ANNEX I

PROGRESS IN FINANCIAL AND CORPORATE RESTRUCTURING IN JAPAN

The 1999 *International Capital Markets* report discussed progress in implementing the Japanese authorities' framework for revitalizing Japan's financial sector and restructuring its corporate sector. This annex provides a progress report on developments in these two important areas, drawing heavily on the views and analysis of market participants.

Restructuring and Revitalizing Japan's Financial System: Progress and Challenges

The Japanese authorities have made progress recently in implementing their framework for revitalizing the financial system. The major banks have been recapitalized; reported capital ratios are strong; several mega-mergers of major banks have been announced; one nationalized bank has been reprivatized, and a deal to reprivatize the other is near completion; new funds have been allocated for financial revitalization; "big bang" reforms have been largely completed; and a strengthened Financial Supervisory Agency (FSA) has pressed banks to recognize bad loans and write off or provision against impaired assets. Looking ahead, the main challenges are to build on this progress by addresing the remaining issues facing the major banks, and to more fully address the deteriorating financial condition of the smaller deposit-taking institutions (including credit cooperatives) and life insurance companies.

Progress in Implementing the Authorities' Framework for Revitalization

Recent measures have addressed the need to restructure and revitalize Japan's financial system. First, new funds were allocated to deal with financial revitalization. Recently enacted legislation adds ¥10 trillion for depositor protection, bringing the total amount of public funds available for dealing with banking problems to ¥70 trillion ($640 billion or 14 percent of GDP). Second, big bang financial reforms are largely complete. Brokerage commissions have been fully liberalized, remaining restrictions on the stock brokerage business of banks' securities subsidiaries were lifted, and insurance companies are now allowed to enter the banking business through subsidiaries or by setting up holding companies. The main remaining reform—cross-sectoral competition between banks and insurance companies—will take place by October 2000.

Perhaps most important, the authorities have strengthened the supervisory apparatus. They have continued to increase supervisory resources, and the FSA will assume significant new responsibilities when it is transformed into the Financial Services Agency in July 2000 (Table A1.1). Through on-site inspections, the FSA has compelled major banks to recognize and write off or provision against the bulk of their impaired assets. In addition, following inspections of all regional banks in the winter and spring of 1999, the authorities intervened in five regional banks and provided public capital injections into six others in exchange for restructuring plans. Starting July 2000, the FSA will conduct intensive on-site inspections of credit cooperatives, as part of an effort to address weaknesses at smaller financial institutions.

The authorities recognize that further work remains to be done. Amid concerns about the situation of smaller financial institutions, the removal of blanket deposit insurance—previously scheduled for March 2001—has been postponed by one year. The coverage limit of ¥10 million per depositor per bank is now scheduled to go into effect on April 1, 2002, and liquid deposits will be covered in full until March 2003. The extension for liquid deposits was intended in part to avoid the risk of large-scale disruptions (from

Table A1.1. Japan: Reallocation of Financial Regulatory Functions

Function	Previous	July 2000	January 2001
Planning and formulation of legal system	MOF	FSA	FSA
Planning of resolution scheme and crisis management	FRC/MOF	FRC/MOF	FSA/MOF
Resolutions and capital injections based on 1998 legislation	FRC	FSA	Authority expires in March 2002
Inspection and supervision	FSA	FSA	FSA
Oversight of Deposit Insurance Corporation	FRC/MOF	FRC/MOF	FSA/MOF
Oversight of Securities and Exchange Surveillance Commission	FSA	FSA	FSA

Note: FRC = Financial Reconstruction Commission; FSA = Financial Services Agency; and MOF = Ministry of Finance. The Financial Supervisory Agency was renamed the Financial Services Agency in July 2000.

bank failures) until speedy resolution methods and a variety of private payment services are well established.

Key Challenges for the Major Banks

The major banks face challenges in a number of areas that are core elements of the task of sustainably revitalizing the Japanese financial system. These include the quality of capital, bad-loan recognition and management, the efficiency of mega-mergers and reprivatized banks, and core profitability.

Quality of Bank Capital

Major banks have increased their capital substantially, including by applying to the Financial Reconstruction Commission—which is responsible for the restructuring process—for public funds. Major banks now have an average reported capital ratio of about 12 percent, but only a relatively small share of this capital consists of what analysts consider to be "primary" economic capital (e.g., retained surplus, common stock, and general loan-loss reserves).[1] About one-fourth of Tier 1 capital consists of preferred stock subscribed by the government, and another one-fourth consists of deferred tax provisions that can only be used if the bank makes future profits (the regulatory ceiling on deferred tax provisions is five years' taxable profit, while in the United States it is 10 percent of Tier 1 capital or one year's taxable profit, whichever is lower). In addition, a considerable share of the major banks' subordinated debt and other limited life capital liabilities will mature within the next two years, so banks will need to turn to the market for substantial amounts of new equity before long. Finally, bank capital remains vulnerable to market risk, especially once mark-to-market accounting is introduced in FY2000–01. As of March 2000, the book value of major banks' equity holdings amounted to one-and-a-half times their Tier 1 capital.[2]

Bad-Loan Recognition, Provisioning, and Disposition

Notwithstanding considerable progress by banks in dealing with bad loans, private estimates suggest that bad loans may still not be fully recognized and provisioned. According to one representative estimate, the true cumulative bad loans of the 17 major banks totaled about ¥65 trillion as of March 2000 (Table A1.2).[3] Assuming a true loss rate of 90 percent (based on historical trends in loss rates and an estimated current loss rate of about 85 percent), this implies loan losses of about ¥58.5 trillion,

[1]See Moody's Investors Service (1999), pp. 16–17.
[2]The subsequent decline in the Japanese equity market may have erased unrealized gains on these holdings.
[3]The figure excludes the two nationalized banks, which are now largely "clean" and in any event can put bad loans back to the authorities. It also excludes nonperforming loans to crisis-stricken Asian emerging markets.

Table A1.2. Japan: Estimated Uncovered Losses of Major Banks, March 2000[1]
(In trillions of Japanese yen, except as stated)

	Baseline	Higher Loan Rates	More Bad Loans
Cumulative bad loans	65.0	65.0	65.0
Reported nonperforming loans	30.0	30.0	30.0
Loans sold to the CCPC[2]	11.5	11.5	11.5
Loans to *jusen*	4.9	4.9	4.9
Restructured loans and other	18.6	18.6	18.6
Estimated loss on cumulative bad loans[3]	58.5	65.0	58.5
Possible additional migration from Class 2[2]	. . .	. . .	30.0
Estimated loss on possible additional migration from Class 2[4]	. . .	. . .	15.0
Required loan-loss reserves[5]	58.5	65.0	73.5
Actual loan-loss reserves, including CCPC[2]	52.3	52.3	52.3
Uncovered losses	6.2	12.7	21.2
Uncovered losses/tier–1 capital (in percent)	27.4	56.2	93.8
Memorandum items:			
Assumed loss rate for cumulative bad loans (in percent)	90.0	100.0	90.0
Assumed loss rate for possible additional migration from Class 2 (in percent)	. . .	. . .	50.0

Source: Market participants' estimates.
[1]Excluding those of Long-Term Credit Bank and Nippon Credit Bank.
[2]CCPC stands for Cooperative Credit Purchasing Corporation.
[3]Using the assumed loss rate for cumulative bad loans as shown under the memorandum items.
[4]Using the assumed loss rate for possible additional migration from Class 2 as shown under the memorandum items.
[5]Estimated loss on cumulative bad loans plus on possible additional migration from Class 2.

compared with major banks' cumulative provisions and write-offs of about ¥52.5 trillion. In addition, uncertainties remain about banks' loan classification, especially of the Class 2 loans that are outside the "special mention" category; increased migration of these loans would also raise losses. Moreover, the value of collateral has continued to erode, though at a decreased rate. Looking ahead, bad loans may increase further as corporations restructure (see below).

