited its SME clients once a week. Since banks have to go through such lengthy procedures with heavy reliance on human power, they assumably have little choice but to limit the number of loans.

Banks tend to focus on collateral rather than business prospects when giving out loans, which is also mainly due to information asymmetry problems. This leads to the second hurdle to SME lending, which is insufficient collateral on the part of the SMEs. Almost all the banks that were interviewed said that they asked for collateral when making loans, mainly in the form of real estate, or to be specific, certificates of land-use rights[53].

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51 The World Bank. "Enterprise Surveys: Vietnam (2009)." 2009. p.4. (http://enterprisesurveys.org/Data/ExploreEconomies/2009/vietnam#finance)

52 Vietnam Investment Review. "Only one third of SMEs able to get bank loans." May 12, 2011.

53 All land belongs to the People and is administered by the State. "Land-use rights" are allotted or leased to individuals and organizations. Ownership of buildings is permitted.

The results from the Enterprise Survey by the World Bank coincide with this: 90.8% of the loans required collateral in Vietnam, much higher than the 78.1% in the whole East Asian region. This percentage is a whopping 99.9% for small enterprises with 5 to 19 employees, while the regional average is 82.8%. According to the same survey, the value of collateral that is necessary for the loan is also much higher: the average in Vietnam is 217.7% of the loan amount, compared to the 172.9% in other East Asian countries. It is therefore understandable that many SMEs face difficulties in meeting collateral requirements. SMEs usually do not hold sufficient assets that can be handed in as collateral, especially in urban areas where access to land-use right is limited.

3.2.4. Retail Banking

a. Main Features

Retail banking for individual and household enterprise customers is fairly new in Vietnam. The successive years of rapid expansion of the economy brought higher income and more savings to the population. However, it was not until recently that people started to put their savings into bank accounts instead of keeping them under mattresses. This is due to several factors, one of them being wide-spread distrust towards the banking system. This was brought forward by bad experiences from the collapse of credit cooperatives in the early 1990s[54], as it resulted in massive numbers of depositors losing their savings.

The lack of confidence toward the banking system has receded somewhat after numerous efforts by the government, including policies to strengthen the monitoring role of the SBV and establish financial safety nets. In the meantime, banks themselves have actively sought to attract deposits in order to strengthen their funding base to match the strong demand for loans. They have been offering new products and better services as well as expanding their branch networks and ATMs. There are at present 2,200 bank branches in the country (December 2011 figures), and ATMs can now be found even in rural areas. Thanks to these efforts, the banking system has become more and more familiar in everyday life, especially for the people living in urban areas, contributing to a higher banking penetration ratio of 10 - 20%.

As mentioned earlier, interest rates are now capped at 14% per annum for VND deposits, and this, along with an inflation rate around 20%, has made it difficult for many banks to attract deposits.

Banks usually handle not only VND but also foreign currency and gold deposits. In Vietnam, people have strong preferences to hold US dollars and gold as assets,

[54] In the 1980s, credit cooperatives expanded rapidly to serve the agricultural households and SMEs, and at its peak there were more than 7,000 of them scattered around the country. However, due to their engagement in poorly-managed and sometimes fraudulent activities, nearly all of them collapsed in the early 1990s, and without deposit insurance at that time, resulted in massive losses in savings of the depositors.

reflecting the low confidence toward their own currency. Although most of these assets are held informally[55], a portion is being deposited in banks. The SBV has been attempting to discourage US dollar and gold deposits in order to prevent the dollarization and goldization of the economy, that is, the over-reliance of the economy on the US dollar and gold. The interest rate cap for US dollar deposits is set at 2%, much lower than the 14% for VND deposits. In the meantime, gold lending was prohibited for credit institutions after May 1, 2011, while gold deposit activities will be prohibited starting on May 1, 2013[56]. It remains to be seen whether these rules will be adhered or not, though.

b. Obstacles to Retail Lending

Banks in Vietnam are still principally corporate lenders, and retail lending accounts for a relatively small share in the business for the majority of the banks. Most banks usually only offer basic products such as housing, automobile and car loans, to a limited degree.

The biggest obstacle to retail lending is insufficient information about the customer. The Credit Information Center was established in 1999 as an independent unit under SBV. The CIC collects information for both individuals and corporations, such as the customer's outstanding loans, loan guarantees, and bad debt. Credit information has been gradually piling up, but is still not sufficient for credit judgment. Also, although the situation is improving, there still remain problems of data not updated promptly and at times incorrect. Even information of defaulting on a loan may not show up due to errors.

It is also difficult to grasp the accurate income picture of the individual customer. Banks cannot rely on income statements prepared by the employers, as they can be easily manipulated. Also, quite a few people have multiple sources of income so that just looking at one income statement is not enough. Therefore, banks need to cross-examine various documents in order to get hold of the true income picture, which makes the underwriting process long and labor-intensive. One bank that was interviewed mentioned that it requires the customer to hand in income documents of the spouse as well when applying for a loan.

A few banks are starting to offer products that go beyond basic. For example, one bank is working on offering "priority banking" services such as wealth management to

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[55] There is no accurate figure for the amount of US dollar and gold assets hoarded in the country, as a significant percentage is held informally by individuals. The World Gold Council ranked Vietnam second in the world after India for hoarding gold: it was estimated that Vietnam held between 460 and 1,000 tons of gold worth US$21 to $45 billion. (Vietnam Net Bridge. "Vietnam is world's 2nd largest gold hoarder." June 16, 2011.) Meanwhile, the National Financial Supervisor Commission's Deputy Chairman Le Xuan Nghia said in a speech he made in June 2011 that the country's gold holdings ranged between 20 and 45% of the GDP. (IBTimes. "Vietnamese Gold Rush Gathering Momentum." June 14, 2011)

[56] Circular No.11/2011/TT-NHNN issued by the SBV in April 2011.

its retail customers who have more than US$100,000 in deposits. At the point of the interview, the bank had just finished screening the customers that fell under the criteria, and was preparing to offer the new services to them.

Another bank is marketing different deposit products according to the customers' income. For lower-income customers, it offers installment savings accounts of small amounts, for example, US$10 per month. For middle-income customers, it offers bonus interest rates and additional services when the deposit amount reaches a certain threshold. For customers with high-income, it offers a special account in which the funds are transferred to the products with the highest return from time to time.

Internet banking is not yet popular in Vietnam. Even though some banks offer this service, there are flaws in safety measures and it is considered unsafe.

3.2.5. Payment System

a. Interbank Payment

The SBV has been working on the modernization of the interbank electronic payment system. In 2009, the second phase of the Interbank Payment System (IBPS) was completed and put into operation, bringing improvements in various aspects such as processing capacity and operational procedures. The IBPS is directly managed and implemented by the SBV, and is composed of two sectors, RTGS (Real Time Gross Settlement) and RPS (Retail Payment System). High value payments of VND 500 million (US$24,000) or more are handled by the RTGS, while the RPS is for low value payments of less than VND 500 million. As of June 2011, the IBPS connects the 66 subsidiaries of SBV and nearly 800 branches of 99 credit institutions. The system processes on average 60,000 to 70,000 transactions per day.

Even though the IBPS has shown substantial improvement in recent years, there still remain issues that need to be addressed: limited participation, occasional errors in connections, overload when the number of transactions becomes large, lack of supporting staff, to name a few. Moreover, the IBPS has not fully covered the total payment flow of the economy. Bilateral payment still accounts for a relatively large proportion of interbank payments, while securities payments and settlements as well as foreign currency payments are processed not through the IBPS but through commercial banks.

b. Card Payment

Cash is king in Vietnam, especially among individuals. The government has been working on the expansion and development of non-cash payments in Vietnam. One of the measures is to promote card payment. The number of payment cards in circulation reached 34 million in the end of June 2011, more than a ten-fold increase compared to five years ago. 51 banks issued cards with over 240 card brands. Meanwhile, installment of ATM machines and POS devices expanded at a remarkable pace. There were nearly 12,000 ATMs and about 58,000 POS devices by the end of June 2011. Three major card alliances, Banknetvn, Smartlink, and VNBC offer financial switching that interconnects the payment card systems of their member banks. The ATM networks of the three alliances are now connected with one another, enabling cardholders to initiate transactions at nearly all the ATMs in the country.

Despite these developments, payment card transactions are still low, accounting for less than 5% of total payments. Most of the payment cards are debit cards that can be used to deduct sums from bank accounts at ATMs as well as make purchases and payments. However, even though people in general use the cards at ATMs frequently, they seldom use them at the POS. In fact, a survey revealed that only 3% of the cardholders knew that their cards could be used for purchases and payments[57].

Credit cards are not yet common in Vietnam. They are held by a limited number of people and are used mainly at large or high-end stores. Issuing banks, merchants, and cardholders all face obstacles that prevent the issuance, acceptance and usage. Regarding the issuing banks, lack of personal credit information forces them to be cautious in giving out the cards, although they have become more willing than before.

As for merchants, they are reluctant to offer credit card payment options as they do not want to pay the accompanying acceptance fees. Some of the merchants pass on the fees to the cardholders, even though this is prohibited. That leads to the reluctance of the cardholders to pay by credit cards. In some cases it may be inconvenient to use the cards: for example, the terminal in supermarkets is sometimes installed at the customer service counter, not at the register.

In spite of these obstacles, some of the innovative banks see great potential in credit cards and are committed to growing the business. One bank has an in-house credit rating system and changes the upper limit of credit according to the rating of the cardholder. Another bank offers a service to prevent fraudulent usage, that every time the cardholder uses the card, a short message is sent to his/her mobile phone.

3.3. Banking Sector Challenges

3.3.1. Issues on Reform

One fundamental reason for the weakness of the banking sector, or of the whole financial sector in Vietnam, is its weak currency. Low confidence among the public towards the VND has led to the dollarization and goldization of the economy, reducing the effects of monetary policy while hindering the development of formal finance. A stable macro-economic environment is therefore a prerequisite for the health and sustainable growth of the financial sector.

On top of that, further modernizing the banks is a crucial issue for the country.

[57] Cimigo. “Tech-centricity or Customer-centricity?” December 2009, p.20. (http://www.cimigo.vn/en-US/ReportDetail.aspx?ProductId=167)

Although the Vietnamese banking sector has gone through various reforms that have resulted in enhancing the effectiveness of the industry and strengthening the financial system as a whole, it has still not caught up with international standards and there still remains a host of challenges that need to be addressed. The most frequently pointed issue is the independence of the SBV. This has been one of the major causes for the instability of both the financial sector and the macro-economy.

The following focuses on three other interrelated challenges that the country faces; strengthen the supervisory capacity of the SBV, allow more market mechanism to the banking sector, and consolidate the banks.

a. Strengthening of the Supervisory Capacity of the SBV

Many banks that were interviewed pointed out that a number of banks with lax governance and compliance policies were disrupting the whole industry. These banks tend to put high priority in increasing volume and gaining market share, and the way they pursue them is by giving out loans easily without enough scrutiny while collecting deposits at comparatively high rates. They even sometimes do not follow the rules set by the SBV, bringing about unhealthy competition.

A good example is the frequent breaches by many banks of the 14% cap on deposit interest rates before the SBV started to enforce the rules strictly with severe penalties. Some banks straightforwardly offered interest rates above the cap, while others came up with creative tactics so that depositors could receive the equivalent of interest rates above the cap. In any case, these banks attracted deposits away from the banks that adhered to the cap. Furthermore, some banks seem to be breaching the cap again recently. Not only low standards of compliance by the banks, but also lax management and weakness in inspections on the part of the SBV, allow such violations.

To tackle this problem, the SBV needs to strengthen its supervision capacity. It is important for the SBV to undergo fundamental restructuring of their organization and operations as well as staffing so that it can supervise the banks more closely and effectively.

b. More Market Mechanism in Banking Sector

The health of the Vietnamese banking sector is of increasing concern, as it faces mounting NPLs and liquidity problems. However, the government has affirmed that it will not allow bank failures. In October 2011, the SBV released a notice in which it vowed that it would not let any bank to collapse[58], followed by a similar statement made at a regular press conference by the Minister of the Government Office Vu Duc Dam in November 2011[59]. The government fears that a single bank failure might bring about a domino effect in which the whole banking sector would be seriously affected.

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[58] Saigon Money.com. "SBV vows not to let any banks out of control." October 25, 2011.
[59] Vietbiz24. "Vietnam Govt pledges no collapse of the banking system." November 5, 2011.

This stance is in a way natural when considering the weakness of the present banking sector, but nonetheless brings various side-affects, the most serious of them moral hazards. All the banks that were interviewed mentioned that the SBV would never allow any banks to fail, that it would come to the rescue to save the troubled banks. Such kinds of notions, while contributing to the short-term stability of the banking system, tend to lead to reckless operations and irresponsible management on the part of the banks.

It is therefore important that once the banking sector stabilizes, the government shifts to a stance that allows market mechanisms to work, making clear that it will not bail out troubled banks. Setting out rules for an orderly exit when necessary will also be needed. When looking back at history, the Vietnamese financial sector is not immune to failures and consolidations. There once used to be more than 50 JSBs but they were dissolved or consolidated to the present 37, while more than 90% of the credit cooperatives collapsed in the early 1990s.

c. Consolidation of the Banking Sector

The need for consolidation to strengthen the banking sector was pointed out over and over again by the banks that were interviewed. They recognized that small banks with weak performances eroded the stability of the whole banking sector, and that they needed to be consolidated to become stronger.

The SBV also has been sharing this view. As recently as in October 2011, the SBV unveiled its strategy to put emphasis on consolidation and restructuring of the banking system over the next five years.

Consolidation has already started to take place. In mid-2011, Lien Viet Bank (LVB) and Vietnam Postal Savings Service Corporation (VPSC) merged to become Lien Viet Post Joint Stock Bank (LVPB). VPSC, a subsidiary of state-owned Vietnam Post Corporation (VNPost), had been suffering from losses and was insolvent.[60] This deal is considered as a resolution method in which LVB, a small but healthy JSB established in 2008, agreed to purchase all assets and assume all liabilities of VPSC. LVB's aim through this merger was to expand its retail banking operations, taking advantage of the nationwide network of VNPost. There are at present 11,000 post offices across the country, including remote areas with no existing bank branches, and the newly established LVPB will be able to use them as retail outlets.

In October 2011, state-owned BIDV signed bilateral cooperation agreements with Bac A Commercial Joint Stock Bank (BacA Bank) and Global Petroleum Commercial Joint Stock Bank (GP Bank) to provide liquidity support of VND 5 trillion (US$240,000) and VND 3 trillion (US$144,000), respectively. There were rumors that the two banks

60 The main reason that VPSC became insolvent was that, in order to win deposits, it set interest rates that were higher than the interest rate it received from the Vietnam Development Bank, the policy bank that VPSC was required to deposit a set amount of funds into.

were facing liquidity problems and they needed support from a large institution, although BIDV denied this. BIDV also reached agreement with De Naht (First) Joint Stock Commercial Bank (Ficombank) in November 2011, where BIDV would provide credit to Ficombank of up to VND 5 trillion (US$240,000).

Then in December 2011, the SBV approved the merger of three small banks based in Ho Chi Minh City: Ficombank, Tin Nghia Joint Stock Commercial Bank (TinNghiaBank), and Saigon Joint Stock Commercial Bank (SCB). According to the news release by the SBV, all three banks "were facing liquidity problems due to the utilization of a large amount of short-term deposits to extend medium and long-term loans."[61] The SBV had supported liquidity for the three banks previous to the approval of the merger, and the merger itself was in line with the SBV's policy of a comprehensive restructuring of the banking system. The SBV assigned state-owned BIDV to cooperate with the three banks as a state representative. BIDV will be responsible to fully support post-merger operations to ensure that the merger would go smoothly, including sending staff to the executive board and other key divisions. This merger is seen as the first step to the consolidation that had been much anticipated to strengthen the banking sector.

3.3.2. Issues on Strategies

a. Effective Implementation of Advanced Skills and Technologies

The Vietnamese banks themselves acknowledge that they need to strengthen and modernize themselves in order to compete with both domestic and foreign institutions. The large players in particular have been working intensively to enhance their competitiveness by restructuring their organizations and operations, as well as developing internal control and audit systems to improve their risk management. In this process, some of the large banks have hired global consultants such as McKinsey and Deloitte, in an attempt to adopt international standards. For example, McKinsey has been working with one bank to enhance their banking strategy, while working with another to apply an in-house rating system to assess credit risk, and yet another to make suggestions as to how to improve their banking operations.

One issue is that these efforts have not yet been reflected in their actual banking operations. The corporate customers that were interviewed expressed dissatisfaction towards the service level of the banks: one mentioned the difficulties in negotiating with the banks as they changed their policies frequently or lacked flexibility, while another pointed out that the staff was not adequately trained and was short on professionalism.

The banks may have introduced advanced systems and technologies that are close to international standards, but they still lack the proper skills to make them work effectively. It will also take time and experience to gain the expertise and know-how in

[61] The State Bank of Vietnam. "Three commercial banks to be merged." (What's new). December 6, 2011. (http://www.sbv.gov.vn/)

management skills. Especially for the JSBs that have been seeing rapid expansion of their organizations in recent years, they may be behind in training their staff to reach satisfactory levels.

b. Further Strengthening of the Capital Base

In addition to the efforts to improve their management and operations, there has also been a rush to strengthen the capital base not only among the small banks to adhere to the VND 3 trillion (US$144,000) capital requirements, but also among the major banks whose chartered capital well exceeds the required level. More than ten banks have increased their chartered capital during 2011, including state-owned BIDV and VietinBank as well as JSBs such as Techcombank and Eximbank. These banks are injecting capital as a buffer against potential losses as well as for future expansion plans.

The efforts are viewed positively by the international financial community, as there have been concerns that the Vietnamese banks were thinly capitalized in comparison to other banks in the region. Further efforts are necessary, though. Credit has been expanding rapidly, and there needs to be thicker capital buffers to shield the banks in case of deterioration in asset quality.

c. Educating Retail Customers

Strengthening the retail arena will contribute to a more diversified lending portfolio for the banks. Insufficient information about individuals is a big obstacle to retail lending, as mentioned earlier. Another reason that cannot be neglected is that people in general do not have sufficient financial knowledge. One bank that was interviewed mentioned that many people simply did not understand the nature of financial products. Another said that the reason most banks did not offer products that go beyond basic was that people would not be able to understand them.

Therefore, banks need to educate the individuals on financial knowledge. One bank has already started this along with offering wealth advisory service for its mass-affluent individual customers, a service fairly new and unknown in the country. The bank goes out of the way to explain in detail about how the service works through direct contact as well as through seminars that it organizes. Such kinds of efforts in a broader sense will serve to empower the customer, and will eventually lead to promoting retail lending.

3.3.3. International Issues

Banks in Vietnam predominantly operate within the borders. They are usually too small and too inexperienced to go abroad. Even the country's largest bank, Agribank, is equivalent to a medium-sized bank in the Southeast Asian region. The rapid expansion of the domestic banking sector also allows them to stay at home and seek profit opportunities. Most of the very few banks that do have operations abroad have branches in the neighboring Lao PDR and Cambodia. For the Vietnamese banks, therefore, competition with foreign banks mostly occurs within the country.

Some banks that were interviewed expressed concern about the ASEAN Economic Community starting in 2015, in which financial services will be liberalized within the region. They mentioned that banks in Vietnam were weaker than their peers in other countries in terms of technology, human resources, and size, so they would face tougher competition with the opening of its financial markets to ASEAN banks.

3.4. Health of the Banking Sector and Financial Safety Nets

3.4.1. Safety Net Measures and Current Situation

a. Deposit Insurance

Vietnam's financial safety net is gradually taking shape. Deposit insurance was introduced in 2000 with the establishment of the Deposit Insurance of Vietnam (DIV), a state-run entity responsible for protecting depositors. According to the Law on Credit Institutions, all deposit-taking credit institutions must participate in deposit insurance, paying an annual premium of 0.15% (flat rate) of the average balance of all insured deposits. The deposits being insured are for VND only, and the maximum insurance coverage amount is VND 50 million (US$2,400) per individual per bank. As of the end of 2010, the DIV has made insurance payment of more than VND 18 billion (US$864,000) and recovered nearly VND 8 billion (US$384,000). The DIV is also responsible for the examination and supervision of the insured credit institutions.

The present deposit insurance system has shortcomings that need to be dealt with. The insurance coverage of VND 50 million (US$2,400) is considered too low to ensure the confidence of the depositors. This amount has remained unchanged since 2005 while the inflation rate has gone up by more than 50%. The low financial capacity of the DIV is another concern. The reserve ratio (the ratio of deposit insurance fund to total insured deposits) is 1%, much lower than the 2.5 - 3% often seen in other countries.

Meanwhile, the National Assembly is working on passing the country's first Deposit Insurance Law in 2012. Currently, deposit insurance is regulated by the decrees of the government, in the absence of any specific law[62]. Passage of the Deposit Insurance Law is expected to strengthen the legal framework to protect the rights of the depositors and increase confidence towards the banking system.

One area of controversy is the coverage of deposit insurance. The coverage of only VND deposits is meant to be consistent with the government's policy to fight against dollarization and goldization, that is, to lower the economy's reliance on the US dollar

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[62] The current legal framework on deposit insurance are Decree No.89/1999/ND-CP of the government on deposit insurance, and Decision No.218/1999/QD-TTg of the Prime Minister on the establishment of the DIV.

and gold. However, some insist that foreign currencies and gold should be covered also, so that people would be encouraged to put such assets in banks instead of hoarding them privately. In this way these assets would be available for the country's economic development.

b. Other Safety Nets

Another important financial safety net is the SBV's function as lender of last resort. According to the Law on the State Bank of Vietnam 2010, the SBV will consider and decide to give special loans to credit institutions that fall into insolvency or are facing insolvency (Item 2 Article 24).

There are rules on addressing credit institutions that face financial difficulties. In accordance with Item 3 Article 146 of the Law on Credit Institutions 2010, the SBV will consider and put credit institutions facing insolvency under special supervision. This scheme includes measures such as assigning inspectors from the SBV to directly supervise day-to-day operations of the credit institution, requiring that the credit institution implement appropriate measures to deal with the weak performance or unsafe/unstable activities, and requiring the credit institution to submit regular reports on the implementation process. In case the credit institution fails to show any positive recovery in its liquidity and falls into bankruptcy, the SBV will withdraw its license after the termination of its special supervision plan. Asset liquidation will be implemented in accordance to the Bankruptcy Law.

Other mechanisms of financial safety nets set by the SBV include a wide range of prudential regulations applied to credit institutions as well as off-site and on-site supervisions. One problem is the insufficiency in the supervision and monitoring capacity of the SBV, as mentioned by a number of interviewees, bringing doubts to the efficiency of the actual implementation of these measures.

3.4.2. Effects of the Global Financial Crisis and Measures to Cope with Stricter Regulations

Many of the banks in Vietnam were negatively affected by the 2008 global financial crisis through sluggish international trade and reduced FDI inflows. They saw the asset quality of their export customers deteriorate with the plunge in exports, as well as less fee income coming from international transactions. However, all in all, the banking sector weathered the global financial crisis fairly well.

One reason is that the macro-economy maintained solid growth during the crisis, thanks to aggressive stimulus measures by the government. The country was able to achieve solid real growth rates of 6.3% in 2008 and 5.3% in 2009, even though they are lower than the average rate of 8.4% during the previous three years (2005-2007).

A more important factor is that banks in Vietnam are not yet integrated into the global financial markets. As mentioned earlier, the banking sector in Vietnam is still in its infancy and is in the process of establishing itself within the country, thus it does not have the luxury or the necessity to make investments abroad. Most of the banks have no branches out of the country, nor have sizable investments in foreign financial assets.

Deleveraging by foreign banks has not occurred in a noticeable way, either. This may be partly due to the fact that strategic investors are required to lock in their investments in the local banks for five years. On the other hand, HSBC increased its stake in Techcombank from 10% to 20% in 2008, while BNP Paribas increased its stake in Oricombank first in 2009 from 10% to 15%, then in 2011 to 20%. Commonwealth Bank of Australia also raised its stake in VIB from 15% to 20% in 2011. The fact that these three foreign banks increased their shares in their strategic investments may reflect continued commitments of foreign banks in the Vietnamese banking sector despite difficulties at home.

Another reason for the limited impact of the global crisis is the strict capital control measures imposed by the government. Short- and medium-term capital inflows are restricted, while transferring money out of the country is difficult. Along with the sluggish stock markets in recent years, this prevented a rapid inflow of speculative money to the country, as well as an abrupt outflow in the wake of the crisis.

Stricter regulations imposed in the international financial community after the crisis has not reached Vietnamese banks. Vietnam still adheres to Basel I rules, and at the moment is working on the implementation of Basel II. It is true that the regulatory environment has become stricter for the Vietnamese banks, but that is mainly for the purpose of catching up with international banking standards rather than to avoid the next financial crisis.

3.4.3. Challenges and Risks

The gradual rise in nonperforming loans (NPLs) has aroused concerns on the health of the banking sector in Vietnam. The NPL problem is not new in the country: it has always been an issue especially for the SOCBs. It used to be that SOCBs, as policy lenders, were not able to reject lending to SOEs or state projects even if they were not commercially viable, resulting in a pile-up of NPLs. The government has in the past injected public money to reduce the NPLs, but it is believed that the SOCBs still have substantial amounts left in their balance sheets.

The recent surge in NPLs is due to weak exports reflecting the global economic slowdown, as well as tighter credit controls, both of which hurt borrowers. According to SBV figures, NPLs accounted for 3.4% of total loans at the end of October 2011, rising from 2.2% at the end of 2010.

What makes the NPL problem in Vietnam troublesome is that these figures are widely regarded as unreliable. Even though the Vietnam Accounting Standard (VAS) is based on the international accounting standard, there are some gaps in important areas including the definition of NPLs. The SBV introduced in 2005 new rules for classification of NPLs, which brought the VAS closer to International Financial Reporting Standards (IFRS)[63], but discrepancies still remain. Differences between VAS and IFRS include loan loss provisioning, accounting for investment activities, and financial liabilities[64]. Also, there is ample room for discretion on the side of banks in applying the method, resulting in the difference in NPL standards from bank to bank. Some banks do not even disclose their NPLs to the public.

The SBV is at present working on unifying the classification standards while improving transparency, but in the meantime there will always be suspicion and doubts over the official NPL figures, undermining the overall confidence towards the banking sector. Moody's reported that bad loans under IFRS can be up to three times more than those under VAS[65].

Although the rise in NPLs is a serious matter, there is little concern among the interviewees that it will lead to a financial crisis. First of all, there is great confidence toward the SBV, that the central bank would rescue the troubled bank in danger of a bank run. Secondly, they mentioned that it was difficult to find a trigger that would cause a financial crisis. As long as the economy continues to grow at a fairly high pace, this will mask the many problems Vietnam faces including the issue of NPLs. Thirdly, a financial crisis in a developing country is usually accompanied by an abrupt outflow of money out of the country, a situation that is unlikely to happen in Vietnam. The strict control on the foreign exchange, as well as the sluggish stock market, has prevented foreign funds from flooding into the country in the first place. The fact that Vietnam's borrowings from abroad mainly consist of long-term loans in the form of FDIs and ODAs, is also considered to prevent large capital outflows.

[63] Decision No.493/2005/QD-NHNN.
[64] Biallas, Margarete and Kien Dam. "Vietnam: Financial Sector Diagnostic." International Finance Corporation. August 2008. p.17.
[65] Moody's Investors Service. "Banking System Outlook: Vietnam." August 2009. p.3.

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4. Malaysia[66]

Introduction

In Malaysia, since the Asian financial crisis in 1997, drastic restructuring of the banking sector was implemented, and the number of banks decreased sharply. Then, the Financial Sector Masterplan and the Capital Market Masterplan were drawn up by the Bank Negara Malaysia (hereafter the BNM) and the Securities Commission, respectively, and the banking sector and the capital markets have developed steadily. In particular, government and corporate bond markets expanded, and a large part of long-term financing provided by banks was replaced by corporate bond issuance.

Now, a relatively well developed financial system in the Asian region exists in Malaysia. Malaysia's Sovereign rating is A-, its long-term foreign currency rating by S&P.

Malaysia's population was 28.4 million in 2010. Per capita nominal GDP was 8,323 US dollars, and the real GDP was 173.8 billion US dollars. Judging from these figures, Malaysia's market is relatively small, and as the financial system develops more, competition among banks will become harder[67].

On the other hand, regarding demographics, according to the UNESCAP, the growth rate of the working population between 25 to 59 years old will be 10.1% in the period 2010 to 2015, and 8.1% in the period 2015 to 2020. As the averages of Asian countries are 8.0% and 6.5%, respectively, Malaysia's situation is relatively good.

In the above environment, Malaysia's banking sector has been playing a role of supporting economic growth, by responding to the structural changes of the economy after the Asian financial crisis, such as the big decline of the investment rate and the change to an export-led growth strategy, and the constant expansion of personal consumption.

In the future, the tasks for the banking sector are to support economic growth led by domestic demand expansion, and economic integration of the Asian region.

Furthermore, it is observed that Islamic finance is gaining popularity with Malaysians as it advocates ethical financing. This is also reflected at the global level, where the viability of Islamic finance is driven by the increasing global demand for less risky, Shariah-compliant products, particularly in Asia and Middle East.

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[66] For writing this report, the author made a lot of interviews to various authorities and private financial institutions in Malaysia. Also, many of the interviewees were kind enough to comment in detail on the ongoing draft. The author would appreciate all the cooperation from the interviewees. However, the views in this report are strictly from the author's perspective.

[67] The fact should also be recognized that a significant geographical area remains unserved.

4.1. Characteristics of the Banking Sector

4.1.1. Overview of the Banking Sector

a. Structure of Financial Industry

Malaysia's financial institutions are composed of the banking sector and nonbank financial institutions. The banking sector comprises banks and offshore banks. In the latter group, various kinds of pension and mutual funds, insurance companies, stockbroking firms and development financial institutions (hereafter DFIs) are included.

Among these types of banks, commercial banks, Islamic banks and investment banks are the predominant market players. Commercial banks and investment banks are based on the BAFIA (Banking and Financial Institutions Act 1989). Islamic banks are based on the Islamic Banking Act 1983. The first standalone Islamic Bank - Bank Islam Malaysia Berhad (BIMB) - was established in 1983. Commercial banks were permitted to establish Islamic windows in 1993, and started to operate Islamic finance businesses within one institution. The first transformation of an Islamic banking window into a subsidiary was in 2005.

According to the BNM website, there are 25 commercial banks (of which 8 are local), 15 investment banks (all of them are local), 17 Islamic banks (of which 11 are local) and 5 international Islamic banks. While local banking groups have commercial and investment banks as separate institutions within the group, foreign banks operate both businesses within one organization.

The top few Malaysian banks are some of the biggest players in the Southeast Asian region. However, by global comparison, the size of banks is relatively small. Maybank, the biggest commercial bank, is ranked 134th by *The Banker* (July 2011 edition), and within the top 500 are CIMB Group Holdings (176th), Public Bank (191st), AMMB Holdings (343rd), and Hong Leong Bank (374th).

b. Scope of Businesses

The scope of banking businesses is generally specified under the BAFIA, except investment banks where they are also regulated by the Securities Commission pursuant to the Capital Markets and Services Act 2007 (CMSA2007). Commercial banks have corporate and individual customers, and are involved in deposit businesses (current, ordinary and term deposits), lending businesses (overdrafts, revolving credits, loans with deeds, loans with bills, etc.), domestic and foreign exchange businesses, and so on.

Islamic banks have to follow the principles of Islamic law (Shariah) when they do businesses, but provide mostly the same kind of financial services as commercial banks.

Investment banks are involved in deposit businesses (big-size term deposits), lending businesses (term loans, revolving credits, syndicated loans, etc.), bills discounting, factoring, leasing, securities underwriting, businesses related to establishments, mergers and terminations of corporations, businesses related to share listings, investment advisory businesses, and so on.

Regarding the offshore market, as the ground laws, there are the Labuan Financial Services and Securities Act 2010 and the Labuan Islamic Financial Services and Securities Act 2010.

In 1990, the Labuan International Business and Financial Center (Labuan IBFC) was opened. Its main businesses are out-in transactions, such as foreign currency denominated loans and credit guarantees to residents. The banks in the offshore market receive various tax-related incentives.

Furthermore, the government has established many DFIs as specialized financial institutions. Each of the DFIs has a specific mandate to develop and promote key sectors that are considered of strategic importance to the overall socio-economic development objectives of the country. These strategic sectors include agriculture, small and medium enterprises (hereafter SMEs), infrastructure, maritime, export-oriented sector as well as capital-intensive and high-technology industries.

c. Barriers to Entry and Their Liberalization

Regarding new entry to the banking industry and opening of branches, approvals of the BNM are necessary. Post 2000, the entry of foreign banks has been allowed on a gradual, sequenced and managed approach under the Financial Sector Masterplan.

Since 2000, barriers to entry have been gradually liberalized. In 2003, the BNM permitted foreign banks to enter the Islamic banking industry, and gave licenses the next year to Kuwait Finance House (Malaysia) Berhad, Al Rajhi Banking and Investment Corp. (Malaysia) Berhad and a consortium of Islamic financial institutions represented by Qatar Islamic Bank, RUSD Investment Bank Inc. and Global Investment House, now collectively known as Asian Finance Bank Berhad. Also, in 2005, opening 4 branches a year was permitted to existing foreign banks.

Furthermore, in April 2009, the BNM announced that foreign banks would be allowed to operate in Malaysia under new licenses. Following the announcement, on June 2010, 5 new commercial bank licenses were offered. This was the first issue of new licenses since 1970's. Regarding giving new licenses, the judgment criterion was how each bank could contribute to Malaysia's economic development. The presence of these foreign financial institutions is expected to a) add to the diversity of the financial services industry, b) support the new areas of growth including green technology, c) facilitate the transformation of the Malaysian economy towards achieving high value-added and high income economy status, and d) further enhance Malaysia's international linkages through facilitating international trade and investment flows between Malaysia and other parts of the world.

4.1.2. The Banking Sector Development Policy

a. Restructuring of the Banking Sector after the Asian Financial Crisis in 1997

The resolution of non-performing loans after the 1997 crisis was carried out by the government-established Danaharta (an asset management company), Danamodal (a special-purpose company for bank recapitalization) and the CDRC (Corporate Debt Restructuring Committee). Danaharta is an institution that is in charge of the securitization and sales of non-performing loans that it bought from banks. If recapitalization is judged to be necessary for banks, Danamodal does it. The CDRC is involved in the negotiations among banks and corporations for the purpose of debt rescheduling and restructuring of corporations.

By September 2000, 41% of non-performing loans of the banking sector were under control of the government, and the recapitalization of RM7.6 billion in total was implemented for 10 banks.

By the way, the government-led restructuring of the banking sector was not done by bank closures, as was done in Thailand and Indonesia, but by mergers. Only four banks became under control of the BNM.

Malaysian local banks were generally small, and from the standpoint of financial system development and enhancement of competitiveness of banks, restructuring of the banking sector was inevitable. In 1998, a consolidation program for finance companies was implemented, and the restructuring of banks started.

Then, banks formed groups with their own will, and the restructuring made 10 commercial banks the core banks. As a result, during the period of 1997 to 2001, commercial banks decreased from 36 to 26, finance companies from 39 to 12, and merchant banks from 12 to 10.

b. The Financial Sector Masterplan

In 2001, after the various policies responding to the Asian financial crisis had achieved some results, the BNM and the Securities Commission announced the Financial Sector Masterplan and the Capital Market Masterplan, respectively. The former was a 10-year comprehensive plan including the future vision of the financial sector as a whole and 114 recommendations, targeting not only banks but also DFIs, insurance companies and the Labuan IBFC. Following this plan, various reforms were implemented, such as reviewing of the contents of bank businesses, and the banking sector restructuring.

The main objective of the Masterplan centered on improving the efficiency, innovation, flexibility, resilience and dynamism in the banking system. The 10-year plan was divided into 3 phases with specific recommendations to be executed as follows.

Phase 1 (2001-2003): to enhance capacity of local financial institutions

Phase 2 (2004-2006): to level the playing field between local and incumbent foreign banks

Phase 3 (2007-2010): to liberalize the banking sector and introduce new foreign competition

One of the main policies of the Masterplan was the rationalization of the banking sector and improving the efficiency of banks. The Plan permitted commercial banks to provide services such as factoring, etc., that had been provided by finance companies, and promoted consolidation of commercial banks and finance companies. In 2004, many commercial banks merged with their related finance companies. Also, the Plan promoted establishment of investment banks by the mergers among merchant banks, stock brokers and discount houses.

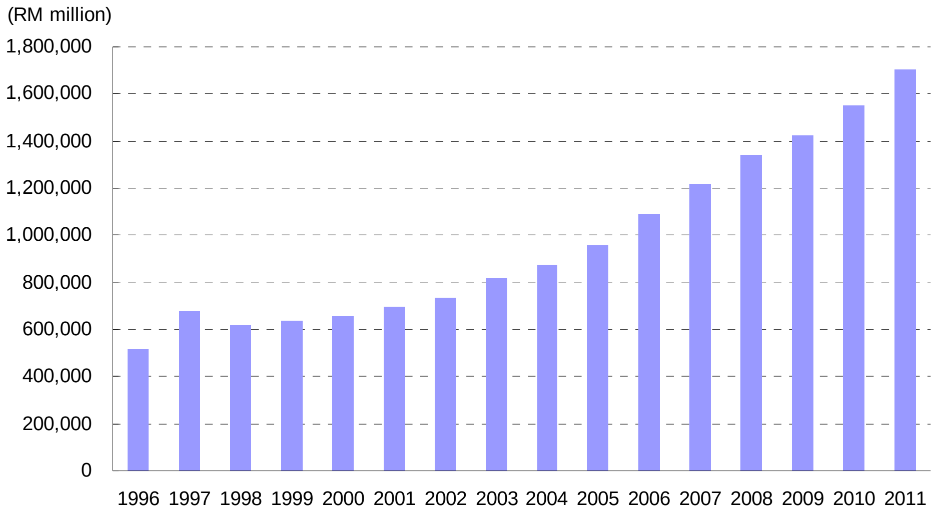
All of the recommendations of the Masterplan have been implemented. The competitiveness of local banks has been greatly improved and 6 out of the 8 domestic banking groups have expanded their business abroad mainly within the Asian region.

4.1.3. Current Situation of the Banking Sector

a. Expansion of the Banking Sector

Total assets of the banking system (Figure 4.1.) have been increasing steadily since 2002, when the banking sector restructuring after the Asian financial crisis was mostly completed. In October 2011, the figure was RM1,704.2 billion, 2.8 times that of the end of 1998. In 1998, the composition was 73.6% by commercial and Islamic banks, 20.0% by finance companies, and 6.4% by investment banks. On the other hand, in 2011, after finance companies were absorbed by commercial banks due to the reform, the composition was 78.4% by commercial banks, 17.6% by Islamic banks, and 4.0% by investment banks.

Figure 4.1. Total Assets of Banking System

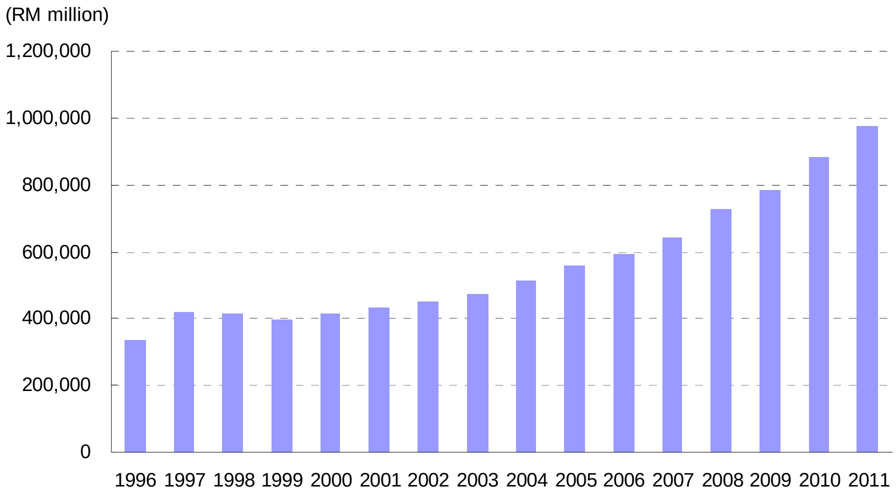


Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

Total loans of the banking system (Figure 4.2.) were RM977.5 billion in October 2011, 2.4 times that of the end of 1998. Total deposits of the banking system (Figure 4.3.) were RM1,239.7 billion in October 2011, 2.9 times that of the end of 1998. Based on these figures, the loan-to-deposit ratios (LDR) can be calculated as shown in Figure 4.4., which shows gradual decline. It indicates the improvement of liquidity positions of the banking sector. However, the ratio has been increasing gradually since 2010[68].

Figure 4.2. Total Loans of Banking System

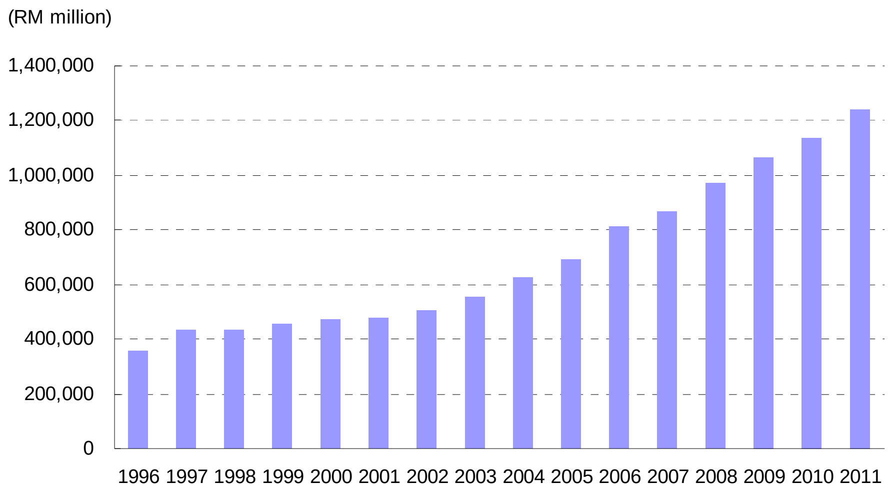


Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

[68] Care should be taken that the LDR is a very crude measure of banks' liquidity. The banking system has maintained stable excess liquidity buffers for shorter than 1 month of 18% of deposits as of the end of 2011, over and above the minimum liquidity buffer requirement and is a net lender to the BNM in the interbank market.

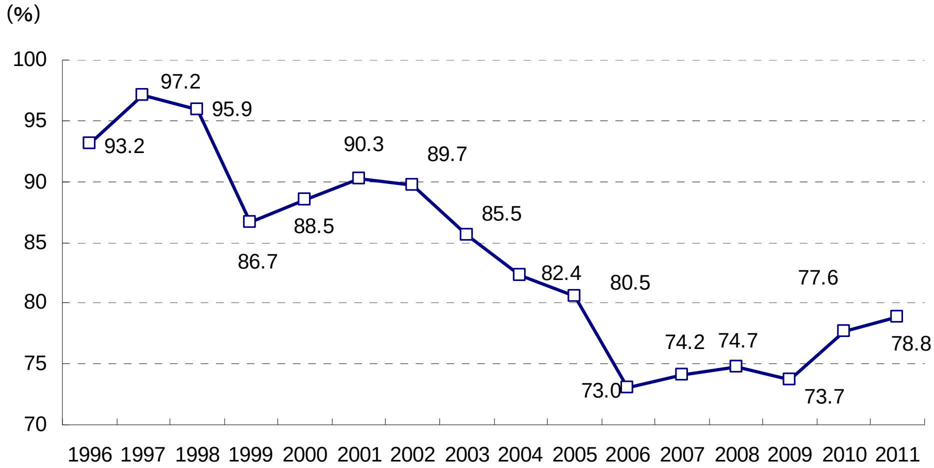
Figure 4.3. Total Deposits of Banking System



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

Figure 4.4. Loans to Deposits Ratio of Banking System



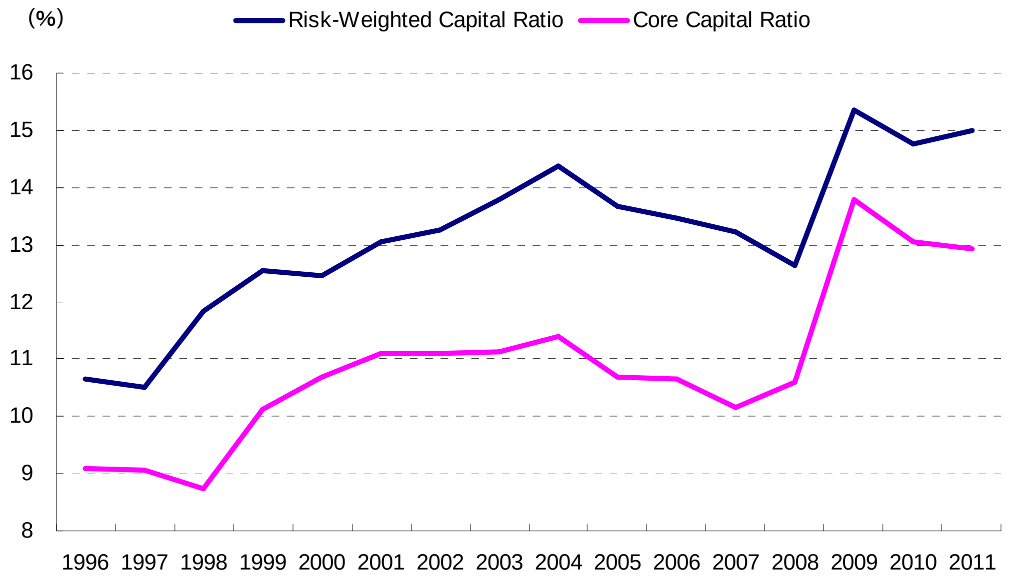
Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

b. Capital Ratios and Impaired Loan Ratios

Capital ratios of the banking system have been rising steadily. As shown in Figure 4.5., as at the end of 1998, the Risk-Weighted Capital Ratio was 11.8%, and Core Capital Ratio was 8.7%. In October 2011, these figures were 15.0% and 13.0%, respectively.

Figure 4.5. Capital Ratios of Banking System



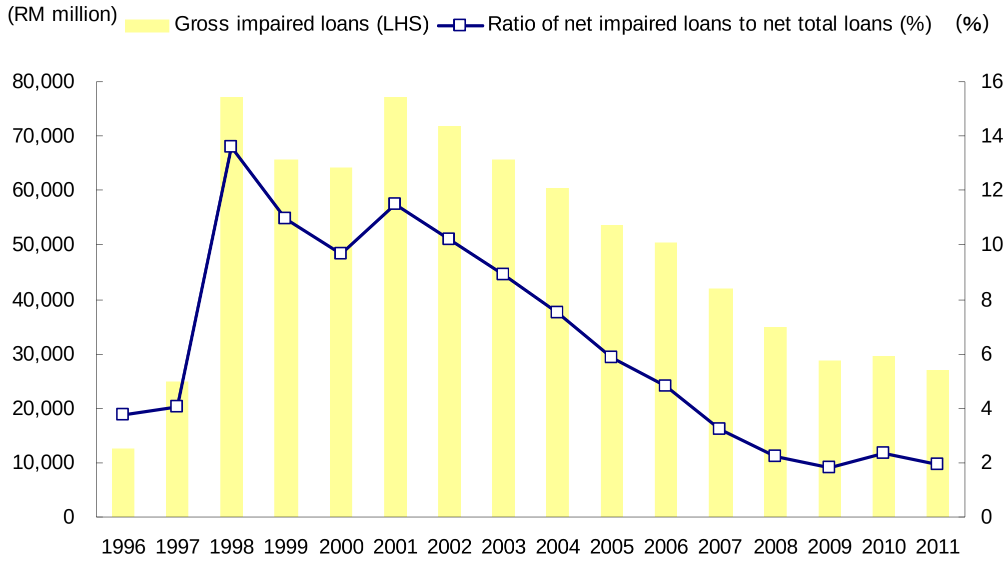
Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

The impaired loan ratios have also been improving. As shown in Figure 4.6., as of the end of 1998, gross impaired loans were RM77 billion, and the ratio of net impaired loans to net total loans reached 13.6%. However, since 2002, the ratio has continued to decline. In October 2011, gross impaired loans were RM27.1 billion, and the ratio was 1.9%.

Based on the capital ratios and impaired loan ratios, it can be said that there is no problem regarding the soundness of the banking sector.

Figure 4.6. Impaired Loans of Banking System



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

c. Profit Ratios and Profit Structure

Regarding the profit ratios of the banking sector, during 2006 and 2010, return on assets and return on equity have not changed a lot (Table 4.1.). Pre-tax profit per average employee increased from RM131,800 to RM191,800, which means the improvement of efficiency. Reflecting this, staff cost per employee increased from RM74,800 to RM96,000.

Regarding the profit structure, firstly, the increase of fee-based income has been remarkable. The ratio of fee-based income to the sum of net interest income and fee-based income was 17.5% in 2006, but increased to 20.3% in 2010. Most of the fee-based income comes from investment banking businesses.

Secondly, reduction of loan loss provisions thanks to the decrease of impaired loan ratios has contributed very much to the increase of pre-tax profits.

Comparing each type of bank, return on assets and return on equities have improved for commercial banks, but have deteriorated for investment banks and Islamic banks. This may be because of the increased levels of competition stemming from the increase of investment and Islamic banks.

Net interest margin improved slightly from 0.39% in 2007 to 0.61% in 2010, according to the BNM's *Financial System Stability and Payment Systems Report*.

Table 4.1. Income and Expenditure of Banking System

(RM million)

	2006	2007	2008	2009	2010p
Interest income	52,135	59,790	63,147	56,365	65,647
Less: Interest expense	27,809	32,847	34,058	26,558	31,340
Net interest income	24,325	26,943	29,089	29,807	34,307
Add: Fee-based income	5,168	6,896	7,386	7,857	88,748
Less: Staff cost	7,510	8,557	9,343	9,839	11,398
Overheads	8,211	9,522	10,826	10,841	12,364
Gross operating profit	13,773	15,760	16,306	16,984	19,293
Less: Loan loss and other provisions	6,538	5,370	4,170	4,904	4,336
Gross operating profit after provision	7,234	10,389	12,136	12,080	14,957
Add: Other income	5,715	7,312	7,034	4,911	7,810
Pre-tax profit	**12,949**	**17,702**	**19,170**	**16,991**	**22,767**
Pre-tax profit / Average assets (%)	1.3	1.5	1.5	1.2	1.5
Pre-tax profit / Average shareholders' funds (%)	16.2	19.7	18.6	13.9	16.5
Pre-tax profit / Average employee (RM '000)	131.8	165.0	169.5	148.5	191.8
Cost incurred per ringgit of revenue earned (sen)	44.7	43.9	46.4	48.6	46.7
Cost incurred per ringgit of net interest income (sen)	64.6	67.1	69.3	69.4	69.3
Overheads to staff cost (%)	109.3	111.3	115.9	110.2	108.5
Staff cost per employee (RM '000)	74.8	79.8	82.6	86.1	96.0

Source: Bank Negara Malaysia, *Financial Stability and Payment Systems Report* 2010

4.2. Roles of the Banking Sector

While the Malaysian banking sector has multiple roles to play, this section chooses to narrow the scope to the banking sector's role in providing corporate financing. The other significant roles of the Malaysian banking sector include facilitating access to financing to all households in Malaysia through the provision of basic banking services to households (deposit accounts, cash-in cash-out services, loans and loan servicing, remittances), and access to other financial products such as insurance and unit trusts, etc.

4.2.1. Structural Changes that are Affecting Corporate Financing

a. Expansion of Exports and Investment Rate Decline

In order to think about the roles of the banking sector, focus should be placed on the relationship between the financial system and the real economies. Since the financial crisis in 1997, structural changes of the economy took place in Malaysia. From the GDP statistics (Table 4.2.), regarding the industrial structure, the share of the services sector increased by 7% from 1996 to 2010, and those of other industries decreased a little.

Bigger changes can be seen in the expenditure side. The share of total consumption to GDP expanded from 59.2% in 1996 to 66.6% in 2010, led by private consumption. On the other hand, investment decreased from 48.4% in 1996 to 21.9% in 2010 due to the languishing private investment growth. Furthermore, imports did not change a lot during this period, but exports increased from 96.5% to 109.9%.

Table 4.2. GDP Statistics

(%)

	1996	1998	2000	2002	2004	2006	2008	2010
Agriculture	9.8	9.6	8.6	8.3	8.2	7.9	7.5	7.3
Mining and quarrying	7.6	7.9	10.6	10.2	10.0	8.8	7.9	7.0
Manufacturing	29.1	27.9	30.9	29.0	30.7	30.9	28.8	27.6
Construction	4.7	4.0	3.9	3.9	3.5	3.1	3.1	3.3
Services	50.7	55.7	49.3	51.3	50.3	52.0	55.2	57.7
Less : Undistributed FISIM	6.0	7.5	4.9	4.5	4.2	3.9	3.8	4.1
Plus : Import duties	4.0	2.4	1.6	1.7	1.4	1.1	1.3	1.3
Consumption	59.2	56.0	53.9	56.6	59.3	61.5	65.8	66.6
Private consumption	47.8	44.7	43.8	44.2	46.5	48.6	52.3	53.2
Public consumption	11.4	11.3	10.2	12.4	12.9	12.9	13.5	13.4
Investment	48.4	30.3	25.3	23.5	22.2	22.4	22.3	21.9
Private investment	35.6	17.5	13.4	8.2	11.5	11.7	11.9	11.0
Public investment	12.8	12.7	11.9	15.3	10.6	10.8	10.4	10.9
Change in stocks	1.0	0.1	1.6	1.3	1.0	0.1	-1.0	2.1
Exports of goods and non-factor services	96.5	102.9	119.8	111.1	120.0	124.2	117.8	109.9
Imports of goods and non-factor services	102.9	89.0	100.6	92.5	102.4	108.2	104.9	100.5

Source: Bank Negara Malaysia, *Annual Report*, *Monthly Statistical Bulletin*, CEIC Database

Note1: 1996 and 1998 are based on constant 1987 prices, and others are based on constant 2000 prices.

Note2: weight of each item in GDP at purchaser's prices

These changes can be analyzed also by the savings and investment gap (Table 4.3.). In 1996, investment was bigger than savings and the current account was in deficit. After the financial crisis occurred, investment declined sharply and savings became much bigger than investment. The current account showed a surplus and was 17.7% and 11.5% against GDP in 2008 and 2010, respectively. Since 2008, savings of the private sector have expanded rapidly, and excess savings ballooned. On the other hand, the public sector had been running deficits.

Table 4.3. Savings and Investment Gap

(%)

	1996	1998	2000	2002	2004	2006	2008	2010
Gross national savings to GDP (a)	37.1	39.7	35.9	32.7	35.1	37.0	37.0	32.9
Total investment to GDP (b)	41.5	26.7	26.9	24.8	23.1	20.5	19.3	21.4
(a)-(b)	-4.4	13.0	9.0	8.0	12.1	16.6	17.7	11.5

Source: International Monetary Fund, *World Economic Outlook Database*, September 2011

Thus, the economy since the Asian financial crisis went through big structural changes. Regarding domestic demand, private consumption grew at a decent pace except during the 2008-09 global financial crisis, but private investment remained weak, growing at an uneven pace.

These changes greatly affected the roles of the banking sector. Corporate financing demand for durable equipment investment decreased, and short-term borrowing for working capital became dominant. It became difficult for banks to increase corporate loans. That is why banks tried to increase consumer loans, supported by the constant growth of consumption.

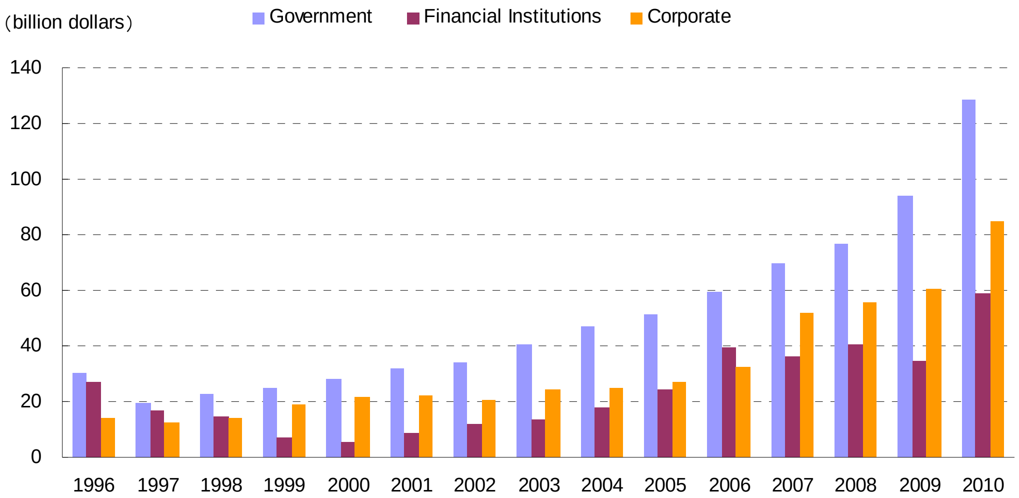
The shift in the sectors that drive economic growth is also a key factor accounting for the moderation in financing. The construction sector, which was one of the primary drivers of economic growth during the pre-crisis period, was characterized by a high financing intensity, as more capital was needed for construction and large infrastructure projects. The manufacturing and services sectors, which became the biggest contributors to economic growth after the crisis, have lower financing requirements. The lower financing intensity in the manufacturing sector could be attributable to the large presence of MNCs (multi-national corporations), which rely more on internally generated funds for their operations. The services sector requires less financing for their investments given that their operations are less capital intensive.

The average annual real GDP growth rate was 9.5% for the period 1990 to 1996, 3.7% for 1997 to 2000, and 4.7% for 2001 to 2010. Malaysia is aiming to become a high-income country with per capita income of more than 15,000 US dollars by 2020. For this to be achieved, recovery of investment is indispensable.

b. Development of the Bond Markets

Another factor that is affecting the roles of the banking sector is development of the bond markets. Since the financial crisis in 1997, thanks to the successful development policies of the authorities, the outstanding balance as of the end of 2010 compared to the end of 1998 was 5.7 times for government bonds, 4.0 times for financial institutions bonds, and 6.0 times for corporate bonds (Figure 4.7.). Islamic bonds are playing an important role in the bond markets, and 20% of the outstanding government bonds and 60% of the outstanding corporate bonds are Islamic bonds.

Figure 4.7. Outstanding Balance of Malaysian Bonds



Source: BIS

Compared with bank loans, firstly, bond issuance can provide longer financing. Most of the longest bank loans are for 7 to 10 years, but 15 to 20 year bonds can usually be issued. In order to issue bonds, various requirements by the Securities Commission such as preparation of necessary documents must be fulfilled. However, corporations with high credit rating (more than AA) would be able to obtain more favorable terms.

Secondly, bond issuance is a fixed-rate financing. Bank loans are basically variable-rate financing, and it is not easy to get a 10 year fixed-rate bank loan.

When the Asian financial crisis occurred, corporations depended heavily on the banking sector. Even long-term project financing was provided by banks. That is why duration mismatching was usual. The crisis became a good lesson for corporations regarding how they should finance long-term projects and how risk-management should be done.

For the last five years or so, the average annual issuance of corporate bonds has been RM40 to 50 billion. Many of the issues are related to green-field project financing. Many of the projects are related to infrastructure such as toll roads and IPPs (Independent Power Producers). It is expected that the number of long-term projects will increase as the Economic Transformation Program (explained later in detail) will be implemented.

Regarding issuing corporations, many of them are banks that issue bonds for liquidity enhancement or recapitalization purposes. Others include public corporations and domestic and multi-national blue-chip companies.

Thus, it can be said that bond issuance and bank loans are complementary. On the other hand, big companies are always comparing various financing opportunities, and for them, bond issuance and bank loans are alternatives.

A big challenge is to support financing for SMEs with lower credit quality. It is desirable, by developing data on credit risks of corporations, to make an environment in which more and more corporations can use both bank loans and bond issuance[69].

c. Changes of Corporate Financing Structure

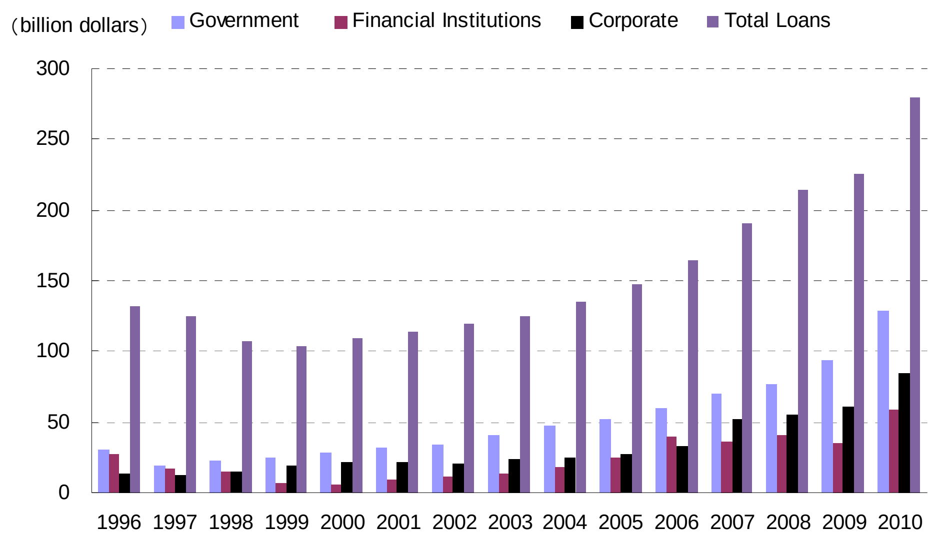
(1) By Outstanding Balance

In order to see the changes of corporate financing structure, Figure 4.8.1. was made by adding total loans data to Figure 4.7. The total loans data are from Figure 4.2., though in Figure 4.8.1., they are shown in US dollars. Figure 4.8.2. shows the ratios obtained by dividing the sum of outstanding balances of financial institution bonds and corporate bonds by bank loans, and by dividing the outstanding balance of corporate bonds by bank loans. In 1996, these figures were 31.0% and 10.5%, respectively, and in 2010, they were 51.3% and 30.4%. In particular, since 2005, the increase of these figures has been remarkable. From these calculations, it can be said that the presence of bond issuance has been increasing recent years regarding financing

[69] Danajamin Nasional Berhad (Malaysia's first financial guarantee insurer) was established in May 2009 to provide financial guarantee for bonds and sukuk issuances to a wider range of viable Malaysian companies to access the bond/sukuk market (http://www.danajamin.com/).