Much of the collateral taken against impaired loans has yet to be liquidated. Private analysts estimate that banks have sold about ¥25 trillion (face value) of bad loans since 1997, compared with a total outstanding stock of ¥100–150 trillion. The Cooperative Credit Purchasing Company has begun to sell its assets, but the Resolution and Collection Corporation appears intent on collecting on all of its loans (the purpose for which it was established) and has made less progress in loan disposal. The large overhang of collateral still available for sale has contributed to a depressed real estate market, as land prices have continued to fall in most areas. Nonetheless, collateral sales may pick up in the period ahead. Low deposit rates imply a limited incentive for banks to remove bad loans from their balance sheets; a rise in interest rates may make disposal more attractive. In addition, the April 2000 introduction of a new Chapter 11–style bankruptcy law, and recent enhancements to markets for securitized assets, may accelerate the resolution of bad debts.

Improving the Efficiency of Reprivatized and Merged Banks

The two long-term credit banks that were nationalized in 1998 are now being reprivatized. Long-Term Credit Bank (LTCB) was sold in March 2000 to a group of investors led by U.S.-based Ripplewood Holdings and was renamed Shinsei (meaning rebirth) Bank in June. In June 2000, after halting negotiations, a basic agreement to sell Nippon Credit Bank (NCB) to a group of investors led by Softbank was reached. The agreements between the authorities and the private purchasers have two notable features: (1) Tier 1 capital includes ordinary voting shares purchased by the investors, convertible preferred shares contributed by the Deposit Insurance Corporation, and the realization of capital gains on equities portfolios, and it does not include any deferred tax assets (the new banks have capital adequacy ratios of about 13 percent); and (2) for the first time in Japan, a warranty for loan-related assets was given: LTCB shall have the right to cancel the sale of the loan-related assets if problems with those assets result in a decline in their value by 20 percent or more. In addition, the total cost to the taxpayer of resolving LTCB and NCB is expected to be about ¥7 trillion ($64 billion), although capital gains might eventually be realized from sales of the Deposit Insurance Corporation's convertible shares.

The reprivatizations of LTCB and NCB represent important steps forward in resolving major banks' problems. The head of the Financial Reconstruction Commission has noted that an offer by the Ripplewood group was chosen over those of rival bidders because it minimized the taxpayer's burden (least-cost principle). The new management of LTCB is expected to focus on fee-generating wholesale operations, such as asset securitization, project finance, and brokering mergers and acquisitions, though foreign investment banks in Japan have reportedly not made much money in these areas. Also, LTCB still raises funds primarily through debentures and therefore has a weak deposit base, which may become a problem when interest rates start to rise. The new NCB is expected to focus mainly on making loans to small and medium-sized companies; market participants view this as an expensive way for Softbank to acquire a banking license.

During the past year, four mergers between major banks have been announced, which will create four of the five largest banks in the world in terms of assets.[4] Mizuho Bank will combine Dai-Ichi Kangyo Bank, Fuji Bank, and Industrial Bank of Japan; a yet-to-be-named entity will combine Sanwa Bank and Tokai Bank; Sumitomo Mitsui Bank will combine Sumitomo Bank and Sakura Bank; and Mitsubishi Tokyo Group will combine Bank of Tokyo-Mitsubishi, Mitsubishi Trust, and Nippon Trust. With these mergers, the ten city banks that existed before the 1997–98 financial crisis will be reduced to five, not counting Daiwa Bank, which is pursuing a trust and regionally oriented strategy (Table A1.3).

Planned mergers hold the promise of accelerated bank restructuring and significant economies of scale and scope. However, the impact of the mergers will depend crucially on how much strategic reorientation and restructuring is actually achieved. Delivering on existing plans may prove to be more complicated than expected, as past mergers have encountered significant difficulties. In addition, while some cost-cutting is desirable as banks adjust to new competitive pressures such as Internet banking, the Japanese banking system already compares favorably with those in other major advanced countries in terms of number of staff or branches and ratios of costs to revenues.[5] Competitive pressures will also limit the scope for banks to raise lending margins, particularly as big bang reforms create more opportunities for both investors and borrowers. Finally, the merger plans put little emphasis on shifting low-yielding corporate lending to securities markets.

Raising Core Profitability

Core profitability of the major banks remains weak compared with internationally active banks in other industrial countries. Return on assets is only about one-third to one-half that of large U.S. banks. Moreover, existing plans to raise core profitability—including those that center around cost-cutting measures—do not seem fully

[4]In April 2000, Chuo Trust and Mitsui Trust merged into Chuo Mitsui Trust Bank.

[5]The average ratio of operating costs to revenues (excluding realized gains on investment bonds) was 61 percent for Japanese city banks in 1999, compared with 68 percent for U.S. money center banks (see Atkinson, Ishida, and Ishii, 2000).

Table A1.3. Japan: Changing Banking Landscape Among Major Banks, Since September 1997

	Action	Following Mergers
Dai-Ichi Kangyo Bank Fuji Bank Industrial Bank of Japan	Merger announced	Mizuho Bank
Sanwa Bank Tokai Bank	Merger announced	Sanwa-Tokai
Sumitomo Bank Sakura Bank	Merger announced	Sumitomo Mitsui Bank
Bank of Tokyo-Mitsubishi Mitsubishi Trust Nippon Trust	Merger announced	Mitsubishi Tokyo Group
Daiwa Bank	Withdrawal from international operations	Daiwa Bank
Hokkaido Takushoku Bank	Closed	. . .
Long-Term Credit Bank	Nationalized	Sold to New LTCB Partners CV Renamed Shinsei Bank
Nippon Credit Bank	Nationalized	Sold to Softbank and other investors
Chuo Trust Mitsui Trust	Merged in April 2000	Chuo Mitsui Trust
Yasuda Trust	Became subsidiary of Fuji Bank	. . .
Toyo Trust	Alliance with Sanwa Bank	Toyo Trust
Sumitomo Trust	. . .	Sumitomo Trust
Asahi Bank	. . .	Asahi Bank

credible to the markets, as suggested by the subpar performance of bank stock prices (Figure A1.1). The key problem is their continued focus on prime corporate lending, which absorbs capital but produces little revenue. Margins for comparable loans are similar in Japan to those in other industrial countries, but Japanese banks' loan portfolios are heavily concentrated in low-yielding corporate lending. Private analysts suggest that, if banks are to significantly improve core profitability, they will need to shift these loans to securities markets—repackaging and selling loans to institutional investors and other nonbank institutions—and expand more profitable operations, such as consumer and small-company lending and fee-related capital market activities.

A second important obstacle to improved core profitability is the large scale of public financial intermediation. The government's Housing Loan Corporation and the Postal Savings System play significant roles in mortgage lending and deposit taking, respectively, with the result that public financial institutions account for about one-fourth each of personal financial assets, household borrowing, and corporate borrowing. Postal savings deposits pay attractive rates; they are quite liquid (they can be redeemed without penalty after six months); and they are viewed as backed by the full faith and credit of the government. In addition, the Postal Savings System pays no taxes or deposit insurance premiums, and is not subject to capital adequacy requirements. The proposed reform of the Fiscal Investment and Loan Program merely separates its financing from the Postal Savings System and does not directly address the size of public financial intermediation. In fact, the proposed Fiscal Investment and Loan

Program reform may intensify competition between public and private financial intermediation, as the Postal Savings System will have greater authority to manage its assets.

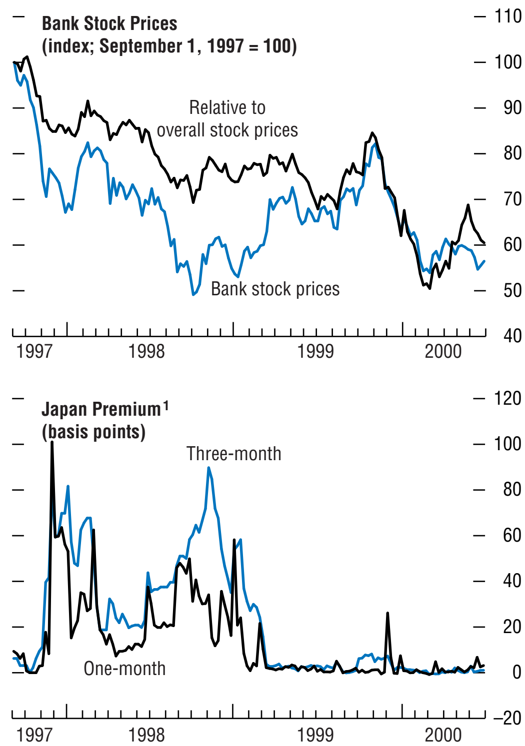
Challenges for Smaller Banks and the Life Insurance Sector

Smaller Banks

Many smaller financial institutions, especially second-tier regional banks and credit cooperatives (which together account for 14 percent of deposits), face more severe asset-quality problems than the large banks. Summary results of the on-site inspections of second-tier regionals, released in September 1999, showed that (1) bad loans (Classes 2–4) were 20 percent more than reported in self-assessments; (2) required loan-loss provisions—based on banks' own loan provisioning standards—for these additional problem loans amounted to 1.1 percent of total credit (almost three times the percentage for first-tier regionals); and (3) average actual provisions for Class 3 loans to "in danger of bankruptcy" debtors were about 50 percent, compared with the Financial Reconstruction Commission guideline of 70 percent. Also, as of March 2000, second-tier regionals had an average capital ratio of 8.1 percent, compared with 9.9 percent for first-tier regionals and 11.8 percent for major banks.

The authorities have begun to address problems at weak regional banks. With FSA encouragement, a number of banks have raised capital from private sources and taken steps toward restructuring, announcing mergers or alliances (apparently, some weaker banks have even persuaded depositors to "exchange" their claims for equity). Also, six regional banks have submitted restructuring plans and received public capital. Separately, the authorities have intervened in five banks that are now under the supervision of a financial reorganization administrator appointed by the Financial Reconstruction Commission, and in May 2000, the government announced plans to sell a failed regional bank to a foreign buyer. However, consolidation among smaller

Figure A1.1. Japan: Banking System Strains, 1997–2000



Sources: WEFA; and Bloomberg Financial Markets L.P.
[1]Average U.S. dollar LIBOR of Fuji Bank, Bank of Tokyo, and Norinchukin Bank minus the LIBOR fix.

banks is proceeding more slowly than among major banks. Local communities are reportedly reluctant to see any change in the status of banks with strong local ties, while near-zero interest rates have reduced the value of "owning" depositors and thus make regional banks less attractive takeover targets. Also, as in the nonfinancial sector, labor costs are difficult to cut.

The tools for resolving credit cooperatives are now being put into place. Credit cooperatives came under the jurisdiction of the FSA in April 2000. The FSA plans to conduct on-site inspections of all credit cooperatives during the current fiscal year. Recently enacted legislation allows credit cooperatives to issue preferred equity securities (similar to preferred shares issued by banks) and to apply for public funds (until March 2002). Related legislation adds bridge-bank functions to the umbrella banks for credit cooperatives and allows the use of reorganization proceedings under the Commercial Code to dispose of failed institutions.

Life Insurance

The overall financial strength of the life insurance sector has continued to deteriorate, reflecting continued negative spreads. In FY1999, premium income, net investment income, and insurance in force all fell. The Japan Rating and Information Service, which rates the claims-paying ability of most large and medium-sized life insurers, assigned investment grades to almost all large life insurers, but to fewer than half of medium-sized life insurers. Some companies have announced plans to reorient their business from term life products to taking care of the retirement and healthcare needs of an aging population.

The authorities have made progress in addressing the problems of life insurance companies. In April 1999, stricter disclosure standards were implemented. In May 1999 the FSA began on-site inspections of loan portfolios using stronger examination standards, which is leading to more realistic recognition of and provisioning for bad loans. The FSA intervened in Toho Mutual Life in June 1999 and in Daihyaku Mutual Life in May 2000.[6]

Recently enacted legislation strengthens the regulation of life insurers and allows them to apply for court-supervised rehabilitation. The new law requires life insurers to report to the FSA five-year projections of the main components of their balance sheets, and also allows them to apply for reorganization under the Civil Rehabilitation Law and (with court approval) lower future guaranteed rates of return on policies. The legislation would also make it easier for mutual insurance companies to reorganize as ordinary stock corporations (demutualize). Finally, the legislation grants up to ¥400 billion in public funds to support the Life Insurance Policyholders Protection Corporation, as its notional resources have been exhausted by the failure of Toho.

As of April 2001, the sale of some insurance products through banks will be permitted (for example, banks will be allowed to sell life insurance products linked to mortgages and fire insurance for homeowners). This change is expected to increase competition and link the reorganization of the insurance industry with that of the banking sector. Hitherto, life insurers have sold policies mostly through their own salespeople. Anticipating the regulatory change, some insurers have begun strengthening ties with banks. The reorganization of marketing systems, especially in-house sales staff, is expected to be key to insurers' long-term survival.

Progress in Corporate Restructuring

Last year's *International Capital Markets* report noted the fragility of the corporate sector in Japan, a situation brought about by the weakening of corporate governance following financial

[6]Toho's negative net worth (about ¥650 billion) was covered by the Life Insurance Policyholders Protection Corporation and a reduction in future guaranteed rates of return on life insurance policies. GE Edison Life took over Toho's policies in March 2000.

Table A1.4. Status of Industrial Revitalization Proposals Targeted to Corporate Restructuring

Proposal	Legislative and Tax Changes	Expected Timing
Facilitate debt-equity swaps	a) Raise the ceiling on size of preferred stock issuance from ⅓ to ½ of outstanding shares b) Tax-deductibility of debt write-off by banks	Passed (August 1999) Uncertain
Civil Rehabilitation Law	Introduction of provisions similar to those of Chapter 11 in the United States	Passed, end of 1999 extraordinary Diet session, effective April 1, 2000
Tax incentives to reduce excess capacity	Extend tax loss carry forward from 5 years to 7 years	Passed (August 1999)
Share swap scheme	Introduction of exceptions to provisions in the commercial code to permit share exchanges	Passed (August 1999), effective October 1, 1999
Stock transfer scheme	Introduction of exceptions to provisions in the commercial code to permit establishment of a holding company in between shareholders and operating firms	Passed (August 1999), effective October 1, 1999
Ease restrictions on asset sales	If acquired company's net assets are less than 5 percent of the acquirer's net assets, the latter is not required to obtain special shareholder approval	Passed (August 1999)
Shorten time required for spin-offs	Introduction of exceptions to provisions in the commercial code to shorten process	Passed (August 1999)
Reduction of registration taxes	Registration taxes lowered to 0.35 percent from 0.7 percent	Passed (August 1999)
Expand application of stock option schemes to subsidiaries	Introduction of exceptions to provisions in the commercial code to permit extension of stock options to employees of subsidiary firms	Passed (August 1999)
Mark-to-market accounting	Increase transparency of financial accounts	Passed (1999), phased in during FY2000–FY2002

Source: Goldman Sachs (1999b).

liberalization and the burst of the asset price bubble. It was widely recognized that revitalization of the corporate sector hinged on reducing the burden of the debt overhang through decisive actions aiming to facilitate the reduction of financial leverage and the shedding of excess labor and unproductive assets. During most of the post-bubble period, the restructuring process has been constrained by a number of structural impediments and adverse incentives.[7] Starting in 1999, a number of official initiatives and developments in business practices (e.g., employee stock option plans) have removed most of the major impediments and created conditions favorable to the restructuring process. This section provides a progress report on these initiatives and developments, reviews the progress in actual restructuring, and discusses prospects.