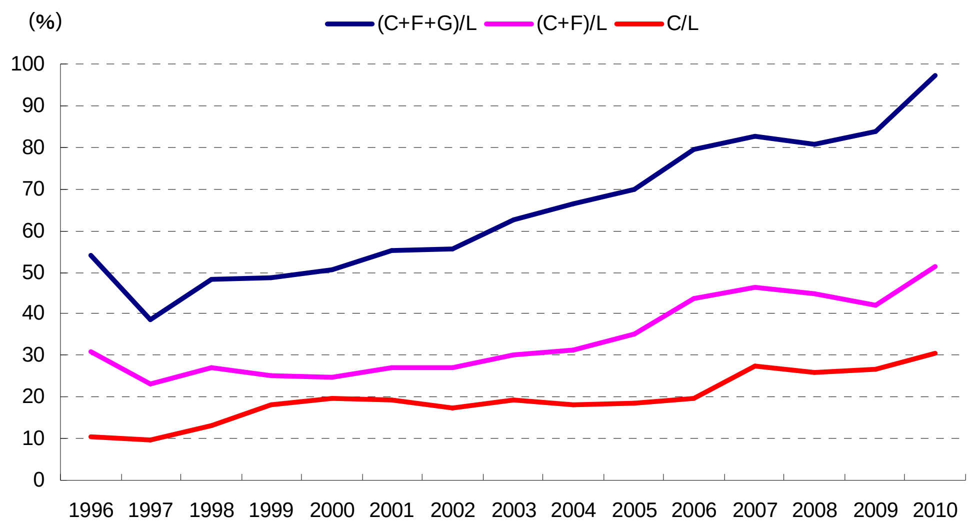
for financial institutions and corporations.　Comparing the size of bond markets to that of the banking sector, Malaysia has the largest bond market in ASEAN.

Figure 4.8.1. Outstanding Balance of Bonds and Loans



Source: BIS, Bank Negara Malaysia, *Monthly Statistical Bulletin* September 2011

Figure 4.8.2. Bonds to Loans Ratio

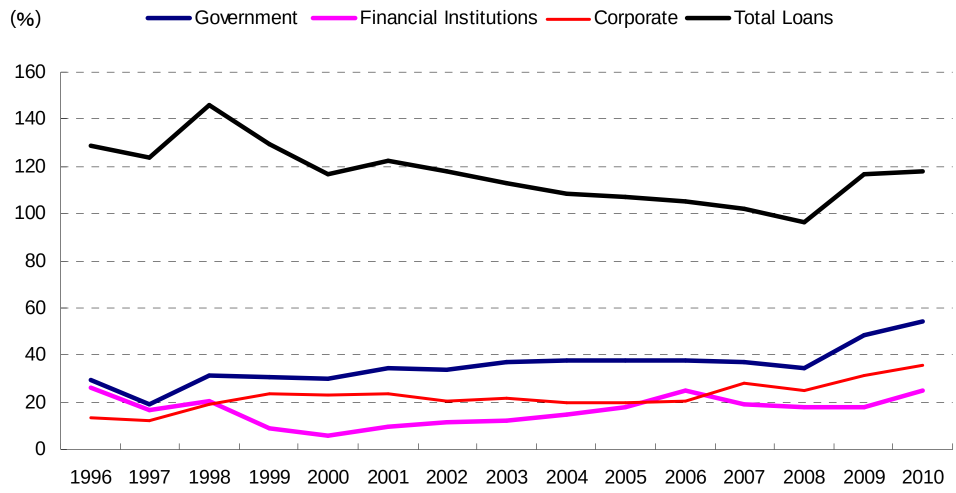


Source: BIS, Bank Negara Malaysia, *Monthly Statistical Bulletin* September 2011

Note: C: Corporate, F: Financial Institutions, G: Government, L: Loans

Also, against nominal GDP (Figure 4.8.3.), the outstanding balance of financial institutions bonds, corporate bonds and bank loans were 26.5％,13.6％,129.0％, respectively in 1996, but were 24.7%,35.8%,117.8%, respectively, in 2010. It shows that the importance of corporate bonds increased, and bank loans expanded slightly slower than nominal GDP. However, it should be emphasized that the size of bank loans is still the biggest.

Figure 4.8.3. Outstanding Balance to Nominal GDP

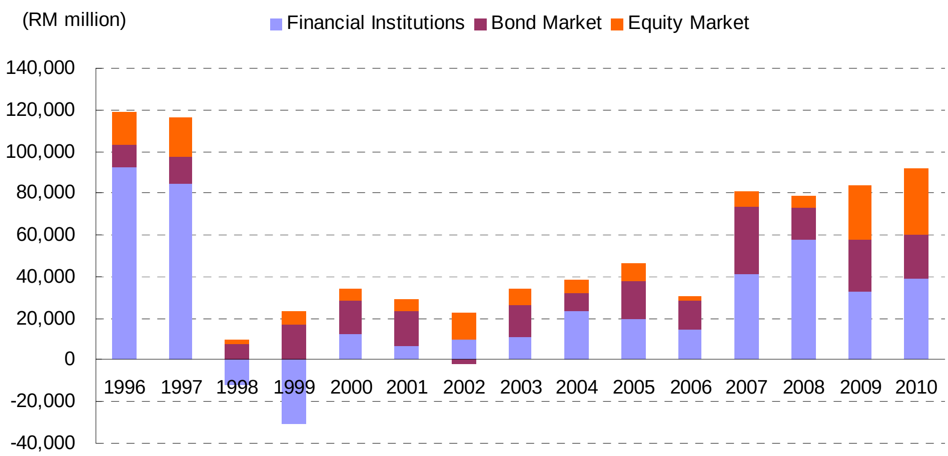


Source: BIS, Bank Negara Malaysia, *Monthly Statistical Bulletin* September 2011

(2) By Net Changes in Financing

The net amount of corporate borrowings from financial institutions, bond markets and stock markets are shown in Figure 4.9.. The total amount of corporate borrowings stayed very low after the Asian financial crisis, but since 2007, such financing has been recovering.

Figure 4.9. Financing of the Corporate Sector from Domestic Sources



Source: Bank Negara Malaysia, *Annual Report*, *Monthly Statistical Bulletin*

Before the Asian financial crisis, borrowings from financial institutions maintained an overwhelming weight, but declined rapidly due to the crisis. Since 2007, they have recovered. On the other hand, bond issuance has been steadily increasing for the whole period. Stock issuance also decreased due to the crisis, but since 2009, it has recovered.

Looking at financing in the economy as a whole (last two years, Table 4.4.), for the corporate sector, banks, bond markets and stock markets play equally important roles. For households, most of the financing comes from banks, and for the government, most of the financing is done by issuing bonds, and some borrowing also exists. Regarding the economy as a whole, the weight of bank loans is 42.0%, and it is very clear that banks play a very important role in financial intermediation.

Table 4.4. Financing of the Economy (Net Change in 2009 and 2010)

(RM million)

	Businesses		Households	Government	Total Financing
	Total	of which: SMEs			
Financial Intermediaries					
Banking Institutions	54,145	3,541	96,524	17,143	167,812
Development Financial Institutions	9,595	-1,301	14,412		24,007
Other Domestic Intermediaries	7,857	-755	-350		7,507
Capital Market					
Bond Market	46,206			86,191	132,397
Equity Market	58,184				58,184
External Financing					
Foreign Direct Investment	15,551				15,551
External Loan	-5,814			-165	-5,979
Total	185,725	1,485	110,586	103,169	399,479

Source: Bank Negara Malaysia, *Annual Report* 2010

Note: Figures are the sum of 2009 and 2010.

Furthermore, it should be added that, in the total assets of the banking system, RM1,704.2 billion in October 2011, 2.4% or RM40.1 billion was invested in government bonds, and 11.2% or RM191.7 billion was invested in other securities including corporate bonds. These investments must be included in the roles that banks play in the field of government and corporate financing.

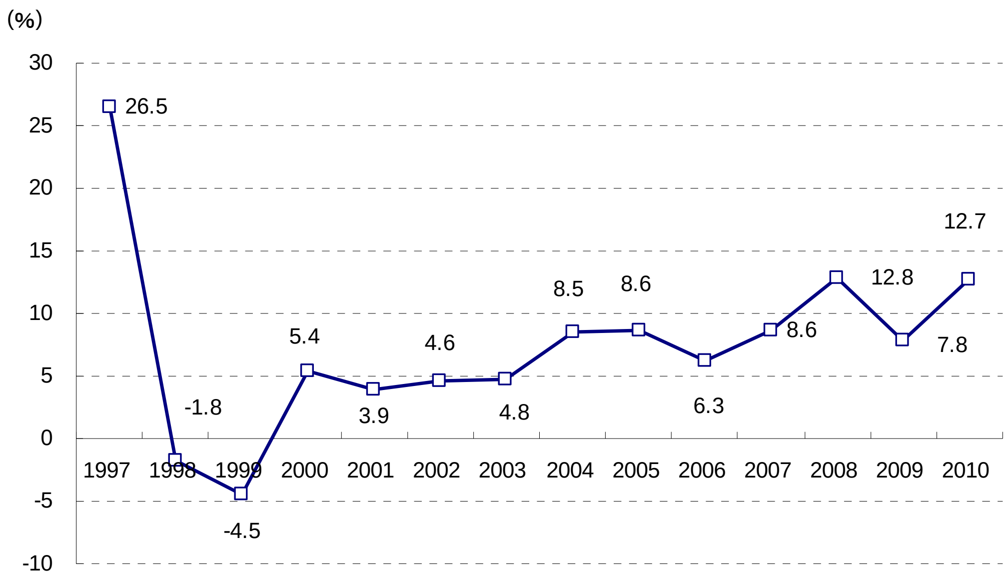
Bond investments by banks are divided into trading accounts and hold-to-maturity accounts. Also, banks play important roles in the bond markets as underwriters in the primary market and as market makers in the secondary market.

4.2.2. Current Situation of Corporate Businesses

a. Overview of Bank Loans

As was seen in Figure 4.8.3., total loans against GDP have been declining gradually for a long time, and recovered a little in 2009 and 2010. Figure 4.10. shows the annual growth rate of total loans of the banking system (refer to Figure 4.2.). It also shows gradual recovery. In summary, bank loans have been gradually recovering in recent years after a long slump, and are mostly catching up with GDP growth rates.

Figure 4.10. Growth of Total Loans of Banking System



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: Year on year

Looking at the composition of total loans by sector (Table 4.5.), the household sector has gradually increased its weight, and since 2005, the weight has been stable at around 55% of the total loans outstanding. The reason is that, because of the decrease of financing demand for durable equipment investment due to the decline of investment rates, and also because of the expansion of financing from bond markets, corporate loan demand has not grown much. In this kind of situation, the effort to expand consumer businesses based on the constant growth of consumption led to the increase of the household sector's weight in bank loans. On the other hand, the weight of loans to manufacturing, construction and financial sectors declined remarkably. Regarding manufacturing and construction, the decrease of financing demand for durable equipment investment may have caused the decline, and regarding financial industry, the increase of bond issuance may have caused the decline.

Looking at the recent situation, since the middle of 2009, private sector financing has recovered. Corporate loans grew only 3.0% in 2009, but grew 9.4% in 2010. The buoyant demand for financing by businesses was underpinned by improved sales and investment. The increased business activity resulting from higher domestic demand led to more loans being disbursed for the purpose of working capital, increasing at an annual rate of 11%. Loans disbursed for investment purposes also expanded, in particular, for the purchase of non-residential property and transport vehicles, which increased by 50.5% and 48.8%, respectively, in 2010.

Table 4.5. Composition of Total Loans by Sector

(%)

	1996	1998	2000	2002	2004	2006	2008	2010	2011
Primary agriculture	1.7	1.8	2.6	2.5	2.1	2.3	2.2	2.3	2.1
Mining and quarrying	0.3	0.4	0.4	0.2	0.2	0.2	0.3	0.4	0.4
Manufacturing	16.2	15.5	15.1	13.5	12.3	11.2	11.2	9.4	9.3
Electricity, gas and water supply	1.3	1.3	1.8	1.4	0.9	0.8	0.6	1.3	1.1
Wholesale, retail, restaurants and hotels	8.4	8.7	8.7	8.3	8.8	8.9	8.5	7.4	7.3
Construction	7.9	9.8	8.0	6.8	5.9	5.2	4.8	4.3	3.8
Real estate	5.3	3.8	3.4	2.9	3.0	2.9	3.5	4.4	4.9
Transport, storage and communication	2.0	3.6	2.7	2.1	1.8	1.9	3.2	2.9	2.8
Financing, insurance and business services	9.1	8.5	7.6	6.6	6.5	5.8	6.6	7.1	7.4
Education, health and others	2.3	1.6	1.4	1.3	1.0	1.0	1.7	3.7	3.7
Household sector	40.3	42.4	45.3	51.9	52.3	56.1	54.1	55.4	55.3
Other sector	5.1	2.7	2.9	2.6	5.1	3.7	3.3	1.4	1.8

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note1: Before 2004, figures are for commercial banks and Islamic banks.

Note2: Figure for 2011 is at the end of October.

Meanwhile, loans to the household sector increased by 9.8% in 2009 and by 13.4% in 2010. The expansion in household loans reflected the strong growth in consumption expenditure, which in turn was driven by the steady increase in household incomes, because of stable employment prospects and rising wages.

Though the total loans maintained 13.1% growth in October 2011, the slower economic growth and external uncertainties could dampen demand for loans in 2012. However, the government-led progress of the ETP may push the increase of bank loans and bond issuance. It is expected that the loans to various sectors such as construction, oil and gas, electronics and services will grow.

b. Corporate Businesses

The main corporate businesses in Malaysia are corporate & investment banking, targeted mainly at big companies and medium size companies (middle market), business banking, targeted at small size companies[70], and retail banking, targeted at consumers. In addition, there are transaction banking including cash management services and trade financing, Islamic banking, global financial banking which means overseas businesses, and market related treasury businesses.

The roles of banks within corporate businesses are, needless to say, to support economic growth by fulfilling corporate financing needs for working capital and durable equipment investment. The main types of loans are short-term revolving credits, overdrafts, and long-term term loans (mainly for 2 to 5 years).

Regarding the size of corporations, while corporate loans account for 45.0% of total loans in September 2011, loans to large corporations are 30.1%, and loans to SMEs (including individual businesses) are 14.9% (Table 4.6.). In the first half of the 2000's,

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[70] Malaysian SMEs can be grouped into Micro, Small or Medium categories. These groupings are decided based on either the number of employees or annual sales or revenue generated by a business. For further information, refer to the Bank Negara Malaysia, *SME Annual report* 2007, Appendix 3.

loans to households grew rapidly. Loans to large corporations did not grow much in this period, but they resumed double digit growth after 2007. Loans to SMEs have grown constantly, but they were damaged more seriously by the global financial crisis in 2008 than loans to large corporations were.

Table 4.6. Banking System Loans by Borrower

(%)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Share of total										
Business enterprises	n.a.	45.1	42.6	40.4	39.6	40.6	46.6	44.9	44.6	45.0
Large corporations	n.a.	27.8	25.4	23.2	22.4	22.9	29.4	29.7	30.1	30.1
SMEs	n.a.	17.3	17.2	17.2	17.3	17.7	17.2	15.2	14.5	14.9
Households	n.a.	48.8	51.4	54.5	56.5	55.1	53.4	55.1	55.4	55.0
Total	n.a.	93.9	94.0	94.9	96.1	95.7	100	100	100	100
Change in loan outstanding										
Business enterprises	-1.4	-2.4	2.6	3.0	5.0	10.3	13.2	3.0	9.4	14.1
Large corporations	n.a.	-8.8	-0.6	-0.9	2.0	11.3	16.2	4.9	14.2	12.8
SMEs	n.a.	10.0	7.7	8.7	9.1	9.1	9.4	0.5	2.4	16.1
Households	14.7	12.8	14.4	15.1	8.7	7.4	9.1	9.8	13.4	12.5
Total	4.6	4.8	8.5	8.6	6.3	8.6	12.8	7.8	12.7	13.8

Source: Bank Negara Malaysia, *Quarterly Bulletin*, various issues

Note: The figure for 2011 is at the end of September.

Looking at interest rates, while the overnight policy rate (OPR) was 2% in 2009, it was raised by 0.75% in 2010 and by 0.25% in May 2011. As a result, it is now 3%. Also, the base lending rates (BLR) of commercial banks rose from 5.5% in 2009, to 6.54% now (Table4.7.).

In Malaysia, while banking sector reforms and development progressed, the growth of corporate loans has been relatively low until recent years, as was stated in this report[71]. Therefore, competition among banks seems to have become hard for corporate businesses. Companies usually have business relationships with more than 2 banks, and even middle class companies usually choose to borrow from a bank that offers the lowest borrowing rate. There are many cases that the profitability of banks becomes particularly low when they do business with blue-chip companies.

In order to avoid competition only by prices (interest rates), banks are naturally trying to establish long-term business relationships with companies, and to make businesses more profitable. Regarding SMEs, many of them are owner companies, and in such cases, it is relatively easy for banks to construct long-term business relationships and to maintain high profitability. From this point of view, it is desirable for banks to increase businesses with SMEs.

[71] The following statements until the end of this sub-section are based on the understanding achieved from the interviews to several private banks made in November 2011.

Table 4.7. Interest Rates

(%)

	2010		2011		
	3Q	4Q	1Q	2Q	3Q
Overnight policy rate (OPR)	2.75	2.75	2.75	3.00	3.00
Interbank rates					
Overnight	2.73	2.72	2.74	2.97	2.99
1-month	2.81	2.83	2.79	3.08	3.09
Base lending rates (BLR)					
Commercial banks	6.27	6.27	6.27	6.54	6.54
Average lending rates (ALR)					
Commercial banks	5.19	5.05	5.06	5.07	5.05
Fixed deposit rates					
Commercial banks					
3-month	2.73	2.74	2.74	2.99	3.00
12-month	2.95	2.97	2.98	3.23	3.22

Source: Bank Negara Malaysia, *Quarterly Bulletin* Third Quarter 2011

On the other hand, banks generally have to compete harder in doing business with middle class and large corporations. In such cases, it is more difficult to construct close relationships with customers. In the investment banking area, the target is to get comprehensive business with large corporations, such as bond and stock market related businesses, mergers and privatization related businesses, asset management, foreign exchange, and so on, and to make businesses more profitable. In order to achieve this goal, banks are trying hard to establish strong and long-term relationships with corporations.

Transaction banking is also very important. Recently, banks are trying to get comprehensive business when they get cash management business, such as loans, deposits and various consumer businesses. As the business becomes more comprehensive, it becomes more difficult for customers to change banks.

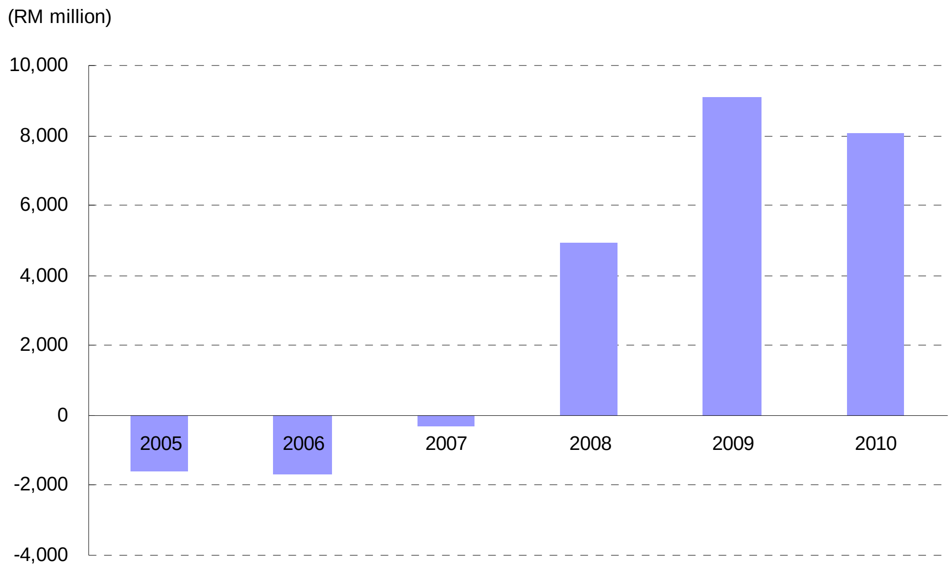
Furthermore, because non-bank corporations are expanding overseas business with their main focus on neighborhood countries, banks' global banking business is also increasing in importance. This point will be explained later in more detail.

In Malaysia, many corporate loans are directed to GLCs (Government-Linked Companies) and GLICs (Government-Linked Investment Companies) such as Khazanah Nasional Berhad. GLCs are companies that are controlled by the government, and GLICs are investment arms of the government that allocate government funds to the GLCs. Also, bank loans to the government have been increasing rapidly since 2008 (Figure 4.11.). In the future, it seems that bank loans will continue to be directed to the public sector, because by strengthening relationships with the government and public corporations, banks can expand corporate business and increase their market share.

c. Businesses with SMEs

As a key engine of growth in the economy, accounting for 99% of the total number of business establishments in Malaysia, the SMEs continue to draw support from the financial sector to meet their financing needs, with outstanding financing to SMEs from banking institutions and DFIs reaching RM141.1 billion or 37.6% of total business loans as of the end of 2010, according to the BNM. Of the RM141.1 billion, RM128.1 billion, or 90.8% was provided by the banking system.

Figure 4.11. Financing of the Government from Banking Institutions



Source: Bank Negara Malaysia, *Annual Report* 2006-2010

The Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank) is a DFI specializing in SME finance. It was established in October 2005. Its objectives are to provide financing and advisory services to SMEs involved in the manufacturing, services and construction sectors, particularly Bumiputera entrepreneurs. Its loans outstanding to SMEs as of the end of 2010 were RM3.78 billion.

The BNM places a high emphasis to promote financing to SMEs. It says that the number of SME cases received by the Bank's Integrated Contact Center in relation to access to financing issues fell by 38% from 2009 to 2010 (327 cases). This reflects an improved environment for financing to SMEs, attributed in large part to the development of a more comprehensive institutional framework including support and advisory services for SMEs as well as pre-emptive measures by financial institutions to assist viable SMEs facing temporary financial difficulties and expedite the approval and disbursement of loans.

These include collaborative efforts in 2010 to establish SME Financing Help Desks that are well-equipped to provide advisory services at SME associations and business chambers nationwide, as well as the Association of Banks in Malaysia's "PARTNER" initiative to streamline and simplify loan application procedures for SMEs.

Such efforts over the years have contributed towards the advancement and transformation of SMEs which saw more than 4,600 SME accounts with a combined financing value of RM14.9 billion upgraded to become large enterprises during 2010.

Also, micro enterprises constitute 78.7% of all businesses in Malaysia and employ over 1.2 million employees. 87.7% of micro enterprises are in the services sector, with significant involvement in the retail, food and transportation sub-sectors. The *Pembiayaan Mikro* framework that was introduced in 2006 to provide micro entrepreneurs with access to financing without collateral has seen significant progress over the years. *Pembiayaan Mikro* is currently offered by 10 participating financial institutions with total outstanding micro financing amounting to RM775.9 million, benefiting more than 66,000 customers as of the end of 2010.

Regarding SME financing, the Credit Guarantee Corporation Malaysia Berhad (CGC) was incorporated in 1972 as a limited company. The shareholders are Bank Negara Malaysia and all the commercial banks operating with a total of more than 2,600 branches in the country. The objective of CGC is to assist SMEs, especially those with inadequate collateral or without collateral, obtain credit facilities from financial institutions at a reasonable cost, by providing guarantee cover on such facilities. The CGC formulates and manages viable credit guarantee plans with the participation of its partners (lending institutions).

In July 2008, CGC introduced the SME Credit Bureau, a databank of credit information on SMEs. It is a joint venture between CGC, Dun and Bradstreet Malaysia, and the Association of Banks in Malaysia. In October 2010, it was renamed Credit Bureau Malaysia. The name change reflects the transformation of the bureau from provider of SME credit information into a full-fledged credit bureau for SMEs.

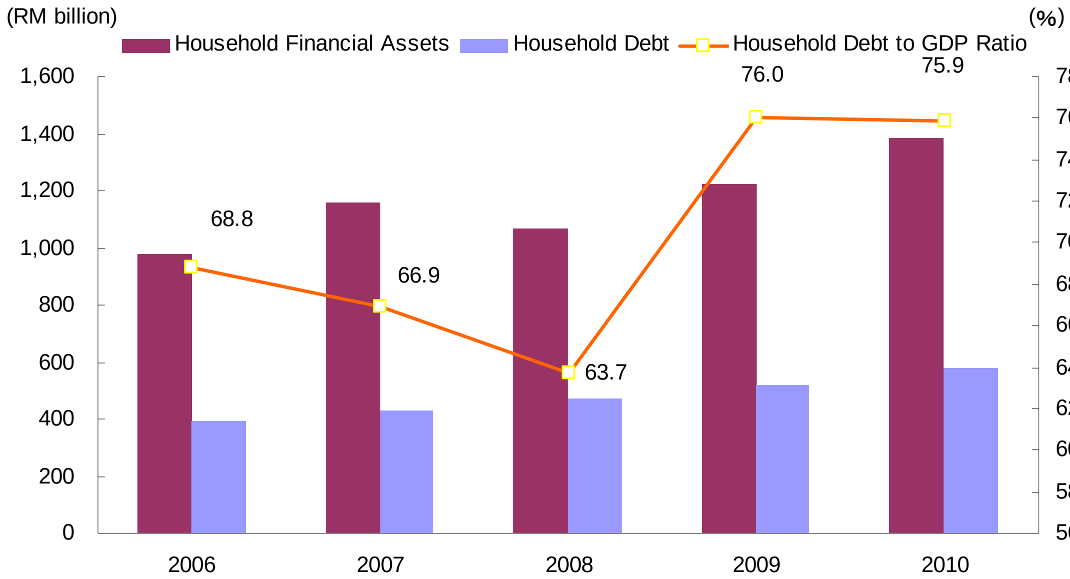
Each bank is making various efforts to be involved in SME businesses. SME loans are profitable, but accompany relatively high credit risk exposure, and it is not always easy to get enough collateral. Some banks are selecting relatively credible SMEs and trade only with them. Also, various efforts are being made to utilize CGC and reduce the credit risks involved. Furthermore, some banks are adopting an aggressive lending strategy by simplifying the assessment procedure of small-amount loans. There also is a strategy to improve profitability by increasing fee business, deposits and trade financing.

4.2.3. Current Situation of Consumer Businesses

a. Overview and Strategies

As was already stated, consumer loans are expanding by alternating the low growth of corporate loans. As the economic growth rates are high, financial assets of the household sector are increasing. They increased about 1.4 times from 2006 to 2010, and were RM1,386 billion as of the end of 2010 (Figure 4.12.). Their ratio against GDP became 181.0% from 170.2%, which means that the expansion is a little faster than GDP. During the same period, household debt expanded about 1.5 times and was RM581.3 billion, as of the end of 2010. In 2009, household debt ratio against GDP rose rapidly. The causes are not necessarily clear, but it seems that new housing loans by the young generation and automobile loans accompanying replacements increased.

Figure 4.12. Household Financial Assets and Debt



Source: Bank Negara Malaysia, *Financial Stability and Payment Systems Report* 2010

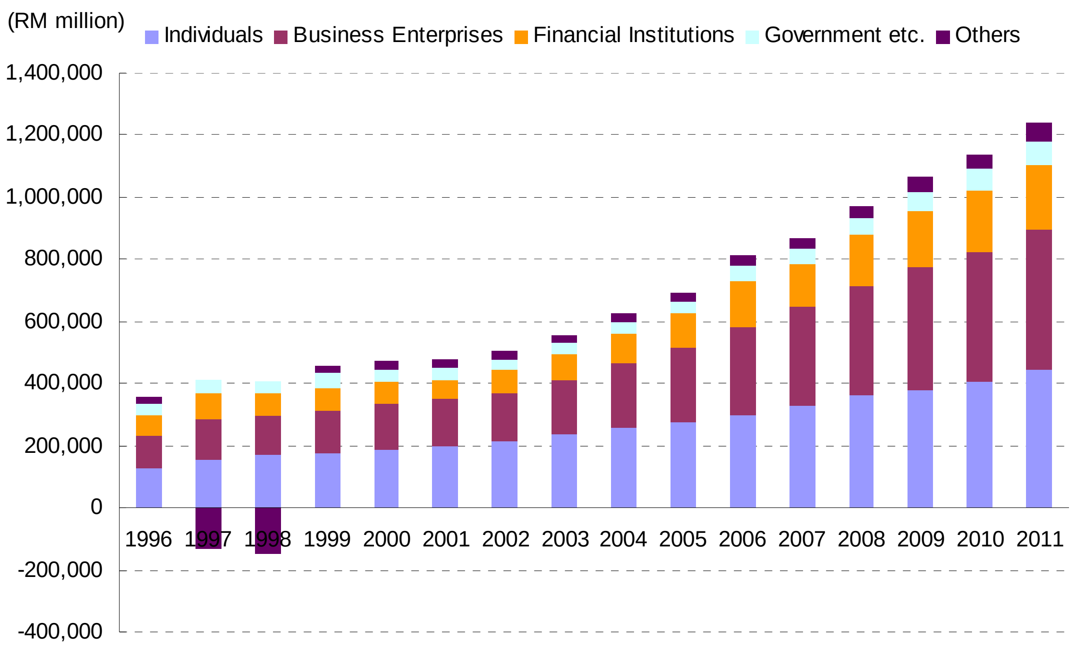
Looking at bank deposits, at the end of 2010, 35.8% of total deposits, or RM407.8 billion were by individuals (Figure 4.13.). This amount is equal to 29.4% of household financial assets. This ratio was 30.6% in 2006, and there was not a big change. As liquidity is high these days, it is easy to gather deposits at proper interest rates, and there is little possibility that banks will have trouble with funding. Even if it should happen, that would be a problem for a specific bank, and not for the banking system as a whole.

The government is targeting Malaysia to become a high-income country with per capita income of more than 15,000 US dollars by 2020. Therefore, the potential of consumer business is large and many banks regard consumer business as one of their most important areas. Particularly, the number of rich people will increase, and it will expand the market for wealth management business.

Also, as high economic growth has been continuing, the way of thinking among young people seems to be changing. They usually have strong appetites for consumption. They also like to take risks, and job hopping is increasing among them. Consumer businesses have to respond to the various transaction needs of this young generation. By providing comprehensive services including many kinds of asset management products, housing loans and personal loans, and so on, banks can decrease business costs and create competitive business.

Segmentation of customers is also popular. Banks provide preferential treatments to elderly customers and customers with large outstanding deposits, in order to stabilize funding. There is also a strategy to make a combination of corporate and consumer business.

Figure 4.13. Total Deposits of Banking System by Holder



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

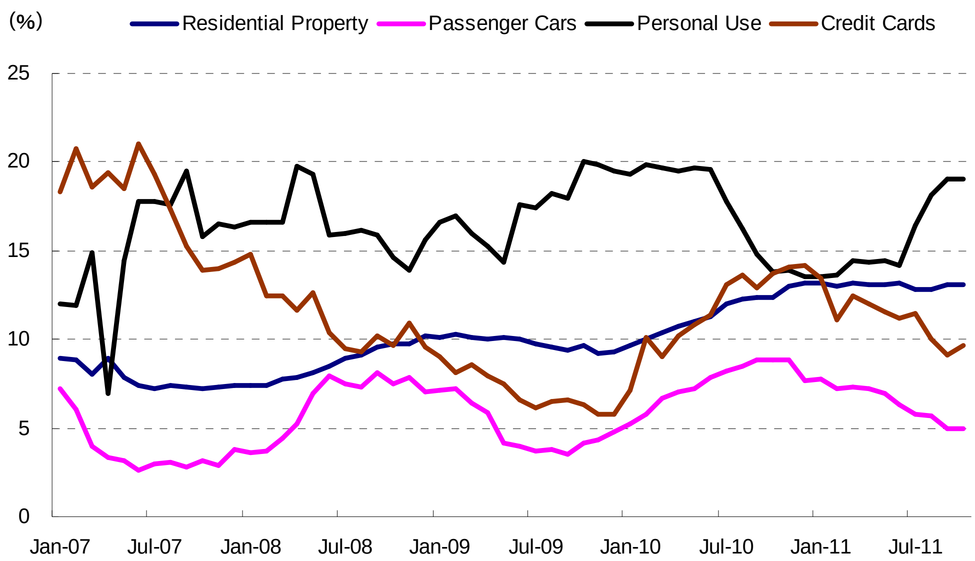
Many banks are trying to increase the interface of consumer transactions in order to make transactions easy and speedy. First, there is an effort to expand business utilizing various communication tools, whose target is mainly young people. According to the Association of Banks in Malaysia, among commercial banks, Internet banking is adopted by 20 banks, telebanking by 14 banks, and mobile banking by 8 banks. These efforts are still in the primary stage, except for larger banks. Secondly, banks are increasing ATMs and other self-service terminals, and improving and diversifying their functions. Thirdly, there is the example of efforts to open simple business spaces in super markets, post offices and train stations, and to quickly provide services such as deposits, asset management products, insurance and loans. The purpose of this strategy is to cover as many various income-level customers as possible.

b. Details of Consumer Businesses

As consumer businesses, there are housing loans, automobile loans, personal loans and card loans. Total loans of the banking system to households were RM540.5 billion in October 2011. By a calculation from the Classification of Loans by Purpose data, the shares were 48.7% for the purchase of residential property (housing loans), 24.1% for the purchase of passenger cars (automobile loans), 9.1% for personal use (personal loans), 5.8% for credit card (card loans), and 12.3% for others.

The growth rates of each type of loan are shown in Figure 4.14.. Loans to the household sector have been growing rapidly in recent years. The main reason is that housing loans, accounting for about half of the total, have been growing. Personal loans have also been growing constantly. Automobile loans have been growing relatively slowly, and the growth rate of card loans has been going up and down.

Figure 4.14. Growth of Household Loans



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: Year on year

Housing loans are growing steadily, partly because of the house ownership promotion policy by the government. As more foreign banks that formerly transacted mainly with home-country-originated companies are entering consumer businesses, competition is very hard. As the risks of housing loans are low, because they have accompanying collateral, many banks are lending at interest rates that are far lower than base lending rates.

Housing prices have been increasing recent years. It can be said that there is a real estate boom, but many people say that it is not a bubble. The areas where real estate prices have increased sharply are limited to urban and surrounding areas. Price increases in these locations are making homeownership increasingly less affordable for average Malaysians. In order to avoid speculative residential transactions, borrowers are subjected to a loan-to-value (LTV) ratio of 70% for the third and subsequent house financing facilities, a restriction which took effect on November 3, 2010. LTV ratio means loan amount compared to house price[72].

Loan applications for the purchase of passenger cars also continued to increase in 2010 as households locked-in borrowings at relatively low rates. This was further supported by the introduction of several new popular car models and other attractive offers for new car buyers.

Personal financing (usually without collateral) has increased significantly in recent periods. In 2010, outstanding personal financing grew by 17.5% to account for 14.6% of household debt (2006 : 9.6%). DFIs, cooperatives and building societies accounted for the bulk of this growth, with almost 80% granted under salary deduction schemes. Given the salary deduction feature, credit assessments by these institutions are mostly limited to reliance on incomplete computations of debt-servicing ratios. The absence of robust credit and affordability assessments will result in households being more at risk of becoming over-indebted[73].

Card loans have also been continuing to expand quickly, and the BNM is gradually enhancing regulations for them (Figure 4.15.). Outstanding credit card balances increased by 15.2% to RM30.8 billion as of the end of 2010 to account for 5.3% of household debts. Similarly, outstanding balances per credit card holder rose by 15.1% to RM9,516.

To ensure that credit card debts are maintained at manageable levels, a number of pre-emptive measures have been introduced. Individuals with an annual income of RM36,000 or less will be limited to owning credit cards from not more than two issuers and an aggregate credit limit not exceeding two times the individual's monthly income per issuer. This means that the combined credit limit will be capped at RM12,000. About 2 million people are said to be included in this income category. The minimum income eligibility criterion for credit card applications has also been strengthened to RM24,000 per annum from RM18,000 previously.

c. The Risks Accompanying Expansion of Loans to the Household Sector

The household debt level continued to expand at a faster pace of 12.5% in 2010, and the ratio to GDP remained almost unchanged at 75.9%. While this is higher compared with other regional economies, risks of financial stress in the household sector remain limited at present, because financial assets are more than two times

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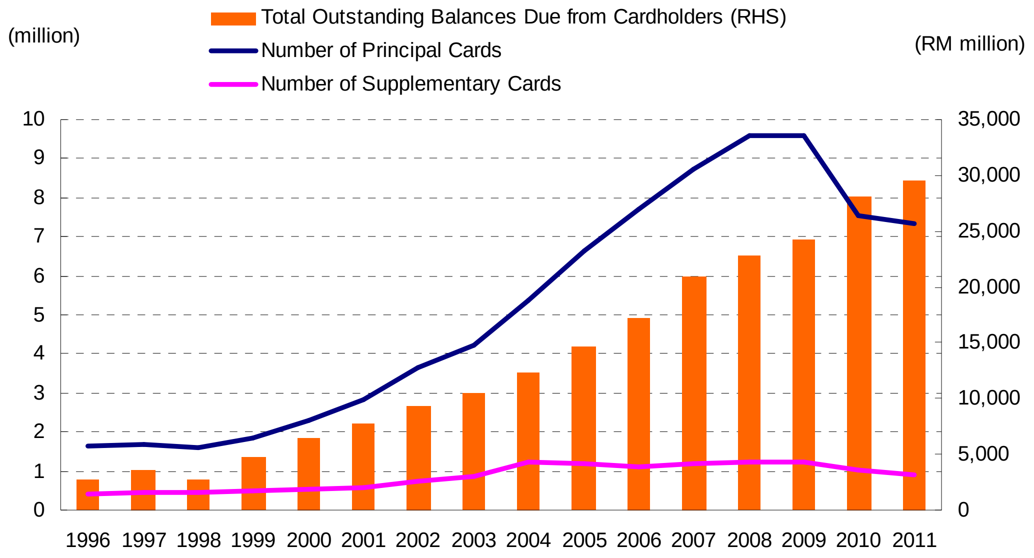
[72] Non-individuals taking housing loans are subject to a maximum LTV limit of 60%.

[73] On the other hand, regulations for these financial institutions have gradually been developed. Major DFI lenders to households are regulated by the BNM. As for credit cooperatives, the Cooperatives Commission of Malaysia has released a set of guidelines on responsible financing (effective 1 Dec 2011) which is consistent to the Guidelines on Responsible Financing adopted by banks and DFIs.

debts[74]. The delinquency rate is also low at 2.3% of total banking system household financing and has been on a sustained improving trend over the recent decade.

Figure 4.15. Credit Card Operations



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

Also, banks can use credit checks through the Central Credit Reference Information System (CCRIS), which ensures comprehensive assessment of borrowers' aggregated debt repayment obligations and credit worthiness. This online system is operated by the Credit Bureau established within the BNM. The Credit Bureau was established in 1982 for the purpose of credit risk management and promotion of a sound credit culture. All the important financial institutions are participating in the Credit Bureau, and banks can get credit information about individuals and corporations.

Furthermore, the BNM established the Credit Counseling and Debt Management Agency (AKPK) in April 2006. It provides advisory and supporting services to the individuals who have trouble repaying debts.

It must be added that the highly competitive environment and the increased indebtedness of households are calling for pre-emptive measures to preserve the resilience of the household sector in the future.

While many banks are aggressively expanding their consumer business, some banks are a little cautious, because as household debt expands, asset quality might deteriorate. Since business with high-income customers involves low risk, some banks adopt strategies of selling various asset management products to middle and

[74] Some attention is needed that, with one third of household financial assets in the form of equity, households are susceptible to volatile swings in equity prices.

high-income households.

There is some opinion that the recent expansion of personal loans involves problems. Household debt to GDP ratio is almost 76%, and this is the second highest ratio, following South Korea, within the Asian region. Regulations to credit card holders are becoming stricter, but consumers can easily borrow money from informal money lenders, that are not regulated by the BNM[75].

The interest rates for personal loans are relatively low, and the borrowings are not for houses or cars, but for cheaper durable consumer goods, etc. A regulatory framework for entities not regulated by the BNM must be developed.

Also, the debt service ratio of the household sector rose to 47.8% in 2010 from 39.5% in 2008. There is some opinion that it is becoming harder for Malaysia to maintain its high economic growth by depending on consumption.

4.3. Future Tasks for the Banking Sector

4.3.1. The Financial Sector Blueprint 2011-2020

The BNM announced the Financial Sector Blueprint 2011-2020 in December 2011. The Blueprint aims to enhance the capacity and capability of the Malaysian financial sector to best serve Malaysia's needs as a high value-added and high-income economy by 2020. It says that the financial sector should become more competitive, dynamic, inclusive, diversified in terms of institutions and arrangements, and integrated, with the ability to offer world class financial services, in terms of breadth, depth and quality.

The transformation of the financial sector will be accelerated by the continued process of financial integration and increased connectivity within the region, continued gradual and sequenced liberalization of the financial sector, integration of payment and settlement systems, and greater cross-border cooperation in maintaining regional financial stability.

The Blueprint is a plan for the coming 10 years. The future tasks for the banking sector included in the Blueprint can be explained from domestic, regional and international standpoints.

Firstly, Malaysia is trying to improve per capita GDP by implementing the Economic Transformation Program, and other measures. The ETP tries to construct a high value-added, knowledge-intensive economy, by promoting industries such as the environmental industry, bio-technology, agriculture, infrastructure, and so on. One of the tasks for the banking sector is to support this plan.

Secondly, the ASEAN region has a plan to establish the ASEAN Economic

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[75] Regarding regulations to credit cards issuers, there are only 4 non-bank issuers of credit cards in Malaysia - AEON credit service, Diners Club (Malaysia), MBF Cards (Malaysia) and Synergy Cards. All issuers of credit cards in Malaysia are subject to similar regulations and are recorded in CCRIS to facilitate comprehensive assessment of indebtedness and eligibility.

Community by 2015, and regional financial integration should be promoted. Supporting of the integration will also be an important task for the banking sector.

Regarding the real economy, regional trade integration has already been making progress for a long time. The countries within the region are complementary among each other in various ways, and the meaning of regional economic integration is huge. The BNM is supportive of initiatives to promote regional financial integration. The concrete ways of financial integration are, for example, for banks to go abroad following cross-border activities of home-country corporations, cross listings among the capital markets in the region, and so on. Also, even within Malaysia, local banks can support corporations abroad by giving necessary advisory services.

Since 2000, cross-border activities of local banks have been expanding, as will be explained later in detail.

Thirdly, Malaysia is actively promoting Islamic finance to further entrench its position as an international Islamic financial center. For this purpose, the banking sector also has some future tasks.

The exact contents of the Blueprint are shown in Table 4.8. Regarding each item, several recommendations are proposed. **Effective intermediation for a high value-added and high-income economy** includes measures such as enhancing new ways of financial intermediation to support various sectors including infrastructure development, improving access to information to reduce information asymmetries, developing pension and wealth management industries, and so on[76]. **Developing deep and dynamic financial markets** includes improving money markets, bond markets, investors, market risk management, foreign exchange markets, and so on. **Financial inclusion for greater shared prosperity** includes adopting innovative channels and new products and services to enhance the outreach of financial services that will meet the distinct needs of all citizens[77]. **Strengthening regional and international financial integration** includes promoting greater foreign participation in the financial sector, deepening cross-border cooperation among regulators to promote orderly provision of financial services in the region, and so on. **Internationalization of Islamic finance** includes increasing the diversity of players, enhancing Islamic money, foreign exchange and capital markets, enhancing financial linkages between different jurisdictions, and so on.

In the following part, as the important tasks for the banking sector, 4 points will be addressed such as improvement of competitiveness of the banking sector, contribution to economic growth, participation in regional economic and financial integration, and promotion of Islamic finance. Also, as the important items for crisis

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[76] The development of the pension industry is also expected to enhance the role of pension funds as a key source of funding, particularly for the longer-term and risk-based financing needs of the economy.
[77] Thanks to the various efforts by the BNM, the take-up of deposits has increased from 1,975 deposit accounts per 1,000 adults in 2000 to 2,954 deposit accounts per 1,000 adults in 2010.

prevention framework, risk management and capital ratio regulations, corporate governance, bank supervision, consumer protection, payment and settlement systems, and capital account liberalization are pointed out.

It can be said that the recognition of the tasks for the banking sector stated in this report is mostly proper if the Blueprint is referred to.

Table 4.8. Contents of the Financial Sector Blueprint 2011-2020

The financial sector that best serves the Malaysian economy
1. Effective intermediation for a high value-added and high-income economy
2. Developing deep and dynamic financial markets
3. Financial inclusion for greater shared prosperity
Enhancing regional and international financial linkages
1. Strengthening regional and international financial integration
2. Internationalization of Islamic finance
Safeguarding the stability of the financial system
1. The regulatory and supervisory regime
2. Raising the standards of governance and risk management
3. Regulation and greater regional and international integration
Key enablers for the development of the financial system
1. Electronic payments for greater economic efficiency
2. Empowering consumers
3. Talent development to support a more dynamic financial sector

Source: Bank Negara Malaysia, Financial Sector Blueprint 2011-2020

4.3.2. Improvement of Competitiveness of the Banking Sector

a. The Situation of Competition among Banks

As was stated several times, competition is very intense within the Malaysian banking sector. At present, as the economic growth rate is rather high and the banking businesses are expanding, banks can achieve stable profits. However, this favorable situation for banks may change in the future. Therefore, banks must enhance their competitiveness further.

The size of each bank is small by international comparison, and it is not easy for banks to compete in international financial markets. Also, even within the domestic market, the number of foreign banks is increasing due to the new licenses given in line with liberalization. In this environment, local banks have to differentiate themselves from other banks.

Particularly, the competition in corporate business such as loans and investment banking is very hard. It seems that it is not easy for smaller banks to penetrate into this area.

The liberalization of entries of foreign banks is gradual. When new foreign banks apply for entry, the BNM considers thoroughly what kind of contribution they can make to the Malaysian economy. It expects foreign banks to operate new types of businesses in Malaysia, and to bring in customers of their home countries.

Even for foreign banks, competition is not easy. For the last ten years, local banks have managed to improve their services and deliverables, and maintain market share of above 70%. Therefore, it is not easy in recent years for foreign banks to do business in Malaysia. For MNCs, the global network that foreign banks have has some meaning, but in the domestic market, it does not appeal enough to local corporations.

In this situation, liberalization will not necessarily lead to a rapid increase of foreign banks in Malaysia. It is not easy for existing foreign banks to gain market share, and it is more difficult for them to increase product lines.

Regarding local banks, each bank has some special characteristics, but most banks are adopting strategies to seek profitable businesses in every business area. Therefore, strategies are inclined to become somewhat similar and competition becomes particularly hard in the attractive businesses for banks such as the business related to the ETP, housing loans, and so on.

Other strategies that are adopted include enhancement of comprehensive business, strengthening of relationships with customers, quick approvals of loan disbursements, and so on. In this situation, banks are also expected to observe prudent underwriting standards and responsible behavior in their lending activities. They have to strengthen their institutional set-up and capacity through more robust risk management standards and practices, stronger corporate governance structure, and balanced and diversified business portfolios.

b. Measures to Enhance Competitiveness of Banks

Banks are required to further improve efficiency, and to choose and restructure businesses. Improvement of quality of services, expansion of automated services provision, and product innovation are necessary. Regarding these purposes, firstly, enhancement of delivery channels, which means expansion of internet banking and mobile banking, and so on, to provide convenience and better offerings for customers, is necessary. Secondly, it is also important to concentrate on human capital development[78].

Thirdly, it is also necessary for banks to expand high value-added and fee-based

[78] To accelerate the development of intellectual capital and managerial capabilities of senior management in the financial sector, the International Center for Leadership in Finance (ICLIF) was established in 2003. Focusing on senior management capabilities, the ICLIF complements the technical training programs undertaken by the Malaysian Banking Institute.

In addition, various other institutions have been established such as International Center for Education in Islamic Finance (INCEIF), Financial Sector Talent Enrichment Program (FSTEP), Financial Institutions Directors' Education Program (FIDE), and International Shariah Research Academy for Islamic Finance (ISRA). Some of them are mentioned in this paper.

business, such as advisory business, asset management, and wealth management.

Fourthly, expansion of overseas business is one way to break the growth limit of the domestic market. The fierce competition is one of the reasons for banks to expand their global business. As explained later in detail, they mainly go to other ASEAN countries, China and Hong Kong. Indonesia is regarded as a particularly attractive market. The reasons are that Indonesia has a common religion and similar culture as Malaysia, and that in Indonesia, the potential of growth of banking is large because only about 20% of people have bank accounts and the net interest margin is large. In Malaysia, most of the people already have bank accounts and it is not easy to expand business efficiently. According to the BNM, some of bigger local banks get about one third of their total profits from overseas business.

4.3.3. Contribution to Economic Growth

a. Basic Tasks for Banks to Contribute to Economic Growth

It is an important task for the banking sector to contribute to the economic growth of Malaysia. The banking sector is based on the real economy and corporate activities, and it is important for it to maintain a sustainable pace of growth. The important things for the banking sector in order to contribute to economic growth are, first, to realize efficient financial intermediation and respond to the needs of the real economies. Such intermediation must be firmly anchored and aligned to the objective of generating sustainable and balanced growth, raising the standards of living, creating employment and promoting development.

Second, banks should also focus on the new growth areas that will catalyze Malaysia's transition to a higher value added economy. These include areas such as green technology, infrastructure development, education, and entrepreneurship and innovation. These are key focal points that will yield increased national productivity, drive innovation and stimulate the formation of businesses. It is anticipated that a significant portion of new frontier industries will be spearheaded by young, innovative SMEs that would require substantial investments in research and development, and for the commercialization of research and development. Banks are encouraged to support these endeavors. The envisioned outcome for the banking sector in this respect is to develop a vibrant risk capital ecosystem and greater financing avenues beyond traditional financing.

b. The Economic Transformation Program

It is very important for Malaysia to raise per capita income and overcome the so-called middle income trap. First, the GTP (Government Transformation Program) is now being implemented, and various social reforms are now underway. The NKRAs (National Key Results Areas) have been deemed the priority areas for the nation. They are reducing crime, fighting corruption, improving student outcomes, raising living standards of low-income households, improving rural basic infrastructure, improving urban public transport, and addressing the cost of living.

Secondly, regarding economic policies, the ETP (Economic Transformation Program) has been started in order to transform Malaysia into a high-income growth nation, focusing on enhancing competitiveness. The Malaysian government launched the ETP in October 2010, in an effort to transform Malaysia into a high-income nation by year 2020 (income per capita must become 15,000～20,000 US dollars). For that purpose, annual 6% growth in Malaysia's GDP between 2009 and 2020 is necessary.

The ETP is aiming to shift towards a service-based economy, with the services sector contribution growing from 58% to 65%. It identified 12 key growth engines, known as National Key Economic Areas (NKEAs, Table 4.9.). Also, as concrete measures, it identified 131 entry point projects (hereafter EPPs) that concretely outline actions required to grow the economy. The EPPs and other business opportunities identified under each NKEA are anchored to how much they contribute to GNI. For example, there are 10 EPPs for financial services (Table 4.10.).

Table 4.9. National Key Economic Areas

1. Oil, Gas and Energy
2. Palm Oil
3. Financial Servives
4. Tourism
5. Business Services
6. Electronics and Electrical
7. Wholesale and Retail
8. Education
9. Healthcare
10. Communications Content and Infrastructure
11. Agriculture
12. Greater Kuala Lumpur / Klang Valley

Source: The ETP Website

Table 4.10. EPPs for Financial Services

1. Revitalizing Malaysia's capital markets
2. Deepening and broadening bond markets
3. Transforming or rationalizing developmental financial institutions
4. Creating an integrated payment eco-system
5. Insuring most, if not all, of our population
6. Accelerating growth of the private pension industry
7. Spurring the growth of a nascent wealth management industry
8. Accelerating and sustaining a significant asset management industry
9. Developing regional banking champions
10. Becoming the indisputable global hub for Islamic finances

Source: The ETP Website

While 92% of funding is expected to come from the private sector, public sector investment would be used as a catalyst to spark private sector participation. This would likely translate into increased public sector spending and lending.

The ETP will generate RM1.4 trillion of private sector investments over 2010-2020, raise private investment to 18% (from 10% currently) of GNI and grow private investments by 12.8% annually over 2011-2015 (versus 2% over 2006-2010).

Also, the ETP will create 3.3 million jobs over the next ten years, with 64% in the medium to high income categories.

The purpose of implementing the investment projects in NKEAs is to motivate investments in Malaysia that are inclined to go overseas. By increasing investments, the ETP will be able to achieve improvement of efficiency and competitiveness of the economy.

Along with this medium-term plan, various structural reforms are required. For example, fiscal deficit has been continuing since 1998. It must be reduced to some extent from the present level of 5.4% of GDP. Also, tax reforms, and increase of upper limits for foreign investments to the industries such as education, health care and finance are required. The lack of skilled workers should also be tackled.

For the banking sector, an important task is to provide necessary financial intermediation in order to smooth the progress of the ETP, from the standpoint of contribution to economic growth. By providing corporations with necessary financing related to the ETP projects, banks also can get huge business opportunities. Therefore, all of the banks are paying attention to the ETP.

In the short term, the budget for the fiscal year 2012 is also closely related to the economic growth. As important policies, it has announced pro-growth spending in the public sector, acceleration of private investment, promotion of development of the capital market and enhancement of Islamic finance, and anti-inflation measures and social policies.

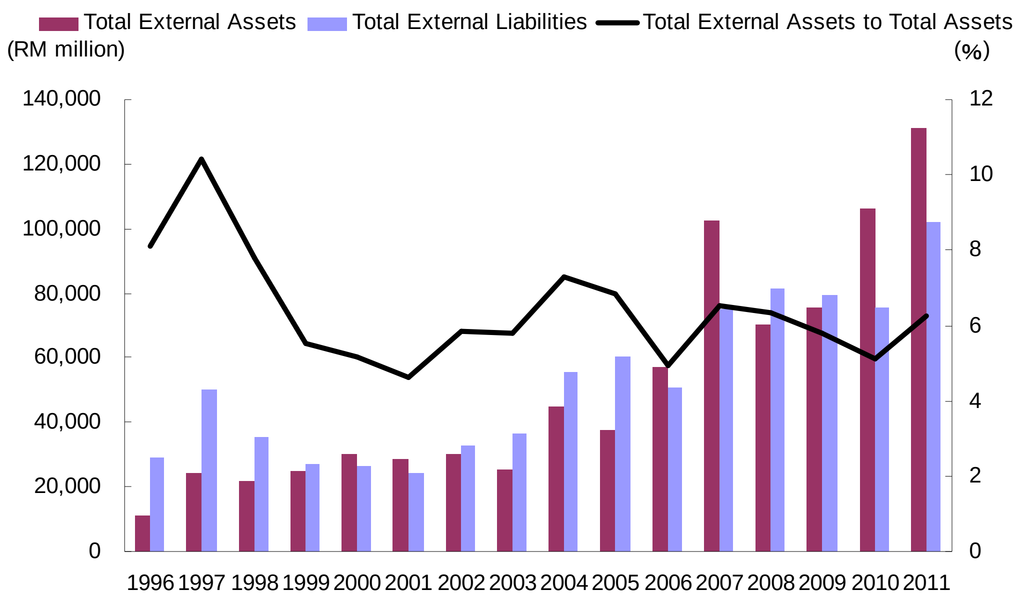
4.3.4. Participation in Regional Economic and Financial Integration

a. Situation of Cross-border Transactions by Banks

Intra-regional trade transactions have been increasing within the Asian region. Also, inward portfolio investments to the Asian region have been expanding. In these environments, promotion of regional financial integration is increasing in importance. Regarding policy aspects, the ASEAN governments have planned to construct the ASEAN Economic Community by 2015, and this necessity is being felt by more and more people within the region. As a part of this plan, the Capital Market Integration Implementation Plan was established and various efforts are being made to integrate capital markets within the region.

For the banking sector, it is important to participate in the regional economic and financial integration and to support this trend. Looking at the situation of cross-border banking transactions, the ratio of total external assets of the banking system to total assets has been stable at around 4 to 8% (Figure 4.16.). After the Asian financial crisis, total external liabilities have never exceeded total external assets by a big margin, and in recent years, the latter has been bigger than the former to some extent.

Figure 4.16. Total External Assets and Liabilities of Banking System



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

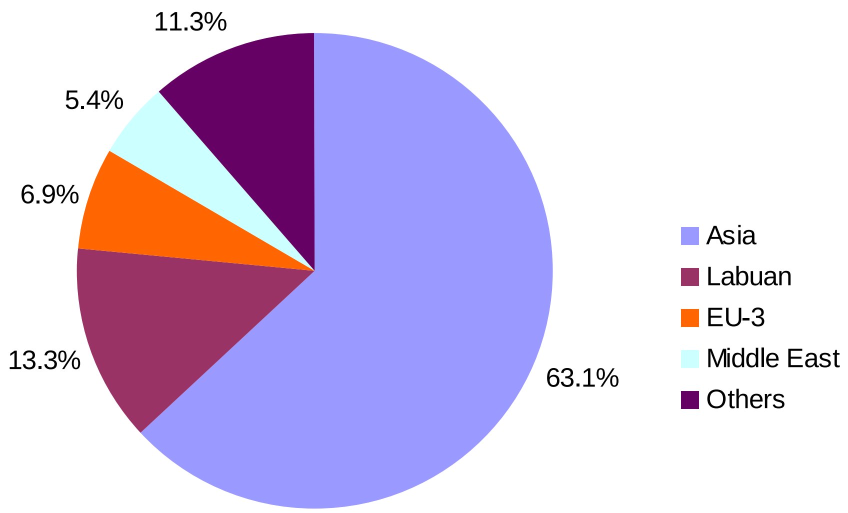
Note: 2011 is at the end of October.

According to the BNM, 63.1% of banking system external exposure was directed to Asia as at end-2010. This shows that the main target of the overseas business of the banking sector is the neighboring countries (Figure 4.17.1.). Many of the external assets are deposits and equity holdings (Figure 4.17.2.). On the other hand, many of the external liabilities are claims from affiliated enterprise, deposits and bond issuance (Figure 4.17.3.). It seems that the main borrowers of external liabilities are foreign banks. In recognition of this, ASEAN countries have embarked on an initiative to facilitate meaningful presence of ASEAN banks across the region by 2020.

b. Overseas Business of the Banking Sector

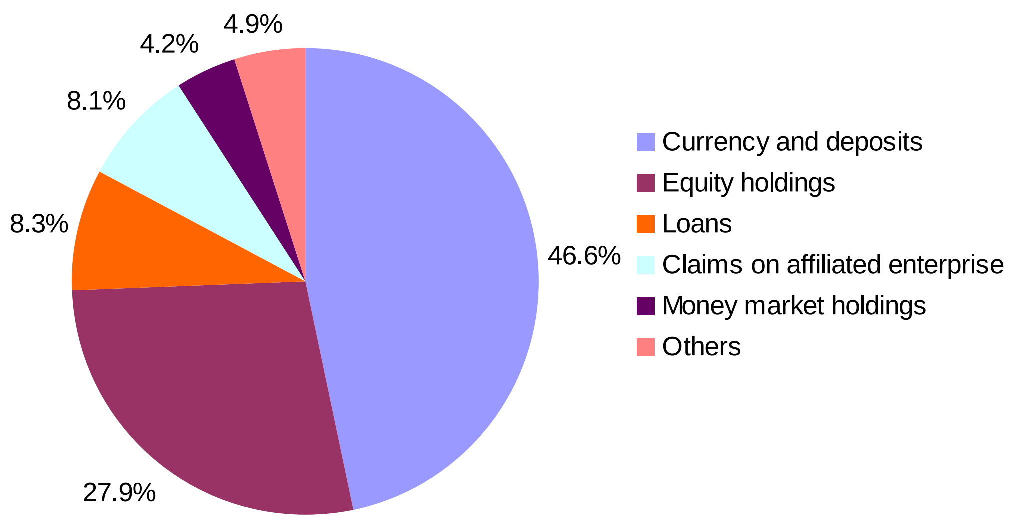
As was already stated, expansion of overseas business is one of the important strategies for local banks. Many of the banks see themselves as regional banks, and are expanding business in the neighboring countries. In addition to corporate business, they are trying also to expand consumer business overseas.

Figure 4.17.1. Banking System External Exposures by Region or Country



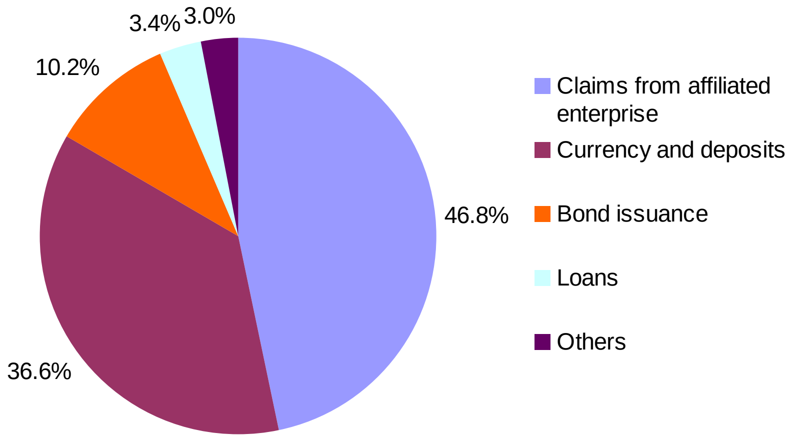
Source: Bank Negara Malaysia, *Financial Stability and Payment Systems Report* 2010

Figure 4.17.2. Banking System External Assets by Type of Transactions



Source: Bank Negara Malaysia, *Financial Stability and Payment Systems Report* 2010

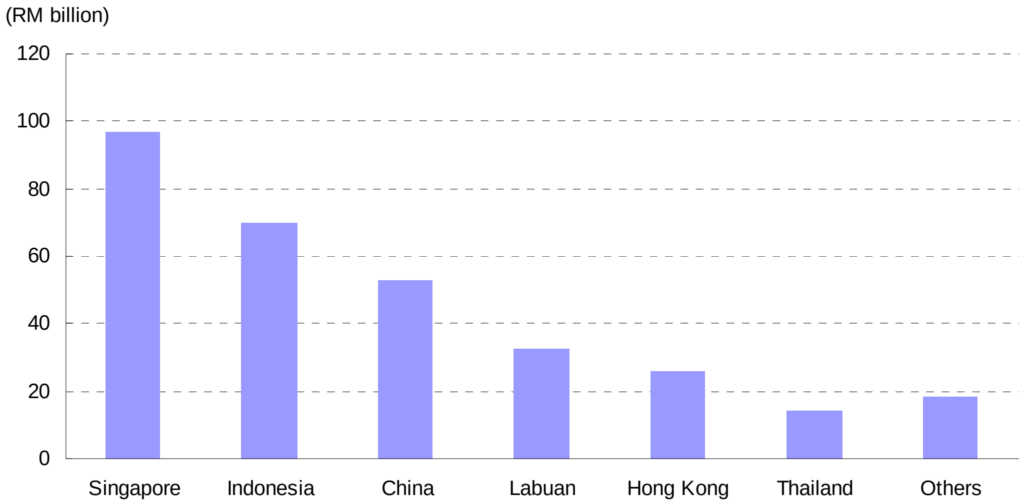
Figure 4.17.3. Banking System External Liabilities by Type of Transactions



Source: Bank Negara Malaysia, *Financial Stability and Payment Systems Report* 2010

Several Malaysian banks have emerged as regional players with an important role in contributing to the overall development of the countries in which they are present. As of the end of 2010, Malaysian banking groups had over 50 establishments across 19 countries abroad. The asset size of overseas operations of domestic banking groups expanded to RM311 billion, accounting for about 20% of total domestic assets (Figure 4.18.). Historically, Singapore has been the most important destination, but in recent years, Indonesia is becoming more popular.

Figure 4.18. Banking System Assets of Overseas Operation



Source: Bank Negara Malaysia, *Financial Stability and Payment Systems Report* 2010

Note: as of end of 2010

In 2010, major overseas operations of domestic banking groups continued to record strong profits and higher returns on assets. This has contributed to an increasing portion of the banking groups' profitability, ranging from 0.1% to 33.7%, coming from overseas operations. The credit risk emanating from overseas operations remained manageable throughout the year. Gross non-performing loans of major overseas subsidiaries, on aggregate, remained stable at 3.3% of total loans.

While the expansion of overseas operations has led to the more efficient intermediation of regional financial flows and greater diversification of risks and revenue, the deepened financial linkages have also increased the degree, channels and dynamics of potential cross-border risk transmission. Expansion of overseas operations is an important task for Malaysian banks, but they have to be careful about the risks involved.

4.3.5. Promotion of Islamic Finance

a. Present Situation of Islamic Finance in Malaysia

In the area of Islamic finance, Malaysia's position as the global hub for Islamic finance should continue to be reinforced. This will contribute to promote the more efficient mobilization of funds through the financial markets.

Islamic finance in Malaysia was started in 1960s for the Muslims that account for 60% of people. The establishment of the Pilgrim Fund Board (*Lembaga Tabung Haji*) in 1960s was the starting point of Shariah-compliant financial services with specific mandate of deposit taking for pilgrimage purpose. As time went on, there emerged increasing demand from Muslim population for wider range of Shariah-compliant financial services, and demand for the services expanded also from non- Muslims. This led to the enactment of the Islamic Banking Act 1983 and the Takaful Act 1984. In 1983, Bank Islam Malaysia Berhad, the first Islamic bank in Southeast Asia, was established.

In 1993, commercial banks were permitted to operate Islamic finance businesses by opening Islamic windows. In 1994, in order for Islamic banks to manage liquidity, Islamic Interbank Money Market (IIMM) was established.

Furthermore, National Shariah Advisory Council was established in 1997 to harmonize Shariah interpretation in the industry. Also, the Financial Sector Masterplan announced in 2001 set out specific recommendations on Islamic finance, and its successful implementation has led to the existing landscape of Islamic finance in Malaysia.

In August 2006, the Malaysia International Islamic Financial Center (MIFC) initiative was launched by the BNM to promote Malaysia as a major hub for international Islamic finance. It tries to achieve this goal through focus areas such as a) sukuk origination, b) Islamic fund and wealth management, c) international Islamic banking, d) international takaful, and e) human capital development. MIFC has become a national agenda and receives strong support from both government and private sector.

Various incentives are accessible to financial institutions participating in MIFC including new licenses for conducting foreign currency businesses, attractive tax incentives and facilitative immigration policies.

Also, another key factor that has contributed to the development of Islamic finance industry is the BNM's swift efforts in promulgating the required guidelines and regulations for carrying out Islamic finance activities.

Thanks to the development policies by the government, Islamic finance has been expanding steadily in Malaysia[79]. In 2009, the sukuk market, the equity market and the fund management were the world's largest. In particular, 54% of Islamic bonds were issued in Malaysia. Also, the takaful industry ranked second after Iran, and the Islamic banking industry ranked third following Iran and Saudi Arabia. For the last five years, Islamic finance experienced double digit growth in various areas. The total assets of Islamic banks account for 22% of those of conventional banks (Figure 4.19.). Also, takaful premiums accounted for 12.1% of those of all the insurance companies in 2010 from 6.5% in 2006.

In the capital markets, the weight of Islamic finance is larger[80]. As of June 2011, the size of outstanding sukuk was RM 194billion, or 58% of the outstanding balance of the bond markets. Also, 89% of stocks were Shariah compliant, and their market capitalization amounted to RM 836.17billion, which was equal to 62% of total market.

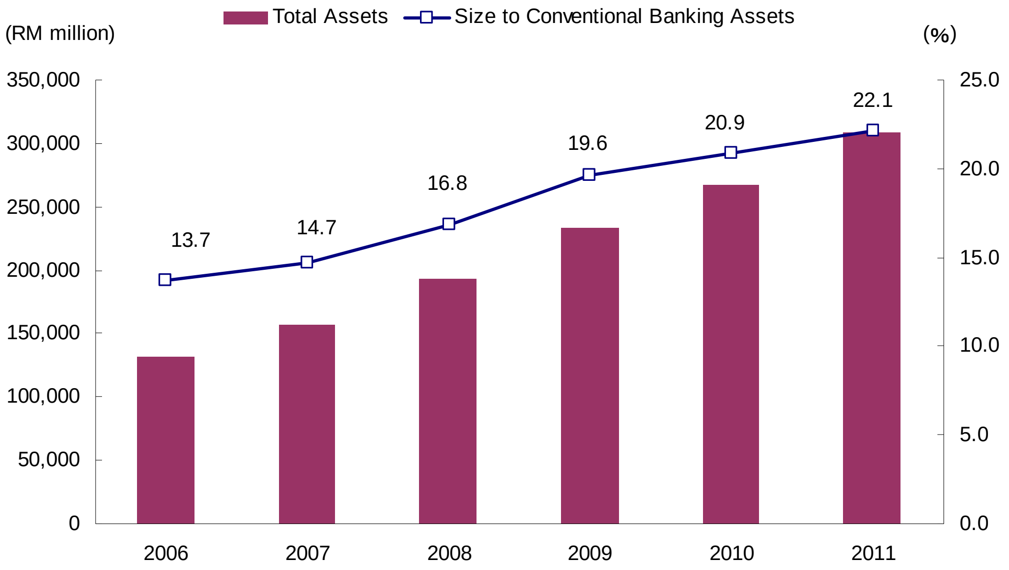
The expanding trend of Islamic finance will continue in the future. In the Central Bank of Malaysia Act 2009, it is emphasized that there are two types of financial system in Malaysia, namely, conventional finance and Islamic finance.

b. Contribution of Islamic Finance to Malaysia's Financial System

Islamic finance is contributing to Malaysia's financial system in various ways. Firstly, it enhances financial stability. Shariah governance, which requires accordance with Shariah, is promoting the improvement of governance. The existence of strong Shariah governance framework coupled with the Shariah injunctions ensures that funds are mobilised for productive purpose and supported by underlying assets. These are also consistent with universal values which promote ethical investment and financing activities. In Islamic finance, speculation is prohibited, and for example, speculative transactions using derivative products or foreign exchange dealing transactions are not implemented. Therefore, it seems that Islamic finance can contribute to the global financial stability.

[79] Refer to Pricewaterhouse Coopers [2010] about the following data.
[80] Refer to the Securities Commission [2011] about the following data.

Figure 4.19. Total Assets of Islamic Banking System



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

Note: 2011 is at the end of October.

These points seem to be appealing to customers including non-Muslims. The basic idea is that profits and risks should be shared between banks and customers. It is similar to joint ventures. In summary, Islamic finance is outstanding from the standpoint of ethics and fairness.

Secondly, as targeted in the MIFC initiative, Islamic finance is expected to bring in the Middle-East investors, expand cross-border transactions, and diversify the financial sector.

Thirdly, Islamic finance is expected to contribute to economic growth. The EPPs of the ETP include promotion of Islamic finance. By 2020, Islamic finance is expected to create employment for 12,000 people.

The contribution to the economy also lies with the underlying buy-and-sell asset transactions which is a requirement in the contracts.

c. Tasks for Further Developing Islamic Finance in Malaysia

The approaches to develop Islamic finance are roughly divided into participants and infrastructure development (promotion of competition, development of foreign exchange and capital markets, human capital development, protection of Islamic deposits, etc.), and development of legal and regulatory framework (enhancement of Shariah framework, development of related laws and regulations, improvement of risk management, establishment of international standards through Islamic Financial Services Board, etc.). In particular, in the latter area, the regulatory framework must be consistent with those by BIS, IAIS (International Association of Insurance Supervisors), and so on, and regulatory arbitrage must be avoided. In Islamic finance, for example, the concept of deposit costs is different from that of conventional finance, and proper guidance and governance are necessary. Also, takaful includes the concept of mutual help, and is different in the character of fiduciary duties, etc., from conventional insurance.

Regarding the future tasks for Islamic finance, basically, it is imperative to improve recognition of Islamic finance among people and to expand Islamic finance businesses. Also, as was stated in this report, the key priorities for Malaysia would be on internationalization of Islamic finance as outlined in the Financial Sector Blueprint 2011-2020.

In addition to these, first, regarding market development, liquidity management is an important problem. Many countries do not have an Islamic interbank market for adjusting liquidity, and short-term liquid instruments are lacking. In Malaysia, the International Islamic Liquidity Management Corporation (IILM) was established in October 2010, by the collaboration among the authorities of many countries. The IILM will be a part of international Islamic infrastructure to issue high quality Shariah-compliant financial instruments in major reserve currencies to support the liquidity needs of the global Islamic financial system. In each bank, proper liquidity management is mandatory.

Also, in order to provide depositors a competitive rate of return, banks have to effectively manage the displaced commercial risk (DCR) by prudent administration of profit equalization reserves (PER). DCR refers to the risk that Islamic banking institutions will have to forgo part of their share of profit in order to provide market rates of return to investment account holders. The management of various kinds of market risk is a big challenge for Islamic banks.

Second, regarding human capital development, by establishing an international research institution named ISRA (The International Shariah Research Academy for Islamic Finance), a university named INCEIF (The International Center for Education in Islamic Finance), and an institution called IBFIM (Islamic Banking and Finance Institute Malaysia) that caters for training needs of the industry practitioners, the organizational structure has been developed in Malaysia in order to develop and internationalize human capital, and to promote cross-border transactions. In the future, this framework should be strengthened more. Each bank also has to keep and educate specialized employees.

Third, regarding legal framework, in the Central Bank of Malaysia Act 2009, the status of Shariah committees was improved. In October 2010, the BNM issued the Shariah Governance Framework for Islamic Financial Institutions. The role of the Shariah Committee has been elevated from that of an advisory nature to one with a high degree of authority and clear accountability for decisions on Shariah matters.

Also, the BNM formed a high-level Law Harmonization Committee in 2010 to review, harmonize and further strengthen the legal infrastructure. The committee has a diverse membership from the Government, regulatory authorities, experienced Islamic finance practitioners and scholars. In this committee, part of the discussion will be on the differences between conventional and Islamic laws, about land laws or contract laws, for example, that are impeding the expansion of Islamic finance.

Fourth, regarding risk management, it requires identification and measurement of risks based on different stages of Shariah contracts in Islamic financial transactions. It should be emphasized that the regulatory and supervisory framework has taken into account the peculiarities of Islamic financial transactions.

For example, the BNM has prepared a guideline named the Capital Adequacy Framework for Islamic Banks, whose newest version was announced in July 2011. The Framework specifies the risk measurement methodologies for the purpose of calculating minimum capital requirements to be held by Islamic banks against credit risk, market risk and operational risk. In Islamic finance, risk profiles of various transactions are different from those of conventional finance, so care must be taken. For example, the risk profile of Ijarah is different from that of conventional leasing.

Also, the transparency regarding the rate of return framework and profit equalization reserves is a focused point by the BNM. Each bank has to clear the requirements and maintain operational soundness.

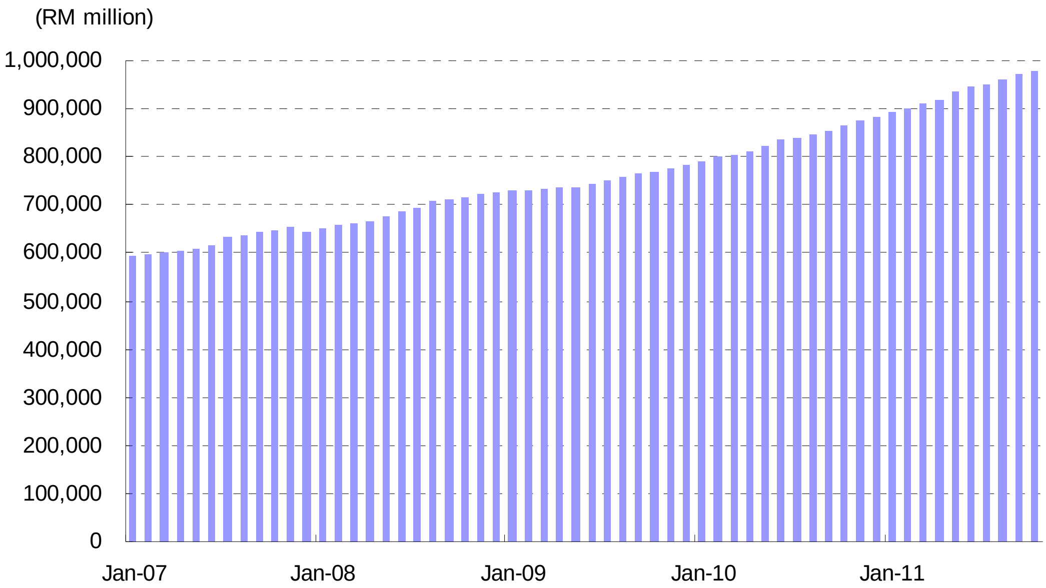
Furthermore, banks have to be careful of Shariah risk. This concept means that, if a transaction is judged to be inconsistent with Shariah, the transaction must be cancelled and achieved profit must be donated. This means huge potential costs and serious risk for banks. That is why it is very important for banks involved in Islamic finance to deepen Shariah understanding. In order to mitigate Shariah non-compliance risk, the BNM has pursued various initiatives over the years, such as strengthening the Shariah governance framework, ongoing discussion (both at domestic and international level) among the Shariah scholars to resolve contemporary issues, provision of scholarships for furthering Islamic finance studies, etc.

4.4. Soundness of the Banking Sector

4.4.1. Impact of the Global Financial Crisis on the Banking Sector

Overall confidence and stability in the Malaysian financial sector have been preserved throughout the global financial crisis, underpinned by a strong financial sector and negligible exposure to subprime-related assets and affected counterparties. Ample liquidity in the financial system also mitigated the risk of systemic contagion, thus allowing the financial sector to continue providing financial intermediation and services to the economy at large. In the banking sector, partly thanks to the 150 basis point reduction in the overnight policy rate, total loans continued to increase (Figure 4.20.), and the impaired loan ratio continued to decline.

Figure 4.20. Total Loans of Banking System



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* October 2011

The reasons the impact of the crisis was small are, first, basically, the experience of the 1997 financial crisis contributed. The financial reforms that followed, mainly led by the 2001 Financial Sector Masterplan, improved the capabilities of financial institutions. The number of banks decreased and competitiveness and soundness improved markedly. Governance was also improved by strengthening monitoring functions towards directors. Bank supervision was enhanced. Furthermore, because the bond markets were developed, some risk diversification in the financial system was set in place.

Second, the emergency measures for keeping liquidity were effective. The extension of the blanket guarantee on all depositors by the government in October 2008, which was adopted in Singapore and Hong Kong, too, also provided added confidence to depositors, averting any unusual surge in deposit withdrawals. The guarantee was extended to all ringgit and foreign currency deposits with banks and deposit-taking DFIs regulated by the BNM.

Third, the exposures of the banking sector (external assets plus external liabilities) towards the US and European countries were less than 15% of total assets. Also, as few foreign investors participated in the domestic capital markets, sudden capital outflows did not happen even when the volatility of international financial markets heightened. The legal requirement for all foreign institutions in Malaysia to be locally incorporated also limited any contagion effects.

In July 2009, the Corporate Debt Restructuring Committee (CDRC) was reinstated as a pre-emptive measure to facilitate corporate debt resolution. Given the structural change in the funding composition within the economy, the scope of the

CDRC was expanded to cover the debt restructuring not only of bank borrowings but also of debt securities. The CDRC initially planned to accept cases for companies with aggregate indebtedness of RM100 million or more and with at least 3 financial creditors. Subsequently, in February 2010, the CDRC revised the eligibility criteria to a minimum of aggregate indebtedness of RM30 million or more with at least 2 financial creditors. In 2010, the CDRC received only 13 applications for assistance from distressed corporations with a total debt value amounting to RM2.2 billion.

In reaction to the global financial crisis, stress tests for banks have been enhanced, and it has become usual to assume extreme shocks. Stress tests are implemented by both banks themselves and the BNM.

Furthermore, to further enhance access to capital market financing, Malaysia established its first guarantee institution, Danajamin Berhad, in 2009 to provide credit enhancements to viable corporations and businesses.

The experience of the global financial crisis may be evaluated positively, because Malaysian authorities learned many lessons.

4.4.2. The Central Bank of Malaysia Act 2009

A new Central Bank of Malaysia Act was passed in 2009. The work for this enactment was started long before the global financial crisis. It provides greater clarity on the Bank's financial stability mandate and the corresponding primary functions.

The important point is that it became possible for the BNM to require various actions for improving governance by the financial institutions not regulated by the BNM. The Act enables the conduct of more effective and holistic surveillance, covering both regulated and non-regulated institutions and markets in the financial system. If necessary, the BNM will be able to intervene and take resolution measures to mitigate risks that stem from regulated and non-regulated entities.

As the domestic financial system becomes more integrated with the regional and global financial markets, the Bank's ability to respond swiftly to manage and resolve crisis in an orderly manner is critical to prevent disruptions to the intermediation process and the broader economy. The Act institutionalizes clear triggers and a more flexible set of crisis intervention and resolution policy instruments to deal with distressed institutions or markets. It also provides for coordination and cooperation arrangements with other supervisory authorities at both the national and international levels.

In 2010, the Financial Stability Executive Committee was organized, and has been in charge of various decisions. The members are gathered from the Ministry of Finance, the MDIC, the private sector, and so on, for the purpose of checks and balances.

4.4.3. Safety Net Mechanism

a. History of the Deposit Insurance System

When the financial crisis happened in 1997, the blanket guarantee of deposits was adopted and was continued until the establishment of the MDIC (Malaysia Deposit Insurance Corporation) in 2005. Construction of a deposit insurance framework was planned in the 2001 Financial Sector Masterplan. The MDIC started the deposit insurance system whose upper limit of the insured amount was RM60,000 per depositor.

At the global financial crisis in 2008, the blanket guarantee was implemented only for deposits of individuals. It was administered by the MDIC on behalf of the Government. The blanket guarantee was time-limited from October 2008 to the end of 2010. At the same time, Australia, Hong Kong and Singapore also adopted the blanket guarantee policies.

The blanket guarantee by Malaysia was a pre-emptive policy to maintain confidence, and no bank resolution actually happened. Also, in many cases, blanket guarantee is adopted only as an announcement by the government, but in the case of Malaysia, it was accompanied by legislation.

The Malaysian authority keeps in close communication with the authorities of Hong Kong and Singapore. In Singapore, there are many branches of Malaysian banks, and the cross-border cooperation is very important. In 2010, in Malaysia, insurance companies also were included in the deposit insurance system, and the same system was adopted also in Hong Kong and Singapore. However, it should be added that this is only cooperation and harmonization of the system is not targeted.

Reacting to the global financial crisis, the Malaysia Deposit Insurance Corporation Act 2011 was enacted. In its preamble, purposes of the new system are clarified. In this Act, as in the system of Canada, the UK and the US, "bridge banks" can be established as subsidiaries of the MDIC (refer to Article 10 of the Act).

Also, insurance companies (their premiums) came to be included in the new system. Therefore, there are three funds in the system, namely, a fund for deposits of commercial banks, a fund for life insurance companies, and a fund for other insurance companies. Furthermore, as each fund is accompanied by a fund for the Islamic peers, there are six funds in total. The reason insurance companies were included in the system was that, due to the experience of the global financial crisis, it became clear that systemic risk existed also for insurance companies, taking as an example AIG (American International Group, Inc.), etc. As insurance companies are regulated by the BNM, the same as banks, they came to be included in the system operated by the MDIC.

Investment banks are not included in the deposit insurance system, because they do not have small amount deposits. Deposit insurance is a system for consumer protection, not for investor protection.

The new Act is based on the lessons of the global financial crisis in 2008. Also, the establishment of a deposit insurance system was included in the 2001 Masterplan, which was based on the lessons of the 1997 crisis.

The MDIC is a member of the International Association of Deposit Insurers (IADI), where it actively contributes its knowledge, expertise and understanding with other members, while also participating in the development of principles and guidance. This shows that the deposit insurance system in Malaysia ranks as one of the highest by international comparison.

b. Details of Deposit Insurance System

(1) Upper Limit of the Guarantee

The present upper limit of insured amount is RM250,000 per depositor. By this, 99% of individual depositors are protected. On the other hand, only 33% of deposit balance is protected. Since corporations and other big-amount depositors are not protected, market discipline works here. Also, regarding the 99% of depositors, it can be said that the existence of the MDIC provides market discipline.

(2) Risk Assessment and Premiums

The BNM and the MDIC are keeping in close communication. By this, they can complement their own risk evaluation with each other. The MDIC always tries to minimize the risk exposure to the deposit insurance funds.

The insurance premiums respond to the risk of each bank. This system is called the Differential Premium System. In this system, a member bank shall be assessed and classified into different premium categories in an assessment year on a combined quantitative and qualitative criteria approach. In order to achieve higher objectivity and transparency, a larger weight is assigned to the quantitative criteria, i.e., 60 out of a total score of 100, while a score of 40 is assigned to the qualitative criteria. For qualitative criteria, each member shall be assessed based on the BNM's supervisory ratings (weight 35) and other information (weight 5). Premium categories are 1 to 4, and premium rates for each category are 3bps, 6bps, 12bps and 24bps against the deposit balance. These categories are different from credit ratings provided by rating agencies, that measure solvency. Therefore, the categories are not announced to the public. If they were open, it might lead to bank runs.

The risk assessment criteria include capital ratios, asset concentration, responses to Basel regulations and IFRS (International Financial Reporting Standards). They are not static and must always be reviewed.

(3) Management of Deposit Insurance Funds

The deposit insurance funds are maintained and administered by the MDIC, although the BNM acts on its behalf in managing the investment activities of the funds in line with the deposit insurer's board-approved investment policy and section 30 of the

Malaysia Deposit Insurance Corporation Act 2011. Generally speaking, the management is implemented in a low-risk, liquidity-emphasizing and conservative way. Conventional finance funds and Islamic finance funds are managed separately. The MDIC is a statutory body, and if necessary, it can borrow money from the government. In many countries, deposit insurance companies are private companies. In these cases, premium rates must be higher and the funds must be larger.

(4) Public Awareness

For the purpose of consumer protection, public awareness is very important. Depositors must know the benefits and the limits of the deposit insurance system. Incorrect knowledge may lead to bank runs. Also, if even one depositor does not know about the deposit insurance system, when a real bank resolution case happens, the government cannot carry out the limited insurance payments and it has to provide the blanket guarantee.

In order to avoid this situation, the MDIC is making various efforts such as distribution of pamphlets in bank branches, TV and radio commercials, and is doing its best to let everybody know about the system. If a new financial product is not covered by deposit insurance, that fact must be clarified to depositors. The MDIC has to prepare information in every language used in Malaysia. Also, the MDIC is making periodical surveys about the extent of information penetration. It also has a call center for the purpose of the provision of information about the deposit insurance system.

c. Bank Resolution System

In order to solve problems of deteriorated banks, early intervention is very important. The BNM and the MDIC cooperate together for doing this. It is the responsibility of the BNM to decide if a bank is viable or not, and pass the bank to the MDIC. The BNM has the ultimate discretion as to whether to pass on the resolution of a member institution to the MDIC. The MDIC is solely responsible for the selection of options for the failure resolution and is accountable for results of the resolution process.

The BNM has broad supervisory powers to intervene and direct banks to take the necessary corrective action. In many cases in other countries, the authorities wait until a bank becomes insolvent. However, if they do so, depositors may be badly damaged. A bank resolution cannot be avoided only by regulation and supervision, and that is why corrective actions are important. Also, as a precondition, giving banks incentives for sound risk management is necessary. Therefore, corporate governance must be enhanced.

The members of the MDIC are limited to commercial banks, Islamic banks and insurance companies. On the other hand, the BNM also covers investment banks and DFIs. Its role is to maintain stability of the financial system as a whole. The role of the MDIC is to implement the resolution of a specific deteriorated bank. The relationship between the BNM and the MDIC is complementary. They have a Strategic Alliance Agreement, and cooperate with each other in various ways such as information exchange, etc.

The most important mission for the MDIC is to minimize the costs that occur to depositors by a bank resolution. A bank resolution must not lead to the whole financial system crisis, because that would mean huge costs. Since the establishment of the MDIC, there has been no payout yet. Large numbers of simulations, case studies, trainings and workshops are carried out by the MDIC, and if a real case should happen, these efforts will be fully utilized to decide how the resolution should be done.

4.4.4. Crisis Prevention Framework

a. Risk Management and Capital Ratio Regulations

In recent years, the BNM has introduced prudential and regulatory reforms progressively, which included regulations on risk management capabilities, governance standards and transparency, to further enhance the strength of the banking system. This was done in tandem with developments in the international scene, which saw a regulatory focus away from rule-based regulation to principle-based regulation, and placing greater reliance on a bank's internal controls and risk management systems.

Regarding risk management and capital ratio regulations, it is necessary to make them consistent with international standards. For that purpose, cooperation among regional authorities is necessary. However, it has to be emphasized that each country has its own conditions, and they must be taken into consideration.

In 2008, the adoption of Basel II started, and following two years of intense efforts by banking institutions, 11 banking institutions completed the transition to the Internal Rating-Based (IRB) approach for credit risk under Basel II in 2010. With their transition, all banks in Malaysia now comply with the Basel II capital standards. This is a long-term process, and there will be gradual enhancement of risk management. The BNM is going to monitor banks closely in order for the minimum requirements to be fulfilled.

In December 2011, the adoption policy of Basel III capital and liquidity standards ("Implementation of Basel III") was announced by the BNM[81]. It says that the BNM targets to implement the reform package in Malaysia in accordance to the globally-agreed levels and implementation timeline which provides for a gradual phase-in of the standards beginning in 2013 until 2019. Meeting the Basel III requirements will not necessarily be easy, but the implementation is expected to deliver a more resilient banking system and the likelihood and severity of future banking crises will be reduced.

The BNM is also making various efforts to improve risk management, such as

[81] Refer to the following for further information:
http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/12_nt_007_25.pdf

through enhancements to guidelines on credit risk management, diversification of credit risk and stress tests. Recently, through its supervisory activities, the BNM has observed a general strengthening of risk management practices among banking institutions.

b. Corporate Governance

It is extremely important to improve corporate governance. Various efforts are being made in order to preserve a clear separation between the ownership and management within a financial institution. It is important to make rules about who can become directors. The issuance of the Guidelines on Fit and Proper for Key Responsible Persons in 2011 will further complement the corporate governance framework. Furthermore, by the Financial Institutions Directors' Education (FIDE) program, capacity building of directors is being implemented. This program applies to both present directors and candidates for directors.

c. Bank Supervision

The BNM adopted an enhanced risk-based supervisory approach in early 2007. Under this approach, a bank is accorded a Composite Risk Rating (CRR). It is derived from an assessment of the risks inherent in an institution's significant activities, the overall quality of its operational management and risk management control functions to mitigate the inherent risks, and the extent of capital and earnings support available to the institution to absorb unexpected losses. The supervisory rating is subjected to review annually, but the rating can be changed at any time.

The recent main focus of supervision is on a) bolstering the capacity of financial institutions to anticipate and respond to emerging risks, b) ensuring that identified vulnerabilities are followed up on and effectively rectified, and c) promoting responsible and fair practices toward consumers in the light of more intense competition.

Regarding supervision, the BNM has close cooperation with domestic and overseas authorities. Investment banks are regulated both by the BNM and the Securities Commission. There are various cooperative and information exchange arrangements in place between the BNM and other relevant authorities. For example, the BNM has in place written understanding with the Securities Commission and the MDIC to facilitate collaboration, cooperation and information exchange.

The BNM is strengthening cooperation with the central banks of neighboring countries. The adoption of Basel II is implemented country by country, but cooperation is effective about technical aspects such as model building. There are official and informal working groups within the region for various activities. Officially, the EMEAP has a working group for supervision. There, discussion for supervisory matters is implemented and the result goes to the BIS for feed-back purposes.

There are more and more financial risks globally, and international financial regulatory reforms are being made. In this environment, bank supervision has to become more and more intensive. Particularly, pre-emptive monitoring and supervision are becoming important. The BNM has to follow the rapid changes of risk conditions. As financial integration is strengthened globally, regional cooperation among the authorities within the EMEAP or the ASEAN should be utilized effectively.

d. Consumer Protection

The consumer banking business is increasingly competitive, and the possibility is increasing for consumers to receive excessive lending or financial services. This might lead to a too heavy debt burden being borne by consumers against their long-term interests. In this environment, enhancement of consumer protection is required. Also, consumers are becoming more and more sophisticated, and complicated financial products are increasing. Therefore, transparency of these products must be ensured.

In recognition that consumer protection and education play a crucial role in ensuring the stability of Malaysia's financial system, the BNM established the Consumer & Market Conduct Department which is responsible for undertaking various initiatives to enhance consumer protection, including issuing a number of guidelines (e.g. Guidelines on Product Transparency and Disclosure, Guidelines on Responsible Financing). The BNM also set up the Credit Counseling and Debt Management Agency to advocate prudent financial management and provide assistance to individuals with credit problems. The BNM also publishes guidance to consumers on money management.

e. Payment and Settlement Systems

The BNM performs oversight over the payment systems and payment instruments in Malaysia, as mandated under the Payment Systems Act 2003. Greater focus is given by the BNM on ensuring the smooth operation of the Real-time Electronic Transfer of the Funds and Securities System (RENTAS), which provides real-time gross settlement (RTGS) of transfers between members for high-value payments as well as Delivery versus Payment (DvP) securities settlement. RENTAS is operated by the BNM's subsidiary, Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear) and its members comprise of financial institutions and institutions that are active players in the money market or capital market.

As of the end of 2010, the total value of transactions settled through RENTAS represents 51.5 times Malaysia's GDP while the daily average turnover of RENTAS recorded an average annual growth of 18.9% in the past five years.

To mitigate potential disruptions or payment gridlock in RENTAS, the BNM continuously engaged MyClear to ensure relevant risk management tools are effectively deployed to ensure smooth functioning of the system. During the global financial crisis, RENTAS remained resilient and continued to operate smoothly without major disruptions.

f. Capital Account Liberalization

The BNM has adopted gradual liberalization of capital account transactions, and there are not many regulations left.

The external exposures of banks (total external assets plus total external liabilities) are contained to around 15% of total assets. Formerly, there was a regulation towards banks to limit foreign exchange open positions to 25% of their capital, but it was abolished because the risk management capability of banks improved. The BNM is now only monitoring their position.

Overall foreign currency exposures of banks, as measured by the net open position were at 3.8% of capital base as of the end of 2010. Other foreign currency exposures in the form of foreign currency deposits and foreign currency denominated securities remained small in proportion to total deposits (4.7%) and securities (3.5%), respectively. Deposits by non-residents were at 2.4% and 10.6% for ringgit and foreign currency deposits, respectively. Ringgit deposits accounted for 81.3% of total funding for Malaysian banks.

Direct exposures of banks to foreign currency asset-liability mismatches remained at less than 1% of total assets of the banking system.

The recent surge of capital inflows is mainly directed to capital markets. The weight of foreign currency denominated borrowings by banks is not high. These borrowings are mostly for specific purposes and in many cases, they are matched with foreign currency assets.

The BNM is continuing gradual capital account liberalization, considering many factors such as whether a new type of transaction will contribute to economic growth. There are various preconditions for liberalization such as financial system development, and the BNM is also very concerned with the sequencing.

4.4.5. The Banking Sector in the Near Future

The government's forecast of the economic growth rate for 2012 is 5 to 6%, but there is some possibility that it will be a little lower. In Malaysia, dependence on exports is high, shown by the size of exports against GDP being about 110%. As the conditions of European economies become worse, the downside risk for Malaysia is also high.

The budget for 2012 includes many consumption promoting policies. However, consumption has been continuing at 6 to 7% growth for a few years, and it will slow due to worsening consumer sentiment. The ETP and economic growth for the next decade are envisaged to be private sector-funded.

Since the global financial crisis, the destinations of exports shifted a little from the

US to China, and exports to European countries also increased by 2 to 3 percent from less than 10%. The main European destinations are Germany, France and the Netherlands. Some downside risk seems to exist for the Malaysian economy.

On the other hand, regarding the banking sector, as the exposures to European countries are small, there is little possibility of contagion of the European debt crisis to Malaysia. Capital inflows are continuing, and the possibility of sudden capital outflows is low. Even if it should happen, Malaysia's foreign exchange reserves are equal to 5 months of imports, and there is no serious concern that a crisis may happen.

However, banks are cautious about the prospects for their liquidity, and some of them are reluctant to increase assets. They prefer short-term, variable-rate loans. Also, borrowing demand may decrease due to the slowdown of the economy. In this environment, the systemic risk is low for the banking sector, but the growth rate of bank loans in 2012 may be lower than that of 2010 and 2011.

Conclusion

The banking sector in Malaysia has been developed through restructuring after the Asian financial crisis and the implementation of the Financial Sector Masterplan. Now, it has become one of the most highly developed banking sectors within the ASEAN region. On the other hand, as the market size is limited due to the relatively small population, competition is very fierce.

Particularly, competition is very hard for corporate loans for two reasons. First, the bond markets have expanded thanks to the efforts of the authorities following the Capital Market Masterplan and the Asian Bond Markets Initiative, and bond issuance became an important financing tool for public corporations, infrastructure related companies, financial institutions and other large corporations. Second, the export-led growth strategy after the 1997 crisis led to the continuation of low investment rates.

In this environment, banks have been seeking limited corporate financing demand, and also expanding consumer finance. It should be emphasized that, in this way, the banking sector has been playing a role of supporting the economic growth. Also, the SME loans have been growing rapidly, and they account for about 40% of corporate loans by utilizing credit guarantee facilities and credit information databases of SMEs.

Several future tasks for the banking sector can be pointed out. First, banks should further enhance their competitiveness. It is expected that more foreign banks will come into the market. Local banks must achieve, in addition to various efforts in each business, improvement of efficiency, restructuring of business lines and expansion of high value-added businesses.

Second, banks have to contribute to the country's economic growth. The government is trying to expand investments by implementing the ETP, to improve the economic growth rates, and to make Malaysia a high-income country. Banks have to support this effort through providing proper financial intermediation. Also, banks should support development of new industries, and the financial industry itself has to make its growth rate higher.

Third, banks should contribute to the regional economic and financial integration. The ASEAN region is aiming to construct the ASEAN Economic Community by 2015, and more and more people are recognizing the importance of the integration. Malaysian local banks are expanding businesses abroad and gaining recognition as regional banks. This strategy should be reinforced, and along with this, the discussion among banks within the region should be deepened about how to progress regional financial integration. This kind of activity is already being organized by the Association of Banks in Malaysia, etc, and it should be enhanced.

Fourth, Islamic finance should be expanded further. Islamic finance contributes not only to the promotion of cross-border financial transactions, but also to the improvement of financial stability and the development of the financial industry in Malaysia.

Finally, the financial safety net mechanism has been developed to a relatively high level in Malaysia. The future tasks for improving soundness of the banking sector are, responses to the international financial regulatory reforms, enhancement of corporate governance, strengthening of pre-emptive bank supervision and cooperation with overseas financial authorities, and strengthening of consumer protection. As consumer loans are expanding, risk management in this area is becoming increasingly important. Also, as global financial integration is progressing rapidly, enhanced bank supervision is indispensable in order to avoid a future crisis.

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5. Indonesia

5.1. Characteristics of the Banking Sector

5.1.1. Domestic Economic Situation and Industrial Structure

a. Population

Indonesia's population is approximately 230 million, the fourth largest in the world and the largest in Southeast Asia. Over half of the population lives on the island of Java, home to Jakarta. Although the influx of people into Jakarta appears to have peaked in recent years, the major cities account for over 40% of the population, and the trend for people to concentrate in the cities is continuing.

Looking at the population structure by age, the population under the age of 15 accounted for approximately 30% of the total population and the population of the age of 15 to 65 was around 66% of the total. On the other hand, the population over the age of 65 was less than 5%[82]. Although the birth rate has been declining in recent years, the population bonus period is expected to last another 20 years.

b. Domestic Economic Situation

Indonesia's economy has been strong since the mid-2000s. In the period from 2005 to 2010, GDP has doubled, with an average growth rate of over 5%. The per capita nominal GDP has reached $3,005, over the $3,000 mark at which durable consumer goods begin to spread rapidly.

Household consumption expenditure and gross fixed investment have contributed significantly to the country's economic expansion. In 2010, household consumption expenditure accounted for 57% of GDP, up 10.3% on the previous year, with the largest economic growth contribution rate of 2.7%[83]. Looking at the breakdown, expenditure on non-food items such as automobiles, two wheeled vehicles and mobile phones have exceeded expenditure on food items, and this trend is increasing. Investments were up 8.5% on the previous year, accounting for 24% of GDP. The contribution rate was 2%, second only household consumption expenditure. A breakdown of investments reveals that construction investment has grown strongly, accounting for over 70% of the total investments, and investments in manufacturing plant and equipment have also performed well, at over 15%.

c. Industrial Trends

Indonesia's main industries are manufacturing, agriculture and mining. Reflecting the trend of increased motorization in recent years, the manufacture of transportation equipment, such as automobiles and two wheeled vehicles, has grown

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82 BPS-Statistics Indonesia "Statistical Yearbook of 2010"
83 BPS-Statistics Indonesia website (http://dds.bps.go.id/eng/index.php/).

rapidly, whereas the index of industrial production is just over 3% on average, falling below the economic growth rate. Agriculture's share of GDP is falling year by year.

In addition to these industries, transportation and communications have grown rapidly, with a GDP growth share that is larger than that of mining. Construction's share of GDP is also rising.

d. Employment

The employment situation is improving, reflecting a healthier economy. The unemployment rate peaked at 11.2% in 2005 and has declined year by year, falling to 7.1% in 2010[84]. In terms of industry sectors, there has been no big change in the labor structure. In 2010, laborers in agriculture, forestry, hunting, and fishery accounted for a massive 38% of the total, followed by wholesale trade, retail trade, restaurants and hotels at 21%, community, social and personal services at 15%, manufacturing 13%, and transportation, storage, communications and construction 5%.

While agriculture, forestry, hunting, and fishery is still performing its role as a major provider of employment, its share is falling, and that of wholesale trade, retail trade, restaurants and hotels, community, social and personal services, and manufacturing is growing.

Wages are trending upwards overall, however, there are still large income disparities among different industries and different regions. In terms of average monthly wages by industry, in 2009 the average for mining was 4,384.8 thousand rupiah, for wholesale trade, retail trade, restaurants and hotels 3,879 thousand rupiah, and for manufacturing 1,282.6 thousand rupiah[85]. The average for mining was more than three times that for manufacturing. In terms of different regions, for example, while the average wage in manufacturing workers in the Jakarta-Padang area was 1,344.4 thousand rupiah, that in the Tengah & Yogyakarta area was roughly 60% of that, at 791.5 thousand rupiah.

5.1.2. Overview of Financial System

a. History of Banking Sector

In Indonesia, before the Second World War, Dutch banks had been playing the key role in the banking sector. In 1945, when Indonesia became independent, the central bank and some state owned banks, which had been Dutch banks, were established. However, the foundations of the current banking system were established after 1966, when the Soeharto administration was inaugurated.

Between 1966 and 1982, the banking sector consisted of Bank Indonesia and state owned banks. During this period, state owned banks dominated the banking sector because they were able to utilize the abundant funds, which had been provided by

[84] BPS-Statistics Indonesia website (http://dds.bps.go.id/eng/index.php/).

[85] BPS-Statistics Indonesia website (http://dds.bps.go.id/eng/index.php/).

foreign aid and profits from the soaring oil prices.

After the financial reforms of 1983 and 1988, the monopoly-market style changed to a modern-market style. In the 1980s, financial deregulation was implemented. In 1983, the liberalization of interest rates and the abolition of loan limits were implemented. In 1988, the deregulation of the establishment of private sector banks, the easing of market participation restrictions on foreign banks entering the banking sector, and the liberalization of foreign capital borrowing was implemented.

While these financial reforms advanced the modernization of Indonesia's banking sector, they also led to a certain instability within the banking sector. In 1997, when the Asian financial crisis occurred, the fragility of Indonesia's banking sector was exposed. After the crisis, non-performing debt had to be sold off, and the banking sector had a huge capital loss. The end result was a severe contraction of bank lending to the private sector and the virtual paralysis of the banking sector's financial intermediary function.

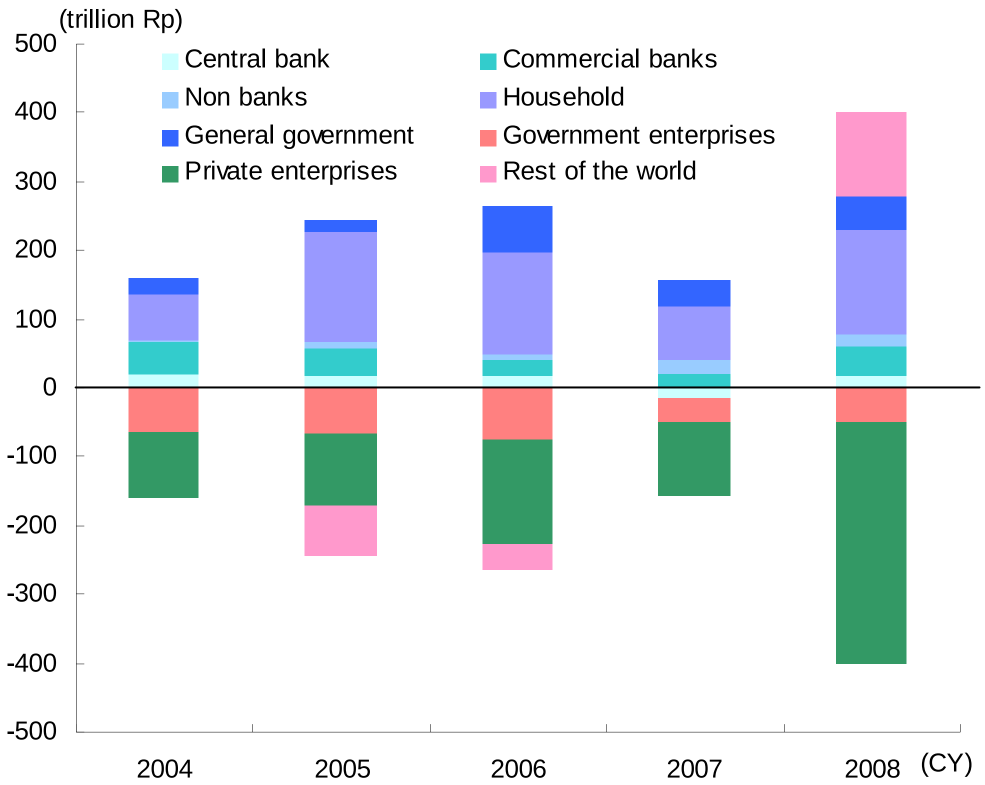
In response to these circumstances, in 1998, the Indonesian government began to implement reform steps founded on the strengthening of the country's banking systems and the securing of its soundness, under the guidance of the IMF. In 2004, Bank Indonesia introduced the Indonesian Banking Architecture (API), which is a comprehensive basic framework for the Indonesian banking system. This was done in order to further strengthen the banking sector, because the reconstruction of the banking system after the Asian financial crisis had finished. Currently, under this plan, Bank Indonesia has been promoting the expansion of Islamic banking and the strengthening of regional banks, as well as the strengthening of commercial banks.

b. Flow of Funds Structure

In Indonesia, the non-financial private enterprises sector and the non-financial government enterprises sector are constantly short of capital. On the other hand, the household sector and government sector have capital surpluses (Figure 5.1.).

Examination of the flow of funds account reveals a structure whereby household and government sector capital surpluses are provided to the public and private corporate sectors through the intermediation of the financial sector. After the Asian currency crisis, regulation caused the inflow of foreign funds to decline. However, as the economy recovered from the plunge, investment in plant and equipment surged, which led to increased demand for capital by the corporations. These financing needs could not be met by domestic surplus alone, and the inflow of foreign funds began to increase once more. Also, though the commercial banks have been the main financial intermediary, in recent years the importance of non-bank financial institutions has grown.

Figure 5.1. Gross Saving and Investment by Sector



Source: BPS-Statistics Indonesia "Statistical Yearbook of 2010"

c. Direct Finance and Indirect Finance

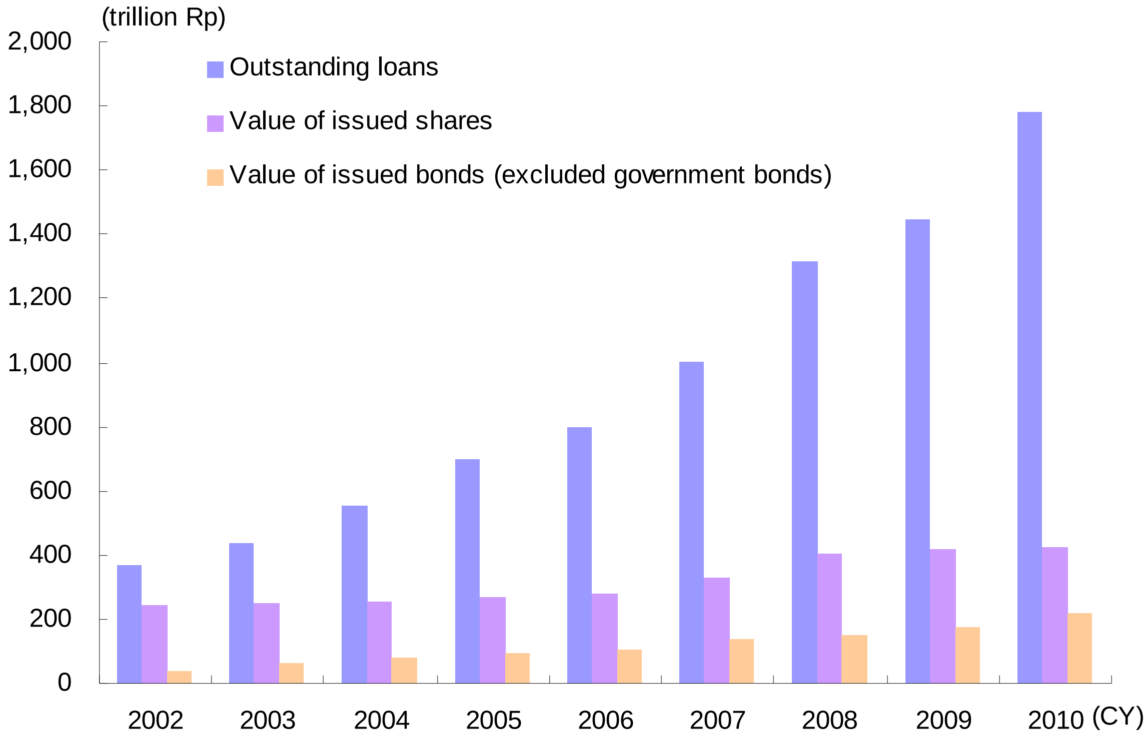
Indirect finance accounts for over half of Indonesia's capital procurement. At the end of 2010, issued shares were worth a total of 495 trillion rupiah, and issued bonds 215 trillion rupiah, against which total loans (rupiah denominated + foreign currency denominated) provided by the capital markets were worth roughly three times that, at 1,784 trillion rupiah[86] (Figure 5.2.).

Since 2000, the loan total has been growing at over 20% from the previous year, on average[87]. At the end of 2010, it was 1,784 trillion rupiah, eight times the 2000 total of 269 trillion rupiah. Loans to businesses account for 70%. However, with the rapid increase in personal loans, the business loan share is dwindling year by year. Of the loans for business, one third is for corporate financing and the rest for small and medium sized enterprise (SME) loans and micro-finance. It is mainly large corporations that make use of corporate financing. SMEs do not have sufficient

[86] Bank Indonesia website (http://www.bi.go.id/web/en/).
[87] Bank Indonesia website (http://www.bi.go.id/web/en/).

accounting systems and therefore cannot use corporate financing. These smaller companies must use SME loans and micro-finance. In recent years, encouraged by government plans to nurture SMEs, the use of SME loans and micro-finance is increasing.

Figure 5.2. Banking and Capital Markets



Source: Bank Indonesia "Indonesian Financial Statistics"

In terms of direct finance, the number of companies listed on Indonesia's stock exchange[88] is growing year by year. From 347 companies in 2000, this number grew 1.5 times to 521 by 2010. As a result, the number of issued shares has grown more than ten times, from 812 billion to 8.68 trillion.

As for the bond market, at the end of 2010, the cumulative number of bond issuing companies has doubled from 91 companies in 2000 to 189 companies and the total value of issued bonds in the private sector has also increased more than sevenfold from 29 trillion rupiah in 2000 to 215 trillion rupiah. However, because only blue-chip companies can issue bonds, more than 70% of issued bonds are government bonds.

Listed companies and those that issue corporate bonds are limited to a few large,

[88] Indonesia Stock Exchange was formed from the merger of Jakarta Stock Exchange and Surabaya Stock Exchange in November 2007. The figure for 2000 is the number of companies listed on both exchanges.

blue chip companies with good credit ratings. Thus, the majority of shares and bonds are private offerings. This is because European and American ratings agencies exclude many Indonesian capitalized firms from their ratings, and domestic ratings agencies lack information and investigation and analysis capabilities, so rating takes a long time. This has prompted the Indonesian government to take steps to improve the ratings system and also to develop the stock and bond markets by integrating the stock exchange and establishing branch offices in regional areas, making it easier for companies to list themselves.

Looking forward, the indirect finance-centered capital procurement structure will not change. On the other hand, there will likely be an increase in the number of large and other companies that seek direct funding in the stock and bond markets.

d. Structure of Financial Institutions

Indonesia's financial institutions may be largely divided into banks and non-bank financial institutions. Indonesia's banks are classified as either commercial banks or rural banks (Bank Perkreditan Rakyat:BPRs). Each type has different sets of regulations pertaining to conditions for establishment and content of services. On the other hand, non-bank financial institutions are securities companies, insurance companies, and finance companies. The types of financial institutions are as follows.

(1) Commercial Banks

The services that the commercial banks are allowed to provide include: (i) receiving deposits, (ii) extending credits, (iii) issuing corporate bonds, (iv) purchasing and selling and guaranteeing bills of exchange, CP, treasury bills and government guarantees, Bank Indonesia certificates, bonds, etc., (v) transferring money, (vi) inter-bank fund borrowing and lending, (vii) payments, (viii) providing safety deposit boxes, (ix) undertaking custodial activities on behalf on another party based on contracts, (x) conducting business in credit cards and trusteeship, (xi) foreign exchange transactions (foreign exchange banks require a separate license), (xii) the establishment and management of pension funds, and (xiii) capital participation in other banks, lease companies, venture capital, securities companies and insurance companies. There are 5 types of commercial banks, depending on the form of ownership.

A: State Owned Banks. Although originally set up as government financial institutions for the purpose of providing financing for specific industries, their *Acts of Establishment* were repealed with the new *Banking Act of 1992*, and they now provide the same deposit and lending services to the general public as other private sector banks. The government owns between 70% and 85% of their shares, with the remainder held by private sector investors.

B. Private National Banks. Many of these banks started out as banks established as the accounting departments of private sector corporate groups amidst the financial deregulation of the 1980s. However, in the wake of the Asian financial crisis, there were many mergers among different corporate groups and the banks' connections with specific corporate groups became more and more tenuous. With some exceptions, the financial scale of these banks tends to be small. While the larger banks focus on big corporations and city residents as their target customers, the smaller banks tend to focus on customers who find it difficult to do business with the bigger banks.

C: Regional Development Banks. Almost all provinces have one of these banks, and their main business is to provide finance for SMEs, for the purpose of stimulating the local economy. Originally, they were financial institutions specializing in long term financing, however, in 1992 they became commercial banks.

D: Joint Venture Banks. The financial deregulation of 1988 made possible the establishment of joint venture banks, a partnership between local capital and foreign capital. There are no restrictions on the types of business in which they may engage.

E: Foreign Owned Banks. The establishment of 100% foreign capitalized banks is not permitted, so banks that have head offices outside of Indonesia may only have branches or representative offices. Branches may engage in full banking services. As for representative offices, while they may provide information to third parties and support and monitor loans made in Indonesia by their main branch offices, they cannot engage in actual business activities.

In addition, the number of commercial banks has dwindled since the Asian financial crisis, and there were 122 as of the end of 2010, according to Bank Indonesia. Of these, there are 4 state owned banks, 67 private national banks, 26 regional development banks, 15 joint venture banks and 10 foreign owned banks. Their total assets are 3,008.9 trillion rupiah, accounting for 98.5% of Indonesia's total banking sector.

(2) Rural Banks (BPRs)

The BPRs are regional financial institutions that provide small sum savings and financial services for low and middle-income earners and SMEs. With the exception of checking accounts, they are allowed to engage in deposit and lending services. They are not permitted to engage in (i) foreign exchange business other than changing currency, (ii) insurance business, and (iii) equity participation in other businesses. The BPRs are not allowed to participate in settlement systems. According to Bank Indonesia, the number of BPRs has been falling since the Asian financial crisis. With 1,706 BPRs at the end of 2010, in recent years they have been closing at the rate of about 50 a year. Their total assets are 45.7 trillion rupiah, accounting for a mere 1.5% of the total banking sector.

(3) Sharia Banks

Sharia banks distribute profit and loss in accordance with Islamic principles.

The National Sharia Council (Dewan Nasional Shariah), under the jurisdiction of the Indonesian government, judges whether a bank is qualified to be a sharia bank, and each bank must have its own sharia inspection committee (Dewan Pengawas Shariah) to judge whether the bank's activities are consistent with sharia law. The services they offer are not very different from those of ordinary commercial banks and BPRs, deposits, loans, etc., and their licenses are granted by Bank Indonesia, and their activities are subject to Bank Indonesia supervision. Further, their main business is to provide micro-finance services to those in low and middle income levels, who would find it difficult to do business with ordinary banks. As of the end of 2010, there were 11 sharia commercial banks, 150 sharia BPRs and 23 sharia business units[89]. While there appears to have been a lull in the opening of new sharia commercial banks and sharia business units, the establishment of new sharia BPRs appears to be on the rise. Their total assets are also growing, worth 100.3 trillion rupiah at the end of 2010, with sharia banks accounting for 3.3% of the total banking sector, up from 2.7% at the end of 2009.

(4) Securities Companies

In order to conduct securities business, (i) brokers and dealers, (ii) underwriters, and (iii) investment managers each need to obtain particular licenses. In recent years, a number of companies have had their licenses revoked, and the number of securities companies in Indonesia has stayed at about 145. As of September, 2011, there were 147.

(5) Insurance Companies

As for insurance companies, there are life insurance companies, general insurance companies, companies administering social insurance program and workers social security, companies administering insurance program for civil servants and armed forces/police, and reinsurance companies. In 2010, there were a total of 142 insurance companies, of which 46 were life insurance companies, 87 general insurance companies, 2 companies administering social insurance program and workers social security, 3 companies administering insurance program for civil servants and armed forces/police, and 4 reinsurance companies.

(6) Finance Companies

The finance companies include those providing consumer finance, credit card companies, lease companies and those providing factoring services. Although the growth in individual consumption in recent years has meant that new companies are participating in consumer loans and the credit card business, there have been cases of

[89] Sharia finance specialist departments run by ordinary commercial banks.

companies having their licenses revoked, and the total number of finance companies is actually decreasing, and they numbered 192 in 2010.

(7) Informal Financial Institutions

The main informal financial institutions are local mutual financing associations and rotating savings and credit associations, or *arisan*, and other financial activity groups. Informal financial institutions exist in every region and are used by many groups of people who do not have access to commercial banks and BPRs.

e. Supervisory and Regulatory Agency

The banks' supervisory and regulatory agency is Bank Indonesia, the Central Bank. Before the Asian financial crisis, there was a dual management system where the Finance Ministry granted and revoked bank licenses, with Bank Indonesia carrying out regulatory duties once the licenses had been granted. Also, Bank Indonesia was under the control of the Finance Ministry. This meant that prudential regulation did not appear to function properly and, at the request of the IMF, under the new *Banking Act*[90] promulgated in 1998, Bank Indonesia became an independent state institution, performing unitary supervision and regulation of the nation's banks.

Bank Indonesia's mission is to secure and maintain the soundness and sustainability of the country's currency and financial systems for the sake of the sustainable development of Indonesia. Based on this mission, Bank Indonesia (i) prescribes and implements monetary policy, (ii) regulates and safeguards the smoothness of the payment system, (iii) supervises and regulates the banks, (iv) issues currency (rupiah), (v) provides an opinion and consideration to government concerning the state budget, (vi) assists the insurance of the state debt securities, and (vii) manages the foreign exchange reserve and foreign exchange transactions. However, it is prohibited from underwriting national bonds and providing the government with credit. Further, the bank supervisory and regulatory powers are due to be delegated to the newly established Financial Services Authority (OJK) from January 2014. OJK will be responsible for the centralized supervision and regulation of all financial institutions, including the banks.

On the other hand, the supervision and regulation of non-bank financial institutions is the responsibility Bapepam-LK, under the Ministry of Finance. Formerly, the Finance Ministry's Bapepam supervised the capital markets, stock exchange and securities companies, and the Finance Ministry's financial services agency (Ojilk) supervised the insurance.

In 2005 these two agencies were merged into Bapepam-KL, which now supervises not only the capital markets, but also all financial institutions, with the exception of the

[90] *Act of The Republic Of Indonesia Number 7 of 1992 Concerning Banking As Amended By Act No.10 of 1998*, revision enforced January, 2004

banks. Also, supervisory authority for non-bank financial institutions is due to be transferred to the newly established Financial Services Authority (OJK) from January 2013.

5.1.3. Banking Sector Situation

a. Regulatory Environment

Bank Indonesia has implemented the regulations in order to secure and maintain the stability and financial soundness of the country's banking sector. These regulations are as follows.

(1) Criteria for Opening a New Bank

The minimum paid-in capital requirement for the establishment of a new commercial bank is 3 trillion rupiah, for a sharia commercial bank 1 trillion rupiah, and for a sharia business unit 500 billion rupiah. The requirement for BPRs differs from region to region; for example, in Jakarta the requirement is 5 billion rupiah, and in major regional cities 1 billion rupiah.

As regards the location of the new banks, there are no regulations pertaining to the location of commercial banks' head offices, neither are there any restrictions on where new branch offices may be opened. In contrast, although the location restrictions on BPR head offices were repealed in 1998[91], branch offices may only be opened in the province where the head office is sited.

(2) Business Regulations

With regard to the financial products and services that the banks may offer, with the exception of derivatives and the issue of negotiable deposit certificates and structured finance, basically there are no restrictions. However, each bank is required to submit a report on its business activities to Bank Indonesia.

There are no regulations in Indonesia covering interest rates, and each bank may set its own. Nevertheless, since March 2011, the commercial banks have been required to publish their prime rates. Recently, the larger banks have been lowering their lending rates in order to win customers. However, Bank Indonesia is considering setting an upper limit on lending rates, stating that "Average lending rates of 10% or more for corporate finance and between 20 to 30% for small and medium sized enterprise loans are still high levels, and this is one factor that is hindering economic growth."

Also, there are no restrictions on bank agencies. For example, when a debit card is used to withdraw cash from a convenience store, the convenience store does not need a license to handle cash. The convenience stores have a business agreement with the

[91] Before the *new Banking Act of 1998*, new offices could not be opened in major cities.

banks, and all they are doing is acting as an agent of the bank for certain services, and they have no responsibility towards the customer. The banks are required to present a written plan to Bank Indonesia every year, detailing their business tie-ups with convenience stores.