Progress in Addressing the Issues

Official Initiatives

A number of Ministry of International Trade and Industry proposals, including proposed accounting changes, bankruptcy law reforms, and measures in the context of the Industrial Revitalization Law, have recently been passed into law. The Industrial Revitalization Law is a comprehensive framework that aims to restore the health of the Japanese economy by facilitating corporate restructuring; increasing labor mobility, job creation, and the accumulation of human capital; accelerating technological innovation; and stimulating the creation of businesses in new, dynamic industries. Most of the measures that target corporate restructuring took effect in late 1999 (Table A1.4). The main objec-

[7] See International Monetary Fund (1999).

tive of these measures is to remove a number of impediments to restructuring, including weak tax incentives to restructure; limited recourse to financial restructuring operations such as debt-equity swaps; the lack of effective bankruptcy proceedings that protect management from creditors (e.g., along the lines of U.S. Chapter 11); and an accounting framework that limits transparency about economic performance.

These measures address the need for both financial restructuring (e.g., reducing the debt overhang) and real restructuring (e.g., shedding unproductive corporate assets). On the financial side, the Industrial Revitalization Law and changes to the Commercial Code facilitate the process of deleveraging, including through changes that raise the ceiling on preferred stock issuance and facilitate debt-equity swaps; allow companies to spin off divisions without undergoing a lengthy asset examination by court appraisal; ease restrictions on the sale of assets; and establish new mechanisms (through share swap and stock transfer schemes) for effecting merger and acquisition transactions and creating holding companies and parent-subsidiary relationships. On the real side, to encourage firms to divest excess assets and cut labor costs, the new Law provides a number of incentives to firms whose restructuring plans are approved by the government, such as exemptions from Commercial Code requirements for administrative procedures associated with divestiture and goodwill transfer; and tax incentives, including extension of the carry-forward of loss from five to seven years, the reduction of the Registration and License Tax, and accelerated depreciation allowances.

Financial and real restructuring measures are complemented by the introduction of accounting changes that aim to increase the transparency of financial accounts, and a much-improved legal framework for bankruptcy. Significant accounting changes, already under way, should help to improve financial disclosure and to bring Japanese accounting practice in line with international standards (consolidated accounting became mandatory in FY1999). In FY2000, firms will be required to disclose their pension funding using discounted present value techniques along the lines of U.S. Financial Accounting Standard 87, and to mark-to-market their tradable financial assets and to mark down real estate assets for sale when the market price is no more than 50 percent of book value. In FY2001, the mark-to-market requirement will extend to cross-shareholdings.

In general, corporate restructuring is aided by a strong legal infrastructure, including a well-designed bankruptcy law. An effective bankruptcy law shields financially distressed but efficient firms from premature liquidation and encourages the shutdown of inefficient firms. A major obstacle to this outcome is the conflict of interest between creditors and debtors. On the one hand, the interests of senior creditors are generally better served by the early liquidation of the firm, which preserves the value of their claims. On the other hand, it is usually in the debtor's interest to keep a nonviable firm operating, as the debtor reaps the upside benefit of continuing operations at the expense of creditors, who bear most of the downside costs. In Japan, the Civil Rehabilitation Law, which took effect on April 1, 2000, aims to solve this conundrum and to facilitate the reorganization of viable businesses through what legal experts consider an adequate balance of creditors' and debtors' interests.[8] Provisions designed to preserve the business value of the firm are balanced by provisions that encourage the active participation of creditors as well as the protection of labor interests.[9] In addition, there are a number of coercive measures that aim to prevent a deadlock during the rehabilitation negotiations.

The Civil Rehabilitation Law introduces a number of measures that protect debtors, in line

[8]International Monetary Fund (1999) compares the Civil Rehabilitation Law to existing legal procedures in Japan and U.S. bankruptcy legislation.

[9]See Gitlin and Flaschen (2000).

with the debtor-in-possession principle. First, debtors are not required to prove that the firm is insolvent to start the rehabilitation procedures. This measure permits the reorganization of viable but financially distressed firms at an early stage and, hence, reduces the likelihood of a premature liquidation. Second, incumbent management retains control of the firm and proposes the reorganization plan. Third, the court can provide a stay against secured creditors, stopping repayment of claims and preserving the assets needed to keep the firm as an ongoing concern. Finally, contracts with bilateral obligations can be terminated, at the debtors' discretion, with the exception of collective labor barganing agreements.

Creditor and labor interests are protected by several provisions. First, a court-appointed supervisor closely monitors implementation of the rehabilitation plan and management actions. Second, a committee of creditors formally represents creditor interests. Third, creditors can apply for rehabilitation procedures. This provision encourages creditor participation and propitiates less costly out-of-court negotiations between creditors and debtors. These negotiations can result in either an out-of-court solution, or a summary process in court if the result of informal negotiations—for example, a "prepackaged program"—is approved by more than 60 percent of the creditors. Finally, labor views must be considered in the reorganization plan, and collective bargaining agreements cannot be terminated.

To minimize the time spent in court, the Civil Rehabilitation Law includes measures that prevent a minority of creditors from creating a stalemate in the negotiations, and that force debtors to propose a credible restructuring plan from the very start of the rehabilitation process. Approval of the reorganization plan requires only a simple majority of unsecured creditors. Also, secured creditors' claims can be exchanged for cash deposits equal to the market value of the collateral. In addition, shareholders' equity is eliminated if the plan is not approved.

Some legal experts consider that the Civil Rehabilitation Law's relative favoritism toward creditors, as opposed to Chapter 11 proceedings in the United States, is not a serious deficiency of the law.[10] According to this view, the existence of a strong market for corporate control in the United States partly balances what some consider the excessive favoritism of U.S. Chapter 11 toward incumbent management.[11] Hence, experts consider that the absence of a market for corporate control in Japan favors a pro-creditor stance. Moreover, in practice, the courts have favored the continuity of management: rehabilitation cases filed with the court since the Civil Rehabilitation Law took effect (April 1, 2000) have generally benefited from a stay.

Corporate Governance

The Japanese system of corporate governance has played an important role in determining the financial strength of the corporate sector. The prolonged financial crisis has prompted a reexamination of the prevailing corporate governance structure based on the main bank system, which served the corporate sector well over much of the postwar period. Factors that contributed to the success of the main bank system in this period included the use of long-term customer relationships to deal with an inadequate financial disclosure framework; restricted access of domestic corporations to international capital markets; and the absence of developed equity and money markets in the domestic sector. In fact, some suggest that in that environment, the bank-centered Japanese system was as effective as, or more effective than, the market-oriented U.S. approach in monitoring management. The system also minimized the costs of reorganizing distressed firms owing to the long-term relation-

[10]Bankruptcy proceedings in the United States are followed immediately by automatic stays, and trustees are seldom appointed to supervise management during the proceedings. In addition, the formal participation of creditors and labor is minimal.

[11]See Bradley and Rosenzweig (1992) and Hotchkiss and Mooradian (1998).

ships between creditors, who exercised a substantial amount of control, and their client firms.[12] The liberalization of the financial system in the 1980s eroded the effectiveness of bank monitoring, as the quasi-rents from monitoring associated with the previous regulatory framework vanished. The increased need for equity capital led banks to place their equity with their main clients. This further weakened incentives for banks to strictly monitor their clients, since banks increasingly relied on their clients for capital. In addition, banks increased their lending to small and medium-sized enterprises to make up for the loss of business with large corporations that accessed capital markets. These loan decisions were usually based on the inflated value of fixed assets used as collateral, resulting in the deterioration of banks' loan portfolios.