(3) Lending Restrictions

In order to restrain the concentration of loans to specific borrowers, the legal lending limits have been implemented which state that (i) loans to connected parties[92] must not exceed 10% of the bank's equity capital, and (ii) loans to non-connected parties must not exceed 20% of the bank's equity capital. These limits apply when a single bank is making the loan by itself, excluding the case of co-operative financing. Also, state owned enterprises and regional government owned enterprises are exempt from these restrictions.

Further, foreign capitalized businesses, in principle, cannot borrow from state owned banks. The exceptions are (i) businesses where Indonesian capitalization is 51% or more, or (ii) businesses where Indonesian capitalization is 45% or more, and 20% or more of the issued shares are listed on the stock market.

In addition, the restriction on personal loans is that the total loan must not exceed 30% of the borrower's annual income, including any loans from other financial institutions.

(4) Restrictions on Foreign Capital

With regard to foreign capital participation, foreign capital may not singly own a commercial bank. While foreign capital may acquire 100% of a bank's shares listed on the stock exchange, the bank may only list 99% of its issued shares, so foreign direct investment is restricted to a maximum of 99%. The remaining 1% must be owned by Indonesian capital. The participation of foreign capital in BPRs is not permitted.

In order for a foreign bank to open branch offices in Indonesia, (i) the bank must in the top 200 in the world, (ii) the bank must be ranked A or above by an international rating agency, and (iii) the branch's capital must be 3 trillion rupiah or the equivalent in foreign currency.

In the case of joint venture banks, the conditions are that (i) the ratio of foreign employees to Indonesian employees must be the same, and (ii) foreign staff are restricted to between three to five years residence in Indonesia.

(5) Capital Adequacy Requirement

In 2008, Indonesia adopted the Basel II international standards (capital adequacy

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[92] An individual shareholder owning 10% or more of the paid up capital of the Bank, a corporate/institutional shareholder owning 10% or more of the paid up capital of the Bank, a member of the board of commissioners of the Bank, a member of the board of directors of the Bank, etc.

ratio above 8%), and the minimum capital adequacy requirements and methods of calculation were stipulated for commercial banks, BPRs and sharia banks. Also, for commercial banks other than sharia banks, the core capital (Tier 1) has been set at a minimum of 100 billion rupiah.

(6) Single Presence Policy (SPP)

In order to prevent deterioration in bank governance, no individual, corporation or corporate group may be a controlling stockholder[93] in more than one bank. Exceptions to SPP are (i) where the banks conduct their businesses based on different principles, such as a general commercial bank and a sharia bank, (ii) where one of the banks is a foreign joint venture bank, and (iii) where a holding company is set up in Indonesia and two banks are owned as its subsidiaries. If one party becomes a controlling stockholder in a second bank, this new bank must be merged with the existing bank.

(7) Restrictions on Capital Participation and Joint Ventures

Capital participation and joint ventures in the banking sector are governed by the following restrictions. As for capital participation, this is only permitted for the purposes of long term investment and is restricted to 25%[94] or less. The conditions that must be met are (i) the bank's capital adequacy ratio must be above the required level (8%), (ii) the capital participation must not have a serious impact on the bank's business activities or increase its risk profile, (iii) the capital participation must be subject to an appropriate internal control system, (iv) the capital participation must be described in the annual business plan, and (v) the bank must not have been subject to an administrative sanction, such as the suspension of a specific business, in the last twelve months.

The conditions that apply to joint ventures include: (i) the venture must have been approved by a special resolution of the general shareholders' meeting, (ii) the capital adequacy ratio must be observed after the merger, (iii) restrictions pertaining to investment in the bank must be observed, and (iv) the bank's post-merger capital must not exceed 20% of the total bank capital in Indonesia.

b. Competition Environment

Although Indonesia did not have any formal laws or systems pertaining to competition before the Asian financial crisis, the IMF conditionality required the development of a proper competition foundation. Based on this requirement, the "*Law*

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[93] A shareholder with 25% or more of the voting rights of issued stocks, or with direct or indirect controlling influence on the bank, even if the number of shares held is less than 25%.

[94] Acquisition of over 25% of shares is seen as a transfer of controlling rights and is considered a takeover. In the event that even less than 25% of shares are acquired, if the holder declares a controlling interest and can be proven to have direct or indirect influence over the bank, this is considered a takeover.

No. 5 of 1999 concerning the Prohibition of Monopolistic Practices and Unfair Business Practices" was enacted and promulgated, and came into effect in March, 2000. The implementation of the *Law* is the responsibility of the Supervisory Commission for Business Competition (KPPU).

Although the banking sector is also, in principle, covered by the competition laws, in actual fact it is Bank Indonesia that centrally monitors the sector in terms of share holding restrictions and merger restrictions. Until now, the competition laws have only been applied once, in 2001, to Bank Negara Indonesia for monopolistic practices, exclusive agreements and market controlling activities, for which they were punished with a cease and desist order.

Thus, although the *Competition Law* and various banking sector restrictions have been implemented, and a fair competitive environment has been established from a regulatory perspective, the reality is that the large commercial banks still control over half of the banking market.

In terms of the commercial banks, while there were 122 banks at the end of 2010, of those, 10 were major banks, including 4 state owned banks, and accounted for more than 60% of the total assets and over 50% of outstanding of credit and outstanding of deposit. In the wake of the Asian financial crisis, major banks went through mergers and integration under the policies of Bank Indonesia, with the result that they maintained their dominance in the banking sector.

Under these circumstances, foreign capital has been seen to make advances into small and medium sized banks and sharia banks, rather than the larger banks. In Indonesia, over 60%[95] of the population do not have access to the banking system (unbanked people), and this is a huge, untapped market. Since unbanked people are in the low and middle-income brackets, which the larger banks do not target, foreign capital is trying to win customers from this sector. Currently, in addition to financial institutions from the developed nations, Asian financial institutions from China, India, and the Middle East are entering the Indonesian market, by virtue of acquisitions and other forms of capital participation. Of course, as described above, there are restrictions on capital participation, and the number of foreign capitalized joint venture banks and branches of foreign banks is actually dwindling.

c. Profit Environment

Reflecting favorable economic conditions, the commercial banks and others in the banking sector are enjoying a stable business environment. In recent years, both deposits and credit have increased, and as of August 2011, the deposit total was 2,460 trillion rupiah, and the credit total 2,079 trillion rupiah, expanding 2.1 times and 3 times, respectively, since 2005. The pace of loan growth has outstripped that of

[95] Bank Indonesia "The role of Bank Indonesia in Financial Education Process In Indonesia", Oct 2010

deposits, causing the loan-deposit ratio to increase rapidly, reaching 82% in August 2011[96].

In terms of operations income, interest earnings account for more than 70% of the total, and are the banking sector's main source of profit. Net interest margins in recent years tend to be between 5.6 to 5.9%. However, the trends can differ, depending on whether the bank is state owned or private sector owned. Operating profits suffered from the negative effects of the global financial crisis followed by the collapse of Lehman Brothers, and the 2009 figures fell below previous year's level. However, they have recovered since and were 48.325 trillion rupiah in 2010, 2.3 times the 2005 level.

Along with stable growth in profits, total assets are increasing year by year, and in August, 2011, were worth 3,253 trillion rupiah, more than double 2005's 1,470 trillion rupiah. The return on total assets has also increased, rising from 2.55% in 2005 to 2.98% in August of 2011. On the other hand, the overhead ratio (operations expenses / operations income) has dipped slightly, falling from 89.5% in 2005 to 86.4% in 2011.

The banks are also managing to maintain good financial health. In August 2011, the capital adequacy ratios were at 17.3%, well above the required 8%. Since the weight of risk assets has increased since the adoption of Basel II, the rate dropped 2% points compared to 2005. However, the rate has been growing at around 17% since 2009. Non-performing loan (NPL) ratios are extremely low at 1% net NPL and 3.1% gross NPL. The banks' liquidity is also guaranteed. Time deposits account for 45% of total deposits, and deposit terms are tending to become longer. Although time deposits of 6 months or longer accounted for less than 10% of total deposits in 2005, those accounted for 18% as of August, 2010.

5.2. Roles of the Banking Sector

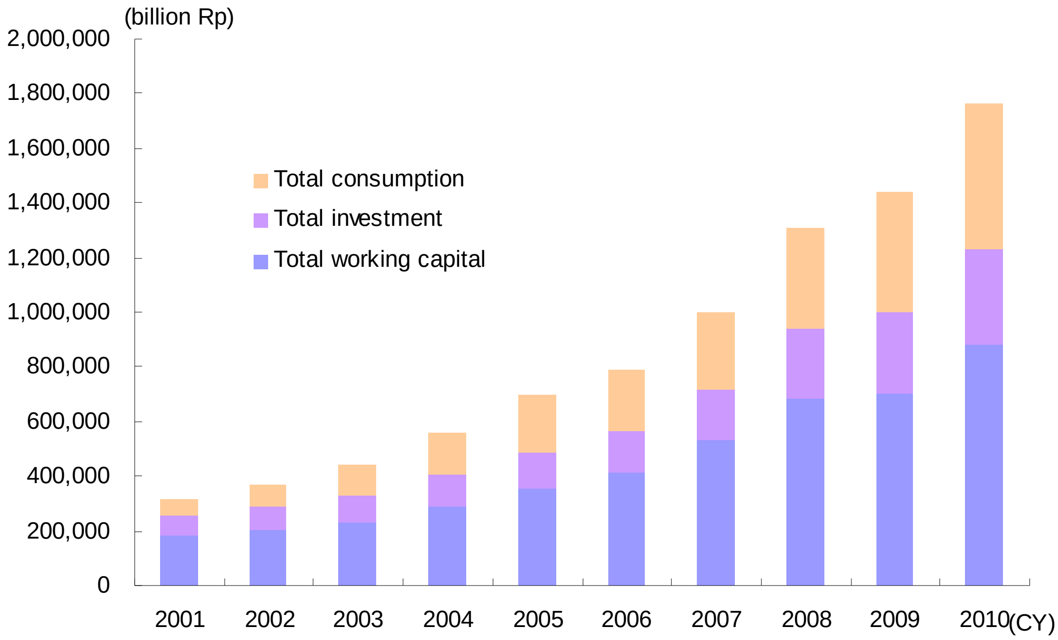
5.2.1. Recent Changes in the Banking Environment and Business Trends

In Indonesia's economy, the vitalization of corporate activity in the corporate sector has led to a robust expansion of plant and equipment investment, and along with the government's infrastructure and energy development plans have resulted in increased investments in this sector. In addition, improvements in the employment and income situation are reflected in steady growth in personal consumption. Against the backdrop of this healthy economic growth, the demand for capital is also expanding. The loans outstanding of commercial banks and BPRs have been growing at an average of 21% since 2001, and in 2010 were 5.6 times the 2001 total. As regards the composition of credit of commercial banks by type of use, the percentage accounted for by total working capital was more than half in 2001. However, that had dropped to 40% by 2010. On the other hand, the percentage for total consumption rose from 30%

[96] Bank Indonesia website (http://www.bi.go.id/web/en/).

to 36% (Figure 5.3.).

Figure 5.3. Composition of Credit of Commercial Banks by Type of Use



Source: Bank Indonesia "Indonesian Financial Statistics"

Under these circumstances, there has been an increase in the number of mainly large commercial banks, with retail finance as the central pillar of their business. There is a growing demand for capital for the purchase of house, two-wheeled vehicles and automobiles, mobile phones and clothing, as well as for payment purposes. In response, the banks have been strengthening their personal consumer loans, such as housing loans, car loans, consumer loans, etc., and have also been working to enhance their Internet and mobile banking provision. Thus, the retail banking business is expanding.

While corporate loans are growing steadily, reflecting the growing need for capital such as capital investment and infrastructure investment, etc., each bank has a different approach to this business. While some banks focus on corporate loans as a means of strengthening their retail banking business, others see small and medium sized enterprise loans, especially micro-finance, as the core to their business, and are attempting to develop nationwide networks. In addition, in Indonesia, as mentioned above, since "The Blueprint of Islamic Banking Development in Indonesia" in 2002, in addition to specialist Islamic banks, there have also been sharia business units set up within large commercial banks, and the sharia banking business is expanding.

5.2.2. Corporate Banking

In recent years, there have been signs of some companies procuring capital from capital markets at home and abroad. However, these tend to be a few large companies, ranked triple A, and developing overseas business. In Indonesia, when companies procure capital externally, this tends to be mainly in the form of bank loans. Corporate loans are mainly for state owned enterprises and large private sector enterprises[97]. SMEs make use of SME loans and micro-finance. In addition, foreign capitalized firms cannot, in principle, borrow from state owned banks[98].

Loan types differ from bank to bank. In general they tend to be operating capital loans of less than a year, capital investment loans of between one to fifteen years, or export / import loans of less than one year. In addition to the rupiah, foreign currency-denominated loans are also possible.

There are no restrictions on interest rates, and each bank independently sets the lending rates for its customers based on its own prime rates. Some of the larger banks have been offering lower lending rates in an effort to attract customers. However, as of August, 2011, the average lending rate is over 10%, on average. Also, since March 2011, Bank Indonesia has required the commercial banks to publish their prime rates.

Credit decisions are based on the company's business, assets and business performance. Many banks insist on looking at the company's business performance over the past three years, not only in the current fiscal year. In principle, the banks do not make unsecured or unguaranteed loans. As collateral, the company's tangible assets (mainly real estate) and deposits are accepted. As for guarantees, only state owned enterprises (government guarantees) and member companies of large corporate groups (parent company guarantees) are eligible.

As regards the relationships between the banks and companies, the close business relationships that used to be seen before the Asian financial crisis have since decreased significantly. Among the commercial banks, there are many that started out as a kind of finance departments within private company groups. Since the Asian financial crisis, there have been successive mergers and integration among these banks, weakening the close ties they enjoyed with the company groups. Also contributing to

[97] Indonesian businesses are categorized in three ways: number of employees, sales turnover, and capital, with the number of employees being the most used category. The divisions are as follows. Large companies are those with 100 or more employees, medium sized companies 20 to 99 employees, small companies 5 to 19 employees, and very small companies 4 or fewer. In terms of turnover, large companies are those with 50 billion rupiah or more sales per annum, medium sized companies 2.5 billion rupiah or more and less than 50 billion rupiah, small companies 300 million rupiah or more and less than 2.5 billion rupiah, and very small companies less than 300 million rupiah. In terms of capital, large companies are those with capital of 10 billion rupiah or more, medium sized companies over 500 million rupiah and less than 10 billion rupiah, small companies over 50 million rupiah and less than 500 billion rupiah, and very small companies less than 50 million rupiah.

[98] Exceptions are (i) businesses where Indonesian capitalization is 51% or more, or (ii) businesses where Indonesian capitalization is 45% or more, and 20% or more of the issued shares are listed on the stock market.

looser ties were stricter rules on bank lending to single individuals and company groups.

Looking at the situation of corporate loans, while loans outstanding are increasing in general for all banks, the pace of growth is rather weak compared to SME loans as well as personal loans. As a result, corporate loan share of total loans is shrinking. As reasons for the poor growth momentum in corporate loans, it has been pointed out that, while there has been an increase in large scale projects under the government's industrial policy, mainly to do with infrastructure development and natural resources development, even Indonesia's larger banks are still small on a global scale, and in addition to the limitations on their capital supply capabilities, they also lack ability in assessment and risk management.

Against this backdrop, there have been some new developments aimed at strengthening and expanding corporate finance. One is the adoption of syndicate loans and two-step loans. These are applied to the large projects that the government has been sponsoring for infrastructure and natural resources development. Syndicate loans have tended to involve mainly foreign capitalized banks, and local banks have usually not participated because they lacked know-how and credit capacity. In the past few years, however, there have been examples of syndicate loans among the local banks. Two-step loans are where large Indonesian commercial banks borrow capital from foreign banks with strong credit capacity, and then use this money to make loans to large domestic projects and companies. For example, the state owned Bank Negara Indonesia (BNI) has borrowed capital from Japan Bank for International Cooperation (JBIC) and used the money in this way.

One other development has been loans made to foreign capitalized companies. Traditionally, as described above, there have been restrictions on loans to foreign capitalized companies, and these companies have tended to procure capital from the branches of banks from their own countries, or joint venture banks, and there have been few loans made by local banks. In recent years, with the healthy growth of the Indonesian economy, many more foreign companies are entering Indonesian markets, and the banks are trying to accommodate the demand for capital from these companies. For instance, through the intermediation of JBIC, BNI has concluded agreements with seven regional Japanese banks to supply capital to Japanese firms entering Indonesian markets, instead of the Japanese regional banks.

5.2.3. SME Banking

In 1990, as part of its industrial policy package (PAKJAN 1990), the Indonesian government introduced The Small Industry Credit Program and required banks to ensure that 20% or more of their total credit was SME loans. However, as non-performing loans reached over 20% of the credit total, and the cost of capital procurement increased in the wake of the Asian financial crisis, many banks began to cut back on SME loans, and the credit program failed and was abolished in January, 2001.

Since the abolition of the program, Bank Indonesia has been trying to encourage SME loans, under the government's SMEs promotion policies. Unlike the earlier Credit Program, there is no set quota as part of a SME loan framework. However, the banks are required to disclose their SME loan plans in the annual business plans that they submit to Bank Indonesia, as well as disclosing the amount of SME loans in their financial statements. Also, the upper limit of loans per customer has been increased from 350 million rupiah to 500 million rupiah.

In addition, a credit guarantee system has been introduced in order to complement businesses' credit. In 1971, a credit insurance corporation (PT-ASKRINDO) was set up with 100% investment by the government in order to provide credit insurance. The company's credit insurance was done through the banks. To use these services, a bank would first apply to PT-ASKRINDO for credit insurance for a particular customer, PT-ASKRINDO would then approve the customer and guarantee the credit. Of course, even without credit guarantee from PT-ASKRINDO, the banks would add interest on the guaranteed portion before making the loan.

On November, 2008, the credit guarantee program (Kredit Usaha Rakyat:KUR) was introduced on base of the *President Decree No. 6/2007*. The objectives of KUR are to accelerate the development of empowerment of small and medium sized business, to improve accessibility to credit and financial institutions, to reduce poverty level and expand job opportunities. The maximum credit amount is 500 million rupiah. The percentage of credit guaranteed is 70% of total allocation of credit provided by banks. The borrowing period of credit for working capital is maximum 3 years and 5 years for investment capital. Indonesian government is promoting the establishment of new credit guarantee institutions in addition to an existing organization such as PT-ASKRINDO to spread KUR. However, the credit guarantee institutions are four organizations as the end of 2010. Therefore, the demands for a small and medium-sized business have not been meet enough.

Today, SME loans are up to the discretion of the banks. Many commercial banks are hesitant to lend to SMEs. One reason is that corporate accounting is not fully established throughout the SMEs, and their financial statements tend to be incomplete, so it is difficult to gauge the company's business conditions from their financial data. While there are some banks that engage in relationship banking, past experiences such as increased non-performing loans have led to an increase in the number of banks adopting a credit scoring system. Naturally, as SMEs' capital demand grows along with Indonesia's economic growth, some of the larger commercial banks are targeting this potential market and expanding their SME financing businesses. SME loans outstanding have increased by 30% annually, and were worth 788 trillion rupiah in August 2011, doubling in 3 years.

5.2.4. Micro-finance

Small financial organizations have existed in Indonesia since the days of Dutch colonialism, and micro-finance has a century long history in the country, and is well established as a financial service. From those early days, finance was conducted on a commercial basis, different from the unsecured small loan services for low income earners provided by banks like Grameen Bank in Bangladesh.

Banks such as general commercial banks, BPRs and sharia banks, as well as informal financial institutions like *arisan* provide micro-finance. In addition, there are micro-finance programs that are supported by international organizations and foreign governments. Currently, micro-finance by the banks accounts for the lion's share of the market.

The main micro-finance provided by the commercial banks is the Micro-Banking service provided by the state owned Bank Rakyat Indonesia (BRI). BRI has been involved in micro-finance since the 1980s and has a nationwide network of BRI-Units that function as micro-finance offices. Additionally, Teras BRI outlets have been established in regions where market and small business development is going on, and the Mobile Teras BRI system has been implemented. Teras BRI outlets can handle ETC transactions on a 24 hour basis. As of 2010, there were BRI-Units nationwide, and 929 Teras BRI outlets. In recent years, in addition to these facilities, e-channel services, such as ATM and telephone banking have become more available.

BRI's small loans are known as KUPEDES, and come in two forms, working capital and investment capital. The loan amount can be from a minimum of 25,000 rupiah to a maximum of 25 million rupiah. Eligible borrowers include those in agriculture, manufacturing, commerce, other services and an individual with a regular income. The loan period is between 3 to 36 months. In order to encourage repayment, borrowers who repay the complete debt before the date due are entitled to an incentive rebate of one quarter of the interest due. Loans need to be secured with collateral such as title deeds to houses and land sufficient to cover the value of the principal. Loan approval is based on past trading conditions and business conditions, reputation, business scale and future potential.

Using BRI's business model as reference, other commercial banks are also beginning to look at providing micro-finance services. For example, the large private sector commercial bank CIMB Niaga has started to provide finance for the upper echelon of those who have need of micro-finance.

Also, the BPRs provide two types of finance. One is a short-term loan for small traders. The loan amount is often between 100,000 rupiah to 2 million rupiah, with a repayment period of between 3 to 6 months. Another type is loans for manufacturers and consumers, generally of between 1 to 10 million rupiah, for a period of between 6 to 18 months. Loan conditions differ from BPR to BPR, and the decision on whether to require collateral is based on the customer's business situation. Thus, since there is flexibility in the loan conditions and the interest rates are lower than those charged by the informal financial institutions, BPRs are an effective source of capital for small businesses and individuals who lack stable income and whose business conditions are difficult to grasp fully.

Of course, large commercial banks like BRI have nationwide networks of branches and offices, and can provide micro-finance services with lower interest rates and greater amounts, and this, coupled with the aggressive participation in micro-finance on the part of the sharia banks, which is mentioned later, has caused the BPR share of the market to shrink. As of August, 2011, loans outstanding of micro-finance of commercial banks were 288.5 trillion rupiah, and those of the BPRs 39.7 trillion rupiah.

5.2.5. Retail Banking

In Indonesia, the retail banking business, such as personal loans, credit cards, public utility payments, and installment payments, is growing, especially among the larger banks. Improvements in the employment and income environments have led to higher personal incomes, and the retail market has huge potential to expand as a result.

Additionally, some large commercial banks provide services such as private banking. However, restrictions on financial products against which derivatives and leverage are applied mean that they are of limited use in terms of operating capital, and though this area is also expanding, its demographic is limited to a small number of very wealthy customers, and the number of banks involved in this kind of business is small, as is its scale.

Recent trends in retail banking are the enhancement of functions of ATMs and Internet banking, as well as mobile banking. In Indonesia, not only Internet banking but mobile banking also offers the same services as a branch office. Even if the customers do not have an account at the branch office, they can create the accounts (virtual accounts) via the Internet or mobile banking, and transactions are made via Internet or mobile banking. Also, some banks offer account management and prepaid mobile banking services. In the past few years there has been an increase in IT crime, and this has prompted stricter security measures, such as one-time passwords when using SMS, and password double checks.

a. Personal Loans

Housing loans account for the majority of personal loans. In recent years, with the growing demand for two wheeled vehicles and automobiles, the automobile market is growing. However, there are very few banks that directly provide automobile loans. The majority of banks provide automobile loans through subsidiary finance companies.

No matter the type of loan, a credit scoring system is applied when the application is assessed, and the applicant's income, profession and the existence of any other debt and its total are checked. Among consumer loans, there is a new type that offers up to

50 million rupiah with a very simple assessment. Also, loans are only available to customers who already have an account with the bank.

Indonesia has no interest regulations, and the banks are free to set their own rates. Taking housing loans as an example, the loan period is usually between 10 and 20 years, and the interest rate may be fixed or variable. As mentioned above, there are no regulations on interest rates, so the banks set their own. The maximum amount of loans differs among the bank. Some banks lend up to 90% of the assessed value of the land or house to be purchased, while others set the loan limit so that monthly repayment will be kept to up to one third of the borrower's monthly income. In terms of collateral, the land or house to be purchased is offered. Some banks require the borrower to take out a life insurance policy to ensure that the loan capital can be recovered in the event of the borrower's death.

Although outstanding housing loans have been growing at a slower pace, they are still posting double-digit growth annually. At the end of 2010, they amounted to 140.6 trillion rupiah, about eight times that of 2001.

b. Credit Cards

In Indonesia, as of April 2011, 20 banks have received Bank Indonesia approval to issue credit cards. The majority of these credit cards are tied with international credit card companies, such as Visa card and MasterCard. However, there are some banks, such as Bank Central Asia (BCA), that do not have such tie-ups and instead issue their own cards.

As for credit card regulations, in addition to the requirement that cards must have an IC chip mounted on them, in order to prevent crimes such as skimming and forgery, there is also a requirement that the minimum monthly payment per customer must be at least 10% of the outstanding debt. There are no credit limit caps or interest rate caps, such as there are in many other countries, and the credit card companies are free to set their own limits. Further, the applicant's income restriction that used to be applied has now been abolished. This means that credit cards have spread among middle level income earners, not only among the wealthy.

Credit card use in Indonesia is increasing year by year, and their use for small amount loans in 2010 was 113% up on the previous year, and their use for shopping was up 120%, similarly. In Indonesia, the trend is for shopping use to exceed that of small loan use. In 2010, there were 4.36 million transactions for small loans, worth 4.5 trillion rupiah, whereas there were 200 million transactions for shopping, worth 159 trillion rupiah.

5.2.6. Payment System

a. Payment Methods

Payment methods used mainly in Indonesia are check, Bilyat giro, credit note, debit note, direct debit, electronic money and cards, as well as cash. A brief summery of direct debit, electronic money and credit cards is setout below.

Direct Debit is used to pay utility bills. This is a method to withdraw directly a user fee from the account by the agreement commercial banks and authorities, which are the Power Authority, Water and Wastewater Authority.

Electronic money used mainly in Indonesia are Flazz card, which is issued by BCA, Indomaret card and e-Toll card, which is issued by Bank Mandiri. While Flazz card and Indomaret card can be used to pay in the stores that are the partners of BCA and Bank Mandiri, e-Toll card can be used to pay for fuel at gas stations as well as toll fees.

Cards used mainly in Indonesia are credit cards, debit cards and ATM cards. The feature of a card-based payment instrument can be summarized: (i) debit cards can be used to withdraw cash in convenience stores and (ii) ATM cards can be used to pay telephone, water, mobile phone, and credit card bills and even fuel at gas stations, as well as other types of payment.

b. Settlement System

Bank Indonesia has two settlement systems, which are the National Clearing System (SKN) and the Bank Indonesia Real Time Gross Settlement System (BI-RTGS). A brief summery of SKN and BI-RTGS is setout below.

SKN was introduced as a settlement system for interbank in Indonesia based on the new *Banking Act* in 1998. Indonesia now has 105 local clearing operators, which consist of units managed directly by Bank Indonesia and third parties appointed by Bank Indonesia. The members are all banks in Indonesia (143 banks including all branch offices about 2,100). Transactions processed through the clearing system include debit transfers and credit transfers accompanied by exchange of paper debit instruments (checks, bilyet giro, debit notes, etc.) and credit instruments.

Bank Indonesia plans to replace the present settlement system with the Bank Indonesia National Clearing System (SKNBI). The changeover to the SKNBI will take place in stages. The objectives of implementing the SKNBI for clearing in Indonesia are to improve efficiency in the retail payment system and achieve compliance with the principles of risk management in clearing operations. In the first phase, the SKNBI was launched in Jakarta on 29 July 2005.

The SKNBI consists of 2 sub-systems. One is the debit clearing. This is used for processing interbank debit transfers accompanied by presentation of paper instruments (checks, bilyet giro, and debit notes. The local clearing operator in each clearing area conducts the debit clearing. The local clearing operator performs the debit clearing calculation based on debit EFD sent in by members. The results of the local debit clearing are then transmitted to the Central Clearing System (SKK) for nationwide processing by the national clearing operator. The other is the credit clearing. This is used for paperless interbank credit transfers. The national clearing operator operates the credit clearing on a nationwide scale. The credit clearing results are calculated by the national clearing operator on the basis of credit EFD sent in by members.

New credit transfers may be processed in clearing only in amounts below 100 million rupiah. If the amount is 100 million rupiah or more, the transaction must proceed through BI-RTGS (Table 5.1.).

BI-RTGS is a system for electronic funds transfer among participants, specifically banks, in the rupiah currency with settlement processed in real time on an individual transaction basis. Since beginning operations by Bank Indonesia on November 17, 2000, BI-RTGS has played an important role in processing payment transactions, particularly for processing high value payments (amounted 100 million rupiah and above) and urgent financial transactions or categorized as High Value Payment System (HVPS). The members are all banks including sharia banks (143 banks) in Indonesia and one switching company.

BI-RTGS is also a settlement processor. As settlement processor, BI-RTGS provides facility for settlement of retail payment transactions, including the clearing system held by Bank Indonesia (SKN-BI) and the clearing system of the card payment system (ATM, debit card and credit card). In addition to retail payment transactions, BI-RTGS also processes settlement of fund transfers of securities trading transactions, interbank foreign exchange transactions, monetary operations and open market operations (OMO), government expenditures and BI-SSSS securities transaction. Currently, HPVS transactions have reached more than 90% in average of all payment transactions in Indonesia, which is considered as a Systemically Important Payment System (SIPS).

Table 5.1. Schedule of Payment System

Operational schedule		
BI-RTGS		
	Open system	6:30
	Interbank transfer for third party	6:30 - 16:30
	Interbank transfer	6:30 - 17:00
	Clearing settlement	11:00 - 17:00
	Cut off system	19:00
SKN		
	Open system	6:30
	Credit clearing	6:30 - 15:30
	Debt clearing	6:30 - 15:30
	Return clearing	8:15 - 11:30
	Distribution of clearing result	17:00 - 20:00
	Cut off system	20:00

Source: Bank Indonesia

5.2.7. Islamic Finance

Although Indonesia has the world's largest Muslim population, the Soeharto regime's strict policy of separating religion and politics has meant that Indonesia has a short history of Islamic finance[99]. The establishment of Islamic banks was first permitted under the new *Banking Act of 1992*. The vitalization of Islamic financial activity really only got underway in 2002 with the release of Bank Indonesia's "The Blueprint of Islamic Banking in Indonesia". The damage suffered by the Islamic banks in the Asian financial crisis was relatively slight, drawing attention to the validity of the system.

The Blueprint divided into three stages from 2002 to 2011 into three stages. Stage One (2002 to 2004), Stage Two (2004 to 2008) and Stage Three (2008 to 2011), and set out strategic steps to be taken in each stage to prioritize the development of Islamic banking.

A legal framework to cover Islamic banking was developed based on the Blueprint. *No. 21/2008 on Sharia (Islamic) banking* was promulgated in 2008. Under the provisions of the Law, a Sharia Banking Committee (Komite Perbankan Shariah) was set up inside Bank Indonesia in order to ensure sharia compliance in actual practice, and the regulations of Bank Indonesia were amended accordingly.

Further, in 2007, in preparation for the final stage of the Blueprint, a grand strategy of Islamic banking market development was outlined, containing specific numeric targets. The program calls for the following visions: (i) Phase 1 in 2008 to build understanding in Islamic banking as beyond banking by reaching an asset target of 50 trillion rupiah and industrial growth of 40%, (ii) Phase 2 in 2009 with the objective of positioning of Indonesia Islamic banking as the most attractive one in ASEAN, and (iii) Phase 3 in 2010 with the objective of attaining Indonesia Islamic banking as a leading Islamic bank in ASEAN.

The job of Islamic banking is to provide capital procurement and other banking services based on sharia principles. Their core business, as can be seen from the sheer number of sharia BPRs, is to provide loans and micro-finance to those SMEs and low-income earners that would normally find it difficult to do business with ordinary banks. Though Indonesia is an Islamic country, the effects of the long separation of state and religion have meant that Islamic commandments are relatively weak. This means that, for the general people, the ordinary commercial banks, with their excellent range of products, services and interest rates, tend to be favored, and it is proving difficult for Islamic banks to win customers away from the ordinary commercial banks. Given these circumstances, Indonesia's Islamic banks tend to focus their energies on

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[99] Islamic finance describes financial transactions that are consistent with Islamic law, based on Islamic teachings. While the receipt and payment of interest are forbidden, the acquisition of profit as a consideration for commercial activity is encouraged. Islamic banks are financial institutions within Islamic finance that conduct banking activities, such as deposits and loans, etc.

micro-finance. This is because the concept of micro-finance suits the Islamic idea of mutual aid.

At the end of 2010, there were 184 Islamic banks, both commercial banks and BPRs, and their combined loan total is growing rapidly. Although this is a mere 2% share of the loans outstanding of the banking sector, whereas the loans outstanding were around 5 trillion rupiah in late 2003, they had grown to 90.5 trillion rupiah by August, 2010. From 2010, the average year on year growth has been 50%, and the pace is accelerating. The loans outstanding have been greater than those of the BPRs since the mid 2000s, and at the end of 2010 were double those of the BPRs.

The global financial crisis that started with the Lehman Brothers' collapse in the early autumn of 2008 has had a slight impact on the Indonesian banking sector. Islamic banks are managing to maintain good financial health, as are commercial banks.

5.3. Financial Reform and Issues

5.3.1. Background to Financial Reform

Indonesia has been promoting financial reform since the 1980s, for the purposes of modernizing and strengthening the banking system. In the 1980s, financial deregulation was implemented. In 1983, the liberalization of interest rates and the abolition of loan limits were implemented. In 1988, the deregulation of the establishment of private sector banks, the easing of market participation restrictions on foreign banks entering the banking sector, and the liberalization of foreign capital borrowing was implemented. In 1992, with the aim of developing the bank supervisory system, the *Banking Act* was enacted, stipulating prudential regulations and bank supervisory authority.

While these financial reforms advanced the modernization of Indonesia's banking sector, they also led to a certain instability within the banking sector. With the deregulation of the financial sector, the banks became embroiled in tough competition to win customers and there was an increase in loans granted without sufficient assessment. Also, the increase in the number of banks belonging to private sector corporate groups meant that there was often insufficient governance of the banks themselves, with the lenders' responsibilities becoming blurred. However, under the system of dual supervision and regulation, Bank Indonesia's supervisory authority was limited, so that even if the banks found themselves in distressed circumstances against the backdrop of a fragile financial base, there was insufficient supervisory guidance to respond to the situation. In addition, following the deregulation and globalization of the financial markets as well as the increase in both domestic and foreign capital flows, not only private sector enterprise but also the banks found themselves with growing foreign debt.

When the Asian financial crisis occurred, the fragility of Indonesia's banking sector was exposed. After the crisis, as foreign exchange rates plunged suddenly, dollar denominated foreign debt that had been increasing until then, suddenly ballooned and the banking sector found itself in a serious financial situation. Also, in the wake of the crisis, non-performing debt had to be sold off, and the banking sector had a huge capital loss. As many banks were left with bad balance sheets, fears that they might go under prompted depositors to rush to withdraw their deposits and close their accounts, leading in turn to insufficient liquidity. The end result was a severe contraction of bank lending to the private sector and the virtual paralysis of the banking sector's financial intermediary function.

In response to these circumstances, in 1998, the Indonesian government began to implement reform steps founded on the strengthening of the country's banking systems and the securing of its soundness, under the guidance of the IMF. First, with the aim of restructuring and reinforcing the banking system, the government decided upon and announced a financial system stabilization package. At the same time, the government set up the Indonesia Bank Restructuring Agency (IBRA)[100] for the disposal of non-performing debt and the reorganization of the banks. In September of that year a program for the injection of public funds was announced, and bank merging and reorganization was carried out.

Along with the reinforcement and reorganization of the banking sector, in November of that year the old *1992 Banking Act* was revised in order to enhance and strengthen bank management and regulatory authority, and the new *1998 Banking Act* was enacted. The new law strengthened prudential regulation, with the introduction of a system for the protection of deposits, and tighter restrictions on legal lending limits. In addition, the authority to grant or rescind bank licenses, which used to be the prerogative of the Finance Ministry, was transferred to Bank Indonesia, giving Bank Indonesia central authority to supervise and regulate the banks.

As a result of this series of policies, the work of re-arranging struggling banks and disposing of non-performing debt was able to go ahead, and a certain degree of clarity with regard to the prospects for government-led bank restructuring was achieved. However, many Indonesian banks still lacked capital strength, and their management base was not necessarily solid enough to be able to withstand a financial crisis. As the banking sector's globalization developed, the local banks also lacked international competitiveness. In response to this situation, Bank Indonesia, in January, 2004, just before the disbanding of IBRA, produced the Indonesian Banking Architecture (API), in order to further strengthen the banking sector.

[100] IBRA was an asset management company (AMC), created with the premise that it would be dissolved by the end of February 2004.

5.3.2. The Indonesian Banking Architecture (API)

The Indonesian Banking Architecture (API) is a comprehensive basic framework for the Indonesian banking system, outlining the direction, outline, and structure of the banking industry for the next five to ten years. The policy direction for the future development of the banking industry set out in the API is based on the vision of building a sound, strong, and efficient banking industry in order to create financial system stability for the promotion of national economic growth.

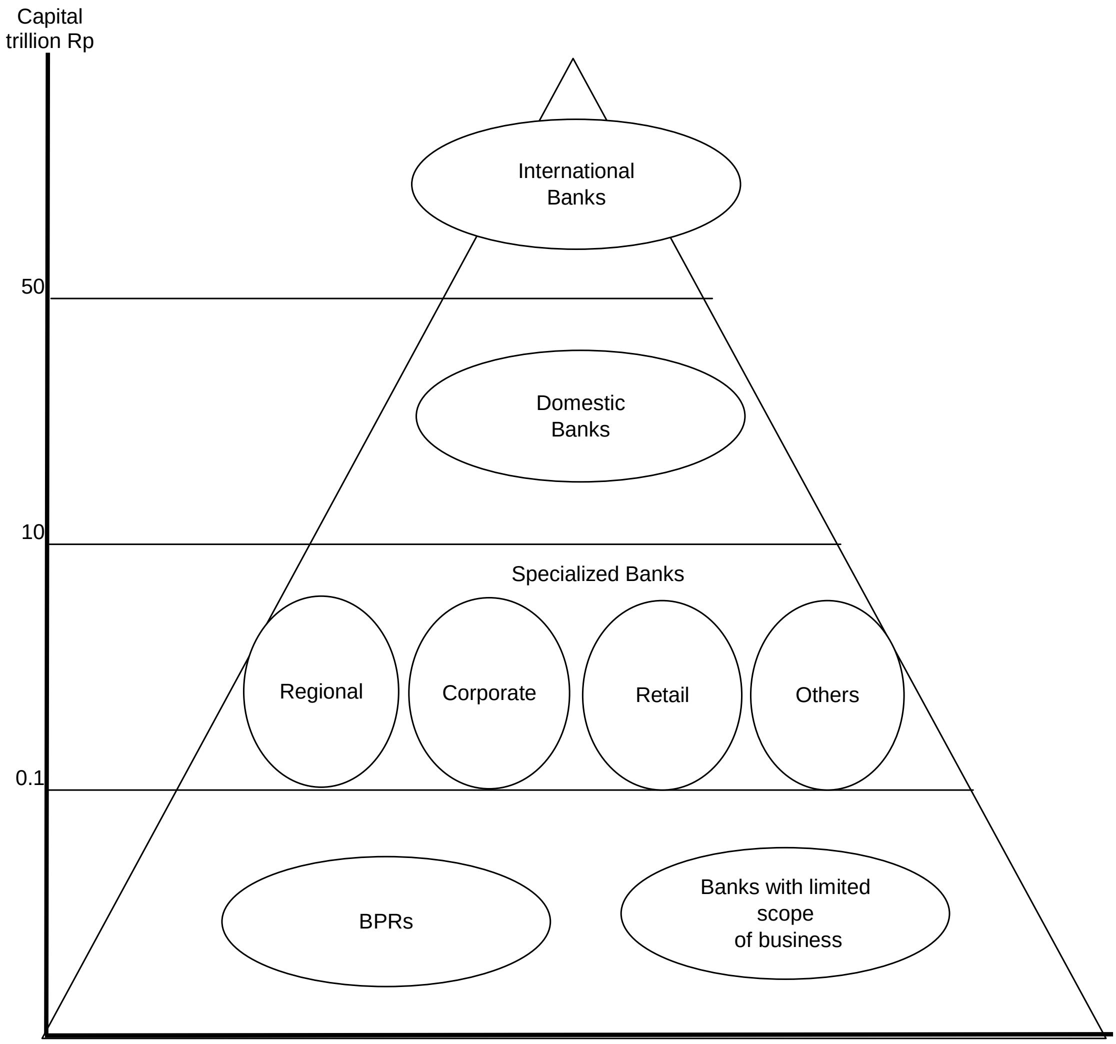
The improvements include more specific strategies for development of sharia banks, rural banks, and SMMEs (Small, Medium and Micro enterprises). The API programs are thus expected to acquire a more comprehensive scope covering the full extent of the banking system as it pertains to commercial banks and rural banks, both conventional and sharia-based, and the development of SMMEs. Overviews of each can be summarized as follows.

a. Structural Reinforcement of the National Banking System Program

This program is aimed at building stronger capitalization into commercial banks (conventional and sharia) as part of the strengthening of bank capacity for business and risk management, development of information technology, and expansion of business scale in order to support increased capacity for bank credit expansion.

The program for improvement of overall capitalization of commercial banks is expected to produce a more optimum structure for the banking system within the next 10 to 15 years (Figure5.4.). This structure is envisaged (i) 2 or 3 banks with potential to emerge as international banks, possessing the capacity and ability to operate with an international presence and having total capital exceeding 50 trillion rupiah, (ii) 3 to 5 national banks, having a broad scope of business and operating nationwide with total capital of between 10 trillion rupiah and 50 trillion rupiah, (iii) 30 to 50 banks operating as focused players, operating in particular business segments according to the capability and competence of each bank, which will have capital of 100 billion rupiah up to 10 trillion rupiah, and (iv) Rural banks (BPRs) and banks with limited scope of business, having capital of less than 100 billion rupiah.

Figure 5.4. Structure of Indonesian Banking System in API



Source: Bank Indonesia

b. Improved Quality of Banking Regulation

This program has the objective of improving the effectiveness of bank regulation and supervision international standards. The program can be achieved through improvements to bank policy-making processes and by phasing-in the comprehensive implementation of the 25 Basel core principles for effective banking supervision[101].

c. Improvement of Supervisory Function

This program aims to improve the independence and effectiveness of bank supervision conducted by Bank Indonesia. This objective will be achieved by strengthening coordination with other supervisory agencies, reorganizing the banking

[101] Bank Indonesia website (http://www.bi.go.id/web/en/).

sector at Bank Indonesia, improving the supporting infrastructure for bank supervision, improvement of risk-based supervision, and more effective enforcement. The main measures are (i) strengthening coordination among supervisory agencies, (ii) reorganization of banking sector at Bank Indonesia, (iii) improving support infrastructure for banking supervision, (iv) improving the implementation of the risk-based supervision system, and (v) improving the guidelines and supervision instruments to improve the implementation of risk-based supervision of conventional and sharia banks.

d. Improvement in Quality of Bank Management and Operation

This program is focused on improving good corporate governance, quality of risk management, and the operational capabilities of management. The main measures are (i) building good corporate governance, (ii) Improving the quality of bank risk management, and (iii) strengthening bank operational capacity.

e. Developing of Banking Infrastructure

The objective of this program is to build supporting infrastructure for effective banking operations, such as credit bureaus and a loan guarantee plan. The main measures are (i) development of credit bureaus, (ii) promotion of the development of Islamic financial markets, and (iii) increasing the role of sharia policy institutions and sharia arbitration institutions in an effort to increase the compliance of sharia banks with sharia banking principles.

f. Improvement of Customer Protection

This program is aimed at empowering customers through the establishment of a mechanism for customer complaints, establishment of an independent mediation agency, improved transparency of information on banking products, and public education. The main measures are (i) formulation of standards for customer complaints mechanism, (ii) establishment of independent mediation agency, (iii) drafting of regulations on transparency of product information, and (iv) promoting public education for customers.

5.3.3. Issues Facing the Development of the Banking System in Indonesia

In terms of API's achievements, thus far the state owned Bank Mandiri has already satisfied the conditions for an international bank, and several others will be recognized as international banks within a year or two. However, only the larger commercial banks have reached API targets with regard to capital adequacy ratios and assets, and among the smaller banks there are many who are unable to attain the targets. Further, there are still many businesses and individuals who have no access to the banking system. There are still many issues to be resolved going forward if the development of Indonesia's banking sector are to be accelerated.

a. Expanding Access to the Financial System

In Indonesia there are many businesses and individuals who have no access to banks, meaning that the capital surplus of the household corporate sectors is not being fully utilized. If this state of affairs is allowed to continue, then not only will capital fail to be used effectively, but financial services will not be able to be used to help stabilize the standards of living of those in low income levels.

Therefore, the extent to which those who cannot access the banking sector can be included within the framework of the banking system is an extremely important issue. In order to expand financial services to encompass these people, it is essential to develop smaller banks and BPRs that can accommodate the needs of SMEs and those in low-income brackets. Although the BPRs are legally recognized, efforts to improve business transparency, such as the implementation of the linkage system[102] and the requirement to submit business reports, have really just started, and many BPRs are still family owned, and many of them are not properly systemized as corporate organizations. In the years to come, there will still need to be efforts made to improve the business consistency of the smaller banks and BPRs, and to spread the availability of financial services. In addition, it will be important to systemize the informal financial institutions, such as *arisan*, that are currently used by many customers.

Further, it will be important to provide services that can be used easily by those who have no access to the banking sector. In order to expand these services, Bank Indonesia has already introduced the following two small sum savings systems.

One is the My Savings, introduced in February 2010. The scheme is a small sum savings system for low-income earners. Each customer can open an account from 20,000 rupiah at a commercial bank, or from 10,000 rupiah at a regional bank. There are no charges for maintaining these accounts or making withdrawals. In addition to opening an account at a bank branch, there is also a system where users can use mobile phones to save from phone cards. Since the use of mobile phones has spread widely among low income earners, these can be used as the infrastructure, with simple procedures, to open accounts and conduct financial transactions.

One other scheme is the Student Saving Movement for primary and secondary school children, which started in July, 2011. The purpose of this scheme is to popularize the My Savings scheme among school children. The children open small sum savings accounts and then, at a time decided by the bank, a temporary branch is opened at the school and the children can perform related transactions there. The purpose is to familiarize the children with financial transactions and enhance their financial literacy, and also to popularize the small savings scheme, not only among schoolchildren, but also among their families, thus reducing the number of unbanked

[102] This is a system for the supply of capital to the BPRs from the commercial banks, in order to complement the supply of capital to customers.

people.

As of late June, 2011, when the plans had been running for about a year, over 70 commercial banks and over 900 regional banks were participating, with 1.8 million accounts opened and 1.8 trillion rupiah deposited.

b. The Development of Accounting Systems and Tax Collection Systems

One reason that the number of businesses and individuals that can borrow from the commercial banks is limited, as the accounting systems and the tax collection systems are poorly developed. This means that businesses' financial situations and individuals' income situations remain unclear.

Although the accounting system does apply to individual entrepreneurs, the requirement to submit financial reports only applies to Indonesian companies with total assets of 25 billion rupiah, regardless of whether they are listed or not, and to all foreign companies. For corporations with assets less than 25 billion rupiah, and individual entrepreneurs, there is no audit report requirement, and financial statements are presented to the local tax authorities on a voluntary basis. Therefore, accounting systems are not very widespread among businesses. The current accounting standards are basically for large corporations so, if accounting systems are to be popularized, accounting standards for SMEs will need to be formulated quickly.

As regards the tax collection system, both businesses and individuals declare income tax alike, so the tax authorities do not have a clear picture of the taxable income. In order to tighten up tax collection, the government has introduced stiffer penalties for tax evasion and a tax payment number identification system. However, the country is very large and contains many islands, and only about half of the population have been allocated numbers, so the new system has not always resulted in better tax collection. If tax collection is to be tightened up, the popularization of accounting systems, as described above, is essential, and a fair and open taxation and tax collection system needs to be developed urgently.

c. Coordination with Banking Systems in ASEAN Countries

It is planned to integrate the financial systems of the ASEAN nations by 2020. However, the group comprised of Singapore, Thailand, Malaysia, the Philippines and Indonesia is at a different level of economic development from the group comprised of Vietnam, Burma, Cambodia and Laos. Given the differences in their economic systems, their financial systems are also greatly different. Of course, Indonesian banks lack international competitive strength in comparison with those of Singapore and Thailand.

Given this set of circumstances, if the advanced standards and systems of Singapore and Thailand are adopted for the purposes of financial integration, there could well be disruption of Indonesia's financial and banking systems. In Indonesia, although the work of adjusting the banking system to international standards has been going on since the 1997 Asian financial crisis, under the guidance of the IMF, there are considerable differences in the state of readiness among the different business types of the large commercial banks, small commercial banks and BPRs. In light of these circumstances, standards and systems will need to be reviewed and coordinated in gradual steps, taking the development of the Indonesian banking system into account.

5.4. Banks' Financial Soundness and Safety Net

5.4.1. Safety Net Structure and Current Situation

In Indonesia, in order to maintain the banks' financial soundness, in addition to the development and strengthening of the management and regulatory system, such as capital adequacy requirements and legal lending limit, a Financial System Stability Forum is held every three months, comprised of Bank Indonesia, the Finance Ministry and the Indonesia Deposit Insurance Corporation (IDIC).

In recent years, thanks to this system, the banks' financial soundness has been maintained. The commercial banks' non-performing loan ratio fell from 7.56% in 2005 to about a third of that, 2.56%, by 2010. Also, since 2008, the capital adequacy ratio has been over 17%, well above Bank Indonesia's 8% criterion. As regards the BPRs, although the non-performing loan ratio fluctuates from year to year, it has been between 7 and 10% since the mid-2000s.

Of course, it needs to be remembered that, every year, about one hundred banks fall into distress and are subject to disposal by Bank Indonesia, and the majority of those are BPRs. Therefore, since the number of small, distressed banks does not decrease, based on the experiences of the 1997 Asian financial crisis, safety nets have been introduced in the form of prompt corrective measures and emergency finance facility by Bank Indonesia, resolution of failing bank and deposit insurance by IDIC, and a system for the protection of depositors.

a. Problem Bank Intervention by Bank Indonesia

Bank Indonesia applies an intensive supervision for a problem bank on the *Bank Indonesia Regulation No.6/9/PBI/2004 concerning the Subsequent Action for Supervision and Designation of Bank Status*. If a problem bank's condition becomes worse, Bank Indonesia will conduct a special supervision of the bank.

<u>A: Intensive Supervision</u>. In the event that Bank Indonesia deems a bank to be in such condition as to have potential difficulties endangering their continued operation, the bank shall be placed under intensive supervision by Bank Indonesia. A bank falling into this category must meet (i) being rated poor or unsound in the scale of bank rating, (ii) undergoing actual or potential problems pursuant to an assessment of composite risk, (iii) having conducted lending in excess or in violation of the legal lending limit and in the opinion of Bank Indonesia the problem-solving plan proposed

by the bank is unacceptable or impossible to achieve, (iv) having violated the net open position and in the opinion of Bank Indonesia, the problem solving plan proposed by the bank is unacceptable or impossible to achieve, (v) retaining statutory reserves ratio in rupiah in the same amount or bigger than the determined ratio for statutory reserves, though the bank is considered to be having basic liquidity problems, (vi) being deemed to have fundamental problems in profitability, and (vii) having net non-performing loans in excess of 5% of total credit.

In order to conduct an intensive supervision of the bank that is deemed to have potential difficulties endangering their continued operation, Bank Indonesia is entitled to perform the following actions: (i) to demand that banks submit their reports of particular issues to Bank Indonesia, (ii) to increase the frequency of business plan updating and evaluation in regard to the intended aims and objectives, (iii) to ask banks to create their action plans for the occurring problems, and (iv) To conduct on-site supervision by Bank Indonesia, if considered necessary.

<u>B: Special Surveillance</u>. Bank Indonesia conducts a special surveillance of a bank that is facing difficulties endangering the continuity of its business despite intensive supervision. The bank will fall into a special surveillance under one or more of the following conditions: (i) capital adequacy ratio is less than 8%, and (ii) ratio of statutory reserves in rupiah is less than the required ratio for a bank, with an indication of worsening condition in the near future or considered by Bank Indonesia as undergoing a basic liquidity problem. Moreover, a bank where liquidity is provided by an emergency finance facility will also fall into a special surveillance.

Bank Indonesia shall order the bank to comply with its mandatory supervisory actions immediately after receiving the letter of notification from Bank Indonesia stating that its capital adequacy ratio is in the same amount or less than 6%. Bank Indonesia may order the bank and the shareholders to carry out certain actions such as: (i) to change the board of commissioners and the board of directors, (ii) to write off credit or bad financing based on sharia principles and calculate bank loss with the bank capital, (iii) to conduct a merger or consolidate with other banks, (iv) to sell the bank to a buyer who is willing to take over all liabilities of the bank, (v) to delegate the management of part or all of bank activities to another party, (vi) to sell part or all of the assets and liabilities of the bank to another bank or party, and (vii) suspending certain business activities of the bank.

In addition, the bank and the shareholders must achieve the capital adequacy ratio and statutory reserves according to the existing provisions within: (i) not more than 6 months for a bank listed on the capital market, and (ii) not more than 3 months for a bank not listed on the capital market or a representative office of a foreign bank.

<u>C: Emergency Finance Facility</u>. An emergency finance facility, hereinafter referred to as EFF, is a financing facility extended by Bank Indonesia to a problem bank that experiences liquidity difficulty, while still complies with the level of solvency

prescribed by Bank Indonesia, and has systemic impact. Funding for an EFF shall be taken from the state budget. If it is difficult to fund by the state budget, the Ministry of Finance may issue government securities in accordance with the applicable regulatory provisions. The requirements for provision of EFF cover the following: (i) the bank is experiencing liquidity difficulty, (ii) the bank has a systemic impact, (iii) capital Adequacy Ratio of the bank is at least 5%, and (iv) guaranteed by collateral.

b. Resolution of Failing Bank

A failing bank is a bank that experiences financial difficulties and endangers the continuation of its business and that cannot be rescued by Bank Indonesia in accordance with its authorities. The resolution of failing banks is classified in two categories: failing bank without systemic risk and one with systemic risk. A coordination committee that consists of the Ministry of Finance, Bank Indonesia, OJK and IDIC, determines the existence of systemic risk of a failing bank after considering the impact that the collapse of the bank may have on the economy and the liquidity of the banking system, as well as the scale of the bank.

A: Resolution of Failing Bank without Systemic Risks. When a bank without systemic risks is considered insolvent and the corrective actions fail, Bank Indonesia will transfer the bank to IDIC to be resolved (Figure 5.5.). Since 2005, IDIC has managed one-tenth of problem banks where Bank Indonesia has intervened.

IDIC shall decide to rescue a failing bank if the following conditions are fulfilled. First, the estimated cost to rescue is at the maximum 60% of the estimated cost not to rescue. Second, the bank should exhibit good business prospects after the rescue. Finally, there is a statement of the general shareholders meeting (GSM) of the bank that at the minimum cover their willingness to: (i) surrender the rights and authority of GSM to IDIC, (ii) surrender the bank's management to IDIC, and (iii) not to press charges against IDIC or other parties appointed by IDIC, if the rescue process is not successful, as long as IDIC or any of the other parties appointed by IDIC carry out their duties in due faith.

IDIC shall carry out the rescue such (i) to occupy, manage, and foreclose on the assets that belong to or become the rights/liabilities of the bank, (ii) to perform temporary capital placement, (iii) to sell or to transfer the bank's asset without debtor's or bank's consent, (iv) to hand over the bank management to other parties, (v) to merge or consolidate with another bank, (vi) to transfer the bank's ownership, and (vii) to review, annul, terminate and amend the bank's contracts which are binding the bank with third parties, which according to IDIC shall incur financial loss.

During the rescuing process, IDIC shall discontinue rescuing a failing bank if new evidence is found that the rescuing cost shall become at least: (i) 200% of the estimated rescuing cost at the time the decision to rescue is made, or (ii) greater than 60% of the estimated rescuing cost at the time the decision to rescue is made. IDIC shall request

Bank Indonesia for license Revocation of the failing bank for which rescue is discontinued.

All costs expended by IDIC to rescue a failing bank shall become IDIC temporary capital placement in the rescued failing bank. IDIC is obligated to sell all shares of the rescued bank within a maximum 2 year period following the surrender of the bank to IDIC.

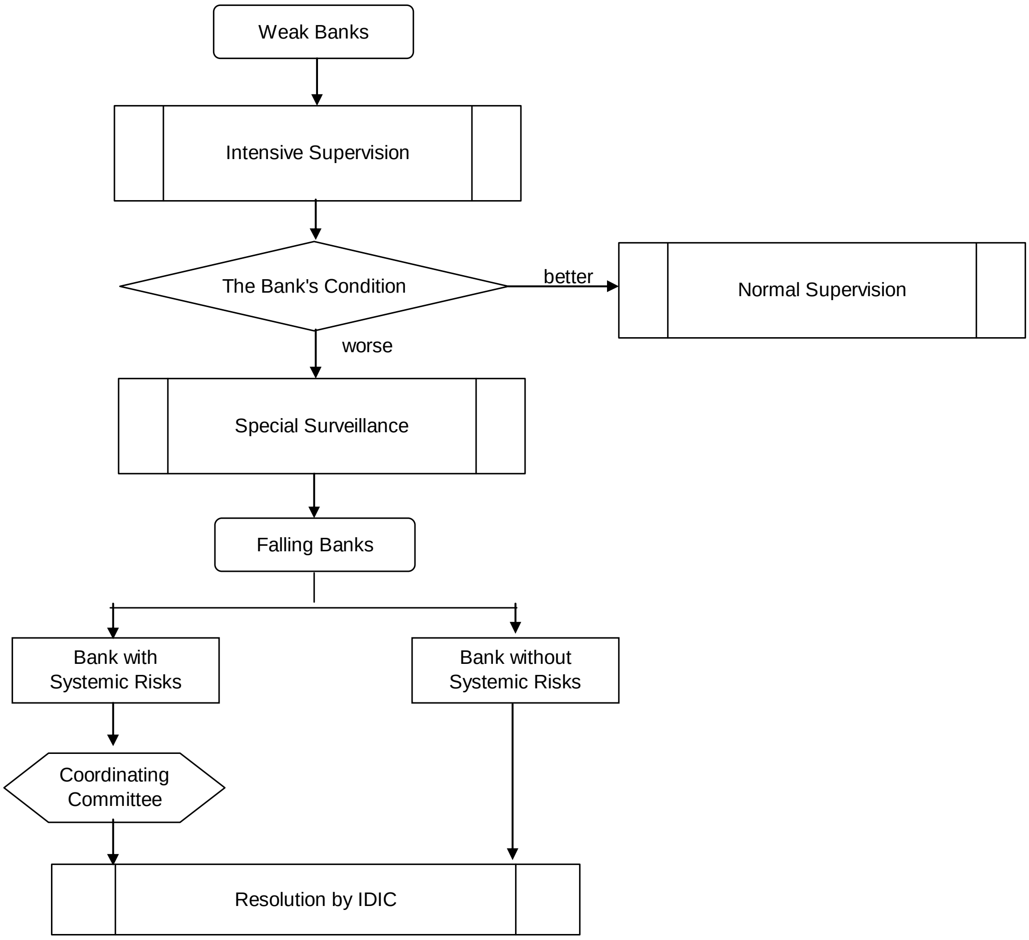
In the event the bank fails to meet the agreed terms and conditions, or if IDIC decides to discontinue rescuing a failing bank, IDIC shall request Bank Indonesia to revoke bank's license in accordance with the prevailing laws and regulations. Then, IDIC shall pay the insurance claim to the depositors of the bank whose license was revoked.

<u>B: Resolution of Failing Bank with Systemic Risks</u>. IDIC handles a failing bank with systemic risks by involving the shareholders participation (one-bank assistance). This measure may only be implemented in the following conditions. First of all, the shareholders of the failing bank inject a minimum 20% capital of estimated handling cost. Secondly, they provide a GSM agreement to surrender to IDIC the right and power of the GSM and the management of the bank. Thirdly, they also provide a GSM agreement not to press charges against IDIC or any other parties appointed by IDIC in the event the resolution is unsuccessful, as long as IDIC and any other parties appointed by IDIC have performed their duties in good faith.

In the event that a bank's equity is positive, after the former shareholders inject temporary capital, IDIC and the former shareholders will sign an agreement to govern the proceeds of sale of the bank's shares. Meanwhile, in the event that a bank's equity is zero or negative after the former shareholders inject temporary capital, the former shareholders have no right upon the sale of the bank's shares.

If the failing bank on its own is unable to achieve a turnaround to recover its position, IDIC will intervene without the shareholders' participation. It will take over all the rights and powers of the GSM, the title of ownership, management, and other interests on the bank. IDIC, or any other parties appointed by IDIC for the rescue operation, are accorded protection under the law from any legal suits by the shareholders and the bank management in the event of unsuccessful resolution, as long as IDIC and the other parties appointed by IDIC have carried out their duties in good faith.

Figure 5.5. The Intervention Process of Weak Banks



Source: The South East Asian Central Bank Research and Training Center

c. Deposit Insurance System

On September 22, 2004, *the Republic Indonesia Law Number 24 concerning IDIC* which is an independent institution to protect depositor's funds, was enacted. The law took effect on September 22, 2005 and IDIC officially began its operations as of that date. Prior to the deposit insurance, the government blanket guarantee had been protecting the all funds of the depositors of a failing bank. However, research showed that the blanket guarantee had contributed to moral hazard by bank managers, and had invited increase of government expenditures. Therefore, the maximum amount of deposits insured per depositor within a single bank is limited.

All banks that operate within the territory of the Republic of Indonesia are obligated to become members of the deposit insurance system. Insured member banks include all commercial banks (including branch offices of banks domiciled overseas that conduct their banking activities within the territory of the Republic of Indonesia) and BPRs that adhere either to conventional or sharia-based lending principles.

The insurance premium is paid 2 times a year: the period from January 1 to June 30 and the period from July 1 to December 31. The premium for each period is determined to be 0.1% of the average monthly balance of total deposits within each period. IDIC discusses changing of the premium rate on the basis of rating of bank.

The insured deposits are comprised of current accounts, time deposits, saving accounts, deposits in foreign currency and sharia-based deposits. The insured deposits include the deposits of the officers and shareholders of a bank that whose license has been revoked.

The amount of deposits that is insured by IDIC is comprised of the deposit balance that consists of principal and accrued interest/return as of the date of the bank's license. The maximum amount of deposit insured is 2 billion rupiah per depositor within a single bank. If the insurance claim is denominated in a foreign currency, payment will be based on the middle exchange rate as per the date of the bank's license revocation. The middle exchange rate is the average of buying and selling rates at the end of the day as announced by Bank Indonesia.

IDIC shall determine whether deposits are eligible for payment or not within no later than 90 working days upon the revocation of the bank's license. Then, IDIC will announce in at least two widely circulated newspapers, the data for submission of claim for deposits that are eligible for payment. The interest rate must not exceed IDIC's published rate. As of January 11, 2012, the maximum insured interest rates are (i) commercial bank's interest rate is 6.5% in rupiah or 1.5% in foreign currency, and (ii) BPRs 's interest rate is 9.5%. If the interest rate exceeds the insured interest rate, neither the principal of deposit nor accused interest will be guaranteed. If the amount of deposit exceeds the maximum amount of deposit insured and the interest rate does not exceed the insured interest rate, the amount of deposit will be guaranteed at the maximum amount of deposit insured. For deposits that are excluded, after disposal of the assets of the bank whose license was revoked, the payment is made according to the amounts of those dispositions.

Based on the current maximum amount of deposits insured[103], 99% of the deposit accounts in Indonesia may be guaranteed under the deposit insurance system. However, it is feared that the current amount of deposits insured will cause moral hazard, as that is greater than the appropriate level[104]. Therefore, IDIC has determined to decrease the current maximum amount. The maximum amount of deposits insured per depositor within a single bank will be down to 1 billion rupiah by January 2012, and will be down to 500 million rupiah by July 2012. In addition, IDIC

[103] After the collapse of Lehman Brothers in 2008, because it was feared that the investors would move their capital from Indonesia to neighboring countries such as Singapore and Malaysia, which would raised the level of the amount of deposits insured, IDIC lifted the maximum amount of deposits insured from 100 million rupiah up to 2 billion rupiah.

[104] It is generally said that the appropriate maximum amount of deposits insured per depositor within a single bank is 5-6 times the nominal GDP per capita.

plans to set the maximum amount of deposits insured by each currency for the deposits in foreign currency.

d. Depositor Protection System

In order to protect depositors, a system has been introduced to ensure (i) the handling of customer complaints, (ii) bank mediation, and (iii) the transparency of financial products. A brief summery of these protection systems is setout below.

A: Customer Complaint Handling. Customer complaints may be filed verbally or in writing. The banks are required to formulate policies and procedures for the receiving and handling of complaints and to ensure that there are staff persons responsible for handling complaints in place at every branch office, and that the policies and procedures are well known throughout the bank. In addition, verbal complaints must be responded to within two working days of receipt, and written complaints within 20 working days. Also, a report detailing the handling of complaints received and the results must be filed with Bank Indonesia four times a year.

B: Banking Mediation. In January 2006, *Bank Indonesia Regulation No.8/5/PBI/2006 Banking Mediation* was enacted. Under these provisions, the role of mediation between banks and customers, which had thus far been the job of Bank Indonesia, was transferred to a third party established by the Indonesian Banks Association.

Disputes handled by this party are limited to unresolved civil cases with a financial claim of no more than 500 million rupiah. The customer, upon receipt of a settlement result letter from the bank, must file for mediation within 60 working days. The mediating agency, upon receipt of the request, must resolve the matter within 30 working days. Naturally, this 30 day period may be extended with the agreement of both the customer and the bank. Both the customer and the bank must put the results of the mediation into an Agreement Deed that is signed, and the bank must abide by the decision.

C: Ensuring the Transparency of Banking Products and Protecting Customer Information. In order to ensure the transparency of banking products, the banks are required to disclose and disseminate information pertaining to their profitability and risk, usage conditions, commission charges, interest calculation and the existence or otherwise of any kind of deposit protection. With regard to the protection of customer information, the bank must explain to the customer the purpose and obtain the customer’s written agreement with such action, before providing customer information to a third party. Further, the banks are required to formulate policies with regard to the disclosure of product information and the handling of customer information, and if there are to be any changes in product information, then any customers who possess these products must be informed of the same within seven working days.

5.4.2. Impact of the Global Financial Crisis and Indonesia's Response to Tougher International Regulations

The global financial crisis that started with the Lehman Brothers' collapse in the early autumn of 2008 has had a slight impact on the Indonesian banking sector. The commercial banks' capital adequacy ratio fell from 19.3% in 2007 and has not recovered to that level. However, it is still well above the international standard 8%, and the core capital adequacy ratio (Tier 1) is above 10%. The non-performing loan ratio has been declining consistently, regardless of the current financial crisis, and is in the 2% range. The reasons given for this include the fact that because Indonesia's financial market is still developing, it is less prone to the effects of international financial market movements, and that, based on their experience of the Asian financial crisis, many Indonesian commercial banks have a rather conservative approach to business and they tend not to get involved in leveraged investment banking or investment in overseas government bonds for operating purposes.

In addition, the introduction of a continuous series of regulations in compliance with international standards under API, in an attempt to strengthen domestic banks' capital strength and business foundations, is also believed to have been a contributory factor. In response to the current global financial crisis, the toughening of international standards related to capital equity requirements, is being considered among the developed nations and G20, and Indonesia has adopted a positive stance with regard to the implementation of the new standards.

For example, Bank Indonesia is positive towards the implementation of Basel III. Naturally, these capital regulations have been introduced for international banks, as defined under API, and while domestic banks and specialized banks will comply, it is expected that slightly easier versions of the standards will be introduced. Further, the commercial banks' capital equity ratio stands at 17%, well above the international standard of 8%, and the core capital adequacy ratio (Tier 1) is over 10%. Accordingly, even if Basel III is implemented, the major banks are expected to be able to satisfy the new criteria.

5.4.3. Risk and Issues

For the commercial banks, one risk factor affecting banks' financial soundness is said to be the sudden increase in their foreign debt. Thus far, since Indonesia's economy has stayed strong and the exchange rate is holding steady at $1 = 9,000 rupiah range, there is little likelihood of any major financial instability, such as the 1997 Asian financial crisis. Nevertheless, although the general trend may be said to be one of improvement, Indonesia's country risk remains high and attention would need to be paid to foreign debt trends. In light of these circumstances, the government and Bank Indonesia have begun to consider the introduction of foreign debt restrictions for banks and businesses, in case the exchange rate plummets.

Meanwhile, for the BPRs, their fragile financial base and general business constitution are said to be their biggest risk factors. Under API, efforts are being made to boost capital strength and reinforce the financial base. However, banks with capital of less than 5 million rupiah account for one fifth of the total. It is pointed out that some of those are BPRs whose business status is unclear. Overall, their non-performing loan ratios tend to be higher than those of the commercial banks, and for the past few years about a hundred banks a year qualify for special surveillance by Bank Indonesia, of which around 30 end up failing. Given that the BPRs are very important financial institutions for individual entrepreneurs and low income earners in regional areas, it is essential that steps be taken to further reinforce their financial bases and business quality, in order to secure and sustain their financial soundness.

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6. China

6.1. Characteristics of the Banking Sector

6.1.1. Macroeconomic Environment and Industrial Structure

a. Basic Facts

The emergence of China as a leading exporter and "factory to the world" was arguably the most significant development of the late 20th and early 21st century. By opening the country to outside investment, and unleashing the potential of China's own entrepreneurs and state-owned enterprises, China's government has been able to achieve in thirty years what many developed countries have achieved over centuries.

China is a single-party state governed by the Communist Party of China. With more than 1.3 billion people (1,336,718,015 as of mid-2011); China is the world's most populous country. As the world's population is approximately 6.7 billion, China represents a full 20% of the world's population, so one in every five people on the planet is a resident of China. Thus, China, with its huge population and sustained economic growth, by raising domestic purchasing power and introducing policies to stimulate domestic demand by its plentiful capital, is now not only enhancing its ability as "the world's factory", but also as "the world's market".

China has experienced a remarkable period of rapid growth spanning three decades, shifting from a centrally planned to a market based economy with reforms begun in 1978. According to the World Bank, over the past 30 years China's GDP has grown at an average rate of about 9.7% per year and inflation has remained relatively subdued, with exceptionally strong growth between 2003 and 2007 averaging about 11% per year. Productivity growth has been rapid and capacity has been expanded by very high levels of investment. All these years, economic liberalization policies have contrived to increase the GDP of China by 10 times since 1978. Moreover, growth remained strong during the recent global financial crisis, reflecting massive stimulus and strong underlying growth drivers.

As the global economy slips into recession in the wake of the global financial crisis, China and other Asian countries are now leading the global economic recovery. After the global crisis, there was increased international anticipation of Asia's economic growth, and the 21st century is being called the "Asian century". The current situation is being described as a "two-speed world economy", with bipolarization between the new emerging economies, such as China with its overheating and fast growing economy, and the industrialized world, where employment has yet to recover, and growth levels are low.

Even against the backdrop of the rapid growth of the new emerging economies, China stands out even more, and it is impossible to discuss the global economy and the future of industry and finance without mentioning China. In 2000, China's economic scale (GDP) was only around 30% the size of Japan's, but in the last decade China's trade and investments have grown rapidly and, in 2006, China had the world's highest foreign currency reserves, in 2009, became the world's largest energy consumer, and in 2010, in terms of foreign acquisitions, passed the UK to become the world No. 2, after the US. China became the world's second largest economy in 2010; increasingly, it is playing an important and influential role in the global economy. China's GDP was valued at US$5.87 trillion, surpassing Japan's US$5.47 trillion, and became the world's second-largest economy, after the United States, in both nominal GDP and purchasing power parity (PPP). Standard Chartered forecast that China will become the world's largest economy (by nominal GDP) by 2020. Goldman Sachs had predicted that China will overtake the US by about 2040, but now it says 2027. The Economist Intelligence Unit forecasts that China will be larger than the US by 2017, using purchasing power parity, which adjusts for price differences between countries to reflect the actual buying power of local incomes.

However, China is further behind when its economy is measured in current dollars. US's GDP in 2010 was US$14.5 trillion at current market price. China's was valued at almost US$5.9 trillion, which was only two-fifths the size of US's. China's nominal GDP per capita of US$4,300 puts it behind around 90 countries (out of 183 countries on the IMF list) in global GDP per capita rankings. With the second largest number of consumption-poor in the world after India, poverty reduction remains a fundamental challenge. Rapid economic ascendance has brought on many challenges as well, including demographics-issues related to an aging population as well as the internal migration of labor, high inequality, rapid urbanization, challenges to environmental sustainability, and external imbalances. Significant policy adjustments are required in order for China's growth to be sustainable.

Looking into the composition of GDP by sector estimation in 2010, the agricultural sector comprises 10.2% of China GDP, and the industrial sector 46.9%. 43 percent of China GDP is made up by the services sectors[105]. The industrial sector that is owned by the Chinese government contributes 40% of China's GDP. As for the labor force, 39.5% of the 812.7 million labor force is employed in agriculture, 27.2% in industry and 33.2% in services. This reflects the fact the two most important sectors of the economy have traditionally been agriculture and industry, which together employ more than 70% of the labor force and produce more than 60% of GDP.

According to the National Bureau of Statistics of China in 2010, private consumption has been 34% and government consumption has been nearly 13% of nominal GDP. At same time, gross fixed investment hovered around 44% and net export of goods and service was 9.2% of GDP. For all of 2011, China's economy grew 9.2%, compared with 10.4% in 2010, but the growth was fueled by fixed investment,

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[105] China Economy 2011, Central Intelligence Agency (CIA), The World Factbook.
http://www.theodora.com/wfbcurrent/china/china_economy.html

while the contribution to growth from household spending continues to shrink.

In terms of private consumption, China's private consumption as a share of GDP has declined from around 55% in the early 1980s to around 34% in 2010. The decline in a country's share of private consumption during the early development stages is not in itself a surprise. Savings naturally rise at early stages of development as households move away from subsistence levels of income and greater capital accumulation is needed to finance investment and growth.

However, the size of the fall in China's private consumption share certainly stands out. Some studies attribute the decline in private consumption to a rise in households' savings rate (to be discussed in the Savings and Investments section later), reflecting precautionary savings, particularly by elderly households, in the face of limited healthcare, pensions, and education benefits. China's high savings will also spur deals. Companies often have surplus cash and banks have surplus deposits. Today those savings are recycled into rich countries via sovereign wealth funds and the central bank, which acts as portfolio investors, buying mainly bonds.

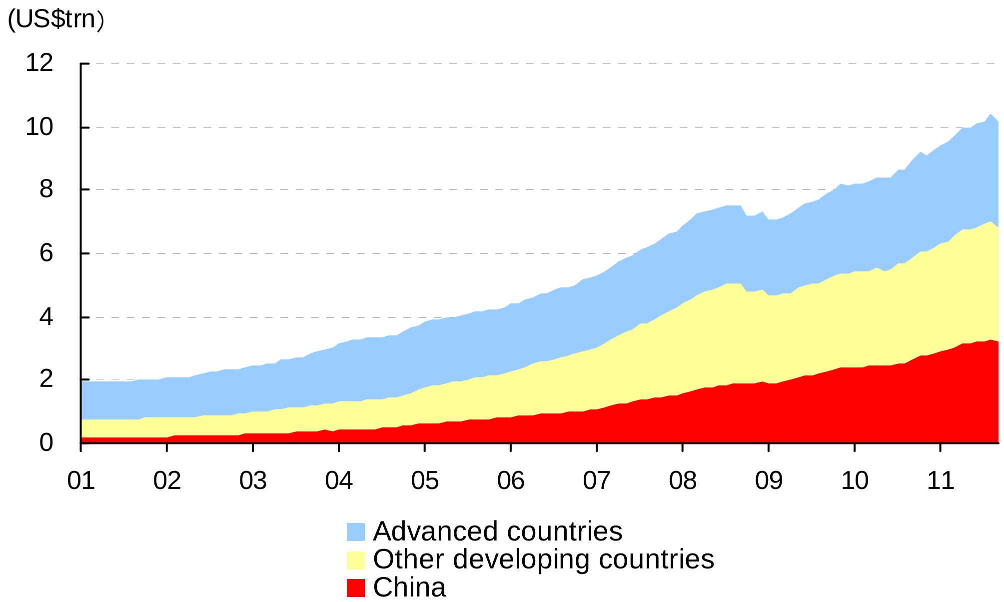
Since economic liberalization began in 1978, China's investment and export led economy has grown almost a hundredfold and is the fastest-growing major economy in the world. Foreign direct investment (FDI) has played an important role in China's economic development. China is the world's third-largest recipient of inward FDI, attracting US$92.4 billion in 2008 alone, and China increasingly invests abroad, with a total outward FDI of US$52.2 billion in 2008 making it the world's sixth-largest outward investor. In 2010, China's inward FDI was US$106 billion, marking a 17.8% increase over 2009. With huge FDI inflows and improved production and management capabilities, China's production capacity has been enhanced and increasingly internationalized, with foreign trade playing an ever more important role in the country's economic growth.

China has also become the world's largest exporter and second-largest importer of goods. Over the past ten years its GDP has more than trebled to US$11 trillion. China has taken over from America as the world's biggest market for many consumer goods. Moreover, since joining the World Trade Organization (WTO) on December 11, 2001, the growth in China's foreign trade has accelerated noticeably to new levels almost every year. China is the world's second-largest trading power behind the US, with a total international trade value of US$3.3 trillion (US$1.7 trillion in exports and US$1.6 trillion in imports) in 2011, a 12.6% jump compared to 2010.

In 2010, the current account balance was US$305.4 billion; percent of GDP was at 5.1%. The current account surplus will narrow to an estimated US$264 billion, 3.6% in 2011, according to the World Bank. China's "twin surpluses" in the current account and capital account, an indication of total money inflows into the economy, were narrower in 2011, they still put pressure on the country to allow faster yuan appreciation to slow the influx of funds. The addition to the money supply also increases inflation pressures in the domestic economy.

Foreign exchange reserves have accumulated along with the steady growth of imports and exports. Global reserves have risen from US$1.3 trillion (5% of world GDP) in 1995 to US$8.4 trillion (14%) today. Emerging economies hold two-thirds of the total. Most of their hoard has been accumulated in the past 10 years. China has curbed the rise in its currency, and kept its exports competitive, by buying huge quantities of dollars and other foreign currencies, amassing US$3.26 trillion of foreign-exchange reserves (worth 54% of China's 2010 GDP) by September 2011 (Figure 6.1.), an increase of 18.1% over the previous year, making its reserves by far the world's largest. These huge reserves offend economic logic, since they mean poor countries, which should have abundant investment opportunities of their own, are not receiving investments because investments are going to richer ones, mainly US.

Figure 6.1. China's World Foreign Exchange Reserves



Source: IMF, Thomson Reuters

Note: Reserves to September 2011.

Moreover, China's central bank is a major purchaser of US financial assets, largely because of its exchange rate policy[106]. In order to limit the appreciation of China's currency, the renminbi (RMB), against the dollar, China must purchase US dollars. Around US$2 trillion of Chin's currency reserves of US$3.2 trillion are in dollars, mostly in bonds. Rather than hold dollars (and other foreign currencies), which earn no interest, the Chinese central government has converted some level of its foreign

[106] IMF, Global Financial Stability Report, October 2010, Statistical Appendix, P.3.

exchange reserve holdings into US financial securities, including US treasury securities, US agency debt, US corporate debt, and US equities. As of June 2011, the largest category of US securities (US treasury securities) held by China totaled US$1.17 trillion and accounted for 25.9% of total foreign holdings of US treasury securities. China is the largest foreign holder of US public debt. While soaring foreign exchange reserves reflect China's enhanced national power to some extent, it is considered to be a major cause of increasing appreciation pressure on the RMB.

While net export has started contributing significantly to growth only in the last few years, foreign invested enterprises represent over 50% of Chinese exports. The booming trade surplus inflates liquidity and contributes to the excessive pickup in investment. This is partly linked to the Chinese exchange rate policy. The RMB value against the US dollar had been fixed between 1995 and 2005, even resisting pressures for depreciation during the Asian Financial Crisis. From the exchange rate reform in July 2005 to the end of 2008, The RMB appreciated by 17% against dollar. In July 2005, the RMB was revalued by 2.1% (from 8.28 to 8.11) and its value is now set with reference to a basket of currencies. In other words, the exchange rate is highly managed despite recent pro-market reforms, which allow banks and enterprises to hedge. Since July 2008, the central bank announced that the flexibility of the yuan would be increased, which had been tightly pegged at about 6.83 to the dollar. After the global financial crisis, China's continued strong growth in 2008-2010 contrasts with weak or no growth in other parts of the world, and the yuan keep appreciating to 6.5 in 2011.

Since September 2008, when the subprime crisis in the US became a global financial crisis, the Chinese government has made a lot of efforts to promote the reform of the international monetary system, such as internationalization of RMB, and has brought up several long-term proposals. However, it seemed that the Chinese government knew the difficulties for an overall reform of the current international money system, and it might also be disappointed about the slow progress of the east Asia regional monetary cooperation, especially some differences about the cooperation between China and Japan (ASEAN+3, ASEAN+6 problem).

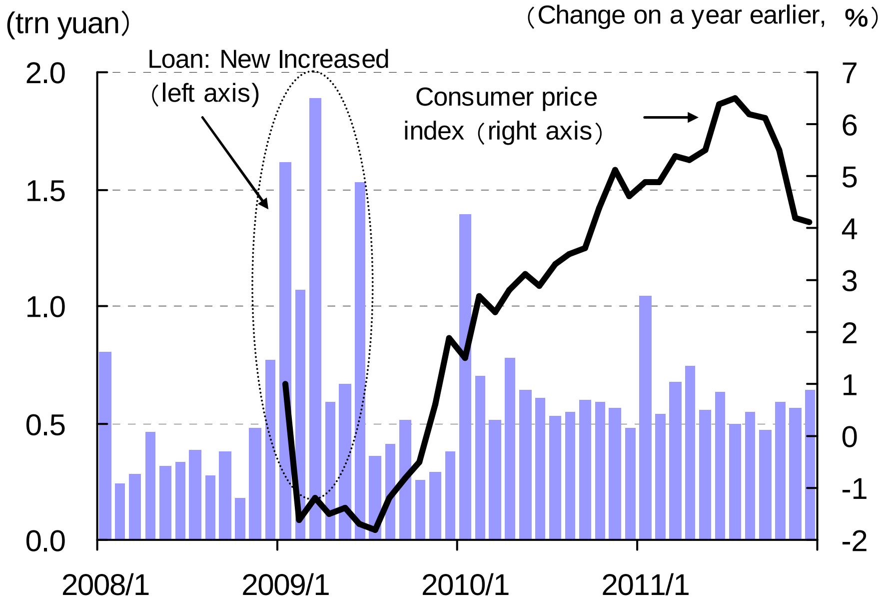
So far, the continued expansion of imports and exports has brought sustained growth in China's trade surplus, which in turn has led to excess liquidity and rapid growth in foreign exchange reserves. All of this has put pressure on the Chinese government to appreciate the RMB. At the same time, the growth in net export has led to biased growth in domestic investment, resulting in rapid economic growth and further increased pressured on the currency. This has now become the most acute problem in China's financial system and macro-economy.

In addition, the fiscal account balance is in the red. The commitment budget deficit for the national (central and local) government was 1.6% of GDP in 2010, down from 2.8% of GDP in 2009 (World Bank). However, with 0.7% of 2010 GDP in local government spending carried over from 2009 into 2010, the cash deficit was 2.3% of GDP in 2010, compared to 2.0% in 2009. The budget deficit of 1.5% of GDP (World Bank forecast) in 2011, compared to 2.3% of GDP in 2010, appropriately suggests some withdrawal of fiscal stimulus, with the low estimate of tax revenues providing a buffer and thus some flexibility.

The last discussion is the current pressing challenge in China. A fully normalized macro policy stance is key to address the macro risks with respect to inflation and the housing market. With food price increases slowing, sequentially, and core inflation still in check, inflation should moderate eventually. However, much of the impact of the higher oil and industrial commodity prices is still in the pipeline, inflation expectations are high, and there is little spare capacity in the economy, overall. To address the risks on inflation and the property market, macro policy is typically better placed than moral suasion and administrative measures. It is too early to stop the macro tightening. Two way risks are better dealt with by maintaining fiscal and monetary flexibility.

On one hand, the government has taken several steps to contain inflation. In addition to normalizing the overall macro policy stance, it took some measures to boost food supply and reduce the cost of production and logistics, including releasing grain from China's large reserves, increasing subsidies to farmers, exempting transport of vegetables from road tolls, and boosting food imports. More recently, this was followed by limiting the increase in domestic fuel prices arising from higher oil prices and applying moral suasion on manufacturers of food and consumer products. Consumer price index increases have fallen back from a peak of 6.5% in July to 4.1% in December, 2011 (Figure 6.2.) and banks had a slowdown 6.4 trillion yuan of new loans in December 2011, more than the peak in 2009. China has begun to ease monetary policy to try to avoid a calamitous drop in growth. In December 2011, the central bank moved earlier than expected to reduce the bank reserve requirements by 0.5 percent point to 21%, paving the way for a bounce in new loans in the final months of the year. The bank had been increasing the rate to reduce lending by banks in order to dampen demand and tackle rising prices.

Figure 6.2. China's Net New Loans and Consumer Prices



Source: CEIC

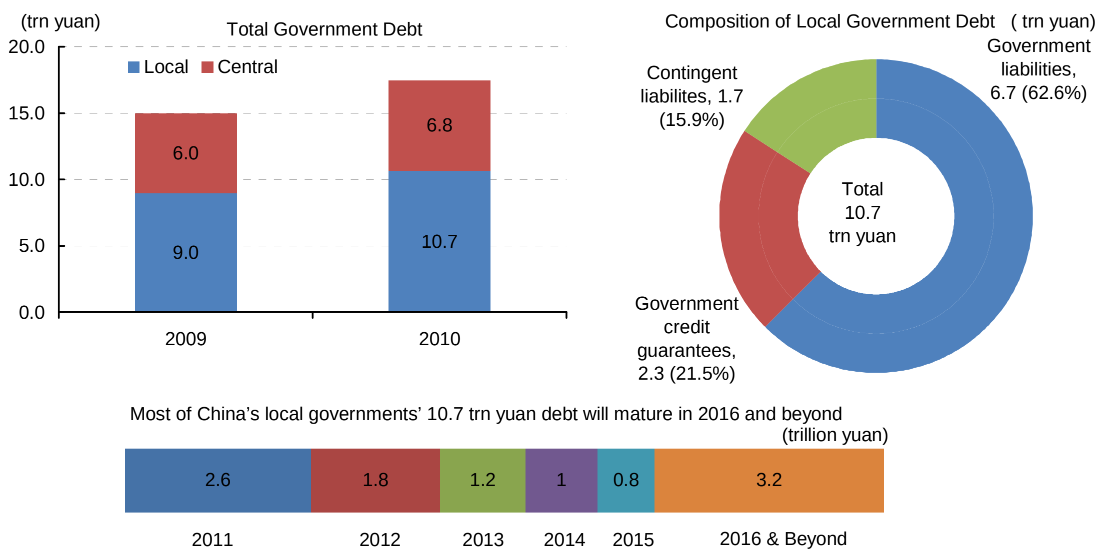
On the other hand, the property market correction is providing the greatest downside momentum, which is a particular source of risk. With tension between the underlying upward housing price pressure and the policy objective to contain price rises, interaction between the market and policy measures could lead to a more abrupt than planned downturn in the real estate market. China reported that the price of new homes fell in 52 out of 70 cities across the country in December 2011. Households are struggling to obtain mortgages; developers are finding it almost impossible to obtain a loan. In the medium term, the widespread use of property as an investment vehicle and the role of local governments add to the risks also. Property construction is an important part of the economy[107], directly and in terms of impact on large sectors such as steel and cement[108]. In 2010, property construction accounted for 13% of GDP, and for more than one-quarter of all investment in what is the most investment-dependent economy in history. Thus, shocks to the property sector that would slow down construction significantly could have a large impact on the economy and on bank balance sheets, taking into account bank exposure to construction and other sectors dependent on the real estate market.

Moreover, a property downturn could affect the finances of local governments, which do a lot of the infrastructure investment and are important clients of the banking

[107] In China, property investment accounts for more than 20% of total fixed investment, so the drop in property prices would precipitate a collapse in the fixed investment-driven economy which would experience a so-called hard landing after years of annual growth of about 9%.
[108] Property directly accounts for 40% of Chinese steel use.

system. China's local governments have piled up a mountain of bad debt, some of it to finance bridges to nowhere and other white elephant projects, which now threatens to constrict growth at a time when the global economy is sputtering. It is adding to other systemic risks in China, including a sharp downturn in the property market and a rapid rise in problematic loans. In 2010, total government debt made up 43.9% of China's GDP and the average debt-to-assets ratio for local governments was 70.45%. Local governments had amassed 10.7 trillion yuan in debt at the end of 2010 (Figure 6.3.). The government expects 2.5 to 3 trillion yuan of that will turn sour, while Standard and Chartered reckons as much as 8 to 9 trillion yuan will not be repaid or about US$1.2 trillion to US$1.4 trillion.

Figure 6.3. China's Local Government Debt



Source: National Audit Office, China Ministry of Finance, Reuters News

Needless to day, those potential risks in China still exist and there are many challenges from home and abroad. Also, the global economic recovery is not solidly based yet, with many unstable and uncertain factors. In terms of domestic economic performance, some long-term problems intertwine with short-term problems, institutional conflicts coexist with structural problems, and macroeconomic management is faced with such challenges as increasing asset bubbles and inflationary pressures, and the challenge of speeding up economic restructuring. In general, the Chinese economies developing in the direction as intended by macroeconomic policies, and the momentum of stable and relatively fast economic growth is becoming more solidly based.

b. Business Framework

Since the mid-1990s the shape of the Chinese corporate sector has started to modify significantly. According to the Second National Economic Census, there were altogether 7,099,000 legal units[109] engaged in the secondary and tertiary industries[110] by the end of 2008, up by 37.3% or an increase of 1,930,000 over the first economic census in 2004. There were 8,864,000 establishments, up by 29.9% or an increase of 2,040,000 over 2004, and the number of self-employed individuals[111] with licenses was 28,737,000, up by 31.4 % or an increase of 6,869,000 over 2004.

The total number of corporations by status of registration was 4,959,000. Compared to the first economic census in 2004, there were 1,709,000 more legal units, up by 52.6%. Of this, the number of state-owned corporations (SOEs) was 143,000, down by 20% or a decrease of 36,000, that of collective corporations 192,000, down by 44% or a decrease of 151,000, share-holding cooperatives corporations 64,000, down by 40.2% or a decrease of 43,000, that of joint-operation, limited liability and share-holding corporations was 659,000, up by 52.5% or an increase of 227,000, private enterprises 3,596,000, up by 81.4% or an increase of 1,614,000, other domestic funded enterprises 119,000, up by 116.3% or an increase of 64,000, that of enterprises with funds from Hong Kong, Macao and Taiwan was 84,000, up by 13.5% or an increase of 10,000, and 102,000 for foreign funded enterprises, up by 30.2% or an increase of 24,000.

Moreover, the Second National Economic Census conducted in 2008 reveals that there was a total of 208 trillion RMB total assets of the secondary and tertiary sectors (industrial and service sectors), up by 114.8% or an increase of 111,100 billion yuan over the end of 2004. Of this, the total assets of the SOEs were 47,700 billion yuan, up by

[109] Legal unit refers to economic unit meeting the following criteria: a) established by law with its own name, internal organization and locations, and capable of fulfilling independently its civil obligations; b) with independent ownership or rights (or authorized with rights) of using assets and bearing liabilities, with authority to sign contracts with other units; and c) with independent financial accounting, capable of compiling assets and liability tables.

[110] The primary industry refers to agriculture, forestry, animal husbandry and fishery. The secondary industry refers to mining, manufacturing, production and supply of electricity, water and gas, and construction. The tertiary industry refers to all other economic activities not included in primary or secondary industries, including traffic, transportation, storage and post, information transmission, computer services and software, wholesale and retail trades, hotel and catering services, financial intermediation, real estate, leasing and business services, scientific research, technical services and geological prospecting, management of water conservancy, environment and public facilities, services to households and other services, education, health, social securities and social welfare, culture, sports and entertainment, public management and social organization, and international organizations. The current census does not include international organizations.

[111] Self-employed individuals with licenses refer to economic units except rural households where the means of production is owned by individuals, individual work constitutes the basic form of operation, and the results of operation are owned by or at the disposal of the individuals concerned. They are individual industrial and commercial households registered at the business registration offices at all levels with operation licenses issued by such offices according to the Civil Law and the Provisional Regulations on Management of urban and rural individual industrial and commercial households. In detail, they refer to the citizens who are engaged in industry, commerce, construction, transport services and other activities within the scope permitted by law, as individual workers, getting registration approved by law.

58.5% or an increase of 17,600 billion yuan, that of the collective corporations were 4,400 billion yuan, down by 15.1% or a decrease of 800 billion yuan, share-holding cooperatives corporations 4,500 billion yuan, up by 141.1% or an increase of 2,600 billion yuan, private corporations 25,700 billion yuan, up by 194.9% or an increase of 17,000, enterprises with funds from Hong Kong, Macao and Taiwan 8,000 billion yuan, up by 89.8% or an increase of 3,800 billion yuan, and 13,500 billion yuan for foreign funded enterprises, up by 118% or an increase of 7,300 billion yuan.

The smaller but highly concentrated public sector, dominated by 150 large SOEs, provided key inputs from utilities, heavy industries, and energy resources that facilitated private sector growth and drove investment, the foundation of national growth. In 2008 thousands of private companies closed down and the government announced plans to expand the public sector to take up the slack caused by the global financial crisis. In 2010, there were approximately 10 million small businesses in China.

Many observers define a Chinese SOEs as one of the 150 or so corporations that report directly to the central government. Thousands more fall into a gray area, including subsidiaries of these 150 corporations, companies owned by provincial and municipal governments, and companies that have been partially privatized yet retain the state as a majority or influential shareholder. SOEs of all kinds have gradually been losing some of the advantages once conferred by their relationship with the state. Since the 1980s, the Chinese government and the ruling party have followed a policy of *zhengqi fenkai*, which formally separates government functions from business operations. The policy has been applied gradually, first to the consumer goods industry, then to high tech and heavy manufacturing, and, more recently, to banking, as officials have attempted to strengthen domestic businesses and the economy to prepare them for unfettered global competition. As a result, government favoritism toward SOEs is fading. Top officials have started holding them more accountable for their successes and failures. Their access to capital at below market rates has been severely limited. From 1994 to 2005, 3,658 state companies failed, according to official statistics. More such bankruptcies are likely.

Reform of SOEs has always been the key link of China's economic restructuring. The Chinese government has made various attempts to solve the problem of chronic extensive losses in this sector and by now almost every state-owned enterprise has adopted the company system. Considering the state-owned enterprises and non-state-owned industrial enterprises, with sales above 5 million yuan, as monitored by the National Bureau of Statistics of China, from 1998 to 2005 the share of private enterprises in the total number of such enterprises has increased from 6.5% to 45%, and the share in total valued added from 2.6% to 18%. For SOEs the shares decreased, respectively, from 39.2% to 10% and from 57% to 37.6% of the total. After being transformed into joint stock companies, the economic benefit of the SOEs increased steadily and their overall strength and quality were remarkably enhanced, gaining continuously in their control, influence and lead in the whole national economy.

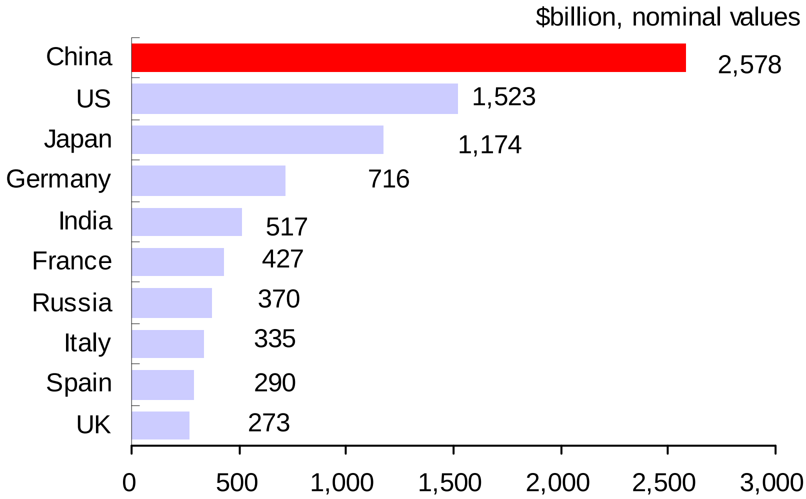
Now the Chinese state is the biggest shareholder in the country's 150 biggest companies and guides and goads thousands more. It shapes the overall market by managing its currency, directing money to favored industries and working closely with Chinese companies abroad. 46 Chinese companies made the list in the 2010 Fortune Global 500 (Beijing alone with 30). Measured using market capitalization, four of the world's top ten most valuable companies are Chinese. These include first-ranked PetroChina, third-ranked Industrial and Commercial Bank of China (the world's most profitable bank and the world biggest bank by market capitalization), fifth-ranked China Mobile (the world's most valuable telecommunications company) and seventh-ranked China Construction Bank (the second largest in the world in terms of market capitalization US$223.3bn at the end of 2010).

6.1.2. Overview of the Financial System

a. Savings and Investments

From 2002 to 2008, the global saving rate increased from 20.5% of GDP to 24% because many of the developing countries, including ASEAN+3 countries with the highest rate-particularly China-accounted for an increasing share of the world's economy. In 2008, China overtook the United States as the largest saver in the world (Figure 6.4.). The gross national saving of China and the United State were almost US$2.6 trillion and US$1.5 trillion, respectively, in 2009. The saving rate rose fast than the investment rate in China. China's saving has exceeded investment since 1996, with gross saving rate and gross capital formation reaching 53.2% and 47.8% of GDP in 2010 (Figure 6.5.).

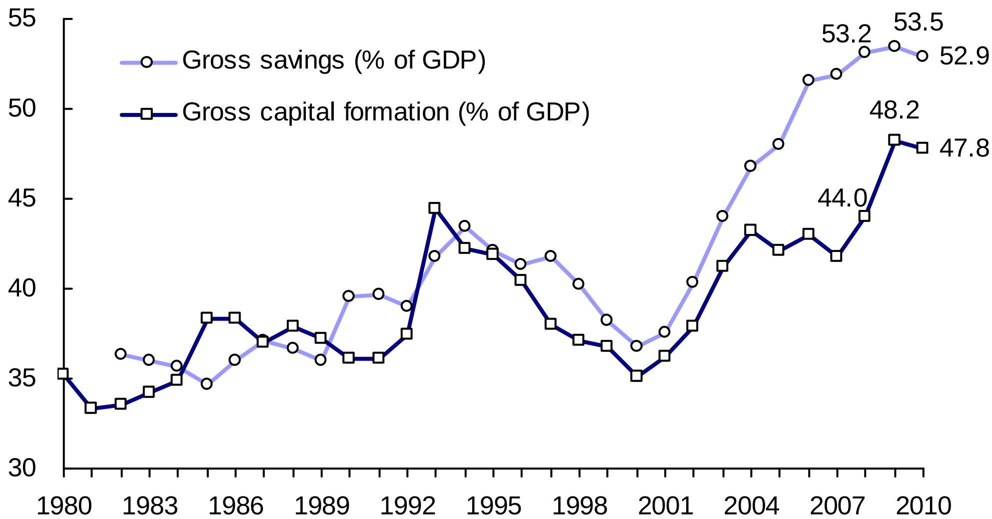
Figure 6.4. China's Gross National Saving (2009)



Source: IMF, CEIC, World Development Indicators of the World Bank, United Nations System of National Accounts

Note: Figure of China is estimated by IMF.

Figure 6.5. China's Saving and Investment



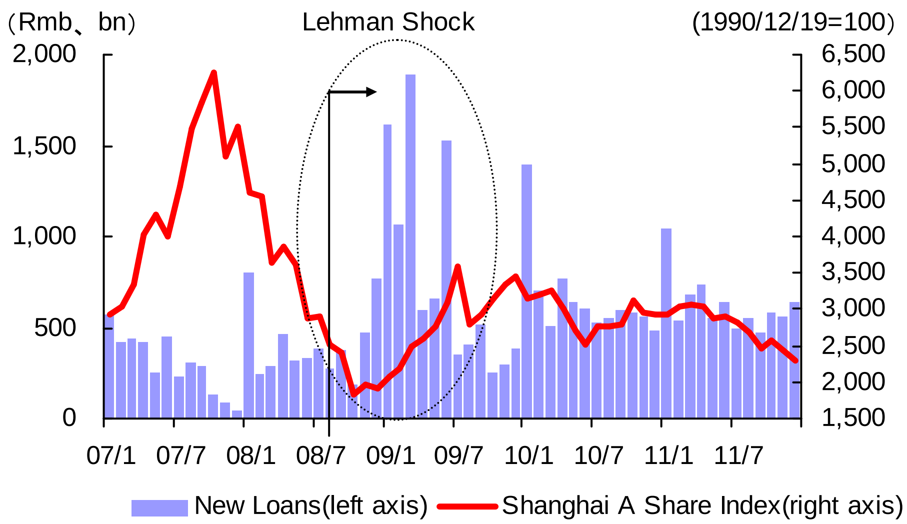
Source: The World Bank

As mentioned, China surpassed the United States as the world's largest saver. Its government, households, and companies saved US$2.3 trillion in nominal terms, equivalent to an astounding 53% of China's GDP. In doing so, China accounted for 23% of the global total, or almost one of every four dollars saved in the world that year.

Chinese households and corporations have become the third and fourth largest sources of global saving in the world. In contrast, the national saving of Asian's other major saver, Japan, has declined dramatically.

Household saving was equal to 23% of GDP in 2008, one of the highest rates in the world and the limited modernization of the financial sector has historically channeled all such saving into bank deposits and more recently into the stock exchange, fueling a potential credit and stock exchange bubble. For instance, China's banks extended 9.58 trillion yuan of new loans in 2009, nearly twice the amount of 2008 (4.90 trillion yuan) and almost triple the amount of 2007 (3.63 trillion yuan), while the Shanghai composite index touched a historical record in 2007 and also increased again after Lehman shock in 2009 (Figure 6.6.). Hence, financial risks are still there for China.

Figure 6.6. China's New Increased Loans and Shanghai Stock Exchange Index



Source: CEIC

However, if China follows the historical experience of other countries, its saving rate will decline over time as the country grows richer, as occurred in Japan and South Korea. It is unclear when this process will begin. But already, the country's leaders have started to craft policies that will reduce saving in order to rebalance its economy[112]. One goal will be increased household income growth, which will raise household consumption as a share of GDP, reversing the decline of the past five years. China's rising wages are a step in this direction.

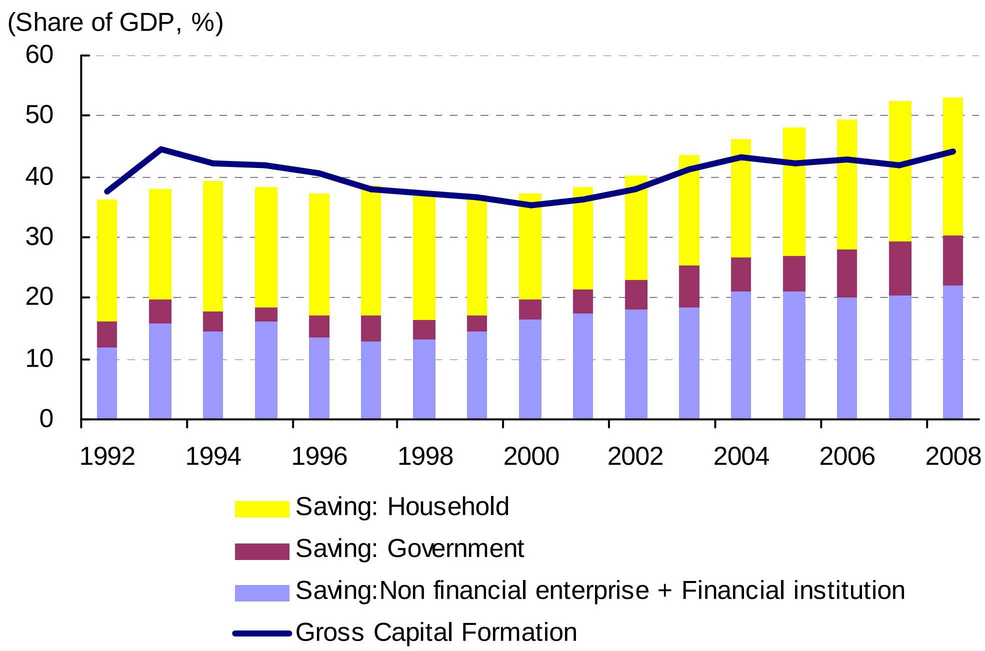
The government had plans to increase public programs for health care and pensions as well, which would give Chinese households less reason to save for

[112] Plans to increase consumption, and hence reduce saving, are being incorporated into the 12th Five-Year Plan.

precautionary reasons. Other factors may also reduce Chinese household saving in the years ahead. One is China's aging population. As workers retire, they begin drawing down the savings they accumulated in their working years. This could lower China's household saving rate. Another factor is the increasing availability of consumer credit and insurance. Although very small today, these markets are growing rapidly. Both credit and insurance enable households to respond to emergency events in ways other than saving, and so could boost consumption.

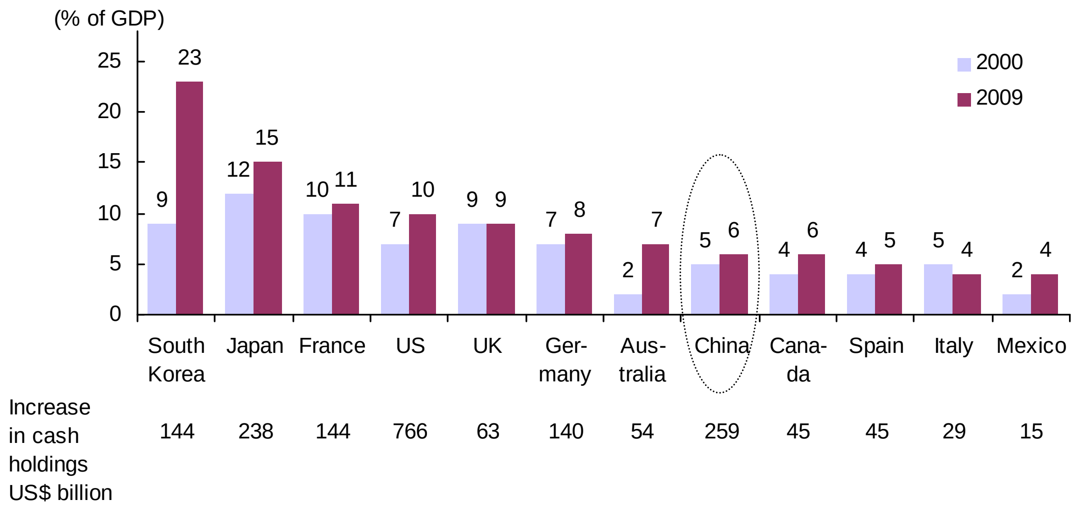
Flow of funds data indicate that all sectors of China's economy-households, corporations and the government-save at very high rates (Figure 6.7.), but have changed little over the past five years. Corporate cash holdings have increased by US$1.9 trillion since 2000 in the major economies, reaching US$3.8 trillion in 2009 some US$800 billion higher than if they had grown at the same pace as GDP (Figure 6.8.). In China, corporate cash holdings have increased US$259 billion in 2009 since 2000. China's corporate saving rate has grown faster than household saving, reflecting strong productivity gains, low corporate taxes, and low dividend payouts. China's government gross saving has grown rapidly as well, reflecting robust growth in tax receipts and public investment.

Figure 6.7. China's Corporate Gross Saving



Source: CEIC

Figure 6.8. Cash Holding of Publicly Listed Companies in Selected Countries



Source: McKinsey Global Institute

Note: Cash holdings defined as cash and short-term investments.

Some policy makers are now calling for companies to invest this money to create jobs. However, corporate saving is not the same as these cash balances. Companies can use their saving for investment, acquisitions, share repurchases, and paying down debt. The amount left over after such spending is the change in the cash balance. There are several additional reasons that corporate cash balances are higher today than in the past. First, companies found during the crisis in 2008 that credit markets can freeze and cut off needed operational funding, prompting them to keep more cash on hand. Second, particularly for US companies, repatriating cash from foreign subsidiaries results in a tax liability. Moreover, some companies are waiting to invest or make acquisitions once aggregate demand increases and uncertainty clears about the strength of the economic recovery.

Nevertheless, the corporate saving rate increased most in Asian economies. There are some differences in corporate saving rate trends across countries (Figure 6.9.). Rates rose in Asia, Canada, and the United Kingdom but fell in France, Italy and Spain. The reasons reflect many different factors, including variations in the profitability of different sectors and their weight in the economy, tax treatment of corporate profits, depreciation allowances, and dividend payout practices. In China, the corporate saving rate has increased US$659 billion, with 17% of GDP in 2008 since 1998. The rise in the corporate saving rate reflects growth in profitability, low dividend payout ratios and relatively low corporate taxes.

Figure 6.9. Corporate Saving Rates in Selected Countries

Source: Mckinsey Global Institute

However, China's corporate saving rate may also decline over time as the economy becomes more open to global competition, which would reduce profit margins. Companies also would have a lower saving rate if they had to pay higher wages and corporate taxes and pay out more dividends. However, if companies had paid more in dividends, the recipients-the government and households-might have save more. All together, these changes would lower China's corporate saving rate from its current 19% of GDP, which is far above the 10-12% average in mature economies and above China's own long-term average corporate saving rate of 15.5%.

In terms of China's investment rates, they could have remained high for decades. The global investment rate began rising in 2002, primarily reflecting the surge in investment in China and other emerging markets. As large rural populations are migrating to rapidly expanding cities, the demand is increasing for new homes, public infrastructure, factories, transportation, offices, and shopping centers. Moreover, China already had built the third largest stock of capital assets in the world by 2008, worth around US$8.2 trillion[113]. Relative to the size of its economy, these fixed assets were worth around 267% of China's GDP in 2008, a level similar to Germany's (at 264%) and higher than that of the United States (at 220%). Nonetheless, China's investment rates will increase even more with the rising of investment in infrastructure, residential

[113] The stock of capital assets includes the value of all plants and buildings, equipment, machinery, infrastructure, and housing. It reflects the cumulative sum of annual investment, less depreciation.

real estate and plant and equipment, according to Mckinsey Global Institute research.

So far, a by-product of the existing macro-financial and institutional environment is low investment efficiency in China. Since 2001, it is estimated that every US$ 1 of Chinese GDP growth has required, on average, nearly US$ 5 of investment, 40% more than in Japan and Korea during its take-off periods[114]. In addition, while the share of China's total savings and investment in G-20[115] aggregated more than 20%, its GDP share is about 10%. These may be a reflection of misallocation of capital to some projects with low rates of return.

b. The Structure of the Financial System (Banking Sector)

Before the financial reform, financial institutions acted only as a cashier for the fiscal authorities. Since the early 1980s, the financial system has developed rapidly, and a relatively comprehensive financial system has emerged. Particularly, the development of banking system has passed through different types of financial reform since 1990s.

China has made progress in moving toward a more commercially-oriented financial system. This has been underpinned by reforms that included recapitalizing the banks, creating new capital markets, introducing a prudential regulatory regime, opening the financial system following accession to the World Trade Organization, and taking steps to reform interest rate and exchange rate policies. Reform of the joint-stock banks has boosted the commercial orientation of the banking system and reform of the rural credit cooperatives has yielded some initial results. In the securities sector, key companies have been restructured, and a resolution mechanism and investor protection scheme set up. Pension sector reform has also progressed, with the National Social Security Fund established in 2000. Broadly speaking, the characteristics and recent developments of the financial system, particularly the banking sector today, can be summarized as follows:

(i) A diversified financial system has been formed. Financial institutions can be divided into banks and non-bank financial institutions. Since reform and opening-up, China's financial institutions have been transforming from singularity to diversification, and have formed a complementary, diversified, and multi-layered financial system, featuring complete function, variety and cooperation on the basis a division of labor stemming from such institutions as banks, securities, insurance companies, trusts and

[114] McKinsey Global Institute, 2006, "Putting China's Capital to Work: The Value of Financial System Reform."

[115] The Group of Twenty Finance Ministers and Central Bank Governors (also known as the G-20, G20, and Group of Twenty) is a group of finance ministers and central bank governors from 20 major economies: 19 countries plus the European Union, which is represented by the President of the European Council and by the European Central Bank. Their heads of government or heads of state have also periodically conferred at summits since their initial meeting in 2008.

Table 6.1. Structure of China's Financial Sector, 2010

	Number of Institutions	Total Assets (in bln RMB)	Share of Total Assets	Share of GDP
Banking Institutions	3,639	93,215	87.6	234.2
Commercial banks	379	74,160	69.7	186.3
Large commercial banks	5	46,894	44.1	117.8
Joint-stock commercial banks	12	14,904	14	37.4
City commercial banks	147	7,853	7.4	19.7
Rural commercial banks	85	2,767	2.6	7
Foreign banks	130	1,742	1.6	4.4
Locally incorporated foreign subsidiaries	40	1,522	1.4	3.8
Branches of foreign banks	90	220	0.2	0.6
Policy banks and China Development Bank	3	7,652	7.2	19.2
China Postal Savings Bank	1	3,397	3.2	8.5
Cooperative financial institutions	2,870	7,893	7.4	19.8
Rural cooperative banks	223	1,500	1.4	3.8
Urban credit cooperatives 1/	1	2	0	0
Rural credit cooperatives1/	2,646	6,391	6	16.1
New-type rural financial institutions	386	113	0	0.3
Village or township banks	349	113	0	0.3
Rural mutual credit cooperatives	37	0	0	0
Non-Bank Financial Institutions	782	13,168	12.4	33.1
Insurance companies	125	4,965	4.7	12.5
Life	61	4,267	4	10.7
Re-insurance 1/	9	115	0.1	0.3
Non-life	55	584	0.5	1.5
Pension funds	1	1,138	1.1	2.9
National Social Security Fund	1	857	0.8	2.2
Enterprise annuities	…	281	0.3	0.7
Fund management companies	63	2,520	2.4	6.3
Securities investment funds 2/	704	2,520	2.4	6.3
Securities firms	106	1,967	1.8	4.9
Futures companies	164	192	0.2	0.5
Qualified Foreign Institutional Investors	106	297	0.3	0.7
Other non-bank financial institutions	213	2,089	2	5.2
Finance companies of enterprise groups	107	1,541	1.4	3.9
Trust companies	63	148	0.1	0.4
Finance leasing companies	17	316	0.3	0.8
Money brokerage firms	4	0.3	0	0
Finance companies	22	84	0.1	0.2
Lending companies	9	0.1	0	0
Auto financing companies	13	84	0.1	0.2
Banking asset management companies 3/	4	…	…	…
Total Financial System 4/	4,421	106,383	100	267

Source: IMF

1: As there is no insurance company engaged in both life and non-life business, data of reinsurance companies are provided instead. In 2007 the insurance sector adopted new accounting principles which are applied to the data starting from 2007.

2: Proceeds raised by securities investment funds are managed by fund management companies on behalf of fund unit holders.

3: The table excludes assets of the four AMCs. According to the FSAP team's calculations, the book value of the non-performing assets transferred to the AMCs amounted to about RMB2.6 trillion as of end 2006 (about 6 percent of total financial system asset).

4: This table does not include informal finance, the estimates of which vary.

Note: Data for 2008, 2009, and 2010 were provided by the Chinese authorities in the context of the FSAP. Data for 2007 were collected from publically available sources, particularly the annual reports of the three financial regulatory commissions and the financial statements of the NSSF. Data on rural and urban credit cooperatives were collected from the CBRC's annual reports.

financial leases. The number of total financial institutions was 4421, including banking institutions, 3639, and non-bank financial institutions, 782, by the end of 2010 (IMF, Table 6.1.).

Banking institutions are the most significant components of China's financial industry as they play an unusually large role in its financial system. After the establishment of the People's Republic of China in 1949, up until Deng Xiaoping introduced economic reform policies in 1978, the country went through a period of socialist planned economy, in which the financial sector was under a "mono-bank" system, monopolized by the state. In other words, the financial system was merely an adjunct to financial policy, and the financial markets and financial institutions seen in capitalist countries did not exist in China. Since reform and opening-up, China's banking system has undergone its transformation from "unified" mode to modern, from a banking system where the PBC was virtually the only bank, to that where the banking institutions are total almost 4,000 banking institutions with the nature of legal person.

China's banking sector is huge and complex and, at the end of 2010, included two policy banks and China development bank, five large commercial banks (LCBs) known as the 'big four'[116] plus the Bank of Communications ("big 5"), 12 joint-stock commercial banks (JSCBs), 147 city commercial banks (CCBs), 223 rural cooperative banks, 2,646 rural credit cooperatives, one postal savings bank, 40 locally incorporated foreign banking subsidiaries and 90 foreign bank branches, etc. Overall, banking institutions numbered 3,639, possessing a staggering 196,000 business outlets and 2.99 million employees. By the end of 2010, the total assets of banking institutions amounted to 93.2 trillion yuan, a 19.9% increase year on year (IMF).

The reformed large-sized state-owned shareholding banks, as the pillar of China's banking industry, have improved their market status and power markedly (See "6.1.3. China's Path to Banking Reform"). According to The Banker's Top 1000 World Banks Ranking (by Tier 1 capital), the Industrial and Commercial Bank of China (ICBC, 6th), the China Construction Bank (CCB, 8th) and the Bank of China (BOC, 9th) ranked among the top 10 largest banks globally by the end of 2010. By market value, the "big 4" ranked among the top 10 world's largest bank holding companies, of which the ICBC and the CCB ranked as 1st and 2nd in February, 2011, respectively. Meanwhile, the banking industry became increasingly competitive, which highlighted the rapid development and increasing asset proportion of the policy banks, joint stock commercial banks and urban commercial banks, and rural financial institutions (including rural commercial banks, rural cooperative banks and rural credit cooperatives).

The securities institutions, growing out of nothing, were developing amongst exploration and standardization. By the end of 2010, there were 106 securities

[116] Industrial and Commercial Bank of China (ICBC), China Construction Bank(CCB), Bank of China(BOC), Agricultural Bank of China(ABC) and Bank of Communications(BOCOM).

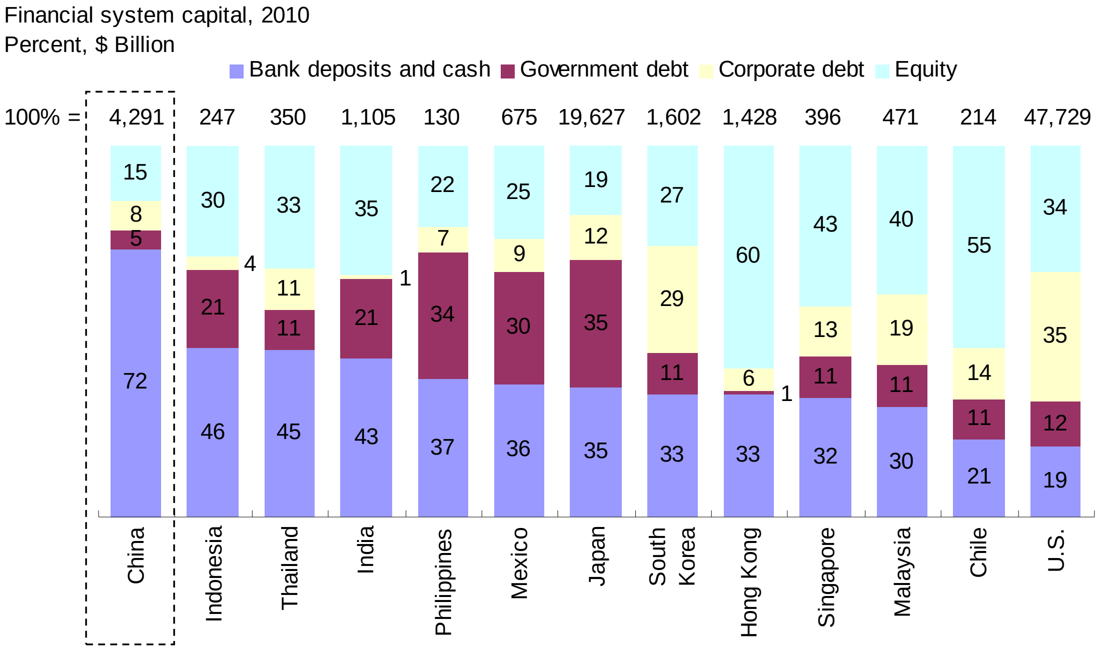
companies, 63 fund management companies, and 164 futures companies in China. The total assets of securities companies were 1.97 trillion yuan, while the assets of fund management companies exceeded 2.5 trillion yuan.

Insurance institutions developed quickly. At the beginning of reform and opening-up, there was virtually only one insurance institution in China. By the end of 2010, insurance corporate bodies and professional insurance intermediaries reached 125 and almost 2,500, respectively, and the total assets of the insurance industry reached 5.05 trillion yuan. The state-owned insurance companies had completed their joint stock reform, while the joint stock insurance companies had made great progress in introducing strategic investors and getting listed. Thereby, the China insurance industry had realized its transformation of its corporate structure and management system, gradually established a standardized corporate governance framework, and escalated its market micro main-body. Meanwhile, the sound insurance system composed of life insurance, property insurance, and reinsurance had been established basically.

213 other non-bank financial institutions also made great headway. By the end of 2010, there were 107 finance companies of enterprise groups, 63 trust companies, 4 money brokerage firms, and 22 finance companies in China.

(ii) Bank-based financial system or superiority of indirect finance. For historical reasons, banks have been played a dominant role in China's financial system, while social funds were mainly allocated indirectly. The Chinese financial sector depends heavily on banks much like the system of Japan and Germany, compared with other Asian countries (Figure 6.10.). Nonetheless, banks, particularly the largest ones, dominate financial intermediation. LCBs make up almost two-thirds of commercial bank assets (Figure 6.11.), with 117.8% of GDP in 2010 (IMF). Meanwhile, bank penetration and the number of depositors with commercial banks were also high in the ASEAN+3 region.

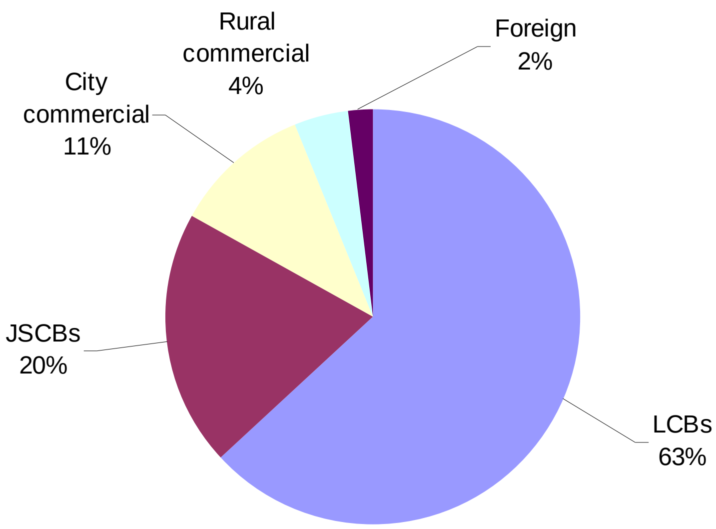
Figure 6.10. Financial Structure of Selected Countries



Source: Mckinsey Global Institute

Note: Numbers may not add to 100 percent due to rounding.