In this environment, managerial incentives began to diverge from shareholder interests, leading to apparent overinvestment and excessive diversification. The situation may have been exacerbated by a tax system that seemed to discourage the distribution of dividends and left managers with excess resources at their disposal.[13] Return on equity among Japanese corporations dropped from about 7.5 percent in the late 1980s to an average of 3 percent in the 1990s. In contrast, the average return on equity in the United States and Germany during the 1990s was 20 percent and 13 percent, respectively.

During the past few years, changes in business practices and market developments appear to have contributed to the emergence of an alternative corporate governance system based mainly on market incentives, as opposed to relationship lending.[14] First, Japanese corporations are streamlining their corporate boards. Traditionally, the Japanese corporate board has been predominantly composed of former employees of the company itself, usually chosen by the chief executive officer.[15] Now many firms are reducing the number of directors, appointing external directors, and introducing executive officer systems (which delineate clearly that directors are solely responsible for overall strategy and should not engage in executive decisions, which are left to the executive officers). As of mid-1999, 40 percent of the firms listed on the Tokyo Stock Exchange planned to introduce, if they had not already introduced, external independent directors. In addition, 185 firms announced the introduction of executive officer systems and were often rewarded by stock price increases.

Second, incentive-based compensation structures have begun to replace seniority-based structures, in part owing to regulatory changes in May 1997 that allow the use of employee stock options. The use of employee stock options is further facilitated by the introduction of the Industrial Revitalization Law and the Law for Facilitating the Creation of New Business, the latter of which permits the extension of stock options to employees of subsidiary firms and nonregular employees, such as consultants, lawyers, and external advisors, and increases the ceiling on the maximum amount of stock options from one-tenth to one-fourth of outstanding shares in small and medium-sized enterprises. In this environment, the number of stock option plans has increased sharply. In 1999, 182 companies announced the introduction of employee stock option plans, compared with 49 in 1997. In total, 8 percent of all listed companies in the Tokyo Stock Exchange plan to or have implemented employee stock option plans. Companies with implemented stock option programs consistently outperformed the market between 1997 and 1999: their average return on equity during this period was 4½ percent, compared with a market average of 2¾ percent, and their average capital gain outperformed the (equally weighted) TOPIX average by 27 percent during 1999.

[12] See Kaplan (1997) and references therein.
[13] In Japan, the tax rate on distributed earnings is 45 percent. In the United States and Germany, tax rates are 34 percent and 36 percent, respectively (see Swoboda and Zechner, 1995).
[14] See Goldman Sachs (1999a, 2000a).
[15] See Kanda (1998) and Prowse (1994) for details.

Third, the *keiretsu* system of cross-shareholdings,[16] one of the major obstacles to increased participation of outside shareholders and the development of an external market for corporate control, is being transformed by a number of market developments and regulatory changes. The ongoing restructuring and consolidation of the banking system and the increased focus on profitability instead of relationship lending has led major banks to start unwinding their cross-shareholdings. The trend is reinforced by the need for merged banks to satisfy the Anti-Monopoly Law limits on concentration of shareholdings, as banks must consolidate their balance sheets before they merge. Reciprocally, nonfinancial firms have started to sell their shares in banks that are reluctant to lend them money.[17] Complementing these developments, outside shareholders appear to be gaining power. Institutional investors have gradually gained ground in attracting domestic savings, amid an increased appetite of domestic households for alternative investment vehicles (other than bank and postal savings deposits). This trend is evident in the substantial funds attracted by investment trusts and private equity funds, most of the latter managed by foreign companies.

The gradual disintegration of the *keiretsu* system and the unwinding of cross-shareholdings have added momentum to merger and acquisition activities. Merger and acquisition activities totaled ¥6.77 trillion in 1999, and comprised mostly sales of assets by bankrupt companies and deals involving foreign firms. More significantly, last year witnessed the first hostile domestic takeover attempt, perhaps indicating a shift in corporate culture. Looking ahead, this trend may be reinforced by recent listing deregulations in the Tokyo Stock Exchange, which allow firms involved in merger and acquisition activities to remain listed so that they can enjoy access to the equity markets during the consolidation period.

Progress and Prospects

During the past two years, there has been some progress in deleveraging corporate balance sheets, though such progress has been limited as the main impediments in the road to reform have been removed only very recently. From 1998 to 1999, aggregate corporate leverage, measured as the ratio of liabilities to net worth, fell from 350 percent to 320 percent.[18] Deleveraging among small and medium-sized enterprises was responsible for most of the decline; from 1998 to 1999, small firms' leverage dropped from 510 percent to 450 percent; medium-sized firms' leverage decreased from 525 percent to 470 percent; and large firms' leverage declined from 240 percent to 225 percent.

Many observers consider that much more remains to be done, however. The limited progress in restructuring has been reflected in the muted market reaction to announced restructuring plans. In 1999, 850 restructuring plans were announced, compared with close to 400 in 1998. However, markets reacted cautiously to most of these announcements. Private analysts expressed concerns that many of the plans were based solely on cost-cutting measures, which they deemed insufficient to boost profitability.[19]

Profitability, as measured by return on assets, increased from 1¾ percent at end-1998 to 2½ percent by end-1999. However, profitability still remains at about half the levels attained prior to the 1990s, and considerable restructuring may be needed to reestablish historical levels of profitability. Private analysts estimate that restoring profitability to the average level enjoyed in 1975–89 through cuts in labor costs alone could raise the unemployment rate to

[16]See Bebchuk (1999) and Hoshi (1998).
[17]See Fukao (1998).
[18]Based on figures published by the Ministry of Finance.
[19]See Goldman Sachs (1999b).

10 percent.[20] In addition, a significant part of Japan's capital stock may need to be replaced and upgraded to remove unproductive assets. The excess capital stock amounts to some ¥85 trillion, according to the Economic Planning Agency, compared with a total of about ¥1032 trillion.[21] Some of the adjustment may already be taking place through bankruptcies. In the first quarter of 2000, more than 3,700 bankruptcies occurred, a 40 percent increase from a year earlier. In this environment, credit quality in the corporate sector continued to deteriorate during 1999, with 30 corporate downgrades, compared with 3 upgrades and 25 downgrades in 1998. Credit analysts considered that the deterioration in credit quality was brought about partly by the inability of corporations to restructure rapidly and successfully in a protracted economic downturn combined with increased deregulation.[22]

Although progress to date has been limited, the restructuring process may be bolstered in the period ahead by the aforementioned measures, including changes in the bankruptcy law and the accounting framework, in the following ways:

- Legal experts and market analysts suggest that the Civil Rehabilitation Law has considerable potential as a corporate restructuring tool. As of end-May, 2000, two months after its enactment, 100 rehabilitation cases had been filed with the Court. In contrast, 300 cases were filed under the Composition Law (Wagi) during the entire previous year.
- The Civil Rehabilitation Law is viewed as having the potential to encourage entrepreneurial risk taking through ex ante incentives. It also complements well the provisions in the Industrial Revitalization Law that are conducive to the establishment of start-up businesses in dynamic sectors of the economy.
- The introduction of consolidated accounting facilitates the adoption of the holding company structure and may allow companies and investors to more easily distinguish profitable and unprofitable divisions, and to reward management accordingly. Also, the adoption of the holding company structure could contribute to the identification of potential takeover targets.
- The introduction of mark-to-market accounting may increase the transparency of company accounts and help to develop a credit culture in Japan, as firms may have to disclose unrealized losses in their portfolios. Also, as firms anticipate potential balance sheet pressures arising from these losses, the unwinding of cross-shareholdings and the securitization of real estate assets could accelerate. Further weakening of the cross-shareholding structure could increase the influence of large institutional investors and foster a market for external control.
- The importance of large institutional investors could be reinforced by two factors: (1) the planned introduction of defined contribution pensions along the lines of 401(k) pension funds in the United States, and (2) the maturing of approximately ¥100 trillion postal savings deposits in the next two years.