Figure 6.11. China's Commercial Banking System Structure by Assets

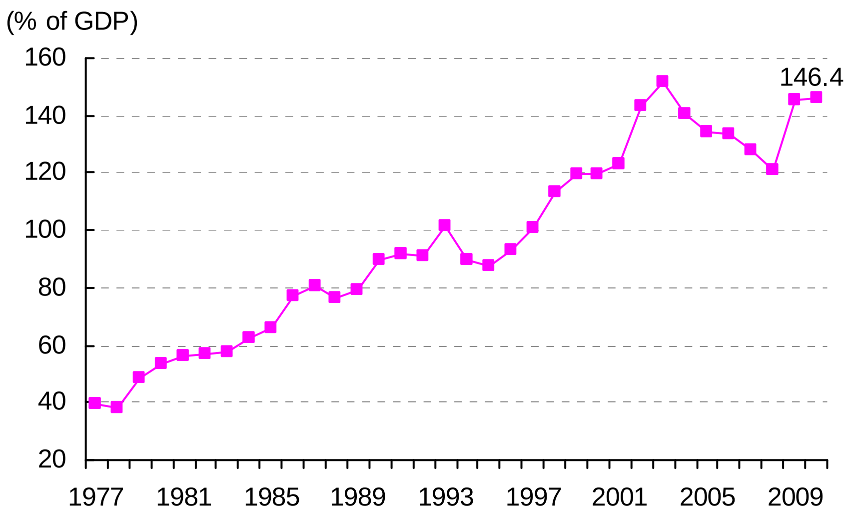


Source: CEIC, IMF

Note: As of 2010

Bank credit is at the heart of the financial system as is often seen in "catch up, overtake" type economies (where the economic management aim is to catch up to the developed economies and overtake them), and China is no exception in this respect. According to the World Bank, domestic banking credit is about 146.4% of GDP in 2010 (Figure 6.12). As strong financing needs from enterprise reflecting high economic growth, China's aggregate financing to the real economy amounted to 14.27 trillion yuan in 2010. Moreover, broad money supply, M2 and M1, have also increased. For instance, the Money and quasi money (M2) to nominal GDP grew 181% in 2011. Banking institutions' total asset of all financial institutions was 87.6% and 234.2% against GDP in 2010 (IMF).

Figure 6.12. Domestic Credit Provided by Banking Sector



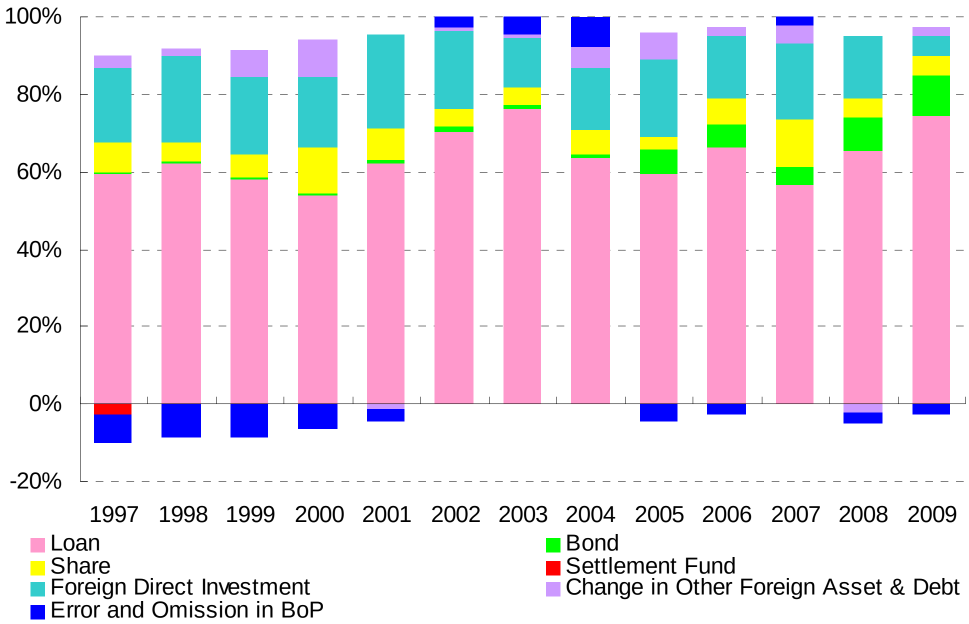
Source: The World Bank

The main funding raising method of the non-financial sector, which is the biggest capital deficit sector, is bank borrowing (Figure 6.13.). In the 1990s, external capital procurement accounted for over 70%. Once into the 2000s, this proportion fell, but still managed to stay in the 60% range, and was often over 70%. Bank loans accounted for more than 78% of total corporate financing in 2010. The corporate debt market is also very small: the outstanding domestic debt was about 11% of GDP, while international issues were slightly below 1%. Around 70% of the household sector's financial assets are bank deposits (Figure 6.14.)[117]. In terms of deposits and lending, according to the

[117] Households account for a relatively low share of total financial assets in China-33%, compared with more than 40% in developed countries and in many other emerging markets. This reflects the large holdings of securities by Chinese corporations and the Chinese government. Banks hold US$3.9 trillion in bonds, funded in part by household and corporate deposits, and Chinese corporations have

People's Bank of China (PBC), total deposits with financial institutions were 71.8 trillion yuan by the end of 2010 and total lending by financial institutions was 47.9 trillion yuan. As demand deposits account for a large part of bank deposits, with demand savings increasing rapidly, the loan to deposit rate shrank from over 80% in the beginning of 2000 to 66.7 % in 2010 (Figure 6.15).

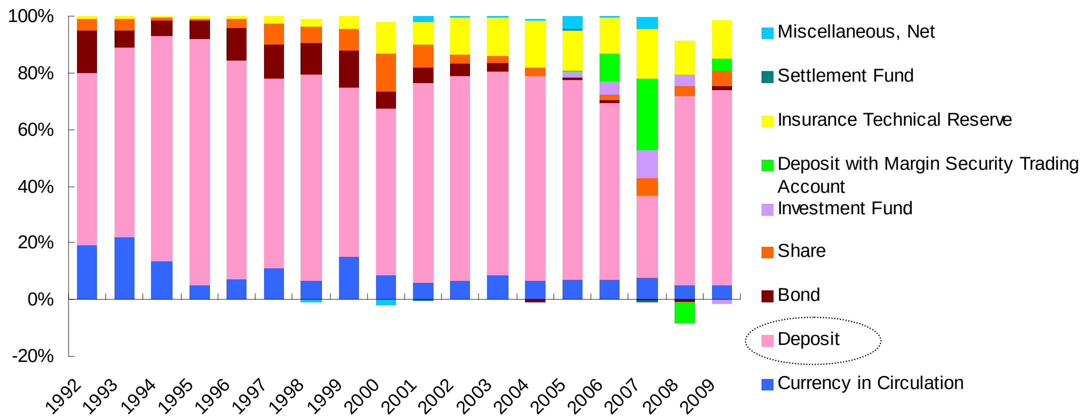
Figure 6.13. Non-Financial Sector Funding in China



Source: CEIC

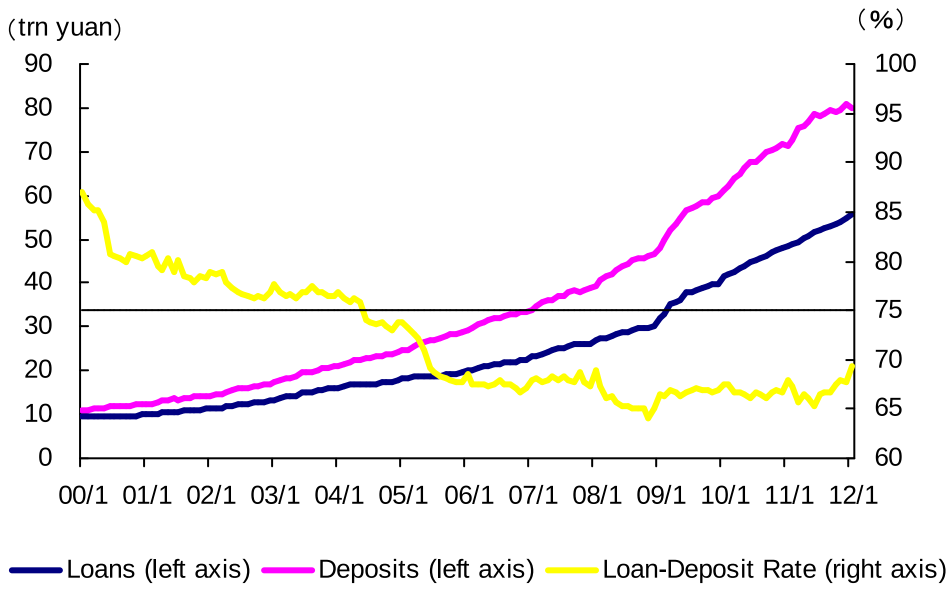
US$3.7 trillion in cash on their balance sheets, held mainly in deposit accounts. The Chinese government manages a total of US$4.3 trillion in financial assets, through a mix of central bank bond holdings, sovereign wealth fund investments, and holdings in publicly listed banks and nonfinancial corporations.

Figure 6.14. Household Financial Assets in China



Source: CEIC

Figure 6.15. China's Loans and Deposits

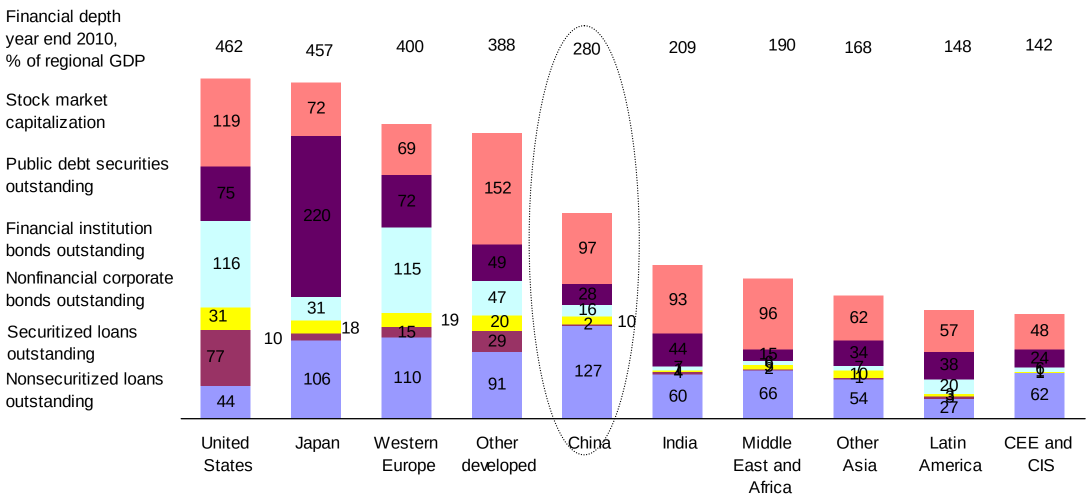


Source: People's Bank of China, CEIC

According to McKinsey's analysis, bank deposits in China continued their strong growth into 2010 to reach US$8.3 trillion. Bank deposit growth is the result not only of years of strong GDP growth and economic development but also the fact that China's households have few alternatives for their investments. Bank deposits are likely to continue to grow as household incomes rise and individuals open savings accounts. In general, China's financing structure still gives priority to indirect financing, while the proportion of direct financing is rather low.

(iii) Capital market unmatured. The role of direct financing (stocks, government bonds, and corporate bonds) has been increasing rapidly in recent years, but it is still limited in total financing. Thus, financial depth[118] is lower in Asian countries, primarily because of the absence of corporate bond and securitization markets (Figure 6.16). Today, developed countries have much deeper financial markets than those found in Asian markets. Financial depth in the US, Japan, Western Europe and other developed countries is near or above 400% of GDP, compared with 280% in China.

Figure 6.16. Financial Depth of Selected Countries/Regions



Source: McKinsey Global Institute Analysis

Note1: Financial depth is calculated as total regional debt and equity outstanding divided by regional GDP.

Note2: CEE and CIS include stand for Central and Eastern Europe and Commonwealth of Independent States.

With the development of financial markets, the proportion of direct financing increased somewhat, with treasury bonds, corporate bonds and stock in 2010 accounting for almost 20% of total social financing. However, the scale of the capital market is still small, and there is low dependence on direct finance. The fixed income market has grown as an alternative funding channel, but remains heavily concentrated in public sector securities. Moreover, the stock market and bond market have yet to

[118] The depth of a country's financial markets-measured as the value of outstanding bonds, loans, and equity relative to the country's GDP-reveals the extent to which corporations, households, and governments can fund their activities through financial intermediaries and markets.

achieve relative balance. Bond issuance was less than 1% for a long period of time in China. Stock fluctuates widely from year to year, and reached 13.8% in 2000, but in other years has been below 10%.

Needless to say, China's massive economic reform since the end of the 1970s promoted the emergence and development of the stock market in China. After the promulgation of the *Securities Law* in 1988, China's stock market registered rapid development. Over the past decade, China's stock market developed from scratch into a national market, the system of regulations and rules of accounting was gradually improved, the number of listed companies grew rapidly, the efficiency of Stock Exchange transactions and the registration and settlement system were enhanced, the secondary market became increasingly brisk, and China's stock market realized rapid development.

The development of China's stock market should be attributed to China's economic and financial reform. Reforms of the whole financial sector included the foundation of the Shenzen and Shanghai stock exchanges, their opening to foreign investors through the Qualified Foreign Institutional Investors (QFII) schemes, the opening of the bond market to corporate bonds and many others. With the gradual improvement of all functions, the stock market also promoted the reform of the economic and financial system, led a series of reforms of the economy and corporate systems, drove forward growth of the national economy, and exerted greater impact on China's economy and society. The stock market promoted the development of China's economy and business. The functions of the stock market in financing and resources allocation were gradually tapped. The size of the stock market continued to expand in currently. At the close of 2010, there were 2,063 listed companies on the stock markets in Shenzhen and Shanghai, up 345 year-on-year. The total market value of shares was 26.5 trillion yuan, and the ratio of stock market capitalization to GDP was 66.7% (PBC).

Looking into the Chinese Stock Market, it can be seen that there have been boom and bust periods in the past decade (Figure 6.17). More recently, Chinese stock markets have been extremely volatile since the middle of 2006. Within 18 months, the Shanghai Stock Exchange (SSE) Composite Index rose more than threefold, reaching 6,124.04 on 16 October 2007. By the end of 2007, 1,530 companies had been listed on the Shanghai and Shenzhen Stock Exchanges with a total market value of 32.71 trillion RMB. During the bullish period, market growth was characterized by rapid gains in the prices of bank stocks, particularly after the listing of the ICBC on the Shanghai and Hong Kong Stock Exchanges in 2006.

Figure 6.17. Shanghai Stock Exchange Index

Source: Thomson Reuters

Note: Date to Feb 10, 2012.

Underdeveloped capital markets limit the alternatives for corporate funding and household savings. Households are limited to holding low yielding savings accounts, suppressing income and consumption. The limited availability of insurance products also creates incentives for higher precautionary savings. At the corporate level, lack of access to capital markets by small, private enterprises creates incentives for higher corporate savings. As a result, the search for higher yielding alternative investments by both firms and households adds to the likelihood that asset bubbles may develop, particularly in the stock market and real estate.

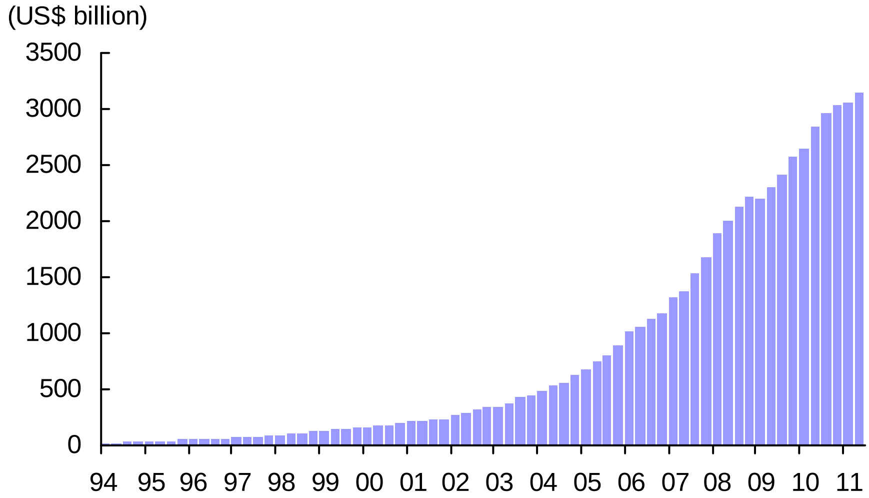
With rapid income growth and a high saving rate, Chinese household wealth more than tripled over the past decade, reaching US$6.5 trillion in 2010. Most of that money is held in low-yielding deposit accounts. With the introduction of popular securities investment funds in 2007, Chinese household equity allocations did jump briefly from 4 % to 19%. But since the Shanghai market fell in 2008 during the global financial crisis, household equity allocations have fallen to just 14% of financial assets. Financial wealth and equity investors are concentrated in China's fast-growing coastal cities, most notably in Shanghai, where nearly 40% of household investors own stocks.

However, the number of shares actually circulating in the stock market is low. As problem occurred over the years, institutional deficiencies and structural contradictions which accumulated during the development of the stock market gradually surfaced. The structure of China's stock markets has been flat all the time with only two stock exchanges, namely the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE). The single standard and high threshold for enterprises to get listed could hardly satisfy the financing demands of different enterprises at different stages of development as well as the risk preferences of different investors. As a result, the percentage of shares actually circulating in the stock market is low, and market stratification is really just beginning. Diversified investment and capital procurement needs are not being met. Moreover, the stock exchanges do not have enough listed products and the exchange system itself needs to be improved and diversified. Also, the profit structure is simplistic and shallow, and competitive strength needs to be improved.

China's bond market maintained notable growth. Before 2005, there were limited varieties of bond products, mainly the four major categories, namely Treasury bonds (T-bonds), policy financial bonds, central bank bills and corporate bonds. In 2005, China's inter-bank bond market launched a range of innovative products successively. In 2010, the bond market witnessed a robust innovation of products, the issuance amount of debenture bonds stayed at a high level, and the channels for enterprises to finance directly from the market had been expanded further. According to BIS, domestic debt securities outstanding grew by US$3.1 trillion by the end of 2010, 51.6% of GDP (Figure 6.18.), with government bonds outstanding[119] percentage of GDP of 28%, financial bonds outstanding, 15%, and corporate bonds outstanding, 8.6%.

[119] Data for government bonds are from the BIS and include both treasury securities and central bank bills/notes.

Figure 6.18. China's Domestic Debt Securities



Source: BIS

In addition, the bond market played an important role in the effective allocation of financial resources and the transmission of monetary policy. The aggregated RMB bonds issued on the bond market during the year registered 5.1 trillion yuan, up 3.1% year-to-year. The amount of government securities, bonds issued by policy banks and short-term financing bills all went up from their amount last year. By the end of 2010, total amount of bonds deposited on the bond market reached 16.3 trillion yuan, among which 15.8 trillion yuan was deposited on the interbank market, up 21.5% year-to-year.

However, China's bond market is still smaller than those of developed countries. Moreover, China's bond market remains heavily concentrated in T-bonds and policy financial bonds and there are very few types of bonds. Nonetheless, the market is split between interbank, the stock exchange and banks, so with different supervisory authorities, the investor structure is also unbalanced.

(iv) Importance of informal finance. The informal financial sector has played an important role in some regions. Since the beginning of the reforms, the private sector has flourished, but it has been confronted with constraints in access to formal finance and has had to turn to the informal financial sector. Because most informal financing activities operate underground, it is difficult to estimate their overall scale. A field survey in Taizhou and Wenzhou prefectures of Zhejiang province indicates that informal finance accounted for 30% of the total financing; in some townships, the share of informal finance even exceeded that of formal finance.

Particularly, inter-connections between banks and nonbank financial institutions

(NBFI) have begun to grow. Laws and rules permit more complex structures even though supervisors are challenged to meet the key elements of the principle of consolidated supervision. Inter-linkages are increasing with the rise of financial holding companies (FHCs), which have expanded considerably since the initiation of a pilot program on integrated financial services under the 11th Five-Year Plan (2006-10) and industrial-financial integrated groups have developed rapidly. At the same time, regulatory policies applying to shadow banking and their interconnections need to be clarified and made transparent. A more structured oversight, regulatory, and supervisory approach is needed to prevent and to manage systemic risks via cross-market products and institutional structures.

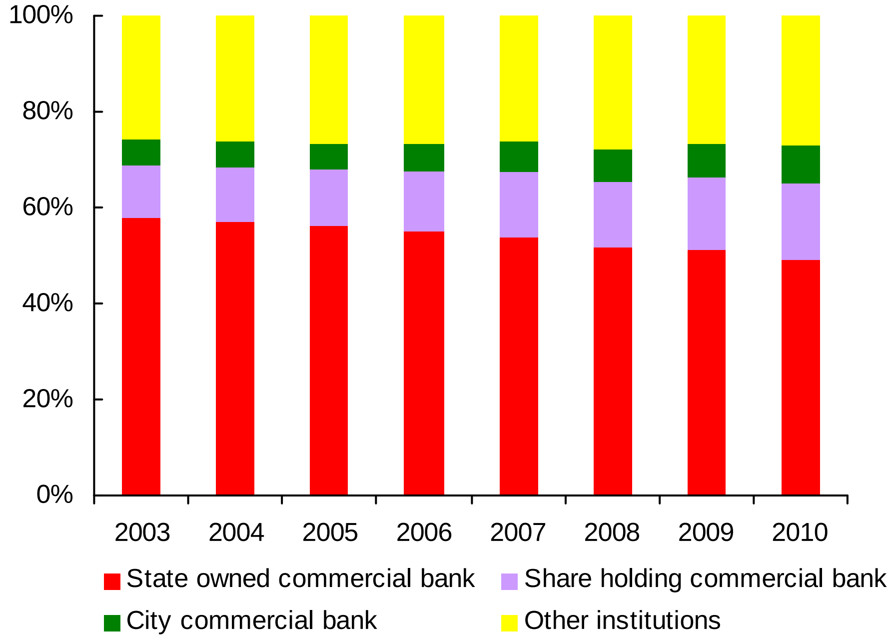
6.1.3. China's Path to Banking Reform

a. 30 Year Banking Reform Process

China has been reforming its economic system since the economic reforms that started in 1978. Even the issue of the non-performing loans of the state owned commercial banks, which had been an item of great concern, was dealt with by learning the lessons of overseas precedents. With China's accession to WTO in 2001, financial reform has developed rapidly. By converting the state-owned banks into limited companies and utilizing the rapidly expanding foreign currency reserve for capital injection, the non-performing loan issue has been completely resolved and the way to listing on foreign markets opened up.

The economic reform policies brought about a great change in China's financial system. In 1983, People's Bank of China concentrated exclusively on its central bank duties and entrusted ordinary banking activities to four main state-owned commercial banks (ICBC, CCB, BOC and ABC). These four main state-owned commercial banks were each assigned an individual role, and even today they account for over half of the share of China's financial system (Figure 6.19.). The ICBC is responsible for urban finance for general industry and commercial enterprises, ABC provides financial services for the agricultural community, BOC handles foreign exchange activity and the CCB is responsible for investment finance for corporate plant and equipment and the development of social infrastructure.

Figure 6.19. Share of Chinese Banking Institutions by Assets



Source: CEIC

Note: Other Institutions include Policy Bank, Rural Commercial Bank, Rural Operative Bank, Urban Credit Cooperative, Rural Credit Cooperative, Non Bank Financial Institution, Postal Saving Bank and Foreign Bank.

With the introduction of economic reform policies, the diversification of economic activity that accompanied the development of a socialist market economy meant that there was a need for financial institutions that could play an intermediary role between capital surplus sectors and capital deficit sectors, and a Chinese financial sector with diverse business types was formed. Subsequently, the Communist Party and government designated the sound development of China's financial sector as an important policy issue, and from the '90s experimented with different types of financial reform. Some of these are described in detail below.

The development of banking in China has passed through five major phases of development. First, the formation of the mono-bank system from 1949 to 1978; second, the period from 1979 to 1993 which saw the establishment of specialized state banks and the formation of a diverse and competitive banking system; third, the period of reform from 1994 to 2002, in which government policy and financial business were separated, and the specialized state banks became state owned commercial banks; fourth, the birth of the joint-stock commercial banks with the listing of large state owned commercial banks on the stock exchange, from 2003 to 2007; and fifth, the turning point period from 2008 to this date, in which, after the global financial crisis, China's financial institutions have been developing their international business operations, in order to improve international competitiveness and to win new markets and revenue sources. For China, 2008 was not just the year when it faced the global economic crisis along with other countries, but it also marked 30 years since the start of the economic reform policies in 1978. In this 30 year span, the work of "turning the banks into real banks", as proposed by Deng Xiaoping in 1979, has almost been completed.

b. Banking Reform of State Owned Banks

What kinds of changes has China's economic reform brought about over the last 30 years? Of course, China's outstanding real economic growth has caused the financial sector to grow quantitatively, but there have also been qualitative changes. The path may be divided into three stages: (i) system restructuring; (ii) experimentation with the market system; and (iii) reorganization into a joint stock system (commercialization). In the first stage of system restructuring, in the period of socialist planned economy between 1949 and 1978 described above, the PBC (Central Bank) performed practically all financial duties.

In the second stage of experimentation with the market system, after Deng Xiaoping's "South China Tour" of 1992, the government began to reform the financial sector. During this period, the government banned the doubling up of banking, insurance, securities and trust businesses, clarified the scope of business of non-bank organizations, and separated the state owned specialist banks from the work of financial policy. Moreover, in response to the financial crisis and deepening non-performing loan issue in Japan in the wake of the collapse of the bubble economy (latter half of the '90s to the early 2000s), and the Asian currency and financial crisis of 1997 to 1998, the Chinese government began to accelerate the reform of the financial sector from the perspective of containing and resolving financial risk.

Next, the reform of the state owned commercial banks and the reform of the financial supervision authority were announced in quick succession. Specifically, the state owned commercial banks' total lending regulatory framework was abolished, and the deposit reserve system reformed and the reserve requirement lowered, etc. In this way, an environment for the establishment of a voluntary loan management structure was developed, and the work of clearing the non-performing loans of the four main state owned commercial banks got underway. At that time, the Chinese banks ' non-performing loan issue was a serious problem. The contributory factors cited include: (i) the massive non-performing loans held by the state owned specialist banks and others in the financial sector as a result of the collapse of the real estate bubble sparked by Deng Xiaoping's South China Tour of 1992, (ii) bad debt as a result of excessive finance for poorly performing state owned enterprises and infrastructure construction, and (iii) increased bad debt due to the failure of state owned enterprises.

From the late ‘90s till the mid 2000s, the four main state owned commercial banks had high non-performing loan ratios, and their capital adequacy ratios were low (Table 6.2.). For this reason, in 1998, the Ministry of Finance issued special government bonds worth 270 billion yuan, and used this as cash to finance capital injections into the four large commercial banks (targeting the BIS 8% requirement), increasing their capital adequacy. As a result of this measure, the four main state owned commercial banks' capital adequacy ratios achieved 8%, but later fell below 8% again. While this was going on, the Chinese government learned the lessons of the S&L (Savings and Loan Associations) crisis[120] that occurred in the US between the late '80s and early ‘90s , and, similar to the American government's establishing of the RTC (Resolution Trust Corporation)[121], established four financial asset management companies [122](Cinda, Orient, Great Wall, and Huarong) and separated 1.4 trillion yuan worth of non-performing loans of four main state owned commercial banks and carried out reforms to improve their financial positions (Figure 6.20.).

120 From the ‘80s to the early ‘90s, the US went through a financial crisis known as the S&L crisis. S&L stands for Savings and Loan Associations, and these were originally small and medium sized financial institutions specializing in housing loans, and they made long term housing loans of 25 years or more, using capital accumulated from deposits. The deregulation of interest rates from the late ‘70s caused deposit interest rates to rise, but lending rates had been fixed over the long term, resulting in negative margins and the S&L business rapidly deteriorated.

121 The US government, in order to resolve the S&L issue, formed the Resolution Trust Corporation in 1989. The Corporation took over failed institutions, sold off the seized assets and made financial donations to the acquiring institutions. In the mid ‘80s, around 3,600 S&Ls were closed, merged and acquired, so their number dropped to around 2,000 by the mid ‘90s. RTC devised various methods of liquidating failed companies, in order to lessen the burden on public funds, but in the end the public burden was some $145 billion.

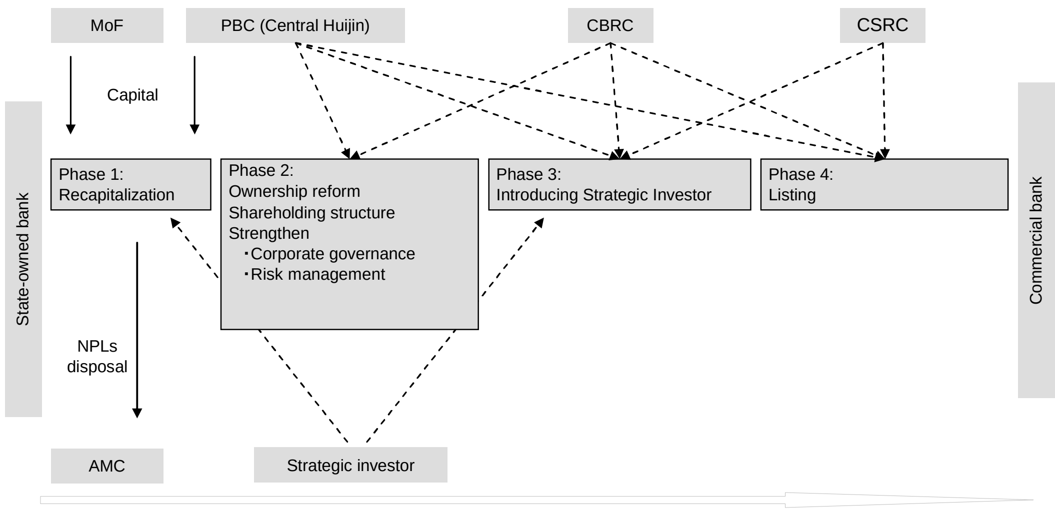
122 Cinda Asset Management Corporation and China Construction Bank (established: April 20, 1999, capital: RMB10 billion), Orient Asset Management Corporation and China Bank (established: October 15, capital: RMB10 billion), Great Wall Asset Management Corporation and China Agricultural Bank (established: October 18,1999, capital: RMB10 million), Huarong Asset Management Corporation and Industrial and Commercial Bank of China (established: October 19, 1999, capital: RMB10 billion)

Table 6.2. NPL and Capital Ratio of Big 4 Large Commercial Banks

Big 4 (Large Commercial Banks)		ICBC	ABC	BOC	CCB
NPL(to total loans)	1997	over 25%			
	2002	25.41%	36.63%	23.37%	15.17%
Capital Ratio	1997	4.05%	2.93%	3.91%	3.54%
	1998	10.40%	8.13%	11.74%	9.31%
	1999	4.57%	1.44%	8.50%	3.79%
	2000	5.38%	-	9.80%	6.51%
	2001	5.76%	1.44%	8.30%	6.88%
	2002	5.54%	-	8.15%	6.91%

Source: CBRC, Annual Report of ICBC, ABC, BOC and CCB

Figure 6.20. China's Banking Restructuring Process



Source: BBVA Research

The four financial asset management companies can carry out a diverse range of jobs, from urging repayment of liabilities to the reclassification, conversion and sale of assets, company restructuring, debt-equity conversion, investment consulting, corporate inspection, asset assessment, commercial borrowing, lending for financial institutions, loan reapplication to Central Bank, bond issuance, etc. The funds with which to finance the asset management companies' purchases of non-performing loans, in addition to private sector bank loans and borrowing from financial institutions, were raised by the companies' bond issues. debt-equity swap claimed a lot of attention in the business of the asset management companies from the perspective of promoting the reform of state owned enterprises. This is a method whereby the asset management companies can take the corporate bonds they have purchased from the large commercial banks and convert them into capital to be loaned to enterprises. As such, it has greatly lessened companies' liability repayment burdens.

Moreover, from the asset management companies' standpoint, if the conversion of purchased liabilities into equity can help to improve the management of those companies and increase their corporate value when it comes time to sell them off, a greater amount of capital can be recovered, leading to incentives of restructuring business. Debt-equity swap means that the asset management companies become shareholders of the target companies, and the rigorous exercise of their shareholder rights is expected to lead to corporate of restructuring in the form of debt restructuring, asset restructuring, personnel restructuring, etc. This kind of resolution of non-performing loans is a top priority of banking reform.

c. Banking Reform post WTO

From the 2000s onwards, China's economic reform developed at an ever faster pace, entering the 3rd stage of reorganization into a joint stock system (commercialization). Particularly noticeable economic reforms have included: (i) the use of the foreign currency reserve for capital injection into the banks, (ii) the relaxation of restrictions on capital participation by strategic investors, and (iii) the listing of the financial institutions on the stock exchange.

China acceded to WTO in December, 2001. At the time of accession, the Chinese government promised to open up the financial sector to foreign participation, such as the complete opening of the banking sector to foreign banks (within at least five years of WTO accession, and by December, 2006). Therefore, as the finishing touches to the reform of the financial sector, in order to meet the agreed timeline at the time of WTO accession, China pushed ahead with financial reform, focusing on developing the domestic rules applied to the financial sector into those meeting international standards, and the fostering of indigenous Chinese financial institutions with international competitiveness.

At that time, there was a strong possibility that China's serious non-performing loan problem would hinder financial liberalization after WTO accession in 2001. This was because China's large commercial banks' non-performing loan ratios had been consistently high since 2000. In 2002, non-performing loan ratios were still high, with 5 large commercial banks' (ICBC, CCB, BOA, ABC and BOCOM) non-performing loan ratio at 26.2%, that of the joint-stock commercial banks[123] 11.9%, and the large commercial banks[124] 23.1%. Given these circumstances, as a result of the measures

[123] Joint stock commercial banks: CITIC Bank, China Merchant's Bank, Shanghai Pudong Development Bank, China Minsheng Bank, Industrial Bank, Hua Xia Bank, Guangdong Development Bank, Shenzhen Development Bank, Everbright Bank, Bohai Bank, Zheshang Bank, Hengfeng Bank, Bank of Communications (from 2007).

[124] The large commercial banks include five state owned banks and 12 joint-stock commercial banks. Bank of Communications was reorganized as a joint-stock bank in 2007, so it is not possible to do a simple comparison of the 2007 data and data from 2006 and earlier.

described above (stage one) to isolate the non-performing loans of the state owned banks, and the use of massive amounts of foreign currency reserve for capital injection (stage two), the non-performing loan ratios began to come down from 2003 onward (stage three).

China's foreign currency reserve is accounted in Central Bank's balance sheet under assets, and Central Bank used part of the reserve in order to 100% fund a new investment company (Central Huijin Investment Ltd., hereafter Central Huijin) that was set up by the State Council (the equivalent of Japan's Cabinet) in 2003. This new investment company then invested in the state owned commercial banks.

From 2003 onwards, the use of massive amounts of foreign currency reserve for capital injection into four main state owned commercial banks began, and their reorganization into joint-stock companies was carried out. In January, 2004, the State Council contributed US$45 billion of foreign currency reserves as capital injection into BOC and CCB, and again in August and September, 2004; these became the joint-stock companies Bank of China Limited, and China Construction Bank. After that, in June, 2004, Central Huijin made a 3 billion yuan capital injection into Bank of Communications, which was undergoing financial reconstruction at the time, and another capital injection of $15 billion to ICBC in April, 2005. ICBC became the joint-stock Industrial and Commercial Bank of China in October of that year. After the global financial crisis, in November, 2008, Central Huijin made a capital injection of 130 billion yuan into ABC, the last of China's five big state owned banks, and in January, 2009, the joint-stock Agricultural Bank of China, Limited was born. Additionally, as part of measures to support the state owned banks' stock market listing, the state owned commercial banks' non-performing loans were bought up twice in 2004, and some 779.1 billion yuan of non-performing loans were transferred to the four asset management companies mentioned above. In this way, by using the asset management companies and foreign reserve capital injections, the financial situation of the five big state owned banks was improved, and their under-capitalization resolved.

Along with the capital injection from the foreign currency reserve, Bank of China and China Construction Bank's capital thus far was completely sold off in order to dispose of non-performing loans, and Central Huijin became the 100% owner of the capital of both banks. In the case of ICBC, the Ministry of Finance and Central Huijin each owned 50% of the capital. The remaining three banks issued subordinated bonds[125] in order to beef up their capitalization. In an important development, as so-called strategic investors, leading foreign financial institutions made investments, and along with the banks' listing on the Hong Kong and Shanghai stock markets, there was funding from ordinary investors, and the three banks were further capitalized.

[125] Subordinated bonds are included in the capital adequacy ratio as supplementary capital.

d. Continued IPOs by State Owned Banks

As a means of improving the management of China's banks, policies to promote capital participation in China's banks were approved in 2001. The use of foreign capital in this way has been highly significant in terms of strengthening capital adequacy and expanding the potential for doing business in global capital markets, as well as improving business quality through stronger corporate governance.

Again, as one means of improving the business management of China's banks, measures were introduced to encourage the capital participation of global private sector financial institutions in the banks. In China, foreign financial institutions' capital participation in indigenous banks had always been prohibited, in principle. However, from 2001, limited approval was granted for investment in medium sized banks. Furthermore, at the end of 2003, policies were introduced to clarify the investment conditions, and raise the upper limits on investment by foreign financial institutions. In 2004, HSBC decided to make capital investment in China's biggest joint-stock bank, Bank of Communications, and more investment in state owned banks was conducted from 2005 onward. Of course, the permitting of foreign financial institutions' capital participation in state owned banks, the core of a key industry, was a dramatic event in China's financial reform process.

In summary, China's banking reform in the 2000s comprised: (i) the disposal of non-performing loans; (ii) the use of the foreign currency reserve and other public funds for capital injection; (iii) the reorganization of financial institutions into joint-stock companies; (iv) the relaxation of restrictions on foreign financial institutions' capital formation among others. Then, after WTO accession, state owned enterprises were converted into joint-stock corporations for the purpose of (i) the business development of the global capital markets; (ii) improved corporate governance, including transparency and information disclosure; (iii) stronger capital adequacy, etc. Additionally, new initial public offerings (IPO) were proposed.

In fact, from 2005 onwards, there was a succession of state owned commercial banks' initial public offerings on the Hong Kong and Shanghai stock markets. In 2005 and 2007, the CCB raised 132.6 billion yuan from its stock market listing, the BOC 110 billion yuan in 2006, and the ICBC 173.2 billion yuan in 2006. These three banks were invested in by Goldman Sachs, Allianz, American Express, Royal Bank of Scotland, UBS, Temasek, Asian Development Bank, Bank of America, etc. Finally, Agricultural Bank of China (ABC), which had not yet been listed, announced its IPO in July, 2010, and raised a record 148.7 billion yuan. To date, the ABC's biggest investors include many overseas investment houses, such as Middle East state funds (sovereign wealth funds) like Qatar and Kuwait, and Singapore's government owned investment house (Temasek).

The reason that the Chinese government listed these state owned commercial banks on the Hong Kong and Shanghai stock markets was to improve their corporate governance through exposure to international financial and capital markets. Originally, the primary goal of listing these banks on the stock market was to open up paths to funding raising. In fact, however, while the listing of China's state owned commercial banks on the Hong Kong stock exchange did indeed have the merit of toughening up the banks' financial bases through their recapitalization, their actual aim was to improve the banks' corporate governance by placing their operations under the scrutiny of investors through the stock markets. In the past, state owned commercial banks' disclosure of accounting information had been extremely incomplete, but from now on, in order to maintain their market listing, they will need to comply with the strict and timely disclosure of information required by the Hong Kong Stock Exchange and Hong Kong's stock market supervisory authorities, and it is believed that this will increase the banks' management transparency. Additionally, share prices fluctuate sensitively in response to business performance, and through the regular provision of information (IR) to institutional investors, the bank's management will be under constant demand to improve their investors' profits. This is expected to provide the pressure to improve the efficiency of the way the banks are run.

The foregoing has summarized China's banking reform over the past 30 years. During that reform process, China's serious non-performing loan problem of the late '90s was dramatically improved as a result of the provision of a combined total of 3.8 trillion yuan by the Chinese government and investors in the period 1998 to 2006, and over US$650 billion spent over a ten year span up until 2008 to dispose of non-performing loans and improve financial health. In 2010, the non-performing loan ratio of the ICBC, the BOC, the CCB and the Bank of Communications had fallen to the 1.5% range and that of the ABC to the 4% range. Further, financial globalization has contributed to the success of the listing of China's large commercial banks on the Hong Kong stock exchange.

Looking back over 30 years, China's banking reforms have made dramatic progress and China is now ready to begin the new challenge of internationalization. Nonetheless, the Chinese banking industry has performed better than that of most other countries and regions during the financial crisis because of clear improvements in management, risk management and supervision that have taken place in the past few years. However, the fact that the impact of the financial crisis was so slight is evidence that internationalization still has some way to go.

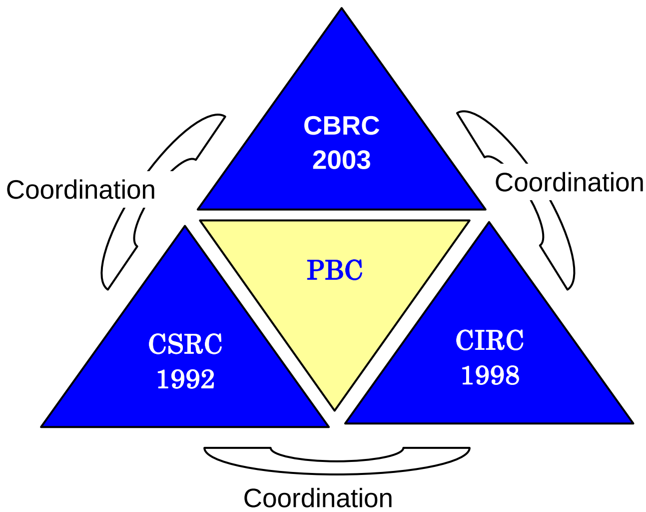
6.1.4. Structure of the Banking Sector

a. Regulatory framework

After the reform and opening-up, China's financial sector has experienced from integrated management to separated operation. It was not until China formally proposed the principle which "separated operation in the banking, securities, insurance and trust business" in 1994 that the financial sector separated management system had basically established. Suited to the emergence of the separated management, China's financial regulatory system has undergone major changes, and the separated management regulatory system has been gradually established.

China's financial industry is classified into the banking industry, securities industry and insurance industry, and there are regulations restricting the business operations of financial institutions spanning different industries. Each industry has its own regulatory authority: the banking industry has the China Banking Regulatory Commission (CBRC)[126]; the securities industry, the China Securities Regulatory Commission (CSRC); and the insurance industry, the China Insurance Regulatory Commission (CIRC). It took the PBC almost 10 years to gradually form the current separated supervision system which includes "one bank (the PBC) and three commissions" (CBRC, CSRC and CIRC). The PBC is responsible for the coordination of these three separate commissions (Figure 6.21.). Since August 14, 2008, a joint conference is held quarterly, headed by the PBS, to enhance communication between the three specialist commissions.

Figure 6.21. China's Financial Regulatory Supervisors



Source: ICFR

According to Article 11 of the Commercial Bank Law, "Without the approval of the People's Bank of China, no unit or individual is allowed to do the business of a commercial bank" and securities companies and insurance companies are prohibited from participating in commercial bank business. With the exception of the issue and sale and purchase of government bonds and bank debentures, the commercial banks are

[126] To ensure the independence of monetary policy, China Banking Regulatory Commission was established in 2003, by separating the function of bank supervisor apart from the People's Bank of China.

prohibited from involvement in the securities business. However, the 2003 amendment of the Law made provisions for exceptions to these restrictions, and there have been some signs of relaxation of the regulations.

With China's accession to WTO, China's financial industry embarked on an international-oriented development path. Financial innovation, technological progress and the competition of the international financial industry left the Chinese financial sector under the powerful blows of integrated operation, which requires China's financial sector should meet the demand and win the competition with diversified financial services. To improve China's comprehensive competitiveness of the financial sector and to adapt to the actual needs of commercial bank reform and development, on December 27, 2003, the standing committee of NPC revised *the Law of the Commercial banks* that passed on May 10, 1995. Article 43 of the revised law stipulates that "Commercial banks in the territory of the People's Republic of China shall not engage in trust investment and securities business, not invest in non-self-use real estate or to non-banking financial institutions and corporate, except as otherwise provided". The exception clause of China's banking sector provides more development room for comprehensive management. Up to now, China's financial industry had formed a certain scale integrated operation. Among them, financial groups[127] are roughly divided into: (i) Financial groups formed by financial share holding companies[128] with several subsidiaries; (ii) Financial groups formed by banks with several subsidiaries; (iii) Financial groups formed by insurance companies with several subsidiaries; (iv) Financial groups whose parent companies are asset management companies; and (v) Financial groups whose parent companies are non-financial companies.

Establishment of CBRC in 2003 was designed to improve the quality of bank supervision. CBRC-the bank regulator-is charged with overseeing banks and other bank-like financial institutions. It also oversees the planned consolidation of rural credit co-operatives. The main contents of China's banking supervision are supervision on risk coverage; internal control; credit risk and liquidity. Particularly, along with capital regulation to curb the credit expansion impulse of financial institutions and to prevent the excessive use of financial leverage, it is necessary for regulators to require financial institutions to have adequate capital. Article 39 of the *Law of Commercial Banks* requires that the capital adequacy ratio of commercial banks should be not less than 8%. In 2004, the CBRC developed *Measures based on the Basel Accord*, which states among other things; first, the minimum capital adequacy ratio of commercial banks. The law requires that the capital adequacy ratio of commercial banks (total capital / risk weight assets) shall not be less than 8%, and the core capital

[127] Under the same control, wholly or mainly in the banking, securities and insurance industry at least two different financial sectors to provide services on a large scale groups.

[128] Financial share holding company is referred to as pure share holding company without business operation, just for share holding.

adequacy ratio (core capital / risk weight assets) shall not be less than 4%. Second, there must be a clear measurement of capital. The total capital includes core capital and supplementary capital. Core capital includes paid-up capital or common stock, capital surplus, earned surplus, retained earnings and minority stake in subsidiary capital. Supplementary capital includes revaluation reserve, general preparation, preferred stock, convertible bonds, and long-term subordinated debt. Supplementary capital should not exceed 100% of core capital, and the long-term subordinated debt included in supplementary capital may not exceed 50% of core capital. Third, there are provisions which include the risk of weight of domestic and foreign governments, corporations, banks, individual claims and other assets. Fourth, guarantee must be provided for collateral and main bodies with the function of risk mitigation. And fifth, there are requirements for business capital provision for market risk and credit risk off the balance sheet.

In 2004, CBRC allowed commercial banks to issue subordinated bonds (followed by similar moves for hybrid bonds) and removed the preferential risk weights (for calculating risk-weighted assets) assigned to large SOEs. CBRC had tightened regulation in an effort to lower NPLs, and to improve risk management and corporate governance at all banks. CBRC issued directives to all of China's large commercial banks to develop internal rating systems in line with the Basel II accord and start collecting the necessary data as soon as possible. Large commercial banks are expected to be Basel compliant by 2012. Moreover, CBRC has continued to guide the restructuring and overseas listing of the large commercial banks, not only so that they could raise capital but also because they would then be pressured by shareholders to improve their corporate governance. The introduction of foreign shareholders proceeded cautiously in response to local criticism that banks were being sold off too cheaply to foreigners.

b. Banking System Performance

China's banking sector seriously implemented macroeconomic policies, continued to optimize credit structures to support transformation of the economic development pattern and economic restructuring, and continuously improved financial services. Great achievements were made in the reform of banking institutions. ABC was successfully listed in 2010 which marked the completion of the shareholding reform of large commercial banks, and the reform of policy financial institutions and rural financial systems steadily proceeded. These moves have further strengthened the foundation for sound performance of the banking sector.

At the end of 2010, the total assets of China's banking institutions, according to CRBC, rose to 95.300 billion yuan (US $14,700bn), a 19.9% increase year on year, with the five large banks accounting for 49.2% of the total (down from 51.3% the pervious year), followed by the 12 joint-stock commercial banks with 15.6% and the small and medium-sized rural financial institutions and postal savings bank accounting for 14.9%.

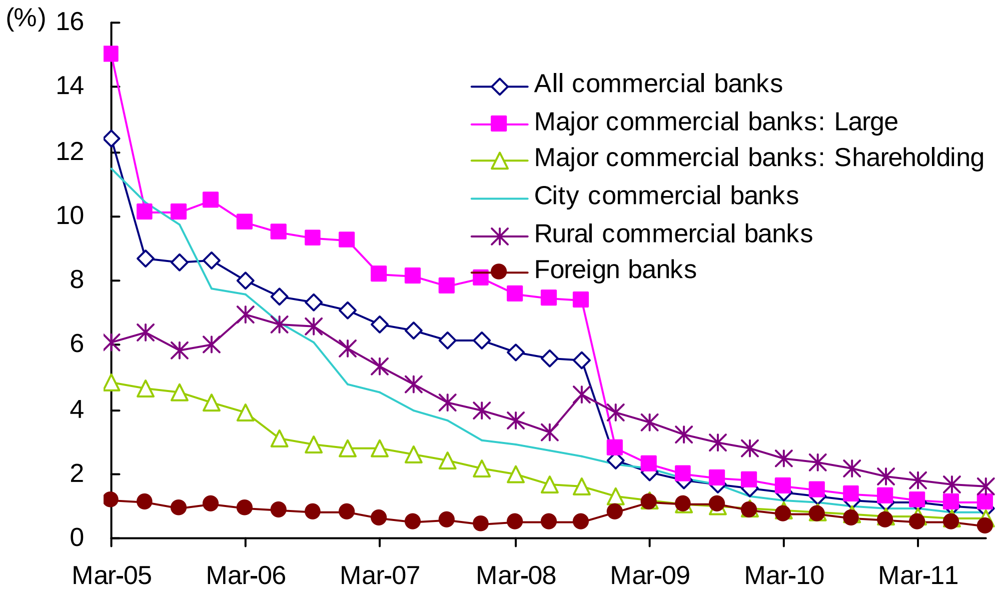
Signifying the continuing strong growth, total banking assets as of the end of March 2011 reached 101,200 billion yuan, an 18.9% increase year on year with the assets of the large commercial banks up 13.8% at 49,800 billion yuan, the joint-stock banks up 25.2% at 15,900 billion yuan, and the city commercial banks up 34.4% at 8,100 billion yuan. With total assets at the end 2010 at 95,300 billon yuan, four times what they were at the close of 2002, China's banking sector has undergone robust growth along with extensive structural reforms, which have substantially strengthened the sector, while asset quality has improved significantly. Total loans grew to 50,900 billon yuan at the end of 2010, a huge growth of 59%, or 18,900 billion yuan, over 2009 and 2010.

So far, the banking sector's balance sheet has expanded rapidly, in part due to the investment-driven stimulus policies of recent years. In 2009, the total amount of outstanding RMB loans expanded by 33% although credit growth slowed down in 2010. The rapid growth in foreign currency loans is likely linked to the expectation of RMB appreciation. Bank exposure to infrastructure construction increased, driven largely by an expansion of local government financing platform (LGFPs), while the share of manufacturing-related loans declined. The upswing in the real estate market also fueled demand for housing loans. Banks' off-balance sheet exposures expanded rapidly, mostly as a result of banks' promoting wealth management products as the government began to limit the pace of new lending.

Moreover, banks' funding appears stable. The sizable and low-cost domestic deposit base has contributed to stable bank funding. While household deposits remained critical to the growth of banks' funding base for most of the reform years, the incremental growth in domestic corporate deposits in 2009 has been significant. Maturity mismatches have also risen. Increasing reliance on medium- and long-term loans for investment project financing has lengthened banks' average asset maturities, particularly for large commercial banks.

Furthermore, the banking systems' nonperforming loan (NPL) ratio has been on a downward trend, reaching 1.1% at the end of 2010 (Figure 6.22.). This decline was driven by the rapid expansion of credit, a decline in NPL levels, and an 816 billion yuan NPL carve-out from one major bank in 2008. Over the longer horizon, large scale NPL carve-outs associated with the 1999-2001 and 2004-05 state-owned bank restructurings have kept overall NPL ratios low. The low level of reported NPLs has also been helped by strong economic growth and some improvements in risk management in banks. The rapid credit growth, however, could result in a deterioration of bank asset quality in the coming years.

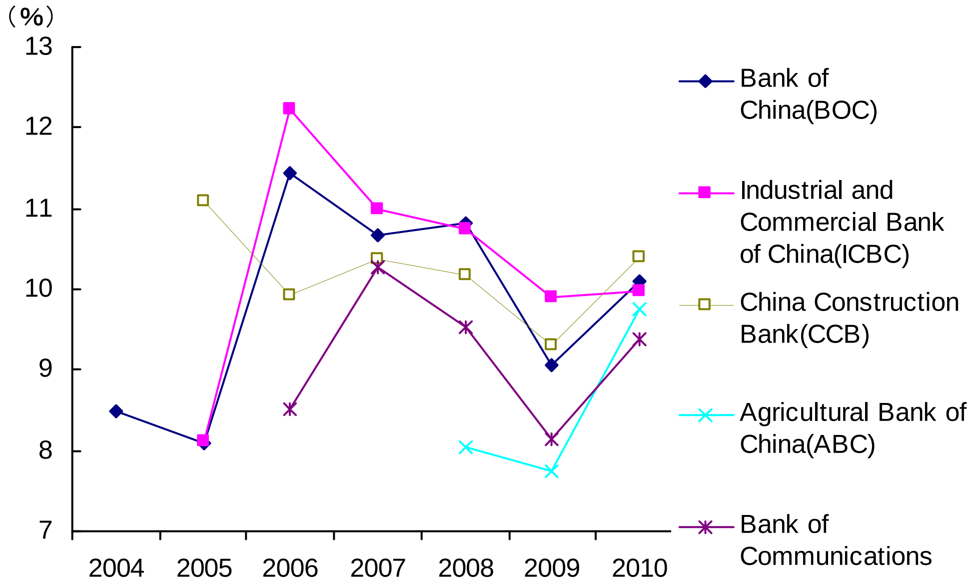
Figure 6.22. China's Nonperforming Loans to Total Loans



Source: CEIC

In terms of capital strength, at the end of 2003 the overall weighted average capital adequacy ratio of China's commercial banks was -2.98%. The ratio turned positive in 2004, rose to 4.9% in 2005 and further jumped to 12.2% at the end of 2010, with all commercial banks meeting the minimum requirement of 8%. The five large commercial banks' Tier 1 ratio maintained a high level above 8% in 2010 (Figure 6.23.). Provisioning has also been expanded dramatically. The provisioning coverage ratio soared from 6.7% at the end of 2002 to 24.8% in 2005 to a significant 217.7% at the close of 2010, with the balance of banking provisions amounting to 1,300 billion yuan, providing an enhanced capacity to cover potential losses. The provisioning coverage of large commercial banks increased to 206.8%, up 61.9 percentage points on the year before.

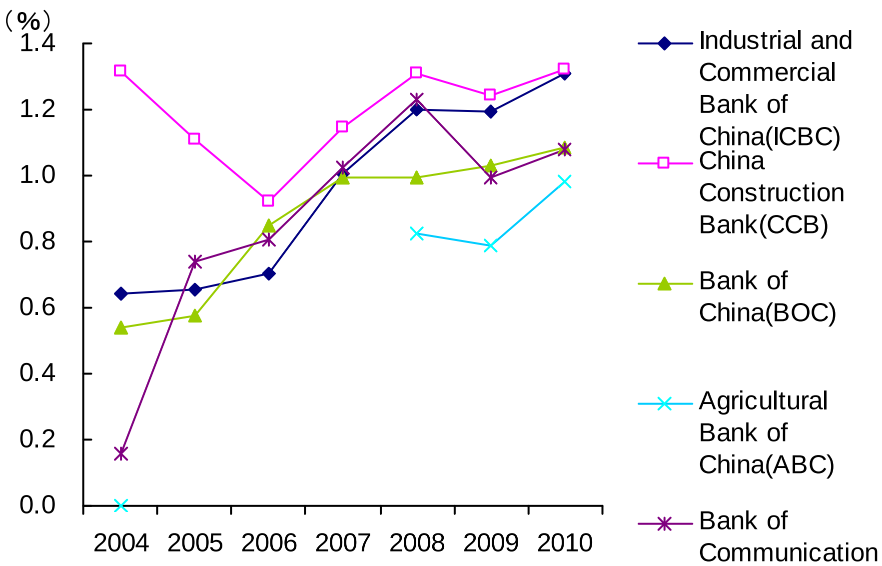
Figure 6.23. China's Large Commercial Banks' Tier1



Source: Bloomberg

These changes have been enabled by continuous improvements in profitability. The post-tax profit generated by banking institutions grew 15-fold from 61.5 billion yuan in 2002 to 899.1 billion yuan in 2010. The five large commercial banks contributed 57.3% of that end of 2010 total, or 515.1 billion yuan, with the 12 joint-stock banks contributing 15.1% of the total or 135.8 billion yuan. Also the return on assets and the return on equity of commercial banks increased significantly from 0.1% and 3%, respectively, in 2003, to 1.03% and 1.75%, respectively, at the end of 2010. Particularly, the performance of five large commercial banks' performance (ROA) was good in 2010 (Figure 6.24.). In terms of liquidity, the ratio of the banking sector slipped by 2.1% points to 43.7% at the end of 2010. The loan-to-deposit ratio, another measure keenly watched in China, was also down 0.1 percentage points to 69.4% at the end of 2010.

Figure 6.24. China's Five Large Commercial Banks' Return on Asset



Source: Bloomberg

c. Competitive environment and "going out" strategy

In the wake of the global financial crisis, while the financial institutions of Europe and the US have suffered significant losses, Chinese banks have been only marginally affected, and their presence on the international stage is increasing. Across a range of indices, Chinese banks have jumped to some of the highest positions in the world, and whereas their international business had previously been underdeveloped, its expansion is now attracting serious attention. Overseas participation is of course part of national promotion policy, but it also reflects the expansion of the banks' international business activities in response to the development of their customers' overseas business activities, and the internationalization of the RMB.

For instance, Chinese banks are slowly but surely increasing their presence abroad and at the end of 2010, the five large commercial banks (the ICBC, the BOC, the CCB, the ABC and the BOCOM) had set up 89 branches and subsidiaries outside China and acquired or invested in 10 foreign banks. Six of the 12 joint-stock banks[129] have established five branches and five representative offices overseas and two of the city commercial banks have opened two representative offices aboard.

Moreover, the financial crisis has presented China's banks with many

[129] China Citic Bank, China Everbright Bank, Huasia Bank, China Guangfa Bank, Shenzhen Development Bank, China Merchants Banks, SPD bank, Industrial Bank, China Minshen Banking Corporation, Evergrowing Bank, China Zheshang Bank and China Bohai Bank.

opportunities for overseas participation. While European and US financial institutions are forced to contract, Chinese banks find room to expand (go overseas strategy), and are blessed with opportunities to purchase European and US financial institutions through M&A, and so on. In addition, they have been able to retain the services of a large number of highly skilled personnel from European and US financial institutions.

The Chinese financial institutions in the banking sector continued to increase their overseas presence by setting up establishments and investing in overseas financial institutions. The major overseas acquisitions undertaken by domestic banks in 2008 included: (i) In January, the ICBC completed the acquisition of Seng Heng Bank in Macao, holding a 79.9% stake. In March, it also acquired a 20% stake in Standard Bank Group at a cost of about 40.945 billion yuan (US$5.6 billion). In July, the ICBC announced that it had signed an agreement to acquire 90% of Indonesia's Halim Bank. In August, it was reported that the ICBC would acquire 100% of Russia's Roservobank for between US$800 million and US$850 million; (ii) In September, the BOC entered into an agreement with the Rothschild family to acquire a 20% stake in the Rothschild bank. Under the deal, the BOC was to take up 663,268 new shares and acquire 577,064 existing shares. (BOC abandoned the plan in April 2009); (iii) In October, China Merchants Bank acquired a 53.12% stake in Hong Kong's Wing Lung Bank for HK$30 billion (US$3.8 billion).

In May 2009, the ICBC was in negotiations with Thai Ministry of Finance to acquire its 30% stake in ACL at a price between 100% and 200% higher than ACL's share price. In April 2010, the ICBC said that it had obtained all the necessary governmental and regulatory approvals to complete the acquisition of all issued shares of Thailand's ACL. In a statement filed with the Hong Kong Exchange, the Beijing-based bank said it had acquired 1.546 billion of ACL's ordinary shares and 282,048 of its preferred shares, which in combination accounted for 97.24% of the total issued shares of ACL.

In June 2009, the ICBC announced that it had agreed to acquire a 70% stake in a subsidiary of Bank of East Asia Limited in Canada for about HK$567 million. The acquisition will help ICBC to expend its operating network in North America. 12 months after completing the transaction, Bank of East Asia will have the right to sell the remaining 30% stake, while the ICBC will be entitled to acquire an additional 10% stake. In January 2011, China's biggest bank-the ICBC signed an agreement that would make it the first Beijing-controlled financial institution to acquire retail bank branches in the US. The ICBC agreed to acquire a majority stake (paid$140 million for an 80% stake) in Bank of East Asia Ltd.'s US subsidiary[130].

On the other hand, after China joined the WTO and the full liberalization of the

[130] Bank of East Asia, which is a publicly traded company based in Hong Kong, has a total of 13 branches in New York and California.

banking industry, foreign banks have developed rapidly in China, though the size of foreign institutions are still small. Although the number of foreign banking institutions in China almost doubled between 2004 and 2010 and the volume of foreign banking assets almost trebled, their proportion of total banking assets in China stayed almost the same at less than 2%. As of the end of 2010, 185 banks from 45 countries and regions had set up 216 representative offices in China while 37 banks from 14 countries and regions were locally incorporated and 223 branches had been established. At the end of 2010, foreign banks maintained outlets in 45 cities of 27 provinces, 25 cities more than at the end of 2002. Curiously, while the volume of foreign banking assets rose from 562 billion yuan in 2004 to 1,740 billion yuan in 2010, this as a percentage of total banking assets only rose from 1.84% to 1.85%, remaining virtually unchanged.

6.2. Roles and Functions of the Banking Sector

6.2.1. Recent Changes in Banking Environment and Industry Developments

a. Recent Changes in Banking Environment

Reform of large commercial banks was further deepened. In 2010, ICBC, BOC, CCB and BOCOM further advanced the reform, improved corporate governance, enhanced decision-making capability and efficiency, intensified risk management and internal control, and replenished capital through various channels, as reflected in the continuous improvement of financial indicators and enhanced overall strength. As of the end of 2010, the CAR of the above four banks stood at 12.0%, 12.5%, 12.4% and 12.1%, respectively; the NPL ratio was 1.09, 1.20, 1.01 and 1.13%; and the net profits after tax were 156.4 billion yuan, 99.5 billion yuan, 133.3 billion yuan and 41.8 billion yuan. CDB continued to improve corporate governance and organizational framework, actively explored the medium and long-term business model, enhanced the comprehensive risk management framework, and steadily promoted market oriented reform.

Moreover, the rural financial system further improved. In 2010, further progress was made in the reform of rural credit cooperatives (RCCs). By the end of 2010, there were 1,976 RCCs at the county (city) level, 84 rural commercial banks and 216 rural cooperative banks. In December 2010, Chong Qing Rural Commercial Bank got listed successfully on the Hong Kong stock exchange, the first domestic rural commercial bank going public, marking a new breakthrough in the development of rural financial institutions. New-type rural financial institutions grew dramatically, with 172 institutions established by the end of the year, and access to financial services in rural areas was largely extended.

Furthermore, reform of other institutions steadily progressed. Small and medium-sized commercial banks continued to improve corporate governance, and actively explored differentiated and specialized business. Foreign banks in China maintained stable performance. Reform and restructuring of Everbright Bank was further deepened, with financial indicators greatly improved. On August 18, 2010, Everbright Bank was listed on the Shanghai Stock Exchange, raising a total of 21.3 billion yuan. Relevant authorities worked actively on the plans of financial restructuring and shareholding reform of the four financial asset management companies to promote their commercial transformation, and launched pilot reform of Cinda Asset Management Company. On June 29, 2010, China Cinda Asset Management Co.Ltd. was officially inaugurated, forming the initial framework of modern corporate governance.

In addition, new achievements were made in integrated financial services and financial innovation. In 2010, integrated financial services of commercial banks made new progress, with 8 commercial banks establishing fund management companies, 4 investing in insurance companies, 7 establishing or investing in financial leasing companies, and 2 investing in trust companies. Financial innovation was steadily advanced, with new achievements in financial service innovation of small and micro enterprises. As of the end of 2010, 109 commercial banks had set up institutions specializing in financial services to small enterprises, and the rating and pricing mechanisms of small and micro enterprises were further improved. Some banks introduced a series of innovative products, including joint-guaranteed loans, leasing right loans, emergency loans, order loans, patent right pledge loans and SME collective notes.

The size and pace of credit expansion were appropriately managed, and credit structure was further optimized. In 2010, banking institutions actively implemented macroeconomic policies, and appropriately handled the size and pace of credit supply taking into account their own business needs as well as the changes in economic and financial environment. As a result, credit growth returned to normal from a high level. Banking institutions continued to implement differentiated credit policies, and enhanced credit support to the restructuring and revitalization of national key industries, weak links in the economy, employment, consumption, energy conservation , environmental protection, and emerging industries of strategic importance, especially laying stress on supporting agriculture, rural areas and farmers as well as SMEs.

b. Industry Development

In general, the current industry development can be focused on corporate banking, small and medium enterprise (SME) business, informal finance and shadow banking, retail banking, and payment system as follows.

(i) Corporate Banking and Big 5 Banks. Corporate banking plays a dominant role in the Chinese banking system. The big four large commercial banks (the ICBC, the CCB, the BOC and the ABC) plus Bank of Communications make up the big five, which seized opportunities in macro-economic changes to advance transformation of corporate banking and optimize business structure in China. The big five banks are the core of China's financial system, and provide financial services within their own spheres.

In 1994 the financial system was overhauled, and in 1995 the Commercial Bank Law was enacted. This cleared the way for the operational barriers that had existed between the four big banks to be removed. For example, Agricultural Bank of China was able to set up branches in inner city areas and accept deposits from individual customers, and provide finance to businesses in sectors completely unrelated to agriculture. Additional measures included releasing the banks from their obligation to provide policy financial support to state owned enterprises, and their non-performing loans were transferred to the newly formed asset management companies. Further, the big four were reformed by streamlining personnel and structures and becoming more efficient. Between 1998 and 2008, some 80,000 unprofitable branches and facilities, just over half of the total, were restructured. The majority of these were branches in sub-provincial regions and rural areas, and around 290,000 employees were laid off.

Within this process, the big four have been shifting their business priorities and management policies away from mainly individual deposits and state owned enterprises' finance to mainly metropolitan area large customer financing and securities investments. In 2010, their share of deposits of all financial institutions had fallen to 50.3%, down from 63.1% in 1998, but of their financial assets, the securities investment ratio had grown to 24.1%.

(ii) SME Finance. Since the economic reform, the ban on private enterprise and self-employed business was removed. In order to provide financial services for these kinds of enterprises, in the cities, cooperative type financial institutions called city credit unions were created. In rural areas, the rural credit cooperatives, which had existed since the days of the planned economy, took over the responsibility of debt for rural and township enterprises.

In 1995, the city credit unions' non-performing loan problem was exposed and government-led integration and merger led to almost all of the credit unions being converted into commercial banks. Based on this experience, the rural credit cooperatives also were integrated and merged into rural commercial banks or rural cooperative banks. Then, as part of the new rural construction in 2006, the government made it easier to establish financial institutions sited in rural areas. Financial institutions established as a result of these policies were town and village banks, loan specialist companies and rural finance mutual aid societies.

Thus, as of 2010, there were eight types of financial institutions providing financial services mainly to small and medium sized enterprises: city commercial banks (147), rural commercial banks (85), urban credit cooperatives (1), rural cooperative banks (223), rural credit cooperatives (2,646), village or townships banks (349), finance companies (9), and rural mutual credit cooperatives (37).

However, the financing difficulties of the small and medium sized enterprises are still serious, and informal finance is still an important source of capital for small and medium sized enterprises. In order to address the issues of the systemization of informal finance and SMEs' financing difficulties, in 2008 the Chinese government experimented with micro-finance in the form of small loan specialist companies, and in merely two years over 1,300 companies were established.

In 2004 the Shenzhen Stock Exchange opened an SME Board, and in October, 2009, the ChiNext Board (the capital reference standard was lowered to 3,000 yuan). Further, in 2007, there was an experimental issue of aggregate corporate bonds that lumped SMEs together.

Additionally, if SME finance is to be promoted, it will be imperative to develop SME finance mechanisms. Currently, there are about 10,000 credit guarantee companies. Of these, some 4,200 handle SME finance. The 2009 Annual Report on Banking Regulatory Commission reports problems in that the private sector credit guarantee companies are small in scale and their capital strength is limited, and that government run credit guarantee companies assessments are very strict.

So far, small businesses are a key engine of China's economic growth, accounting for 44% of employment and 35% of GDP. China's SME lending value of loans was 48.65% of GDP in 2010. 70% of small businesses currently borrow money, and the banks fail to meet almost half of their financing needs. Moreover, the CBRC is encouraging banks of all sizes to increase their exposure to small businesses. The potential here is not just to grow this business but to increase loan yields at a time when margins are under pressure.

In 2009, three main characteristics of winning models in small-business lending were indentified. First, while banks generally start with secured or asset-based lending, they enhance pricing by reducing collateral requirements over time. Second, they attract deposits so as to make this business partially self-funding. Third, they capture synergies by combining lending with the provision of retail financial services to small-business owners and their employees. China Minsheng Bank, the country's ninth-largest local bank, for example, recently launched a small-business lending program using personal assets as collateral. The balance-sheet value of this activity had exceeded US$15 billion by August 2010, one year after its launch, and thanks to better pricing, the bank also significantly boosted margins and loan yields.

Looking ahead, local banks can look forward to tremendous opportunities for growth in wholesale banking, but competitive pressures are also mounting. Particularly, given the strength of the competition to serve well-known state-owned enterprises and midsize corporates, local banks should focus on the small-business segment as a way to grow their loan volumes and increase yields. Strong risk management and risk-based pricing capabilities are necessary to the business model. They can, meanwhile, leverage these lending relationships to capture deposit and personal financial services opportunities.

(iii) Informal finance and shadow banking. The informal financial sector has played an important role in China. The relative scale of informal finance in the financial system also has implications for SME financing and income distribution. A survey in Sichuan province by the International Finance Corporation found that, of more than 600 surveyed SMEs, an average of 45% of the funding for investment of fixed assets came from trade credit among business partners and private lending from friends and relatives, and that an average of 38% of SMEs' working capital came from trade credit and private lending. Informal finance, by effectively mobilizing local funding, mitigates capital outflow from rural and less-developed areas, and promotes local SME development and employment, in turn reducing income disparities.

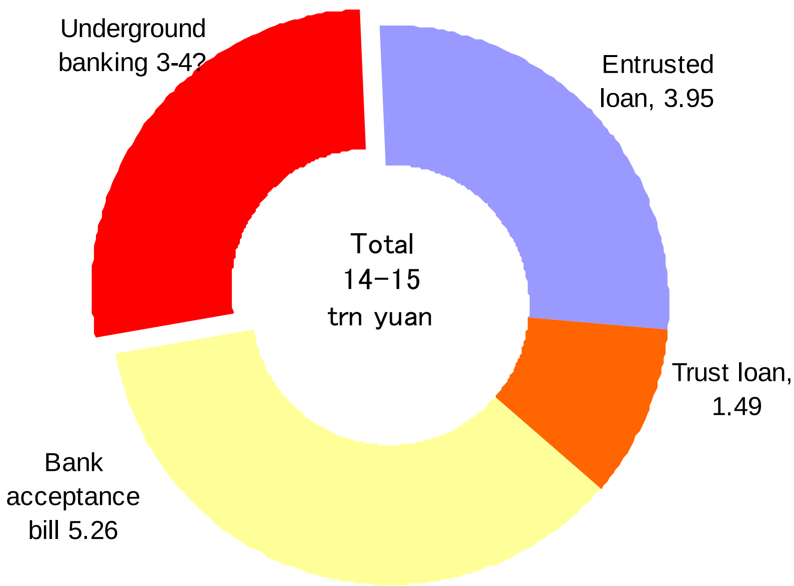
However, most informal financing activities operate underground-lenders and trust companies that extend credit to people and companies that may not qualify for loans otherwise. The fast growth of those underground money and trust companies has brought a new social problem (China's shadow banking problem) currently. Particularly, troubled enterprises are usually heavily involved in underground banking, which is basically direct and informal lending and borrowing between family members, friends, and people from the same community or locality. These unnerving stories always begin with PBC's lending curbs on formal banks, followed by surging underground banking, and then at some point-there is always such a point-inevitable and abrupt breaks in liquidity chains, and ending finally with runaway business owners or their suicide.

Credit Suisse estimated the size of China's informal lending at up to 4 trillion yuan, equivalent to around 8% of above-board bank lending. Interest rates on these loans run as high as 70% and they are expanding at an annual rate of about 50%. The shadow bankers have lent 208 billion yuan to real estate developers so far in 2011, nearly as much as formal bank lending of 211 billion yuan. The risks, analysts say, is that even healthy developers become vulnerable to a liquidity crisis, given the short tenor and high rates of these loans. Formal banks have transferred some risky loans off their balance sheets to the shadow banking[131] industry. According Société Générale's estimate, the size of China's shadow banking would be worth 14 to 15 trillion yuan (Figure 6.25). Of all the varieties of informal credit intermediation, the biggest equivalent to 7% of gross bank loans, on Nomura's reckoning is entrusted loans. In such loans, a bank acts as an agent on a third-party loan between a depositor and a borrower, and books a fee. As it does not assume any risks or rewards of the loan or the corresponding funds, it typically records it off-balance sheet, at principal amounts. The volume of such deals exploded as China tightened administrative controls on formal

[131] China's shadow banking includes the informal financial sector (pawn shops, credit guarantee companies, and micro-finance companies), private equity and wealth management products.

lending.

Figure 6.25. Size of China's Shadow Banking System



Source: PBoC, SG Growth Asset Research

Note1: As of June 2011.

Note2: estimated

The CBRC is reportedly saying that banks should be more tolerant of SME defaults in order to help them through difficult times. Initiatives, such as collective issuance of SME bonds, are also seen as offering increased scope. Further steps may follow. For example, regional credit quotas and relaxing reserve requirement ratios seem possible avenues. At the same time, regulatory policies applying to shadow banking and their interconnections needs to be clarified and made transparent. A more structured oversight, regulatory, and supervisory approach is needed to prevent and to manage systemic risks via cross-market products and institutional structures.

(iv) Retail Banking. Even after financial reform, the big four commercial banks retained their near monopoly for a long time, and were not only involved in wholesale banking, but also provided retail banking for individual customers. The structure of having the ICBC handle the deposits of city residents and the ABC handle the deposits of rural community residents was the personal finance asset management system. Urban credit cooperatives and rural credit cooperatives provided production capital finance to their members, but this financing was very limited. There were no personal loans for housing and consumption purposes.

Since 1998, the big four have been streamlining their branches and have made big reductions in the number of rural branches, and thereby the weight of their retail banking business has fallen. On the other hand, new commercial banks have appeared on the scene, and have developed new business in personal finance and private sector enterprises, many of which are SMEs. Also, the ban on personal finance for housing loans and consumer loans has been lifted. As a result, retail banking targeting city residents, in particular the residents of small, regional cities, and the residents and businesses of agricultural communities, has shifted from the big four and is distributed among the city commercial banks, rural commercial banks and the Post Office (China Postal Savings Bank since 2007).

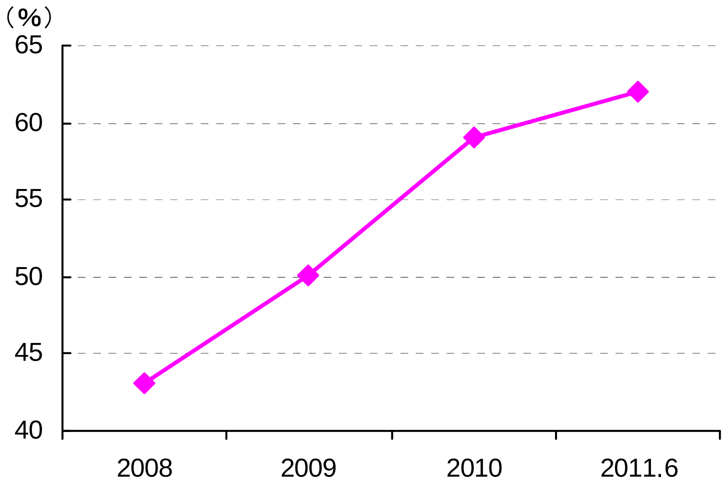
Since 2003, in order to grapple with the Three Agrarian Reforms (farmers, farming and farming communities), a number of financial organizations were created, including rural cooperative banks, village or townships banks, finance companies and rural mutual credit cooperatives, for example.

The China Postal Savings Bank established in 2007 has total assets worth 2.2 trillion yuan and is next to the big four in terms of size, and its business base is still in the rural communities. It was limited to either Central Bank deposits or governmental bonds. The restrictions on deposit operations were removed. It is still unclear as to whether the bank's pumping money from rural communities into the cities will stop, but there is no question that it will play a major role in retail banking targeting individual customers in large rural areas.

The flow of funds table shows that, in terms of individual financial asset management, the principal investment of the household sector is bank deposits, and that ratio is over 60%. Meanwhile, the ratios for bonds and stocks fluctuate year by year, but do appear to be trending upwards. In particular, the ratio for insurance products is moving steadily upwards.

In addition, banks doing business in China face rapidly changing consumer behavior, with big consequences for both local and multinational institutions. Consumers increasingly prefer local banks over multinationals, are less loyal to existing banking relationships, are much more cautious about borrowing, and are more open to Internet and mobile banking. For instance, the ICBC intensified product innovation in new fields based on new technologies to meet new demands, and enhanced functions of the integrated electronic banking (E- banking) platform combining trading, marketing and services. It carried out customer experience activities to solicit customers' opinions and to investigate customers' needs, in order to improve E-banking product factions and customer service level. Besides, the ICBC raised the market influence of E-banking services by conducting a series of E-banking marketing activities. In the first half of 2011, the transaction volume of E-banking increased steadily. The proportion of the number of E-banking transactions increased to 62% of total number of transactions of the bank, up 2.9 percentage points compared to the previous year (Figure 6.26.).

Figure 6.26. Proportion of E-banking Business (ICBC)



Source: ICBC

Note: The proportion of E-banking refers to the number of E-banking transactions against the total number of transactions of the bank

(v) Payment System. China's infrastructure of the payment system was improved. A payment and clearing network system had been set up, with the PBC's modern payment system as its core, financial institutions' intra-bank payment system as its foundation, and bills of exchange payment system and bank card payment system as its important components. The system, as a whole, provided a rapid, efficient, safe and reliable payment and clearing channel for economic, financial and social development, expedited funds turnover, improved the resource allocation efficiency and supported strongly the healthy and rapid development of the national economy.

Established by the PBC and operated since June 2005, the High Value Payment System (HVPS) became the core system of the financial infrastructure and the "aorta" for social economic activities and for the funds movements. It was connected to the banking financial institutions' intra-bank payment systems, the central securities system, bank card payment system, RMB inter-bank borrowing foreign exchange systems, and also to the RMB clearing banks in Hongkong and Macao. So far, the system has operated smoothly, with around 600,000 daily payment and settlement transactions totaling 1 trillion yuan. With each transaction debited or credited on a real time basis, the system reached the international advanced standard in terms of function and efficiency.

Launched in June 2006, the Bulk Electronic Payment System supported many kinds of payment instruments. Running seven days a week, 24 hours a day, it provided a public platform for banking financial institutions' small value, bulk inter-bank payment and clearing transactions, at low cost. Through the platform, on one hand, the public utilities fee collecting entities (payees) needed to open only one account in any of the banks to collect all utility bills (water, electricity, gas, communications) and social security (pension, unemployment, work-related injury and medical insurance). On the other hand, the payers could distribute conveniently wages, allowances and social security insurance to payees who opened accounts in different banks. Besides, the system also supported inter-bank deposits and withdrawals. It provided safe, efficient and round-the-clock payment and clearing services such as inter-bank on-line payment and telephone payment, making the lives of ordinary people much easier.

So far, China made steady progress in building financial infrastructure in 2010. Successful efforts were made to strengthen the payment system, enhance the financial legal system, advance the accounting reform and convergence with international standards, improve the credit environment, and boost the effectiveness of anti-money laundering (AML) programs, which underpinned the sound performance of the financial sector.

The payment system was constantly improved and operated safely and smoothly. First, the inter-bank market clearing house was integrated into the payment system, enabling the Large Value Payment System (LVPS) to play a stronger role in supporting financial market development. Meanwhile, clearing banks in Hong Kong and Macao were allowed to remit and transfer RMB funds to each other, which boosted the use of RMB for cross border and overseas settlement. Second, the Bulk Electronic Payment System (BEPS) was extended to cover the Centralized Collections and Payments Center and China Union Pay, which improved settlement service for the retail payment market. Third, emergency exercises were conducted to improve the capacity to deal with possible failures of the Centralized Accounting Booking System (ABS), and efforts were made to promote remote data backup. Fourth, the inter-bank settlement system for online payments was successfully launched. Fifth, supervision and management of the payment system was strengthened to ensure its sound operation, including efforts to step up daily supervision on system participants, and to assess and improve contingent plans. In 2010, various payment systems processed 12,004 million yuan payment transactions, or 1,663.86 trillion yuan, representing a year on year rise of 36.1% and 37.8% respectively.

New non-cash payment instruments were developed, and risk management was enhanced. The electronic commercial draft system was extended to have nationwide coverage, and the circulating environment of checks was improved by promoting check financing. The use of bank cards was facilitated, as bank cards designed to assist vocational school students were widely adopted and bank cards for government employees were launched on a pilot basis. In the meantime, collaborating with other government agencies, PBC strengthened management of bank card security, including actions to promote better risk management practices, encourage commercial banks to eliminate unqualified card holders and promissory shops, and carry out a special campaign against bank card-related crimes.

Management of non-financial institution payment services was enhanced, representing a major breakthrough in supervision over payment institutions. Based on a registration of designated nonfinancial institutions, which presented a clear picture of payment services provided by non-financial institutions, PBC issued the Administrative Measures on Payment Services of Non-financial Institutions and relevant detailed implementation rules, specifying the procedural requirements for such institutions to open payment services. This marked a significant progress in supervision of the payment services market.

Currently, the PBC started to set up a more safe and efficient "second-generation payment system" by October, 2012, with a more flexible liquidity management function, which could support one point interface for banking financial institutions. Thus, they continued to push forward the infrastructure building of the payment system. Meanwhile, banking financial institutions continued to improve their intra-bank payment system to provide efficient and quality services.

6.2.2. Case Study on Interview with Banking Sector

(i) Industrial Commercial Bank of China (ICBC). ICBC is not only the largest bank in China in terms of capital and assets, it is the sixth largest globally according to *the Banker's* Top 1000 World Banks. It is also the most profitable bank in the world, with pre-tax profits reaching US$32.5 billion in 2010, up 32.78% year on year. It is also the world's largest bank in terms of market capitalization, reaching US$233.5 billion at the end of 2010.

ICBC can claim many domestic accolades, including largest wholesale bank, largest retail bank, largest electronic bank, largest issuer of credit cards and largest custodian bank. It also claims China's largest market share in the corporate deposit market and corporate loan market, as well as the largest market share in the personal loan market. For instance, personal loans grew 35% in 2010 to US$250 billion, doubled that of 2008, in an area where ICBC has been putting particular focus.

Moreover, ICBC is expanding on the world stage and constructing a global business network. At the end of 2010, it had 203 overseas offices (up from 162 at the end of 2009) in 28 countries and regions, including 21 overseas branches and 181 overseas subsidiaries. Overseas assets grew strongly by 4.5% in 2010 to US$75.5 billion, providing US$1.2 billion in pre-tax profits, but this was still less than 4% of total profit.

Working with its Africa partner, South Africa's Standard Bank, ICBC has expanded in Africa since 2011, as well as targeting emerging markets, especially in Asia, with their higher growth rates. The bank is also expecting to complete the acquisition of a small retail bank in the US. The greatest challenge for ICBC, as mentioned in the interview, was the matter of capital stress and the need to keep the bank's capital adequacy ratio above the set 11.5% ratio. As to maintaining high profitability in order to deliver capital growth, ICBC lowered their dividend distribution from 50% to 40% to allow the remaining 60% to provide more capital. With a capital adequacy ratio of 12.27% at the end of 2010, ICBC is comfortably positioned for more growth.

(ii) Bank of China (BOC). BOC is the oldest and most international bank in the country. Bank of China displayed strong growth in 2010 in all areas making it the third largest bank in China and ninth globally according to *the Banker*'s Top 1000 World Banks. With assets up 23.21%, as well as profits up 31.9% in 2010, BOC's performance is remarkable. The bank improved to 18.87% return on equity, reduction in the NPL ratio to 1.1%, and the solid capital adequacy ratio of 12.58%, while also highlighting continued strong improvement in 2011.

Moreover, BOC made significant progress on its diversified business strategy in 2010 in areas such as investment banking, fund management and aircraft leasing. The bank's lending growth had slowed to a more normal rate of 15.28% in 2010 and even lower in 2011, which is compared with a high 49% growth in 2009. However, asset quality had remained sound since the high growth period.

The BOC's large international network (with more than 700 operations aboard) has helped the bank to diversify its offering and expand within its domestic market, which is the fastest growing in the world. The BOC's overseas assets amounted to 2,330 billion yuan, four times that of its nearest Chinese rival, and accounted for 21.46% of the bank's total assets and 19.89% of its profits.

Looking to the future, BOC aims to be the most market-oriented and international bank in China, with the most developed IT systems and best risk management and internal controls. Moreover, the Bank also intends to set a benchmark for the Chinese banking industry in terms of diversified business platform development. While the Chinese market continues to be the main focus, the bank is targeting Asia and the Middle East, as well as Africa and Latin America. Particularly, the bank is now keen to establish business operations in the Middle East.

Furthermore, BOC is in the process of gaining regulatory approval for a second headquarters in Shanghai, which would take advantage of the city's massive commercial focus, and look after Bank of China's business and product development. With an unassailable international network, BOC is well positioned for its expanding domestic market and has strength abroad as Chinese companies seek opportunities overseas.

(iii) China Minsheng Banking Corporation (CMBC). CMBC was established in 1996, and is not only the ninth largest bank in China and the 73rd largest globally according to *the Banker*'s Top 1000 World Banks 2011. It is unique in China for being 100% privately owned. It also has a highly specific market focus following a recent strategic positioning. CMBC focuses on 3 key groups: non-state-owned large and medium-sized enterprises, small and micro-enterprises, and high-end individual customers.

Starting in 2010, CMBC entered into a "second take-off", planning to become a distinctive bank with outstanding efficiency. In 2010, CMBC posted strong net profit growth of 45.25% to reach 17.58 billion yuan, with total assets up 27.9% to 1,800 billion yuan and average return at 18.29%, and the group's growth in net profits out-paced that of assets and loans. The bank also reported a significant increase in its net interest margin to 2.94%, a reduction in the NPL ratio to 0.69% and an increase in provision coverage to 270.45%.

The CMBC's big potential and strength is focusing on private enterprise. The strategic business unit reforms for large private entrepreneurs are to provide one-stop financial services and strengthen these entrepreneurs' brands and market position. The Bank has 8,000 large customers, 300,000 micro and SME customers, and 40 million retail bank customers. In 2010, 66.2% of CMBC's total loans were directed at small and micro-enterprises. But all loans to small and micro-businesses are for less than 5 million yuan, the average period of loan is for six to nine months. The pricing is higher to reflect the risk, and the CMBC uses a selective batch processing system that minimizes risk. NPLs to these small and micro-enterprise borrowers (65% of which are to the service sector) are very low at 0.1%. Furthermore, the Bank proactively improved its enterprise risk management system and accelerated the enhancement of the enterprise risk management capability at the Group level. Specifically, the bank strengthened the establishment of its enterprise risk management framework and improved the Group's concentration risk and country risk management. The bank completed the internal capital adequacy assessment process (ICAAP) program and further enhanced the enterprise risk management.

Now the CMBC has effective financing models for large entrepreneurs and SMEs, as well as small and micro-enterprises, and can out-perform other banks. Their target structural model is 40% entrepreneurs and SMEs, 30% small and micro-enterprises, and 30% high-end wealth management from the current 80% non-state-owned enterprises and 20% state-owned enterprises.

At the present, the CMBC has 530 banking outlets, 70% in eastern China, and a diversified shareholding base of 1.1 million shareholders, the largest holding being 4%, with Morgan Stanley holding a 1% stake. Further, the CMBC will set up a Hong Kong branch in 2012 to support enterprises' business between the mainland and Hong Kong. The CMBC is pushing forward its strategic transformation and its "second take-off "for its unique niche in China's banking market. In addition, all of the top four commercial banks, plus China Minsheng Banking Corporation, are reported to have applied to establish second headquarters in Shanghai, which will help the city to achieve its goal of becoming an international financial center. China's banking ambitions hold no bounds.

6.3. Banking Sector Challenges

6.3.1. Issues on Reform

a. Bank Still Facing Various Reforms

Although the Chinese financial industry had made historic leaps and bounds and striking achievements since reform and opening-up, challenges still exit in the current financial field.

First, the financial system is far from perfect and the financial structure never seems to be reasonable. The uneven development of banking, securities and insurance led to lagging development of both the securities and insurance markets and the low proportion of direct financing. The internal institutional system of all financial sectors is far from perfect. Besides the unreasonable distribution of financial institutions, the development of urban and rural areas and regional financial industry is not yet coordinated, which accompanies the low financial development in rural areas, especially the middle and western region, and underdeveloped regions and many difficulties in financing for “agriculture, farmer and rural area”, and SMEs.

Second, the modern financial enterprise system remains to be strengthened. The challenges have not been completely solved concerning imperfect corporate governance of financial institutions, internal control, risk control and risk management mechanism, lagging transformation of management mechanism, which is in company with the failure to separate government administration and enterprises, and between government administration and banks.

Third, the financial industry has spread extensively while financial operation quality is low. The business type of banks, securities and insurance companies was too simple, and the homogenization phenomenon of financial products is rather common, lacking special and high-quality financial services. Not only is the financial innovation and competitiveness weak, but the sustainable profitability is low.

Fourth, the financial control pressure is building up. The macro control is faced with coordination problems among such objectives as stabilizing price, promoting economic growth, increasing employment and improving balance of payments. The excessive capital liquidity stimulated the overinvestment in some industries and the increase of asset prices, and built up the potential pressure of inflation.

Fifth, the task of maintaining financial stability is challenging due to piling up of various potential risks. New financial risks are accumulating before some historical heritages of financial risk have been completely resolved. Financial credit risk, market risk, and operation risk are still high, while financial supervision mechanism and financial stability mechanism have significant defects. Therefore, further reforms are needed to accelerate its pace of development.

Finally, all such risks and challenges imply that the restructuring process of Chinese banks is not yet over. It is important to focus on prudent lending and modern risk management, including (i) proper credit evaluation and risk management tools, (ii) improvement of staff quality through the training of existing personnel, and (iii) development of better NPLs' management and debt restructuring capabilities.

b. The Challenge of Interest Rate Liberalization

Financial liberalization can provide many benefits. By allowing for the better pricing of capital and risk, liberalization improves the allocation and efficiency of investment. A larger share of intermediation would be undertaken by more efficient banks and those better at assessing risk. More credit would also flow to sectors previously underserved. The range of financial products should also expand, allowing firms and households to better manage risk, and providing them with portfolio diversification opportunities. However, if attempted prematurely, financial liberalization may also expose weaknesses in the financial sector, inhibiting intermediation and creating economic volatility.

China has already made substantial progress in liberalizing its financial markets, and its interest rates in particular. After years of reform, however, there still remains a floor on bank lending rates and a ceiling on deposit rates. The deposit rate ceiling, in particular, appears to bind, as deposit rates have remained clustered at their benchmark, and real deposit rates have on average been zero. Interest rate controls perpetuate important distortions in the Chinese economy. First, households are not appropriately compensated for their savings and their financial income as a share of total income remains one of the lowest in the world. Second, the large administratively determined interest margin provides little incentive for banks to become more efficient and improve intermediation and risk pricing. Third, credit constraints put in place to limit credit growth (since interest rates do not serve that function) create an environment where banks channel funds to large and well-connected enterprises, away from SMEs and households. Fourth, the lack of market determined interest rates robs People's Bank of China of critical information on macroeconomic and liquidity conditions.

China's financial liberalization remains incomplete. The behavior of short-term market interest rates is influenced by regulated rates. So China should further liberalize its retail interest rates to allow all interest rates to better reflect liquidity conditions and the scarcity of capital. By now, most people agree that better economic outcomes are achieved when interest rates are market-determined. Market-determined rates allow investors and savers to base their decisions on market conditions and the scarcity of capital and also provide policymakers with clearer signals of market conditions, improving the conduct of macroeconomic policies. For many countries, interest rate liberalization has also been a necessary building block for further financial sector reforms and development.

In the past, China took important steps to liberalize its interest rates. Short-term interbank interest rates were liberalized first (during 1996 and 1997), financial and Treasury bond yields were liberalized soon after, followed later by the liberalization of the corporate fixed income market (PBC 2005, Arora 2008). The creation of the short-term financing bond in 2005 and medium-term financing note in 2008, with unregulated interest rates and liberal issuance criteria, were major advances in the development of the corporate financing market. In 2007, seeking to make interest rates better reflect market conditions and create a more stable benchmark yield curve at longer maturities, the Chinese authorities also launched the SHIBOR benchmark rate system. Ceilings on loan rates and floors on deposit rates were removed last, allowing banks flexibility in setting lending rates above the regulated floor. However, critically, a ceiling on deposit rates and a floor on loan rates still remain in place, with only around two-thirds of loans taking place at rates above this floor.

Currently, the interbank repo market is quite developed in China; its turnover recently peaked at 25% of GDP. While its liquidity is limited beyond short maturities (80～90% of transactions are for seven days or less), the repo market is central to intermediation in China. Lending in the repo market is dominated by the large state-controlled banks, while smaller banks and non-banks rely heavily on the repo market for funding. PBC is also active in this market, undertaking sterilization and other monetary operations that account for 6% of repo market turnover. While the interbank bond markets (for Treasury, financial enterprise, and corporate bonds) are also relatively large, secondary trading is limited, as most participants hold these bonds to maturity.

The regulation of deposit and loan rates creates multiple distortions. Consequently, much might be gained from further liberalization. The central bank would gain additional independent information on liquidity conditions from money market rates, easing macroeconomic management. At the same time, further liberalization would expand the avenues for banks to compete and boost their ability to develop new financial products. Further, if the remaining regulation of interest rates has kept interest rates too low, further liberalization should also improve the allocation of capital. Finally, since short-term interbank interest rates are central building blocks of other financial asset prices, distortions in these short-term interbank rates also have implications for other asset prices.

Moreover, liberalizing deposit and loan rates would, therefore, allow the full term structure of interest rates to provide more informative price signals, improve the allocation of capital, and strengthen macroeconomic management tools. However, while the end goal is clear, the process of liberalization needs to be managed carefully. There are several international examples in which interest rate liberalization was followed by excessive credit growth and banking system instability. However, this is not a reason to delay reform, as the delay carries with its own risks. Instead, the lesson that should be drawn from these international experiences is that as interest rates are liberalized, monetary policy needs to be proactive in containing excessive lending while supervisory frameworks should remain vigilant to guard against an increase in credit risks.

6.3.2. Issues on Capital Market

a. Restructuring Capital Market

As motioned before, the structural problems of China's capital market could be summarized: (i) the scale of the capital market is small, and there is low dependence on direct finance. Also, the stock market and bond market have yet to achieve relative balance; (ii) the percentage of shares actually circulating in the stock market is low, and market stratification is really just beginning, and diversified investment and capital raising needs are not being met; (iii) the stock exchange does not have enough listed products and the exchange system itself needs to be improved and diversified. Also, the profit structure is simplistic and shallow and competitive strength needs to be improved; (iv) the bond market is small and there are very few types of bonds. In particular, the social market remains underdeveloped. Also, the market is split between interbank, the stock exchange and banks, so with different supervisory authorities, the investor structure is also unbalanced; (v) the commodity futures and financial derivatives markets are lacking in product lineup, product development and brokers, and these need to be nurtured.

On the other hand, the securities companies, which focus on market brokerage, also face many issues. As of the end of 2010, there were 106 securities companies, but their total assets and client assets were very small, on an international scale. Moreover, brokerage business accounted for over half of the securities companies' profit structure, and consulting and asset management accounted for a low proportion of the investment banking business. Furthermore, there was a proliferation of small businesses and it was felt that these needed to be concentrated much more. Their product development was weak and corporate governance was a serious issue.

Additionally, there were many issues with investors. Among individual investors, small investors accounted for a large share, and investments worth 1 million yuan or less accounted for 99% of the total. Their investment stance was very short term oriented, with investments held for no longer than three months on average. Further, the trading turnover ratio was very high, perhaps ten times as much as that of Europe and Japan. Some individual investors' turnover rates were double those of institutional investors. The presence of institutional investors has increased in recent years, but the percentage of insurance companies and pension funds is low. This is due to the fact that China's social security system is under-developed and that the insurance companies are very small. Accordingly, institutional investors' investment terms are also relatively short, and they do not yet function adequately as long term investors.

Securities investment funds (the equivalent of investment trusts) have grown rapidly in recent years, and there are now several hundred funds, but the number is still low in comparison with Japan and the US. Many products are stock-centric high risk products, and there are very few low risk bond funds and MMF type products. Also, the majority of funds target small investors through public offerings, and there are very few funds that target institutional investors. There are not enough fund managers. As for the collective investment phase, there are many different types, other than securities investment funds, but they are each covered by different laws and regulators, and this is hindering the unified growth of the market.

Private equity funds and venture capital funds are not sufficiently developed yet, and foreign companies tend to play the biggest role here.

The undercurrent of these problems is the issue of what kind of capital market regulatory infrastructure there should be. While the scale of the market economy is growing rapidly, the long continuing structure of government control is hindering the development of autonomous regulatory market functions. In the future, there will be a need to strengthen the effectiveness of enforcement and vertical cooperation among regulatory authorities, and self-regulatory organizations will be expected to function adequately.

b. Further Strengthening and Broadening Financial Markets and Services

In summary, the following points should be carried out : (i) further deepening financial institutional reform and perfecting the financial system, (ii) establishing a multi-level financial market system and expanding the scale of direct financing, (iii) perfecting a financial macro control system and promoting the effectiveness of macro control, such as the reform of interest rate marketization ought to be promoted and the RMB exchange rate forming mechanism should be perfected, (iv) strengthening the coordination of financial supervision, establishing and perfecting a financial safety net, (v) deepening the opening-up of financial industry, and strengthening the coordination and cooperation of foreign financial policies, and (vi) strengthening the construction of financial infrastructure and enhancing financial service.

In addition, developing diversified modalities for financial intermediation would create competitive discipline on the banks, offer enterprises alternative avenues for financing, and provide households with a broader range of financing and investment possibilities. The government must move ahead with its priority to deepen fixed income markets and develop a diversified domestic institutional investor base.

6.4. Financial Safety Nets and Challenges

6.4.1. Safety Net Measures and Current Situation

China is the only country in the ASEAN+3 that has no deposit insurance system. China is under a “mono-bank” system, monopolized by the state, with no SME credit guarantee system. If the banks face default or bankruptcy, the State Council, Ministry of Finance, the central bank-People's Bank of China and CBRC will work together to solve the problem. In most of the interviews with policy makers, it was pointed out that China needs to establish and perfect a financial safety net, particularly after a global financial crisis. Building the safety net is the most urgent issue in the draft of China's 12th Five-Year Plan (2011-2015). However there is no time-table of the safety net system as of now.

The current mechanism of separated operation and divided supervision in China plays an important role in maintaining the safe operation of financial institutions, preventing and resolving financial risks. Some problems still remain, such as the failure of supervision to cover the whole industry, supervision vacuum in overlapping financial business, the lack of information sharing, and coordination among different supervisors. In addition, the traditional financial supervision system and philosophy made it difficult to meet the requirements of new situation and systemic risk management, while the supervision and regulations have flaws in pro-cyclicality. Therefore, work should be done to perfect the financial supervision system. It is necessary to strengthen financial supervision coordination and maintain its stability so as to effectively prevent systemic financial risk and safeguard financial stability.

For troubled institutions, regulatory authorities would take disposal measures including administrative intervention, assistance, institutional restructuring and market exit. It is necessary for the regulators to make a reasonable assessment of the risks faced by financial institutions and to take appropriate measures for dealing with the risk in a timely manner. Administrative intervention means that regulatory agencies require institutions to take measures to ride out the storm by relying on them. If the bank still can not ease the difficulties after exhausting all conventional means, the regulatory authorities will have to rescue them. Restructuring means the regulatory authority or central bank comes forward to arrange for participation of specialized agencies to change the shareholding structure of troubled institutions, to inject new capital for a troubled institution and to achieve the purpose of ironing out the crisis. Exiting from the market is divided into voluntary cases and mandatory cases of exit. The former case means the troubled institutions ask the supervisory authorities to assist the institution so that they do not have to exit the market. In the latter case, there is no possibility of restructuring the trouble institution.

Additionally, CBRC has a clear safety and soundness mandate. However, its operational autonomy is often undermined by the use of the commercial banking system for development purposes. CBRC has made strides in improving its framework for supervising commercial banks and emphasizing prudent goals. Nonetheless, it will be important to ensure that the agency's ability to pursue its mandate is unencumbered. This will be facilitated by ensuring more stable resource arrangements that permit greater flexibility in building up a skilled and professional staff and continued commercialization of the banks.

6.4.2. Effects of the Global Financial Crisis and Measures to Cope with Stricter Regulations

The Chinese banking industry has performed better than that of most other countries and regions during the global financial crisis and sovereign debt crisis because of clear improvements in management, risk management, and supervision that took place in the past few years. Many of the banks in China felt almost no effects from the 2008 global financial crisis and the 2010-2011 European debt crisis.

After the current global financial crisis, the financial authorities in all countries began to reflect on deficiencies and loopholes of the financial supervisory system and began large-scale reforms on supervision systems. The key development was the release of Basel III in December 2010, which is considered to be the standard setter for banking regulation and supervision.

On April 27, 2011, CBRC issued official guidelines for implementing Basel III requirements in its *Guidelines for Implementing New Regulatory Standards in the PRC Banking Industry* (the CBRC Guidelines). The CBRC Guidelines are China's equivalent of the Basel III Accord announced by the Basel Committee on Banking Supervision (BCBS) on December 16, 2010 and are sometimes referred to as "China's Basel III".

The CBRC Guidelines is comprised of five sections, covering their overall aims and principles, the need to improve the banking industry's prudent regulatory standards, the need to improve the regulation of systemically important banks, the need to do more to implement Basel II, and future policy. Particularly, the CBRC Guidelines expressly set out detailed requirements on capital adequacy ratios, a leverage ratio, liquidity requirements and provision ratios that PRC banks should comply with. They also provide for different transition periods within which the requirements must be satisfied. The CBRC Guidelines, which were to come into force on January 1, 2012, show how keen the CBRC is to incorporate Basel III in its own regulatory standards, be it, for example, by adopting new rules for systemically important Chinese financial institutions or by adopting capital adequacy rules and leverage ratios that are even more stringent than those of Basel III.

Generally speaking, the requirements and the timelines to satisfy such requirements as provided in the CBRC Guidelines are stricter than those under Basel III. A brief summary of the CBRC Guidelines is set out below.

(i) Capital adequacy ratios. First, the calculation mechanism for capital adequacy ratios is changed to be more sophisticated. Second, different capital adequacy ratios are set out by referring to different classes of regulatory capital of banks. The capital adequacy ratios in respect of core tier1 capital shall be 5%, the adequacy ratio for tier1 capital shall be 6%, and the overall capital adequacy ratio shall be 8%. In addition, a regulatory requirement for two capital buffers has also been introduced by the CBRC Guidelines: a 2.5% reserve excess capital conservation buffer and a 0-2.5% countercyclical capital buffer.

Last but not least, an additional capital requirement of 1% is imposed on systemically important banks. CBRC will define the term "systemically important banks" and set out assessment methods and a continuous assessment framework in its future regulations. Such assessment will likely take into account the size, interconnectedness, complexity and substitutability of the banks. Large commercial banks-ICBC, ABC, BOC, CCB and Bank of Communications shall definitely fall within the ambit of systemically important banks.

(ii) Leverage ratio. As a supplement to capital adequacy ratios, a leverage ratio is introduced, which requires that the tier one capital should take up at least 4% of the adjusted on-and off-balance sheet assets of the relevant bank.

(iii) Liquidity requirements. CBRC aims to establish multi-dimensional liquidity risk control standards and will set out various ratios for supervisory purposes. The CBRC Guidelines provide that the liquidity coverage ratio and the net stable finance ratio must not be lower than 100%.

(iv) Provision ratios. The loan provision ratio (being the ratio of loss reserve against the amount of loans) shall be 2.5%, or the provision coverage ratio (being the ratio of loss reserve against the amount of bad debts) shall be 150%, whichever is higher.

(v) Transition period. To facilitate the implementation of the requirements set out in the CBRC Guidelines, CBRC will update and issue a series of banking regulations in 2011 and commence the implementation of the Chinese version of Basel III from 2012. The systemically important banks are required to satisfy the new regulatory requirements by the end of 2013 while the non-systemically important banks must achieve the same by the end of 2016 (note that in respect of the provision ratios, the deadline for certain banks which encounter significant difficulties may be postponed to the end of 2018).

In most interviews with larger Chinese commercial banks and regulators pointed out different views of “China’s Basel III” and its implications. Both of them are welcome to the new global standards, but gaps remain. For larger commercial banks, the adoption of the CBRC Guidelines is likely to put pressure on banks, which have been protected by regulated interest and exchange rates as well as restrictions on the entry of foreign companies, to increase their regulatory capital and change their business model. Along with catching up with international standards based on the Basel II and Basel III agreements, larger commercial banks are expected to apply the new standards from 2012 and are expected to meet all requirements by 2016, two years ahead of the Basel III schedule.

During this transition period, large commercial banks welcome the challenge of the new regulations for them to become real global banks and enhance the competitiveness of banks' international business activities. Moreover, large commercial banks have enhanced their capital adequacy, built their risk management systems and improved their quality of management for the further development of the banking sector and medium-and-long term strategy missions in the following "Twelfth Five-Year Plan (2012-2017)". According to CBRC, "6+1" commercial banks include the five large commercial banks (ICBC, ABC, BOC, CCB, BOCO) and China Merchants Bank plus China Minshen Banking Corporation (Minshen), which applied the new standards in 2011. They are now preparing to comply with the new capital adequacy requirements by the end of 2013. In addition, China Merchants Bank and Minshen were the joint-stock commercial banks for applying new regulatory standards. They will meet all requirements by the end of 2016.

On the other hand, some regulators were interviewed pointed out that the key issue for China, and perhaps for many other emerging markets as well, is how to keep focused on the domestic policy agenda while adopting the new global standards. The differences and divergences between countries in the G20 countries are significant and perhaps inevitable. Various reform initiatives and global standards (Basel III) developed so far, in an attempt to reduce the probability and severity of future financial crises, to a large extent, are focused on the developed markets. Many details of these standards are calibrated to these markets as well. The issue for China then, and other emerging markets, is how to uphold their domestic policy agenda while adopting the new global standards and still aim to better serve their own markets.

Fortunately, China's financial system has proved resilient to the recent crisis. As a result, banks in China find it quite comfortable to meet the new capital standard and liquidity standards under Basel III. It is important to note that Basel III is only part of an effective regulatory framework. While phasing in Basel III, China also needs other prudential tools such as a new provision ratio, in addition to the provision coverage ratio. In addition, activity restriction will be another effective tool that has the potential to prevent banks from getting too complex for bankers to manage and for the regulators to supervise.

Moreover, some regulators emphasized the need to improve the effectiveness of the regulatory system at both global and national levels. The most important thing is to keep the right balance between enhanced regulation and promoting financial innovation. Furthermore, it is important to note at the outset that while striving towards a convergence in regulatory standards for the sake of a level playing field across different markets among others, regulators should recognize that the starting conditions and future challenges of developed markets and Asian countries differ significantly. Perhaps, it is similar for other Asian countries that for China's financial sector and the banking sector in particular, the priorities are to continue the banking system, addressing various immediate regulatory concerns, instead of re-capitalizing banks or reducing leverage, and to develop deeper capital markets in support of economic growth.

6.4.3. Challenges and Risks

a. Rethinking Portfolio of Banking Activities

After the global financial crisis, financial institutions will need to rethink their portfolio of activities. China's financial institutions' business models could evolve in at least four key ways as the patterns of challenge and risks.

First, the relative attractiveness of financial institutions' different business lines will change. For example interest rate liberalization or higher real interest rates may improve the economics of commercial and retail banking. In the new era, credit volumes will likely grow more slowly as interest rate liberalization or higher rates dampen loan demand and as a result of BIS III regulations, but net interest margins may go up because the cost of retail funding typically rises less than lending rates. At the same time, the yield curve is likely to become steeper than it was in the decade before the crisis, as future investment demand pushes up long-term real interest rates. This will make maturity transformation activities more attractive in the medium term. Therefore, after many years in which commercial and retail banking were overshadowed by other bank business lines, this core activity may become more attractive in the years ahead. However, rising rates may also increase default risk, unless banks tighten their lending standards and improve their risk management system.

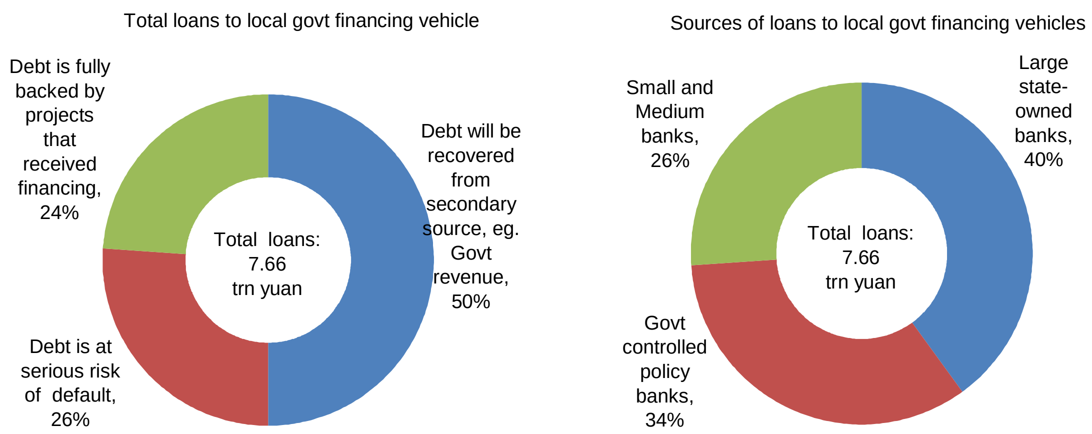
Second, the financial institutions will need to rebuild operations where most of the growth in the world's saving and investment is going to occur; in the emerging markets. China's large commercial banks and other financial institutions should place greater emphasis on expanding their deposit-gathering and investment activities in developing economies. The largest emerging market countries, with their rapidly growing urban populations, will become increasingly important locations for deposit-gathering and asset management. Cities such as Mumbai, Sao Paulo, Seoul, or Shanghai may emerge as major new hubs for raising capital and other financial activities. Financial institutions will need to build branch networks or find other methods of accessing savers and investors to tap this wealth. Because emerging market households have lower incomes than those in mature markets, China's financial institutions will need new technologies, products, and business models to serve them profitably. But competition will be stiff: the leading global financial institutions of today -most of which were historically based in mature economies and reliant on physical branch networks for gathering savings will be challenged by China's financial institutions with new business models, as well as large commercial banks (Big 4) that already have access to local sources of saving and which have global ambitions.

Third, banks and other financial institutions will have a big opportunity to develop more instruments for long - term financing and new vehicles for cross - border investing. Investment in infrastructure and real estate is on track to rise both in absolute terms and as a share of global capital investment. These investments are also good hedges against inflation, and thus may be more attractive in the era ahead.

b. Challenges and Risks

The gradual rise in China's local debt has aroused concerns as to the soundness of the banking sector in China (Figure 6.27.). In 2011, the government was working on a relief plan for local governments, including allowing them to tap the municipal bond market for the first time as an alternative to bank loans, which are becoming harder to get. The risks of default are rising. Nearly 85% of the local government finance vehicle loans in northeast Liaoning province, for instance, missed debt service payments in 2010. However, China's regulators were interviewed pointed out the risk appears to be pretty low for now, given the strength of bank balance sheets. The banking system has a bad loan coverage ratio at the end of 2010 of 218% to cover any losses, up from 80% at the end of 2008 and 155% at the end of 2009. Also, the banking sector's NPL ratio has maintained a low level and the banking sector's basic liquidity indicators appear sound.

Figure 6.27. China's Local Government Debt



Sources: Thomson Reuters, China Securities Journal

Although the Chinese financial system is still facing many challenges, China's banking sector is now growing fast as it catches up with international standards. Therefore, the challenge remains with respect to how to keep the right balance between enhanced regulation and promoting financial innovation without the pendulum swinging too far.

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7. Japan

7.1. Characteristics of the Banking Sector

7.1.1. Domestic Economic Situation and Industrial Structure

Japan is a country with a small land area and few natural resources, yet it has managed to become one of the world's biggest economies. Japan's economy continued to grow after the Second World War and the span of about 20 years between 1955 and 1973 in particular is known as the "period of high economic growth". The average annual economic growth rate during that period was 10%, and in 1973 Japan's gross domestic product became the second largest in the world, after the USA. After entering a period of stable growth, expanding domestic demand and accelerated investment in stocks and real estate in the latter half of the 1980s caused an economic bubble. However, the bubble burst in the early 1990s, and Japan slipped into a protracted economic slump, known as "the lost decade". During that period, some city banks and major securities companies holding non-performing debts were forced into bankruptcy, and the Japanese financial system was seriously shaken. From the early 2000s, against the backdrop of global economic expansion, Japan's economy managed to stage a slight recovery, led by growth in foreign demand, but the economic growth rate was around 2%, and was never able to return to pre-bubble levels. Subsequently, with the Lehman Brothers' collapse in 2008, Japan's economic growth crashed to minus 3.7%, its lowest level since the end of the war.

As for Japan's industrial structure, primary industries (farming, forestry, and fishing) accounted for over 20% of the added value in the 1950s, but in recent years their share has dwindled to the 1% range. In their place, as a result of the fact that smokestack industries, such as steel and chemicals, etc., powered growth in the period of high economic growth, the share of the secondary industries (manufacturing, etc.) increased, reaching the upper 40% range in 1970. After the oil crisis of 1973, there was a greater need to conserve resources and energy, and Japan's economic structure became firmly export driven, powered by assembly manufacturing industries such as transportation equipment and electrical machinery. Since the latter half of the 1970s, as Japan's economy has matured, service and other tertiary industries have accounted for a continuously growing portion of the added value, reaching around 70% in recent years. These changes in the industrial structure are also reflected in the employment structure, which has shifted gradually from a farming, forestry and fishing centric structure, via a period of expanding manufacturing, to the present stage where the service industries are expanding. In terms of companies, while Japan is home to many of the world's leading global companies, the majority of companies are small and medium sized enterprises, which account for 99.7% of a total of around 4.2 million companies. In terms of numbers of employees and added value (manufacturing sector), the small and medium sized enterprises' share is over 70% and over 50%, respectively.

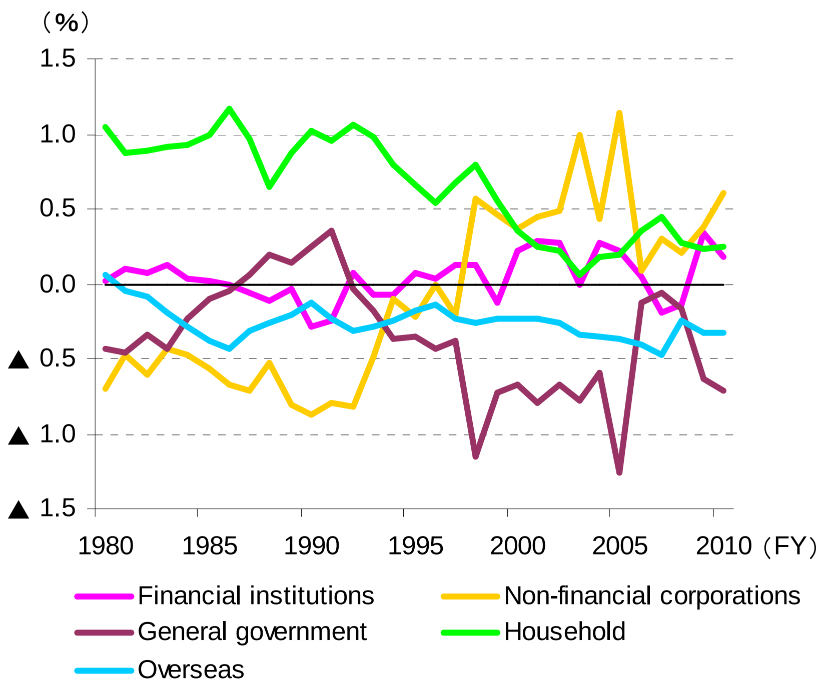
It has been known for some time that Japan's falling birthrate and aging population are a bottleneck to economic growth. As of January, 2011, Japan's population is 127.73 million (Provisional estimates), and has been falling since 2006. The population component by age range is 13.1% for 0 to 14 years, 63.8% for 15 to 64, and 23.1% for 65 and over, and Japan has become one of the world's grayest societies. Japan is already a "super aged society", with over 21% of the population aged 65 and over. According to government estimates, the total population will be below 90 million by 2055, of which some 40% will be aged 65 and over. Also, as the population tends to concentrate in the capital, Tokyo, and other large cities, it is understood that the decrease in population in rural areas and the economic gap between the cities and rural areas are serious problems.

7.1.2. Financial System Overview

a. Capital Flow by Economic Sector

Reflecting the changes in the economic environment and Japan's industrial structure, the capital flow generated by financial transactions has also changed. In terms of the net capital (balance of procured capital and operating capital) of each economic sector, the corporate sector was chronically short of capital up until the early 1990s but, after the bubble burst, it switched to a capital surplus due to an overhaul of its financial situation, restricting plant and equipment investment and repaying debt, etc. (Figure7.1.). The household sector had the largest capital surplus of any sector, but from 2000 onward the advanced pace of aging of the population and the decline in the labor share led to a drop in the savings rate and the capital surplus contracted. The general government sector enjoyed a capital surplus thanks to increased tax revenue in the bubble era but, after the bubble burst, repeated economic stimulus measures and economic recession caused tax revenue to contract, and the rapid aging of the population and increased expenditure on social security have led to a chronic capital shortage. The overseas sector is constantly short of capital as Japan's balance of current account is firmly in the black.

Figure 7.1. Capital Balance by Sector



Source: Bank of Japan and Japan Cabinet Office

Note: ratio to nominal GDP

b. The Changing Financial System

After the war, Japan adopted the so-called "convoy system" of financial supervision, and kept the financial system stable by controlling competition. There was frequent use of administrative guidance with unclear legal grounding. There was much more administrative guidance applied to financial institutions than to other industry sectors, and regulations controlling business sectors, the opening of new branch offices and the development of new products, prevented excessive competition in the financial world. Also, banks that were on the verge of failing were not allowed to collapse but were forcibly merged with other banks, at the instruction of the supervisory authorities, so that there were no bank failures in Japan after the war. Meanwhile, the convoy system kept all of Japan's banks at a similar level of financial health, and innovation in financial services became a very rare occurrence.

Financial deregulation that was introduced from the mid 1980s led to a sharp rise in asset value and the banks' real estate financing increased noticeably. However, the collapse of the bubble in the early 1990s caused many loans to go bad. Subsequently, over a protracted period of time, the non-performing debt issue became one of the banks' most serious problems, and was a serious hindrance to Japan's economy.

Between 1996 and 2001, in order to vitalize Japan's post-bubble economy and to develop Tokyo as an international financial market on a par with New York and London, a series of large scale reforms of the financial system were implemented. This became known as "Japan's financial big bang". The three principles of *free*, *fair* and *global* were the main foundations of the reform. Stock brokerage commission fees were completely deregulated, the ban on investment trust transactions in banks, etc., was lifted, and financial holding companies were allowed.

The disposal of non-performing loans had a serious impact on the financial health of financial institutions, and in the late 1990s some large city banks and large securities companies went bankrupt. During that period, the damage to the banks' capital equity meant that they were forced to cut back on lending, leading to criticism of their reluctance to lend and their withdrawal of outstanding credit. In addition, when Japanese banks sought credit overseas, fears over the instability of the Japanese financial system meant that they were asked to pay extra interest, known as the *Japan premium*.

Under these circumstances, a range of measures were devised in order to resolve the problem of non-performing loans. These measures included the large scale injection of public funds into the major banks, the purchase of non-performing loans, the purchase of bank shares, etc. With the introduction of the Financial Revitalization Program in October, 2002, the disposal of non-performing loans began to advance at a faster pace. Tougher stress tests forced the banks to restructure and increase their equity, and the disposal of non-performing loans advanced so that the major banks' non-performing loan ratio fell to 2.9% by March, 2005, and the non-performing loan issue was settled for the time being.

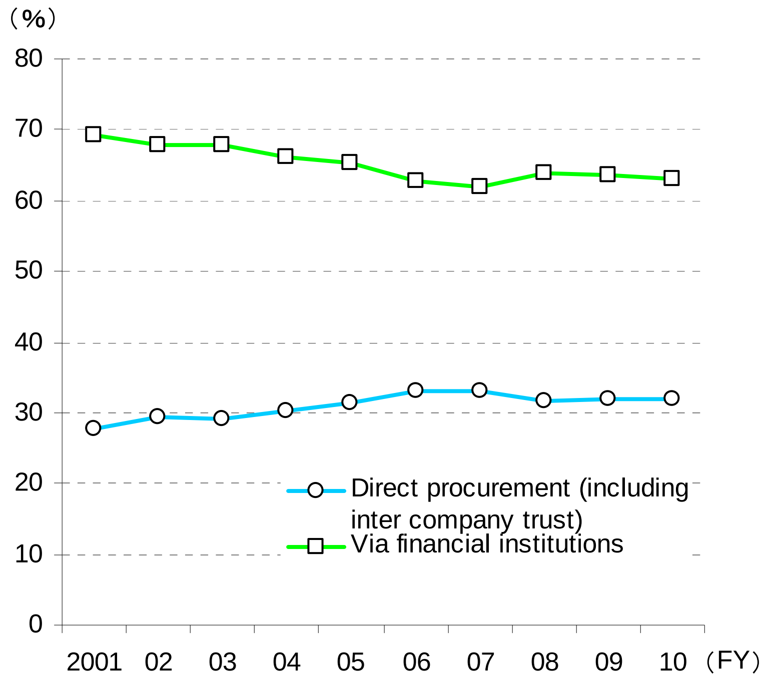
With the tidying up of the non-performing loan problem, in 2005 the Financial Services Agency announced its Financial Reform Program with a shift in financial policy emphasis from the *stabilization* of the financial system to the *vitalization* of the financial system. Specifically, the focus of financial administrative policy shifted to improving the ease of use of the financial capital markets, and ensuring the thoroughness of rules to protect users. Further, in December, 2007, the Finance and Capital Markets Improvement Plan was revealed. The aim of the plan was to strengthen the functionality of Japan's financial and capital markets and improve their international competitiveness, and also to provide suitable investment opportunities for around 1,500 trillion yen worth of household sector financial assets. Specifically, a wide range of issues were tackled, including the diversification of ETF and other products offered on the stock exchange, the creation of professional markets, the nurturing of highly specialized staff and the enhancing of metropolitan functions as an international finance center.

c. Direct Finance and Indirect Finance

In Japan, bank-centric indirect finance accounts for the majority of financial intermediation. As of the end of March, 2010, the indirect finance ratio of stock based domestic non-financial sector capital procurement was around 63%, with 32% for direct finance (with the remainder coming via foreign markets), showing indirect finance providing a very high proportion of capital procurement (Figure7.2.). The historical background here is that the government exercised control by regulating the banks, in order to ensure sufficient capital allocation to the industries most needed for Japan's post-war economic development.