The combination of official measures and changes in business practices may contribute to the establishment of a market-oriented system of incentives, such as employee stock options, and penalties, such as takeovers and credit downgrades, that reward profitability. There is some reason to hope that this system of incentives and penalties could help to transform the prevalent corporate framework in Japan. In a 1998 survey conducted by the Economic Planning Agency, 80 percent of managers at firms with more than ¥10 billion in assets considered that profitability, rather than total sales and growth, would be the most important future determinant of their corporate strategy.[23] This shift in attitudes, along

[20]See Morgan Stanley Dean Witter (2000).
[21]See IMF (1999) and Bayoumi (2000). Private estimates are about ¥100 trillion (see Morgan Stanley Dean Witter, 2000).
[22]See Standard & Poor's (2000).
[23]As reported in Hayakawa and Maeda (2000).

with recent measures that remove impediments and bolster incentives to restructure, and a strengthened system of corporate governance, may signal the changes needed to revitalize Japan's corporate sector and reestablish long-run growth.

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TRENDS IN FOREIGN OWNERSHIP IN EMERGING MARKET BANKING SYSTEMS

The extent of foreign ownership in emerging market banking systems increased considerably during the second half of the 1990s, but there have been divergent trends across different regions. This annex highlights such differences for a group of systemically important emerging markets and provides background material for Chapter VI.

Central Europe

Hungary was the first country in the region to allow foreign strategic investors into its banking system in 1995, and by end-1999 foreign bank participation was about 60 percent of total assets, while foreign control was about 80 percent (see Table 6.1).[1] Following the bank recapitalization programs in the early 1990s, a rapid privatization program brought foreign ownership from 15–20 percent by end-1994 to 60 percent currently. Rating agencies and market analysts expect foreign presence to remain stable or increase gradually, through either more rapid growth of the dynamic, medium-sized foreign banks or the privatization of Postabank. Poland was somewhat slower to implement the privatization of the banking system but the number of banks with foreign ownership has grown considerably in the last two years. Initially, foreign banks were limited to acquiring troubled local banks or to starting up their own operations. The barriers to foreign takeovers were formally removed on January 1, 1999, to comply with the terms of Poland's European Union association agreement and its membership of the OECD. Foreign participation in total assets reached 36 percent by end-1999, but participation in total equity was 56 percent. Foreign control rose to 53 percent of total assets, from a low of just 2 percent in 1994 (see Table 6.1). Foreign participation and control will get a further boost with the approval of the purchase of a 66 percent stake in Bank Handlowy by Citigroup.[2]

The Czech Republic's bank restructuring and privatization program has been slower than those of Hungary and Poland, but recent sales of large banks to strategic investors have reduced the difference between the three countries in terms of foreign ownership. In 1992 the three largest banks were privatized by exchanging more than 50 percent of their shares for privatization coupons, but the diluted ownership structure left the government with a controlling interest in the banks.[3] Inadequate governance and lack of effective corporate restructuring led to a fragile banking system with relatively low foreign participation. Following the May 1997 currency crisis, the authorities took steps to improve prudential supervision of the capital markets and the banking system and announced plans to sell controlling stakes in the four largest banks to foreign strategic investors. The privatization process gathered speed in the second half of 1999 with the sale of Ceskoslovenska Obchodni Banka (CSOB, the former foreign trade bank) to Belgium's second-largest bank—bringing foreign

[1]The large increase in foreign control from 57 percent under the 50 percent threshold to 80 percent under the 40 percent one is due to the 42 percent participation of foreign institutional investors in OTP, the National Savings and Commercial Bank. However, the largely dispersed ownership of this bank may raise doubts as to whether foreign institutional investor could indeed exert control of the bank operations.

[2]The approval of a 66 percent sale fell short of the request by Citigroup for a 75 percent stake. Analysts see the scaling back as an attempt of the authorities to protect minority shareholders and to maintain Handlowy's identity as a Polish institution. Foreign investment in the Polish banking system has recently become a hotly debated issue (see *Euromoney,* 1999, and *Euromoney,* 2000).

[3]See Kawalec (1999).

participation in the system to 44 percent of total assets (Table 6.1). In February 2000, Austria's second-largest bank agreed to buy a 52 percent stake in Ceska Sporitelna (the second-largest Czech bank), bringing foreign participation to about 54 percent.[4]

Latin America

Foreign banks have long been strong competitors in Argentina, as reflected by the relatively high share of assets they controlled by end-1994 (see Table 6.1). The Tequila crisis accelerated the consolidation of the banking industry, but initially, it was the large local banks that acquired branches from bankrupt institutions. During 1997, foreign institutions started to buy local banks that, interestingly, were not troubled banks. The second-, third-, and sixth-largest private banks (all previously family-owned banks) were sold to various European buyers during that year. Taking advantage of the opportunities presented by low stock valuations in 1998 and 1999, foreign banks continued to expand their presence and currently control about half of the industry's assets. Chile also had a relatively high presence of foreign banks in 1994, but a series of mergers and acquisitions—including the merger of the Spanish owners of the two largest Chilean banks—contributed to a sharp increase in foreign control of banking assets (Table 6.1). Analysts estimate that the integration of banking with insurance and pension fund activities will lead to further consolidation and foreign participation in the near term.

In Brazil, foreign participation in the banking system has increased noticeably since the implementation of the Real Plan in 1994, but still remains lower than in most other Latin American countries. Since 1995, many foreign institutions entered the market in the context of two bank restructuring programs. As a result, the share of assets under foreign control increased from 8 percent to 18 percent (see Table 6.1). The landmark acquisitions of HSBC and ABN Amro—who bought the seventh- and fourth-largest private banks, respectively, in 1997 and 1998—together with the entry of other European and U.S. banks is likely to contribute to further consolidation of the system. Several of the acquisitions proved problematic[5] and many of the foreign banks are still restructuring the acquired banks and getting acquainted with a market that, contrary to many others in the region, includes three sizable, well-capitalized, and well-managed private banks. The forthcoming privatization of major state-owned bank Banespa represents a potential turning point in shaping the structure of the banking industry and affecting the future extent of domestic ownership.[6]

Foreign banks started to enter into the Mexican financial system immediately after the privatization of 1990–92, with the exception of Citibank—which had continued to operate as an independent bank when all the other institutions were nationalized. Initially, most of the investments were minority stakes as the law allowed foreign institutions to own only up to 20 percent of local banks. However, the crisis that followed the December 1994 devaluation changed the landscape as the authorities realized that foreign institutions could bring the capital needed by local banks, and allowed the acquisition of ultimate control (i.e., 51 percent or more) of a local bank with the approval of

[4]The privatization process for the largest bank (Komercni) has been under way for some time and the government has reportedly received 10 preliminary letters of interest from domestic and foreign banks (including Bayerische HypoVereinsbank, Citigroup, and Deutsche Bank).

[5]The acquisitions of Banco Excel Económico by Banco Bilbao Vizcaya Argentaria (BBVA) and of Banco Bandeirantes by Caixa Geral de Depositos required much larger-than-expected commitments from the acquirers because of the poorer-than-anticipated asset quality and labor liabilities carried by the banks (see Moody's, 1998). More recently BSCH faced similar problems with its acquisition of Banco Bozano Simonsen (see *IFR Latin America,* 2000).