In the 1990s, when the bubble economy collapsed, the value of real estate collateral crashed and the banks were left with huge non-performing loans. The banks' capital equity was damaged and they found themselves forced to restrict loans, resulting in a credit crunch. This exposed the fragility of a financial system in which credit risk was concentrated in the banks. Subsequently, Japan embarked upon the development of a multi-track financial system that would contribute to the development of both the banking and capital market sectors. In the Japanese financial big bang, which was worked out in 1996, with the slogan "from savings to investments", large scale reform of the financial system was implemented with the purpose of strengthening the financial intermediary functionality of the direct finance sector. In Japan, it was felt that, although based on a traditional indirect finance system, an eclectic, market type of indirect financial system which would incorporate many of the features of direct finance was desirable. In addition to deposits, loans and other indirect financial products, the banks' range was widened to include other financial products, such as investment trust pensions and insurance, etc. Also, the securitization system was improved, where loan claims can be converted into corporate bonds and sold off to investors. These system improvements led to the gradual increase in the share of market type indirect finance, but judging from the portfolio selection in individual financial assets, the share of direct finance did not necessarily grow by much. Further, the global financial crisis of 2008 exposed the fragility of the financial systems in Europe and the US, particularly with regard to the finance and capital markets, and it became clear that it would be a mistake simply to mimic the financial systems of Europe and the US. Today, while continuing to work to expand the financial market sector, Japan's problem is how to construct a strong financial system that properly balances the banking and financial market sectors.

Figure 7.2. Capital Procurement in Domestic Non-financial Sector



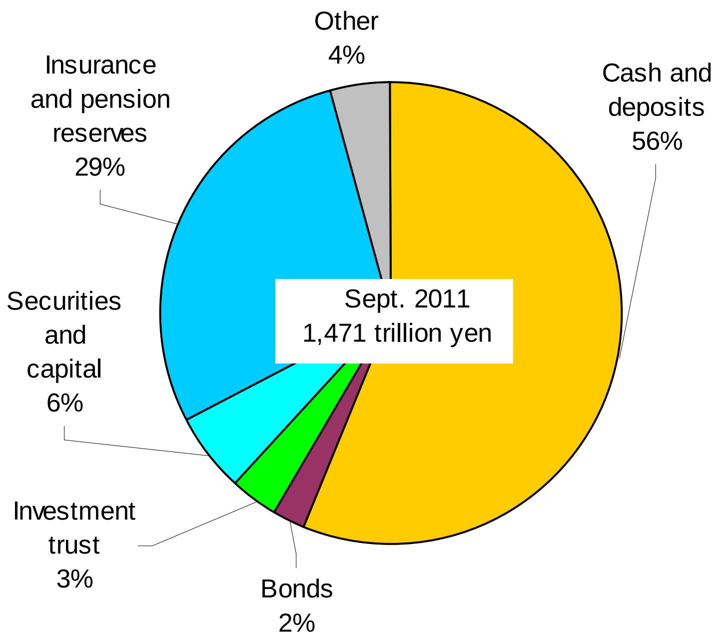
Source: Bank of Japan

d. Financial Assets Balance

In Japan, the household sector is the biggest financial assets holder. Until the 1990s, economic growth brought with it increased incomes and savings ratio was high. Against this backdrop, the household sector's financial assets balance continued to grow. Nevertheless, the 2000s brought new changes in the economic environment, and the pace of growth of individual financial assets slackened. Specifically, 1) the fact that continued low interest rates for an extended period of time and companies' efforts to control personnel costs made it difficult for household sector incomes to grow, and 2) the aging of the population, meant that the household sector savings rate fell from over 10% in the 1990s to the 2% range. Also, the Lehman Brothers' collapse of 2008 caused asset prices to fall through the floor, and this had the effect of reducing individual financial assets by a very considerable margin. Individual financial assets were 1,593 trillion yen at their peak and fell to around 1,471 trillion yen in late September, 2011.

One characteristic of the individual financial assets portfolio in Japan is the high proportion of cash and savings (Figure7.3.). In spite of policy guidance in the late 1990s aimed at encouraging the supply of risk money from individual financial assets, under the slogan "from savings to investments", there has been no sign of any great change in the component ratio of individual financial assets. Even today, cash and deposits account for over 50% of the share, while stock, bonds and other negotiable securities account for only around 10%. The reasons for this include the fact that asset management in Japan is very safety oriented, and that the global financial crisis has renewed awareness of the risk to principal in investment products, and of foreign exchange risk.

Figure 7.3. Personal Financial Assets Component Ratio



Source: Bank of Japan

e. Types of Financial Institutions

Japan's post-war financial system has been characterized by systems of specialization and division of work, and the areas of work of the financial institutions have been minutely sub-divided. In addition to ordinary banks, many specialist financial institutions were established, such as long term credit banks, trust banks, etc., and areas of work divided, with long term and short term finance, banks and securities, and banks and trusts, etc., all being handled separately. The aim of this was to secure the efficient supply of capital to specialized sectors and avoid excessive competition, thus providing the financial institutions with a stable business environment. The system of specialization and division of work functioned well in the post-war years, up until the period of high economic growth. However, as deregulation and internationalization progressed, this system no longer matched actual needs, and regulations were gradually relaxed. In 1993, mutual participation in other business areas was permitted through the establishment of cross-sector subsidiaries among ordinary banks, trust banks and securities companies. Similarly, in 1998, banks, securities companies and insurance companies were permitted to create financial holding companies. Further, in 2002, ordinary banks were permitted to engage in direct trust business, and in 2004 the banks were permitted to engage in stockbroking. Through these kinds of deregulation, the division of work system was all but eradicated.

Currently, Japan's financial institutions come in three types: Central Bank, private sector financial institutions, and public sector financial institutions. The private sector financial institutions that handle deposits are further divided into ordinary banks (city banks, regional banks, foreign banks, etc.), long term financial institutions (trust banks, etc.), cooperative financial institutions (credit associations, credit unions), etc. Financial institutions that do not handle deposits include insurance companies, securities companies, consumer credit companies, etc. The main types of deposit taking financial institutions are as described below.

City banks

City banks are those that conduct their business operations throughout the country. While there were over 15 such banks in the 1980s, from the mid 1990s onward there were many rapid mergers. The city banks have used holding companies to create groups with securities companies, insurance companies, asset management companies and consumer finance companies, etc., and form financial conglomerates. There are currently three major financial groups (Sumitomo Mitsui, Mitsubishi UFJ, and Mizuho: These are called mega banks).

Regional banks

Regional banks are those that have their business base in a particular region. They are divided into comparatively large regional banks and those belonging to the Second Association of Regional Banks. As of October, 2011, there were 64 regional banks and 42 Second Association regional banks. In comparison with city banks, regional banks have a smaller scale of capital per bank, and their main businesses are the traditional banking services of mainly deposits and loans, etc.

Banks operating in large city areas with a certain level of economic scale and population and a concentration of commercial establishments, are able to maintain a certain level of revenue from business activities focusing mainly on the conventional deposit, loan and settlement services. However, regional banks operating in areas with exhausted or stagnating economies are finding fewer and fewer revenue opportunities. These banks need to work to improve their own performance, in order to develop the local economies.

Trust banks

The trust banks have their strengths in asset management for the wealthy, and real estate related business. Deregulation in recent years has meant that some ordinary banks are getting into the trust business, and competition is heating up. Also, in an effort to win new customer bases by expanding their areas of business, etc., some trust banks are merging or cooperating with ordinary banks. As Japan's population begins to age at a faster pace, it is expected that there will be an increase in the demand for trust business services. As of April, 2011, there are 18 trust banks in Japan.

Foreign banks

Foreign banks can open branches in Japan, and are recognized as banks by the Banking Law. As of April, 2011, there are 57 foreign banks which establish branches in Japan.

Other banks

Against the backdrop of relaxation of the restrictions on participation in banking business activities, coupled with the advanced development of telecommunications, Japan's first internet bank was opened in October, 2000. Since then, there have been banks opened by manufacturers and distributors. These banks are characterized by the fact that, via the internet and ATMs, etc., they provide their services through different channels from the conventional "brick and mortar" branch offices. Having no physical premises means that they are able to cut down on personnel and rent costs, allowing them to differentiate themselves from the ordinary banks by offering relatively high deposit rates and low transfer fees.

Japan Post Bank

In Japan, postal services have historically been directly managed by the government since pre-war days, with the so-called "three branches of postal services" comprising postal mailing service, postal savings and postal life insurance. Capital accumulated by the Post Office through its banking and insurance businesses would then be deposited with the government, and then loaned to government institutions (government financial institutions, companies involved in the construction of motorways, companies making housing loans for the general public, etc.). This setup was known as "fiscal investment and loan", and in the realization of Japan's sustainable post-war economic growth, played an important role in developing industrial bases and improving the quality of life of the general public.

However, the postal savings business was backed up by the government's credit strength and was able to accumulate savings deposits on a greater scale even than the city banks, and the system was criticized by private sector financial institutions in that it was taking away business from the private sector. In response, the government decided to privatize the three branches of postal services with the aim of achieving administrative and fiscal reform. Privatization began from October, 2007, and postal savings are now handled by Japan Post Bank. Japan Post Bank provides small account savings for individual customers through its dense network of post offices throughout the country. The maximum deposit amount per person is limited to 10 million yen. Capital is managed principally through investment in government bonds and government financial institutions bonds, etc. Japan Post Bank does not make loans to companies. The original decision was to sell the shares on the market and completely privatize the bank, but due to the effects of changing governments, etc., the future is somewhat unclear in that respect.

Cooperative financial institutions

Cooperative financial institutions are non-profit corporations whose basic principle is mutual aid among their members. They accept deposits from and make loans to small and medium sized enterprises and individuals. There are certain restrictions on who they may do business with, and where, and they are smaller in scale than banks. Types include small and medium sized enterprises financial institutions (credit unions, credit associations, etc.) that mainly make loans to small and medium sized enterprises, and agriculture, forestry and fisheries financial institutions (Norinchukin Bank, etc.) that mainly make loans to the agriculture, forestry and fisheries industry.

Government affiliated financial institutions

Government affiliated financial institutions' main business was to provide financing for sectors that are difficult for private sector financial institutions to handle, and by providing financial assistance for small and medium sized enterprises and individuals, and construction finance for energy development and large production plants, etc., they contributed to the development of the Japanese economy and the stability of the standard of living of the people. However, with government treasury funds as their source of capital, they were able to continue providing long term, low interest and fixed financing, and it was indicated that the government affiliated financial institutions were putting pressure on private sector financial institutions in areas where they competed. In the 2000s, from the perspective of achieving simple and effective government, it was decided that the government affiliated financial institutions should be merged, abolished or privatized and, in 2008, the shift towards the new system began with several institutions being merged into the Japan Finance Corporation.

7.1.3. Structure of the Banking Sector

a. Characteristics of the Banking Business

Business model

The main business of Japan's banks is the conventional business of commercial banks, such as lending, receiving deposits, etc. Therefore, the traditional strengths of

Japanese banks have been their strong relationships with their customers and a stable deposit base.

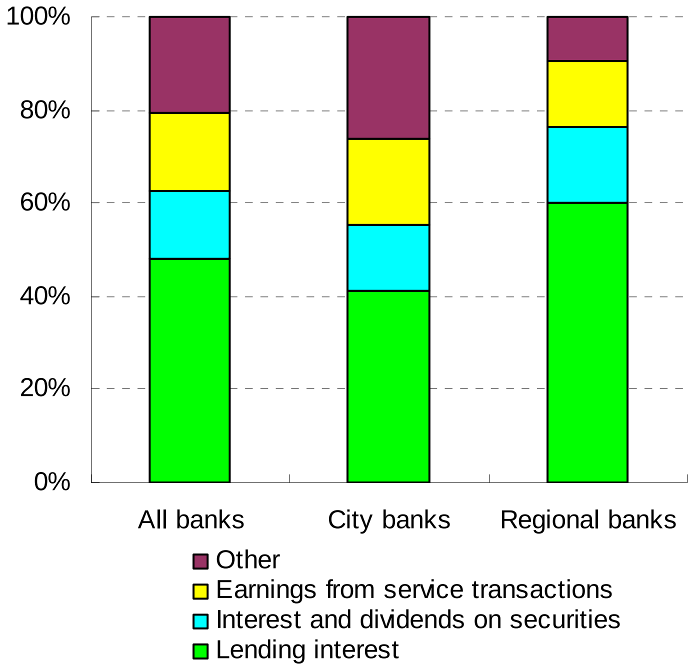
Against the backdrop of the deregulation that began in the 2000s, some of Japan's mega-banks have begun to mimic European and US banks by reinforcing their investment bank businesses with asset fluidity and financial advisory services, etc., although they have been relatively late in this initiative. Therefore, while the global financial crisis caused severe damage and bankruptcies among the investment banks of Europe and the US, Japanese banks held very few sub-prime related products, so direct damage from the financial crisis was slight. In the wake of the financial crisis, amidst the recovery of the business models of the global commercial banks and the tightening of regulations governing highly leveraged finance business, the Japanese banks' business model is once again the subject of attention.

Earnings structure

In the business model of Japan's banks, most effort goes into corporate oriented financing activities. Their core earnings come from the interest earned on loans, and this accounts for around half of their current income (Figure7.4.). However, compared with American banks, the profit margin on loan interest is narrow, and if the banks are to improve their earning power, this margin needs to be increased. As to the main reasons profit margins are so narrow, 1) as borrowing demand falls, competition in the loan business is becoming fiercer, 2) financial products and services are very easy to copy, leaving interest as the only way in which banks can differentiate themselves, 3) the highly profitable consumer loans account for only a very small portion of total loans, and 4) with corporate loans, the borrowing company's risk premium is not appropriately reflected in the loan interest rate.

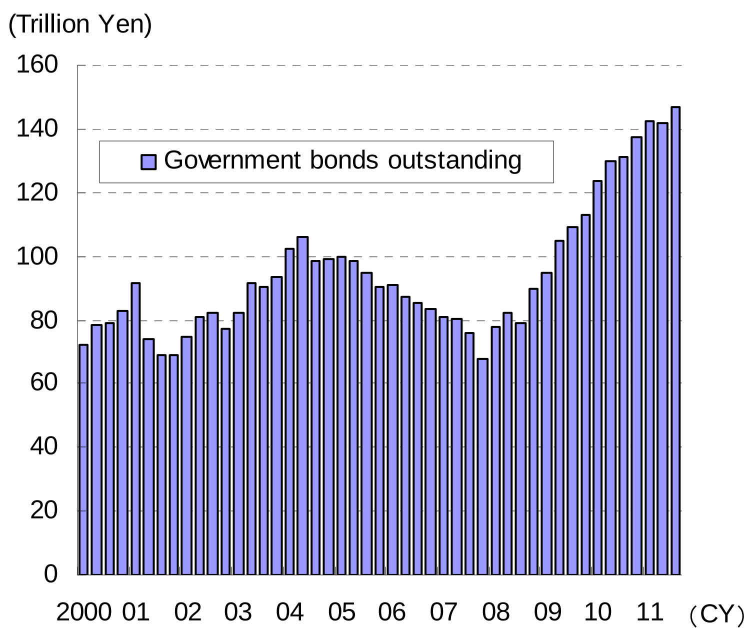
While individual and corporate deposits are increasing steadily, corporate oriented loans are failing to grow, so the banks are working to increase bond investment, particularly in government bonds (Figure7.5.). In recent years, investment in Japanese government bonds accounts for about 20% of the banks' total assets. While the credit risk associated with investment in Japanese bonds is low, the recent European debt crisis has caused some to be concerned about the interest risk on Japanese government bonds. Moreover, the return on government bond management is low, and this is one factor that lowers the earning power of securities investment overall.

Figure 7.4. Current Income Breakdown



Source: Japanese Bankers Association

Figure 7.5. Government Bonds Outstanding Held by Domestic Banks



Source: Bank of Japan

Compared to major European and US banks, the proportion of Japanese banks' total earnings coming from non-interest revenue is very small. Recently, although there has been an increase in the proportion of earnings from handling charges, due to the sales of investment trust and other personal finance products, and the reinforcement of corporate oriented fee business, revenue from handling charges pertaining to deposits is very low. The reasons for this include the fact that Japanese banks traditionally have not charged for account maintenance, and that customers doing a certain volume of business are usually granted a waiver from such charges.

The banks are trying to improve profitability by improving efficiency. From late 1990s, there was a lot of merging and integration of city banks and others, and attempts were made to improve efficiency in order to enjoy the benefits of economy of scale. In particular, the relaxation of regulations allowed the banks to increase their spheres of business, and the development of systems to accommodate this had become a significant burden, so merger and integration were important in terms of reducing costs. Further, the closing of duplicate branch networks contributed to cost reduction. The number of branches nationwide today is about 20% fewer than it was at its peak in the 1990s. This has also been influenced by the diversification of financial service delivery channels, such as the increased use of the internet and mobile phones, and business tie-ups with external ATM networks. Many of the simpler transactions of personal finance services, such as withdrawing or depositing cash, making transfer payments, etc., are done through these low operating cost channels, with the branches now seen as being able to focus more on the face to face type of business, such as negotiating housing loans, selling investment trust funds, etc.

Also, Japanese banks' personnel overheads are higher than those in other industries, and in the processing of non-performing loans, many of these overheads were cut. Recently, much back office work is being outsourced, and more part time and temporary staff are being employed in an effort to cut personnel overheads. As a result, the number of bank employees nationwide has been reduced to about two thirds of what it was at its peak.

The capital that Japanese banks use to make loans basically comes from deposits. There is no over-dependence on the procurement of capital from the market. The ratio of deposits to loan capital (LDR) is about 70%, which is relatively lower than for European and US banks. Further, even more than the city banks, the regional banks' proportion of capital procurement covered by deposits is higher. Since the Lehman Brothers' collapse, both corporate and household deposits have been growing steadily. In order to ensure the availability of capital for use by businesses, corporations are trying to increase deposits. In addition, stronger risk aversion on the part of private individuals has meant an increase in deposits.

Foreign currency denominated operating capital is mainly funded through market procurement, such as yen conversion through repo agreements and foreign exchange swaps, etc. This foreign currency procurement structure is vulnerable to changes in overseas market environments. The banks set limits for each currency and location, and stress tests are applied for each location, so there is very detailed management of capital liquidity.

In Japan, the compartmentalization of financial institutions according to their business type is comparatively tightly maintained. While the city banks have an overwhelming advantage in the big cities in terms of the number of branches, in the regions the regional banks have very strong customer bases. Examination of the banks' loan totals share by type shows that, while the city banks do have a greater share than the regional banks, it is not a majority share. Besides these, Shinkin banks and other cooperative financial institutions manage to retain a certain share of the loan total. Also, in terms of the numbers of banks, while there was much streamlining and consolidation, mainly among the large banks, in recent years, the streamlining of regional financial institutions has not advanced much and there is a possibility that the problem of overbanking has not been resolved. It has been pointed out that falling profitability as a result of tougher competition in the Japanese banking industry could lead to overbanking.

b. Management and Regulation of the Banks

Banking regulations are many and various, including those related to financial soundness (capital equity reserve requirements, large account credit provision regulations, etc.), those related to business spheres (prohibition from participation, subsidiary business sphere regulations, etc.), those with a competition policy perspective (anti-monopoly law 5% rule[132]), and those related to transactions (Financial Instruments and Exchange Act, Act on Prevention on Transfer of Criminal Proceeds, etc.).

The supervision of the banks is the job of the Financial Services Agency. The Agency was born when the Financial Inspection and Supervision Department was made separate from the old Ministry of Finance. At that time, the Agency shifted away from the conventional administrative style of prior restraint with heavy use of administrative guidance, to a post-facto check style that places greater emphasis on market rules. Also, with regard to financial inspection, a Financial Inspection Manual was introduced in 1999, in an effort to improve transparency by having a set of clear rules as a premise.

[132] Act on Prohibition of Private Monopolization and Maintenance of Fair Trade, Article 11.

7.2. Roles of the Banking Sector

7.2.1. Recent Business Environment Changes and Trends

In the early 2000s, once the issue of the financial institutions' non-performing loans had been normalized, attention then shifted to the improvement of the financial institutions' profitability. However, as the borrowing demand from the corporate and household sector stagnated and domestic markets contracted, the financial institutions have found themselves having to formulate business strategies to cope with the new conditions.

The mega banks, at the same time as reinforcing their business foundations through the forming of financial conglomerates, have also tried to improve their retail banking and investment banking businesses. In particular, over the last few years, they have been concentrating on overseas credit, in search of new sources of profit, and have been developing their international strategies through lending to financial institutions in Europe, the US and Asia. While the regional banks offer very closely regional financial services and try to expand financing needs within their home base areas, some are also trying to expand their business areas by increasing their lending in other regions, and by cross regional merger and integration, etc.

7.2.2. Corporate Finance

a. Relationships Between Banks and Companies

Main bank system

One characteristic of Japan's banking system is the main bank system. Each company decides upon one bank that will be the bank that they use for most transactions. It is the custom to maintain this business relationship based on a long term relationship of trust. It is not simply a question of the main bank providing financial services to the customer. In addition to developing a close relationship with the company, occasionally involving capital participation and the seconding of staff, and providing business monitoring, there is also the implicit expectation that, should the customer company run into difficulties, the main bank will have a duty to assist. Also, close knit group relationships are formed among companies sharing the same main bank, and the bank becomes the core of that corporate group. The main bank system has contributed to the securing of businesses' stable capital procurement.

One reason that the main bank system has functioned for so long in Japan is that relationship banking is firmly rooted in the Japanese financial system. It has long been Japanese custom that it is very important to have a relationship of trust with customers and the local community, so the stage was already set for relationship banking to function smoothly within the financial world also.

Meanwhile, 1) with the liberalization of the stock market from the 1990s onward, it became easier for large companies in particular to procure capital from direct finance, and 2) after the collapse of the bubble economy, steps were taken to eradicate companies' mutual cross holding of each other's shares, and these and other developments have led to a weakening of the main bank system's role.

Cross holding of shares

In Japan it has long been part of the main bank system that customer companies strategically purchase shares in each other's companies. After the war, when the *zaibatsu* conglomerates were broken up, companies of the same former *zaibatsu* began to buy up the shares released by the *zaibatsu* families, beginning the cross holding system. In the years that followed, the system became common among non *zaibatsu* companies also. The cross stock holding system had its merits. By establishing a stable stockholder structure, the system facilitated mutual transactions and cooperation, and prevented hostile takeovers by third parties. The Anti-monopoly Law prohibited the banks from owning more than 5% of shares, but cross stock holding among multiple companies in a corporate group would enable the formation of stable stockholders. Nevertheless, stock market stagnation in the wake of the bubble's collapse and the application of market value accounting meant that a sharp fall in share prices could represent a serious business risk to the banks, and those holding cross stock holdings began to sell them off. Then, after the Lehman Brothers' collapse, many Japanese banks found that, while their losses from securitized products were slight, they suffered serious losses from their stock holdings, and the reduction of stock risk became an extremely important business imperative. However, on the corporate side, there was still a strong expectation that their bankers would remain stable stockholders, for the purposes of takeover prevention, etc., and the pace of reduction of stock holdings was never more than very gradual.

b. Corporate Capital Procurement

In terms of Japan's corporate capital procurement structure, in comparison with the major economies of Europe and the US, Japanese companies depend much more highly on external sources for raising capital. A high proportion of corporate capital is borrowed from the banks. After the collapse of the bubble economy there was a protracted economic slump and the total amount of capital raised began to contract. At the same time, the proportion of capital raised internally began to increase. Also, businesses' reduction of interest bearing liabilities led to a drop in the proportion of capital procurement accounted for by borrowing, and stock market stagnation led to a drop in equity finance also. On the other hand, as the bond market developed, the proportion of capital raised through the issue of corporate bonds began to rise.

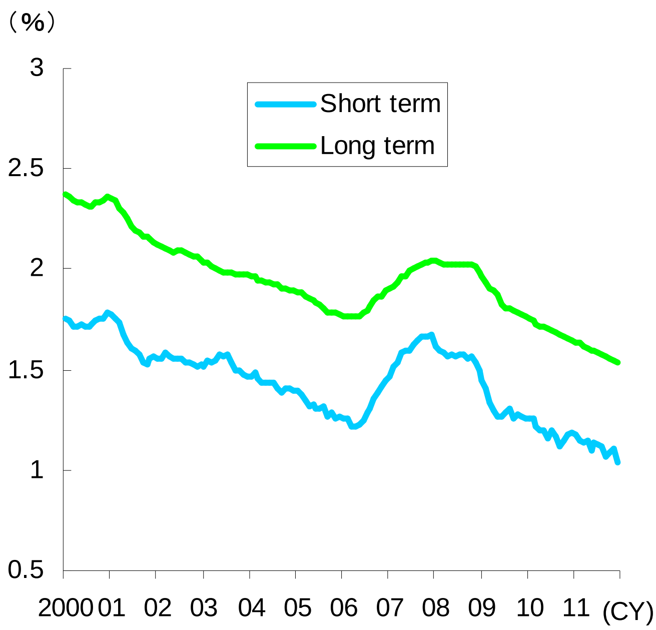
c. Loan Component and Interest Rates

Examination of the loan component according to scale reveals that, in the 1980s, loans to large corporations accounted for roughly 30% of the total, but with the increase in the use of direct financing and internal financing, the borrowing needs of large corporations began to contract and fell drastically by the early ‘90s. In contrast, the banks worked aggressively to increase their loans to small and medium sized enterprises, and that proportion of the loan total increased by a significant margin. However, borrowing demand in recent years has flagged and, reflecting the banks’ loan hesitancy, the proportion of loans to small and medium sized enterprises has decreased. In contrast, the proportion accounted for by housing loans and other personal loans has increased greatly.

The banks’ corporate loans by industry type reflect the changes in Japan’s industrial structure, with the weight shifting from manufacturing and wholesale and retail to tertiary industries.

Lending rate levels fell significantly from the 1990s, influenced by Bank of Japan’s policy of extremely low interest rates. After the Bank of Japan raised its policy interest rate to around 0.25% in July 2006, interest rates rose temporarily, but they have come down again due to the global financial crisis (Figure7.6.).

Figure 7.6. Interest Rates on Loans of the Domestic Banks



Source: Bank of Japan

Note: Stock base

d. Loan Risk Management System

Up until the collapse of the bubble economy, the value of real estate presented as loan collateral was expected to rise, and so the banks actually paid more attention to the value of collateral real estate than the debtor's credit risk. However, in the wake of the collapse of the bubble economy, the value of collateral real estate plummeted, and risk management based on collateral value alone was abandoned, and it became important to have an appropriate understanding of the debtor's credit risk. From the '90s onward, the banks, having learned the lessons of the non-performing loan issue, began to beef up their credit risk management systems by introducing and reinforcing credit rating systems and the quantification of credit risk.

In order to quantify credit risk, a huge amount of data related to corporate finances and defaults needs to be gathered. For small regional banks, there is a limit to the amount of data that each bank can hold. For this reason, database bodies were set up, such as CRITS (Credit Risk Information Total Service) under the Regional Banks Association of Japan, and CRD (Credit Risk Database), led by The Small and Medium Enterprise Agency, for the purpose of reinforcing the banks' risk management systems.

e. Small and Medium Sized Enterprise Loans

Small and medium sized enterprises depend to a large extent on borrowing from financial institutions in order to raise capital. This is because small and medium sized enterprises do not have access to the capital markets. After the economic bubble burst, the protracted economic slump caused financial difficulties for many small and medium sized enterprises, and the introduction of tougher loan assessment criteria by the banks meant that growth in domestic banks' small and medium sized enterprises oriented loans was very slow. From around 2000, the use of scoring models that allow a quick loan assessment based on statistical models led to a rapid increase in small and medium sized enterprises loan totals, but it also led to adverse selection in that there were many applications from small and medium sized enterprises with poor financial details that had been rejected by conventional loan assessment. Currently, many banks have stopped using these models.

Instead, in small and medium sized enterprises' capital procurement, the weight has shifted to the use of public sector government affiliated financial institutions and the Credit Guarantee System. In the Credit Guarantee System, the National Federation of Credit Guarantee Corporations guarantees the loans made by private sector financial institutions, in order to encourage the financing of small and medium sized enterprises with high risk levels. In Japan, around 40% of small and medium sized enterprises are making use of credit guarantees. In the period of financial instability of the late 1990s, the loan guarantee amount increased greatly, and since then also, credit guarantees have played a certain role in preventing the collapse of small and medium sized enterprises due to poor credit capability preventing them from obtaining finance. On the other hand, some have offered the criticism that the expansion of the Credit Guarantee System led to a weakening of the financial institutions' assessment abilities and monitoring. In response, in 2007, the system was overhauled and the guarantee was capped, in principle, at 80% of the value of the loan, putting a certain amount of responsibility back onto the financial institutions. However, with the global economic crisis of 2008, the urgent guarantee system which covered 100% of face value of loan was founded in order to support small and medium sized enterprises' financing, and in addition to this, a new guarantee system is being formulated in the wake of Japan's Tohoku earthquake and tsunami in 2011.

f. Venture Capital Finance

Japan's financial system centers on indirect financing and has been said to be ill-suited to venture capital finance which requires high risk, high return risk money supply. In actual fact, the scale of venture finance in Japan is extremely small in comparison with other developed nations, and it is possible that venture capital is not being adequately financed.

Looking back, new stock markets for start-up corporations were established in around 2000, and there was a period when IT venture companies burgeoned. However, the collapse of the IT bubble put an end to the boom. Venture finance in Japan assumed high profits from offering shares on the market, and when the IPO market went into a period of stagnation, the banks became more prudent about financing venture capital.

As Japan's economy languishes, there are great expectations of the banks' role in supplying risk money for businesses that have the potential to create innovation. For this reason, it is important that the banks improve their 'discernment' skill, so that they can have a sufficient understanding of a company's business situation and potential.

g. The Impact of the Global Economic Crisis

In the wake of the global economic crisis, in Japan too, the direct financial markets failed to function. Even the bigger corporations could not issue CP and corporate bonds, or, even if they could, an extremely high rate was demanded. Therefore, those companies that found it difficult to raise funds from the capital markets were increasingly dependent upon bank lending, principally from their main banks. Japanese corporations choose their capital procurement methods and the banks that they will do business with based on the assumption of this kind of market turmoil and period of economic depression. In normal times, the larger corporations have the incentive to make use of the direct finance market, with its lower procurement costs, but the role of indirect finance, which comes into its own during times of crisis, continues to be vitally important. Further, as a result of the recent financial crisis, many companies are re-assessing the importance of the main bank system, whose role is said to have diminished.

In response to the deteriorating business performance and cash flow difficulties of small and medium sized enterprises in the wake of the financial crisis, the government implemented cash flow countermeasures, such as an emergency guarantee system by the National Federation of Credit Guarantee Corporations, and safety net loans by government affiliated financial institutions, etc. These systems were well used and played a part in supplying a certain level of small and medium sized enterprises finance. Precisely because the indirect financial system functioned properly, even during the financial crisis, the emergency guarantee fund was able to be implemented swiftly, further adding to the credit enhancement effect.

In addition, the Law for Financial Support for Small and Medium-sized Companies was implemented at the end of 2009. This law requires financial institutions to respond cooperatively to requests to modify loan conditions, such as the repayment period and loan interest, etc., when a small or medium sized enterprise applies for assistance in reducing the loan repayment burden. Originally, it was supposed that the financial institutions would not respond easily to requests for rescheduling, but it turns out that recently the implementation rate (cases of implementation/ applications) is close to 100%, with rescheduling requests made by small and medium sized enterprises being approved in almost all cases. It should be remembered, of course, that modifying the loan conditions avoids the loan becoming a non-performing loan, but that if the borrowing company is not able to recover, their loan will very likely become a non-performing loan for the bank. Also, there have been criticisms that easy repayment postponement affects entrepreneurs' moral hazard.

7.2.3. Regional Finance

a. Community Based Financing Initiatives

The business results of regional financial institutions are greatly swayed by the local economy and local corporate trends. In order to assist self-supporting economic development in depopulated areas, regional financial institutions are promoting "community based financing". Community based financing is a business model that represents a move away from the over-dependence on real estate collateral and guarantors, which had been the norm up until the bubble economy, and to provide the customer with loans and other financial services based on customer information accumulated through the process of maintaining a long term relationship with the customer. In addition to the positive provision of finance for local businesses and individuals, their core business is consulting and finance, leveraging the natural resources of the local area, including the creation of new business opportunities, and matching business together and investing in venture businesses in order to uncover new financing demand. Further, in locations where head offices are sited, loans to local government bodies are being increased in response to increased borrowing demand following the contraction in local government tax revenues.

The flow of community based financing has been directed by administrative guidance to the local financial institutions. The Financial Services Agency revealed its "Action Program for the Enhancement of Relationship Banking Functions" (2003 to 2004), followed by the "Community-based Financing Action Program" (2005 to 2006). Targeting the major banks, the "Financial Revitalization Program" had as its aim the strengthening of community-based financing by small and medium sized financial institutions in order to ensure the smooth financing of small and medium sized enterprises and the vitalization of the local economy, and the resolution of the non-performing loan issue. Following this, in 2007 the comprehensive supervision guidelines for small and local financial institutions were overhauled, and the decision was made to promote the weaving of community-based financing into the permanent framework of regional finance.

b. Broadening the Economic Bloc

Meanwhile, the depletion of local economies has been one reason regional banks have begun branching out into neighboring regions. In other words, from the mid 2000s onwards, in addition to attempts to increase lending to large corporations in Tokyo and other major urban areas, some banks can be seen trying to expand their spheres of business into neighboring prefectures. The expansion of business spheres is not only being undertaken by banks on their own, but there are examples of business mergers with other banks. Recently, some banks have formed business mergers by establishing holding companies. One of the benefits of this kind of move is that, while costs can be cut by concentrating functions such as the formulation of business strategies, the development of financial products and strategies, and risk management, etc., in the holding companies, the legacy brand remains intact in the regions, so the relationship of trust with the customer is maintained even after integration and the bank can continue to provide services as before. Also, by expanding the regional banks' business territories, the banks can leverage their cross-regional networks to provide services to companies that seek to expand their business and sales channels into other regions, such as providing information about markets in the areas into which they have moved, matching companies with each other, etc.

7.2.4. Retail Banking

As the corporate loan business failed to grow, in the 2000s there were greater efforts to enhance retail banking. For Japanese banks, the contribution of the personal business sector to total profits was small in comparison to financial institutions in Europe and the US, so efforts were made to improve the earning power of personal business, such as sales of mutual funds and pensions and insurance, etc., to individual customers, as well as the housing loan and credit card business.

a. Deposits

In Japan, deposits account for a large proportion of personal financial assets. As of the end of September, 2011, the total financial assets of the household sector were approximately 1,471 trillion yen, of which about 771 trillion yen, 52%, was in deposits. Formerly, deposit categories and interest rates were controlled by regulations, but the financial liberalization that took place in the '90s meant that the design of deposit interest rates and deposit products was, in principle, deregulated.

In terms of the deposit component ratios of the domestic banks, at the end of March, 2011, liquid deposits accounted for about 55% of the total, followed by time deposits at around 43%. Time deposits used to account for a larger share than liquid deposits, but Bank of Japan's introduction of ultra-low interest rates in the mid 1990s meant that the gap between the two contracted, and the share of liquid deposits gradually began to increase. Then, in April, 2002, full protection of time deposits that had been introduced as an emergency measure was abolished, triggering a large scale shift of funds from time deposits to liquid deposits, and in fiscal 2002 the share size reversed. Foreign deposits and time deposits held by non residents account for only a very small proportion. In terms of the deposit component ratio, individual deposits account for roughly 65% of the total, while ordinary corporate deposits (excluding financial institutions) account for roughly 29%.

b. Over the Counter Sales of Investment Products

Since Japan's financial big bang, other than deposits, the banks have been handling more and more investment type products. The commissions earned from investment trust and pensions and insurance sales are an important source of revenue for the banks.

In 1998, the ban on over the counter sales of securities investment trusts was lifted and sales of these trusts through the banks increased rapidly, with over half of investment trust net assets going through the banks. With regard to the over the counter sales of insurance products, the over the counter sales of housing loan related long term fire insurance were permitted in 2001, followed by personal pensions and insurance in 2002, etc., and the range of applicable products was gradually expanded until, by 2007, all insurance products were available over the counter. Responding to these system reforms, some of the major banks began to focus on personal financial assets, promoting "one stop shopping", where the financial products of securities companies and insurance companies within the same corporate group could be purchased at banks.

c. Personal Loans

A major proportion of personal loans is accounted for by housing loans. With poor growth in corporate financing, the private sector financial institutions are concentrating on the housing loan business. It was determined in 2001 that the loan by the Government Housing Loan Corporation would be abolished in the future. The banks seized the opportunity to meet this new demand, and the banks' housing loan total increased to 100 trillion yen by the end of March, 2010. Also, as housing loan based interest rates have been falling over a long period of time, as a result of preferential interest rate policies adopted in order to win customers in the face of fierce competition, housing loan interest rates are falling to past minimum levels. Also, the Government Housing Loan Corporation became the Japan Housing Finance Agency in March, 2007. Its role is to support private sector financial institutions' housing loan business by purchasing and securitizing the housing loan debts financed by the private sector financial institutions.

In addition, the highly profitable consumer finance and credit card business is being positioned as a core element of the personal retail business, second only to housing loan and investment trust sales. The larger banks in particular identified consumer finance as a strategic business segment from the early 2000s, and have strengthened their capital and business links with consumer finance companies. However, the accumulation of reserve funds against claims for repayment of overcharged interest, and the lowering of interest rates as per the provisions of the revised Money Lending Business Act have forced some consumer finance companies into difficult business conditions of late, and attention needs to be paid to trends in the consumer finance business.

Banks have been establishing affiliated credit card companies and participating aggressively in the credit card business. For this reason, bank affiliated credit cards account for about 40% of the total credit cards issued in Japan (320 million cards in 2010). The credit card business offers high interest revenue from revolving settlement and cash advance, etc., but credit cards in Japan are still predominantly used for single, non-installment payments. In the future, if single payment remains the mainstay, then it will be difficult for Japanese banks to expect the same profitability as US banks, where revolving credit and cash advance are predominant.

d. Private Banking

Since around the mid 2000s, the financial institutions have been concentrating on private banking as a growth sector within retail banking. In comparison with Europe and the US, there is only a small segment of the population with large financial assets in Japan, so private banking has been slow to develop. However, in recent years, the wealthy bracket is increasing, with owners of newly listed companies, and new generations inheriting businesses and assets, etc., and the financial institutions have identified the potential for significant earnings from private banking. Private banking is a simple fee-based business, so it suits the bank's strategy of trying to change their profit structure from interest based to commission based. Also, as has already been seen, the entry of financial conglomerates into the banking, securities and insurance sectors has meant that a single financial group can handle the asset management needs of wealthy customers at lower cost in a one-stop shopping style, and this has contributed to the growth of the private banking business. The mega banks, regional banks, trust banks and foreign banks are all participating in this business, and the competition to win customers is intensifying. The banks are all working to expand their personnel and offices in this business, for example, opening special offices that deal only with wealthy customers.

e. The Role of Credit Information Agencies

Personal loans are being pushed aggressively but, on the other hand, consumer over-borrowing, multiple debt and the increase in personal bankruptcies are becoming a social problem. In response, the banking industry has established credit information agencies so that more appropriate credit decisions can be made. These agencies gather information on personal loans, credit cards and other contract details and repayment details from their member banks and then provide the information to members upon request, in order to prevent excess borrowing. Additionally, the credit companies have linked up with the credit information agencies that have consumer finance companies as members to run CRIN (Credit Information Network).

f. Consumer Protection

In the wake of the financial big bang that started in the late 1990s, as financial products became more advanced and specialized, laws for the protection of the consumer were formulated. In April, 2001, the Law on Sales of Financial Products was enacted, requiring that, when financial products are sold to a customer, "important matters", such as the risk of loss of principal, must be explained to the customer. Further, in September, 2007, the Financial Instrument and Exchange Act was enacted as a revision of the Securities Exchange Act. One of its biggest aims was to ensure the thorough application of rules for the protection of users. It led to the improvement of user convenience and the expansion of products and transactions subject to regulation, such as derivative transactions and funds. The Financial Instrument and Exchange Act has subsequently been amended several times.

7.2.5. International Business

With the progress of internationalization in Japan, in the period from the 1980s to the early 1990s, Japanese banks opened branches all over the world. However, in the mid 1990s, the banks' resources were concentrated on dealing with the domestic non-performing loan problem, and the pressure on overseas assets led to the closure of foreign branches. Then, in the early 2000s, once the end of the non-performing loan problem seemed to be in sight, the banks began to spread overseas once again.

Part of the background to this is said to have been the increase in the number of customer companies expanding their operations overseas, as a result of yen appreciation and contracting markets at home. In the past, it used to be mainly large manufacturing companies that set up operations overseas, but these days there is a wide variety of types and sizes of companies. In particular, a lot of Japanese companies are setting up business in China and south east Asia, and Japanese banks' presence in Asian markets is becoming more and more noticeable.

The major banks have branches all over the world and are involved in a full range of banking activities, from foreign exchange dealings to project finance, syndicate loans, securities business and investment banking, etc. Lending is growing in the new emerging economies of Asia and Latin America, with their high growth rates, and the proportion of total mega bank lending accounted for by overseas lending rose to 15% by March, 2011.

Meanwhile, the regional banks' overseas operations tend to focus on Asia, where most of their customers do business. Their business activities include the supply of information on overseas economic conditions and legal systems, etc., matching customers with local companies, and financing customer companies' overseas business expansion. Due to restrictions on the number of staff that can be seconded overseas, etc., there are only a few regional financial institutions that can provide these services by themselves in their foreign branches. Therefore, in many cases, regional financial institutions support their customer companies' overseas businesses by forming business tie-ups with financial institutions in the new emerging economies and in Europe and the US, or utilize the networks of public agencies and major banks that support overseas businesses.

7.2.6. Financial Settlement Systems

In Japan, the use of cash in personal financial settlement is predominant. This is supposed to be due to the fact that, in addition to Japan's high level of public safety, there is a well developed network of financial institutions' branches and ATMs. Japan has one of the world's highest rates of per capita credit card ownership, as well as one of the highest per capita number of ATMs.

The main financial settlement systems are the domestic funds transfer system, which handles bank transfers and foreign exchange transactions, etc., and the clearing house system that is used to settle bank notes and checks, etc. For the financial institutions that are members of these systems, final settlement is done mainly by the Bank of Japan Financial Network System.

a. The Proliferation of ATM

From the latter half of the 1990s onwards, there was a rapid spread of ATMs sited externally of branch offices, and their installation in convenience stores, etc., became common. ATMs allow the user to perform a variety of functions, such as withdrawing or depositing cash, bank transfer, and the payment of taxes and utility charges. It is usual now for ATMs to be available on weekends and holidays, and many ATMs can be used 24 hours. Also, the on-line network of ATMs has spread among all depository financial institutions, and non-bank and consumer finance companies are connected, as well as Japan Postal Bank and others.

b. The Proliferation of E-money

As an alternative method of settlement to cash, electronic money has spread rapidly throughout Japan since the 2000s, with over 130 million cards issued as of April, 2010. In addition to the provision of services that equip cash cards and credit cards with built-in non-contact IC cards with e-money functionality, the spread of e-money via mobile phones is also spreading. In Japan, the use of e-money in public transportation and among retailers has spread quickly. The IC cards used in public transportation are a kind of pre-paid ticket, and there is strong motivation for an individual to own and carry them. Originally, they could mainly be used in shops close to railway stations, but their use has spread much more widely. Also, cards issued by companies in the distribution industry often have the merit of offering discounts to users of e-money.

c. Domestic Funds Transfer System

The domestic funds transfer system of the Japan Bankers' Association is used to transact transfer payments between different financial institutions. Almost all financial institutions in Japan are members of the system, and an average of around 5.6 million transactions (worth over 10 trillion yen) are conducted daily, making the system the core of Japan's financial system.

The data of the funds transfer system are handled by the Japan Bankers Association's telecommunications system (Zengin system). This is an on-line system that allows financial institutions to conduct daytime inter-bank financial transactions. Domestic financial transactions incur debtor – creditor relationships, and once the day's transactions are completed, the Zengin system computes the net transfer settlement value of each financial institution and sends this information to Bank of Japan. Once Bank of Japan is notified of the transfer settlement amounts, it transfers the amounts to and from the checking accounts that the financial institutions have with BOJ, and the day's domestic transfer settlements are completed.

Japan's domestic settlement transfer system is characterized by the speed at which it deals with bank transfers in real time and the day's settlements are completed. There is no comparable system of similar scale anywhere in the world.

d. Clearing House System

The clearing house is a system where financial institutions bring the notes and checks brought by their customers to exchange. In many cases, the net settlement between banks is done by transfers among the current accounts of the Bank of Japan. In 2010, the quantity of exchanged bills and notes was 87 million, worth 376 trillion yen. In recent years, the trend has been for settlements between financial institutions to shift from bills and checks to bank transfers, so the volume and value of notes and bills exchanged has decreased. Japan's clearing house system has adopted the "suspension of business transactions" system as a self-imposed rule. If the payer dishonors a bill or a check twice in six months, he/she will be required to suspend his/her business transactions for two years.

e. BOJ-Net (Bank of Japan Financial Network System)

Bank of Japan operates a computer network system, the Bank of Japan Financial Network System (BOJ-Net), to transfer funds between BOJ accounts to settle interbank money market transactions, the cash legs of Japanese government bonds and other securities transactions, and net positions arising from private-sector clearing systems. Financial settlements through private sector settlement systems such as the domestic funds transfer system of the Japan Bankers' Association mentioned above are performed by bank transfers among the current accounts held at the Bank of Japan by financial institutions. From the perspective of the reduction of systemic risk, in 2001, financial settlements through the Bank of Japan current accounts were shifted en masse from the DNS (designated time net settlement) system to the RTGS (real time gross settlement) system. Subsequently, with the aim of further improving the stability of the large value settlement system, the next-generation RTGS project was advanced and, in November, 2011, large-value retail payments processed in the Zengin System is routed to the BOJ-NET via a newly constructed interface connecting the two systems, with settlement taking place in the BOJ-NET on an RTGS basis. This meant that large amount transfers of around 100 million yen or more, normally settled by DNS through private sector financial settlement systems, will now be settled by RTGS. This accounts for less than 1% of settlement transactions, but the settlement value accounts for about 70% of total transfer transactions in Japan, and the move has enabled a reduction in the volume of settlement transactions that cannot be completed within the same day.

f. Electronically Recorded Monetary Claims

In December, 2008, the Electronically Recorded Monetary Claims Act was enacted as a new means of settlement. Electronically recorded monetary claims generate a valid claim resulting from a commercial transaction, by electronically recording separate accounts receivable. The system was created in order to reduce the risk involved in the transfer of accounts receivable and to make it easier to use accounts receivable by reducing the administration involved in payment, and the costs of delivering and storing bills and notes, thus diversifying and facilitating small and medium sized enterprises' capital procurement activities.

The electronic monetary claim recording institutions that will play a central role in the systems that are due to begin doing business from May, 2012. In addition to the banks, credit associations and credit unions nationwide are due to become participating financial institutions. This will result in a social infrastructure that provides a new method of payment transaction among domestic companies, and a system that can be used by a wide range of businesses. Also, with the aim of streamlining the administration involved in handling notes and bills, there are indications that some of the city banks will be setting up their own electronic monetary claim recording institutions.

7.3. Issues Facing the Banking Sector

Commercial banking is the main business of Japan's banks and, under the relationship banking and main banking systems, where long term relationships with the customer are considered extremely important, they have been able to provide customer businesses with stable and continued financing. In particular, the banks demonstrated their validity by being able to meet businesses' flourishing demand for capital during Japan's catch up period of high economic growth. During the economic recession also, by utilizing the credit guarantee system and other forms of public support, they were able to support small and medium sized enterprises' cash flow needs.

However, now that the economy has matured and businesses' capital demand is growing only very slowly, it has become more difficult to pursue high profitability with the commercial bank model. In addition, in the wake of the global economic crisis, the further expansion of the investment banking business, in the manner of European and US banks, may not always be the correct choice. Although Japan's banking system has the most advanced systems in Asia, it is difficult to envisage how much growth can be achieved in the years to come.

In the future, there is a strong possibility that the business environment surrounding the Japanese banks will continue to be very severe. As Japan's population decreases and ages, it is unavoidable that the domestic markets will shrink. As capital demand continues to decrease, and the direct finance markets are not sufficiently activated, financial assets are being concentrated in bank deposits, and banks that are facing business difficulties are assigning capital to government bonds. Given this current situation of Japan's banks, the following issues will need to be tackled as priorities.

7.3.1. Profit Issues

Domestic lending is the core of the banks' profit, and as markets contract, it is difficult to envisage a quantitative expansion in this area. Additionally, in order to improve profit margins, it will be necessary to apply interest rates based on credit ratings, but with business relationships so firmly fixed, there is little room for revising interest rates.

Therefore, in order to improve the banks' profitability, poor when considered internationally, and to create a stable profit base, it will be necessary to reinforce the profit base by uncovering and supporting new companies and businesses with high growth potential. For example, there is obvious borrowing demand in growth sectors such as environment, energy, medical and care related businesses, and the banks are redoubling their efforts in these areas.

In order to provide political support for this initiative, in 2010 Bank of Japan introduced a system aimed at strengthening the growth base by providing low interest rates and long term capital supply for financial institutions involved in investment and lending. The system has already reached its upper limit of three trillion yen, and is having a pump priming effect on the efforts of financial institution to strengthen growth potential. Further, in June, 2011, Bank of Japan decided to establish new credit limits for Asset based lending (ABL). In Japan, real estate has conventionally been the main collateral behind loans. However, newly emerging enterprises and IT businesses, etc., have very little collateral in the way of real estate, and face difficulties in borrowing capital. If movable assets such as inventory and accounts receivable can be smoothly converted into collateral, it is hoped that these companies' cash flow situations can be improved.

In the debate on how non-interest profit can be expanded, commission on the sales of investment trust and pensions and insurance is becoming an important source of revenue, but sales of stock investment trust are vulnerable to the market condition, and it is possible that there may be little prospect of stable revenue over the mid to long term. In US banks, the positioning of handling charges as fair recompense for the various services provided in the course of cash and deposit transactions and credit card business, etc., is clear. It may be considered that, in Japan also, there is room to improve the profitability of deposit related business by setting detailed handling charges depending on customer attributes, business location and the content of services.

7.3.2. Risk Issues

The risks faced by Japanese banks would appear to be more or less covered, judging by the capital equity ratios. Nevertheless, while credit costs and non-performing loan ratios are fairly low in comparison with those in Europe and the US, stock market risks are high and attention needs to be paid to interest risk from the perspective of its accumulation mainly in bond investments.

As Japanese bank lending fails to grow, the stable inflow of deposits is being used mainly for government bond investment. The bigger banks keep their investment terms relatively short, from the point of view of inhibiting interest risk, whereas regional banks are very positive about investing in long term government bonds. This is because, as lending margins shrink, the regional banks are trying to maintain their overall profitability by securing the yield on securities. If interest rates take an upward swing, the regional banks in particular stand to suffer serious losses from bond certificates.

Further, there is also a problem in that ownership of Japanese government bonds tends to be inclined towards the banks. Banks are specific investors, and their activities can affect the government bond market. Also, VaR (value at risk) is the most common method of market risk management among the banks, with all banks at a similar level. This means that, in comparison with a market participated by more varied investors, there is a concern that, in a downturn, the government bond market could suddenly fall much further than anticipated. In order to lessen the burden of this kind of risk, the promotion of sales of government bonds to individual investors is an important issue.

There is a view that, going forward, the government bond market will be supported by strong domestic savings, but some feel that there is scant evidence to support this. Certainly, on a stock basis, domestic investors hold 95% of Japanese government bonds, but if government bonds are abandoned by overseas investors, there is a risk that their prices could plummet. Among the industrialized nations, Japan is one country where the national debt is worsening, and if nothing is done to promote the direction of financial reconstruction, it may well become a market target.

While there are concerns over the possible widening of the European debt crisis, examination of the foreign government bonds held by Japanese banks reveals that very few of them have to do with the peripheral EU countries, and any direct impact on Japanese banks will likely be limited. However, attention should be paid to the fact that when there is disruption in foreign markets, inter-market relations can have a major impact on domestic stock and bond prices, and there is a possibility that quite significant domestic securities related losses could be incurred.

7.4. Banks' Financial Soundness and Safety Net

7.4.1. Structure and Current Situation of Safety Net

In Japan, the organizations concerned with the operation of the banking sector's safety net are the Financial Services Agency, which is responsible for the regulation, supervision and inspection of the financial institutions, the Deposit Insurance Corporation of Japan (DICJ), the principal operating entity of the Deposit Insurance System, and Bank of Japan, which functions in its capacity of Central Bank as the "lender of last resort". Also, the Ministry of Finance participates in the planning of financial risk management. These different players collaborate to ensure the stability of the financial system.

a. Deposit Insurance System

The operation of the Deposit Insurance Corporation of Japan

The Deposit Insurance System was set up in 1971, and is principally operated by the DICJ until the mid 1990s, the DICJ itself was a fairly small organization, but with the increase in the number of failing financial institutions in the mid '90s, and the deteriorating financial environment, the scope of operation and the scale of the Corporation had to be enlarged significantly.

Specifically, the DICJ undertakes the following four broadly-classified operations.

1) In terms of activities for the protection of depositors from the viewpoint of depositors, in order to improve and enhance failure resolution framework of financial institutions, the DICJ engages not only in the collection of deposit insurance premiums, but also conducts other operations such as on-site inspection, system verification and training to enhance depositors' name-based aggregation database, which will become necessary when making insurance payments to depositors.

2) As the operator of financial system safety net including public capital injections, etc., the DICJ undertakes such operations as subscribing to shares to prevent the failure of financial institutions (capital injections intended as measures against financial crises under the Deposit Insurance Act) and subscribing to shares to strengthen financial functions (capital injections based on the Act on Special Measures for Strengthening Financial Functions).

3) In cases where a financial institution has failed after suspending deposit repayments, etc., the DICJ, as part of the normal procedures, makes insurance payments to protect insurable deposits up to a certain amount (limited protection), and provides financial assistance, more specifically, monetary grants and the purchase of assets of failed financial institutions, etc., to the assuming financial institution or assuming bank holding company (hereinafter referred to as the "assuming financial institution, etc."), which will take over the business operations of the failed financial institution or implement a merger or other bailout measure.

4) In order to support the collection of claims held by the Resolution and Collection Corporation (RCC), a contracted bank, the DICJ appropriately conducts asset investigations regarding malicious debtors in obstructed recovery cases and also pursues the civil and criminal liabilities of former managers of failed financial institutions and other parties concerned.

If the positioning of the DICJ is compared with those of other countries, there are characteristics in that, in Japan 1) the function of supervision of the financial institutions is concentrated in the Financial Services Agency, and the DICJ has no supervisory role, and 2) the DICJ receives instruction and guidance from the Financial Services Agency.

Outline of the Deposit Insurance System

Financial institutions subject to the Deposit Insurance System are banks and others with head offices located in Japan. However, overseas branches of the above financial institutions, government-related financial institutions, and Japanese branches of foreign banks are not covered by this system.

The types of deposits and amounts protected by the system are the whole amount for deposits for settlement (current accounts, interest-free ordinary deposits), and for other general deposits (ordinary deposits, time deposits, etc.), up to a total of 10 million yen in principal and interest accrued thereon per depositor per financial institution till the day of failure. Foreign-currency deposits, negotiable certificates of deposits, etc. are not protected by the Deposit Insurance System.

The deposit insurance premium rate is determined in light of the long term balance of the DICJ's finances, and the effective rate is currently at 0.084%.

If a financial institution fails, in principle, the whole sum within the guaranteed range is protected (limited protection). The deposit protection methods used under the limited protection system are the insurance payout method and the financial assistance method. In the case of protection based on the insurance payout method, the DICJ will make insurance payment to depositors upon their request after specifying the amount of insured deposits as of the date of the insurable contingency for each depositor based on data on depositors provided by the financial institution where the insurable contingency has occurred. In the case of protection based on the financial assistance method, the DICJ provides financial assistance to an assuming financial institution that takes over the insured deposits of a failed financial institution by implementing a merger, etc., in an amount up to the estimated cost that would be necessary if the insurance payout method was adopted ("the insurance payment cost"). With the insurance payout method, it can prove difficult to continue with the failed financial institution's business, and to deal with the impact on depositors and borrowing companies, so in practice the financial assistance method is preferred. Thus far, there have been no examples of the insurance payout system being used in the disposal of failed financial institutions, and the financial assistance method has been used in all cases.

Provided that the Prime Minister recognizes that unless one of the following measures against financial crises is taken, the maintenance of the stability of the financial system in Japan or in the region where the insured financial institution conducts its business could be severely hindered, measures against financial crises may be taken after deliberation by the Council for Financial Crises. Measures to be taken are 1) Capital injection, 2) Financial assistance whose amount exceeds the insurance payment cost, and 3) Special crisis management.

When the functions of Japan's Deposit Insurance System are compared with those of other countries, in the late 1990s, in the wake of the financial crisis, the Japanese system not only collects insurance premiums and carries out bankruptcy procedures, etc., but is also involved in a diverse range of activities, such as the nationalization of financial institutions and capital injection, and the purchase and sales of non-performing loans.

The Changing Deposit Insurance System

Since the Deposit Insurance System was inaugurated, the limited protection of deposits has been the basic policy, but under former financial administration the convoy system was employed, and banks were not failed, so the Deposit Insurance System was not used for about 20 years since it was first created. However, after the bubble economy collapsed in the early 1990s, with the worsening non-performing loan problem, there was an increase in the number of financial institutions forced into bankruptcy, and the Deposit Insurance System was invoked. At that time, relief financial institutions acting as recipients for the failed financial institutions would receive financial assistance from the DICJ for the insurance payment cost, while costs in excess of that would be covered by financial assistance from outside, such as from industry bodies, etc., so in effect, the whole sum was covered.

However, in subsequent years, the financial institutions' business environment became even tougher, and bankruptcy disposal with this method reached its limit. Therefore, in 1996, it was decided that the whole sum should be protected under the Deposit Insurance System. Thus, in 1998, with the enactment of the Financial Revitalization Act and the Early Strengthening Act, the development of safety net systems, such as frameworks for the nationalization of and capital injection into financial institutions, etc., was carried out. The full protection of deposits was originally supposed to last until March, 2001, but was extended as the non-performing loan problem lingered on. At the end of March 2002, the full protection of deposits, etc. except for liquid deposits (current deposits, ordinary and specified deposits) was abolished. Then, at the end of March 2005, the full protection of liquid deposits was abolished (deposits that meet the requirements for deposits for payment and settlement purposes have continued to be fully protected since April 2005).

Examples of liquidation procedures

The failure of the Incubator Bank of Japan in September, 2010, was the first instance in Japan of limited protection (deposit payoff) being applied. Given the special circumstances that this was a bank with no settlement function, and that there was judged to be no danger of serious hindrance to the maintenance of national or regional credit order, the application of payoff was approved. On this point, although the ban on payoff was partially relaxed in the case of the failure of Ashikaga Bank in 2003, full protection was carried out because it was found that serious problems could arise in the maintenance of the stability of the financial system of the country or the area where the bank was carrying out their business.

When a failed company is being liquidated, this is often carried out between Friday and Monday. The Incubator Bank of Japan also failed on a Friday and because of the gathering of name identification for the insured deposits (a total of 10 million yen in principal and interest accrued thereon per depositor per financial institution till the day of failure) was carried out over the weekend, deposits could not be withdrawn. On Monday, however, under the management of the DICJ as a financial administrator, the repayment of insured deposits and financing business activities, etc., were resumed. Uninsured deposits are only partially repaid, in accordance with the state of the failed institution's assets.

In the liquidation of the Incubator Bank of Japan, the conventional financial assistance system was adopted, and until the business was transferred to the final assuming financial institution, a bridge bank took over the business activities. Bad assets that were not taken over were in principal transferred to RCC. Applications were invited from potential final assuming financial institutions, with the final candidate selected in September, 2011, after documentary examination, the presentation of business plans, the inspection of transfer requirements, etc.

b. BOJ's Function as Lender of Last Resort

If a financial institution finds itself with insufficient funds and there is no other body that can provide funds, Bank of Japan may then lend funds temporarily, in its capacity as lender of last resort. The purpose here is not to rescue individual financial institutions, but to ensure the repayment of deposits and the settlement of contracted transactions, in order to avoid the emergence of systemic disruption.

7.4.2. Prudential Regulation and Compliance with Tougher International Regulations

As methods of ensuring the banks' business soundness, the Banking Act stipulates capital adequacy ratios and large account credit limits (in order to avoid credit concentration risk). There are international capital adequacy standards and domestic standards. The international adequacy standards are applied to larger banks that do business overseas, and to ten or so regional banks. The levels set for capital adequacy are 8% for international standards, and 4% for domestic standards. Banks that fall below these levels will be subject to prompt corrective action by the Financial Services Agency. These measures were introduced in 1998 as a means of promoting the financial soundness of financial institutions' business operations, and may involve a business improvement order, depending on the level of the financial institution's capital adequacy. Currently, with the publication of Basel III, discussion is underway regarding the publication of an announcement on capital adequacy ratios.

Meanwhile, in anticipation of Basel III, the banks are working to improve their own capital adequacy ratios. In particular, the three mega banks have been designated Global Systemically Important Financial Institutions (G-SIFIs), and are required to have high levels of financial soundness. At the end of 2010, Japanese banks' Tier I ratios (current standards) were 12.8% for international standards, and 8.7% for domestic standards, indicating that Tier I capital is steadily accumulating. Currently, many share the view that the new standards can be attained by management effort, including the accumulation of retained earnings, etc.

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