[6]Nine banks were prequalified for the auction, including five foreign banks—BBVA, BSCH, Citibank, Fleet National Bank, and HSBC Holdings—and four private domestic banks (Bradesco, Itaú, Unibanco, and Safra). The share of assets controlled by foreigners would raise to about 24 percent if Banespa is purchased by a foreign bank.

the Ministry of Finance.[7] The first bank to increase its participation to a majority stake was BBVA—which already owned a 20 percent stake in Probursa, and has since acquired the branch networks of two intervened banks (Cremi and Oriente). In August 1997, Citibank consolidated its long-established presence in the country with the acquisition of Banca Confia. A number of other foreign banks established minority investments in Mexican banks, bringing the share of assets controlled by foreigners to about 19 percent of total assets—from a low of just 1 percent by end-1994 (Table 6.1). However, the major breakthrough happened in December 1998, when the Mexican Congress lifted the historical restriction on buying the country's largest banks. A friendly takeover bid of Bancomer—the nation's second-largest bank—by BBVA was the first result of the opening up, and the recent approval of the transaction would bring a substantial increase in the share of assets under foreign control.[8] On May 8, it was announced that BSCH had won the auction for Banca Serfin—the country's third-largest bank—and that it would merge it with its subsidiary Banco Santander Mexicano, to create a combined entity that would control about 11 percent of assets and bring the share of assets under foreign control to about 40 percent.

In the Andean countries, foreign institutions have reached a dominant position in Peru and Venezuela, but Colombia remains a largely domestic system. In the early 1990s, the only foreign bank presence in the Peruvian banking system was the representative office of Citibank. Since restrictions on foreign ownership of banks were lifted in 1993, foreign institutions (including several Chilean financial institutions and a large Italian bank) have increased their control of banking assets from 7 percent by end-1994 to 33 percent by end-1999 (see Table 6.1). Foreign bank participation was minimal in Venezuela before the 1993–94 crisis, but shortly afterward the Spanish banks bought controlling shares in the largest and third-largest Venezuelan banks. Other foreign banks, including banks from Chile, Colombia and Peru, followed the Spanish lead to bring the foreign control of assets to 44 percent in 1999 (see Table 6.1). The expansionary drive of the Spanish banks reached Colombia in the second half of 1996, when BBVA acquired the country's largest private bank (Banco Ganadero) and Santander purchased Banco Comercial Antioqueño, to bring the share of assets under foreign control to 18 percent.

Asia

Korea has achieved substantial progress in bank restructuring, but foreign involvement has involved mostly minority shareholder investments. While negotiations for the sale of KFB to Newbridge Capital were successfully completed in December 1999, an attempt to sell Seoul Bank to HSBC failed; the government has now appointed a foreign institution to manage the bank. Progress in raising capital from abroad has been good in the case of other banks, both in the case of direct investments and through Global Depository Receipts issues. More recently, Korean banks have turned to the international subordinated debt markets in order to raise Tier 2 bank capital, a trend started by the Thai banks in 1998.[9]

Malaysia provides an interesting example of an emerging market where foreign participation has declined over time but remains relatively large for regional standards. Since the late

[7]However, this would not apply to any proposal whereby foreign investors acquire control of a bank whose net capital exceeds 6 percent of the total amount of net capital of all Mexican banks. In practice, this prevented the sale of control of the three largest banks, Banamex, Bancomer, and Serfin (see Fitch IBCA, 1999a).

[8]An unsolicited takeover bid from Banamex, the country's largest bank, left the outcome of the Bancomer-BBVA-Mexico merger uncertain for a short period of time. The Banamex-Bancomer merger would have created a bank with 40 percent of total deposits, and the event would have raised bank concentration issues.

[9]See International Monetary Fund (1999). Hanvit and Cho Hung, the second- and fourth-largest Korean banks, raised US$1.5 billion in international subordinated debt markets over the period December 1999–March 2000.

1950s, when foreign banks controlled 94 percent of assets, Bank Negara Malaysia has encouraged the setting up of new local banks and the rapid expansion of their branch networks. A series of curbs on the activities of foreign banks—such as the prohibition since 1971 of the establishment of new branches, automatic teller machines authorized only at the branch premises, a 30 percent ceiling on foreign shareholdings—has caused them to lose their predominant position in the market, where they now hold a 23 percent share of total assets. Foreign-owned banks have concentrated mostly on corporate banking, although those banks that had established networks prior to the 1971 restriction—such as three Singaporean, two U.K., and two U.S. banks—have successfully penetrated the retail market. Over the past decade, Bank Negara Malaysia has tried to encourage the large number of small banks to merge to form stronger entities, with the aim of consolidating the industry and ensuring that the remaining local banks are in the best position to face the increased competition from foreign banks should Malaysia relax entry requirements in the future, as it has committed to do under the General Agreement on Trade in Services.[10]

Prior to the financial crisis of 1997, Thailand had been relatively closed to foreign banks but this situation is gradually changing. Foreign bank participation in Thailand had been restricted by a limitation of one branch and by the fact that the last foreign bank license was granted in 1978. In 1997, 19 foreign banks held about 9 percent of total banking system assets, but this share understates the role of foreign banks because it excludes those banks operating through the BIBF without a branch license.[11] After the crisis, Thailand increased the limit of foreign ownership, from 25 percent to 100 percent of total equity. Four banks—the Bank of Asia, Nakorthorn, Thai Danu, and Radhanasin—were sold in 1998–99, to ABN Amro, Standard Chartered, Development Bank of Singapore, and United Overseas Bank, respectively. The privatization of the other two remaining intervened banks has proceeded more slowly, reflecting the fact that their larger size has added to the complexity of the negotiations over pricing and gain-loss sharing agreements. The share of assets under foreign control increased from 0.5 percent of assets at end-1994 to 4.5 percent at end-1998 (Table 6.1) but, if Bangkok Metropolitan Bank is sold to a foreign investor, foreign control would increase to about 9 percent.

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[10]See Fitch IBCA (1999b).
[11]See Fitch IBCA (1998).

ANNEX III CONCLUDING REMARKS BY THE CHAIRMAN

At the conclusion of the Excutive Board's discussion of the International Capital Markets *report (Executive Board Meeting 00/80; August 2, 2000), the Chairman made the following concluding remarks.*

Executive Directors engaged in a wide-ranging discussion of developments in the mature and emerging international capital markets. Global financial conditions have generally improved over the past year as the world economy has rebounded, and investors have shown an increased willingness to take on risk. The global financial system has shown itself to be adaptable and resilient, and capable of withstanding sudden and substantial shocks. Nonetheless, there are several important risks and vulnerabilities in the period ahead, particularly relating to developments in the major economies and financial systems. Directors also discussed three key systemic issues: the risks to financial stability from over-the-counter (OTC) derivatives markets; efforts to involve the private sector in the prevention and resolution of crises; and the implications of the expansion of foreign-owned banks in many emerging markets.

Developments and Risks

Directors observed that the strong performance of the U.S. economy has bolstered global financial markets and investor sentiment. U.S. investment themes have increasingly resonated internationally, reflected notably in the worldwide allocation of funds to the technology, telecommunications, and media sectors and, until March 2000, in the buoyancy of stock prices in these sectors. In Europe, Directors noted the progress in financial market integration, against the background of a depreciating euro and the buoyancy of equity and private bond markets. In Japan, they noted that the financial system problems have stabilized to a considerable degree, and that the authorities have put in place a potentially effective framework for financial and corporate restructuring. Some Directors, however, considered that not enough progress has been made by the private sector in implementing this new framework, and that further progress is needed before the Japanese recovery can be sustained.

Directors discussed several risks for the mature financial markets in the period ahead. Some cautioned that a sharper than expected pickup in U.S. inflation, or an unanticipated drop in productivity, might give rise to a broadly based deterioration in investor sentiment, further corrections in equity and corporate bond markets, a general repricing of risk, portfolio rebalancing, and exchange rate adjustments. Directors identified sharp movements in the major currencies as another risk—independent of U.S. inflation risk—and related these possible movements to the mounting external imbalances.

Directors also identified risks pertaining to Japan and Europe. Some observed that, in Japan, expansionary policies—while appropriate from a macroeconomic perspective—might be affecting asset pricing and financial flows in Japan's fixed income and money markets, and could be encouraging position-taking that might not be profitably sustained should interest rates adjust more sharply than expected. It was observed that it will be critically important to carefully and transparently manage the transition to less stimulative monetary and fiscal policies. This situation warrants vigilant monitoring of financial markets—including OTC derivatives markets in Japan—and proactive management by the Japanese authorities.

With regard to the emerging markets, Directors noted the gradual improvement over the past year in the terms and conditions of market access, and the strengthening in emerging market asset prices. They attributed much of this improvement in outlook to the improved fundamentals in most emerging markets, reflected in stronger economic growth, stable exchange rates, and upgrades in credit ratings by the major international agencies. Directors noted, with approval, the ongoing development of domestic financial markets in many emerging markets and the reduced reliance on external financing that this will entail. They considered that the continuing strength in direct investment, reduced reliance on international bank financing, and a lengthening of the average maturities of external financing, are positive developments. They also noted the improved positive sentiment toward emerging markets on the part of investors from mature market countries and the reduction in volatility in emerging market asset prices from the high levels seen during the crises.

Notwithstanding the improved situation relative to a year ago, Directors recognized that flows to emerging markets remain substantially below pre-crisis levels and that borrowing costs remain high, relative to pre-crisis levels. Furthermore, market access by the poorest emerging markets remains extremely limited. Directors noted the sharp cutbacks in financing flows associated with the turmoil in mature markets in April and May, which have highlighted the dependence of emerging markets on conditions in mature markets. However, Directors were encouraged by the subsequent recovery in prices and financing flows, and considered that, as long as there are no major disturbances from the mature markets, the outlook for emerging markets remains generally positive. Directors highlighted, however, the need for continued strengthening in macroeconomic policies and renewed structural reform of corporate and financial sectors in several key emerging markets. They also emphasized the potential risks to financial and economic conditions in several key emerging markets from the spillover effects of either a sharp unanticipated upturn in global interest rates or a substantial downward correction in mature equity markets.

OTC Derivatives Markets

Directors acknowledged the substantial benefits conveyed by derivatives instruments to international financial markets and the global economy more generally. They noted the central role that derivatives instruments and markets play in the effectiveness of the global financial system, and their role in supporting pricing, trading, and risk management in all of the major bond, equity, and foreign exchange markets. Directors agreed that the use of derivatives to unbundle financial risks has created more complete, flexible, and efficient financial markets and improved the pricing and allocation of financial risks.

While some Directors considered that the risks associated with OTC derivatives activities should not be overstated, many Directors believed that they could pose considerable risks to financial stability. They observed that OTC derivatives portfolios expose financial institutions to risks that can be more difficult to assess and manage than the risks encountered in traditional lending and deposit taking. This reflects the complicated and uncertain nature of cash flows associated with OTC derivatives contracts. These Directors noted that OTC derivatives activities are ruled primarily by market discipline, rather than official regulation or oversight. Some also noted that, while the private, decentralized, market-disciplining mechanisms seemed, so far, to have safeguarded the soundness of individual, internationally active, financial institutions—in part because the institutions have been well capitalized—these mechanisms might not adequately protect market stability. Certain markets and countries, only remotely related to derivatives activities, have experienced instability because of spillovers and contagion. Some Directors recalled the experience in the period leading up to the near-collapse of Long-Term Capital Management (LTCM) in the autumn of 1998 and noted that, while no major financial institution failed, private market-disciplining mechanisms did not prevent the buildup and concentration of large counterparty risk exposures.

In this regard, Directors noted several features of OTC derivatives markets that could raise concerns about financial instability. First, gross credit exposures in OTC derivatives transactions are sensitive to changes in information about counterparties and asset prices. Second, information asymmetries, because of limited disclosure and transparency, complicate the assessment of counterparty risk. Third, OTC derivatives activities affect the aggregate credit and liquidity available in asset markets. Fourth, aggregate OTC derivatives activities and counterparty credit exposures are both sizable and highly concentrated in the internationally active financial institutions. This could make these institutions vulnerable to abrupt changes in market conditions. Fifth, OTC derivatives activities closely link institutions, markets, and financial centers, and therefore are possible vehicles for spillovers and contagion. Directors considered that these features could raise the risk of a rapid unwinding of positions in response to new information or changes in risk tolerance.

The Directors who felt that the systemic risks associated with OTC derivatives should not be overstated also noted that, while OTC derivatives combine market and credit risks in ways that would never happen in traditional risks, OTC derivatives also generate significant benefits, which should not be overlooked. They also noted that some progress has been made by the private and official sectors in addressing some of the problems revealed during the LTCM crisis.

Directors noted that measures in three areas could address imperfections in the infrastructure of OTC derivatives markets and strengthen market stability. First, market discipline might be made more effective, particularly through private efforts to improve transparency and disclosure, supported by official coordination and oversight. Second, legal and regulatory uncertainties might be reduced, particularly those associated with closeout and netting arrangements and with the regulatory status of derivatives instruments in various jurisdictions. Finally, micro- and macro-prudential monitoring of OTC derivatives activities can be significantly improved. Banking supervision and market surveillance can pay closer attention to the effects of OTC derivatives activities on risks in financial institutions and markets. Directors agreed that private and public efforts in these three areas, by enhancing market discipline, can strengthen private risk management, and thereby reduce systemic risk.

Private Sector Involvement in Crisis Resolution

Directors agreed that efforts at crisis prevention and resolution, which serve to reduce potential inefficiencies and instability in the international financial system, are in the interests of both the public and private sectors. They observed that, because of the relative absence of clearly established rules of the game in the international context, the reaction of the private sector to new information and new initiatives concerning the official community's approach to crisis resolution could have potentially profound implications for the nature and structure of international capital flows. Market participants' responses to the array of crisis prevention and resolution proposals have, in many cases, reflected a lack of awareness of official sector initiatives. Against these considerations, many Directors stressed the importance of publicizing and making clear the official community's objectives and initiatives, particularly the work on standards and codes. It will also be necessary to improve the level of communication and understanding between the public and private sectors. In this connection, Directors attached particular importance to more active and effective communication by the Fund itself of its views on private sector involvement. Directors also welcomed the Managing Director's proposal to establish a Capital Markets Consultative Group, which they hoped would complement and strengthen efforts for a faster and closer involvement of the private sector in crisis prevention and resolution.

Directors recalled that private sector involvement in crisis resolution is not new. The extent of involvement, however, has been related to the nature of capital flows. Most Directors agreed that it is useful to distinguish between potential outflows in a crisis that are generated by direct or portfolio equity instruments and more inflexible outflows generated by instruments that have a predetermined fixed contractual claim.

Directors agreed that a key lesson from the 1980s was that, when particular lending instruments are involved in restructurings, the private sector will seek out new instruments that are viewed as having a higher probability of repayment and as being insulated from restructurings. Directors noted that the large-scale restructuring of syndicated bank loans, in the aftermath of the 1980s debt crisis, while leaving eurobonds untouched, has provided impetus for channeling flows to emerging markets through the interbank and international bond markets. The more recent experience with concerted interbank rollovers suggests that such rollovers are more likely to be expected as part of future crisis resolution packages. However, expectations that this would occur might lead some international banks to cut their credit lines and run early in the face of an imminent crisis. Alternatively, the possibility of an imminent crisis could prompt international banks to hedge or offset their exposures in other markets, such as the bond market. Most Directors concluded that undue emphasis could not be placed on interbank rollovers alone, and, for them to be effective, they must be part of comprehensive crisis resolution packages.

Directors welcomed the fact that the most recent string of crises has firmly pierced the halo surrounding the status of international bonds. They noted that the experience with bond restructurings and private sector involvement is continuing to evolve rapidly. Some Directors cautioned, however, that if bond restructurings became more common, private sector creditors would, over time, increasingly seek ways of structuring debt so that it was harder to restructure. Most Directors stressed the importance of involving the private sector in a cooperative and voluntary fashion to discourage the creation of ever more short-term or inflexible debt restructures, thereby contributing to a more efficient and stable international financial system.

The Role of Foreign Banks in Emerging Markets

Directors noted that one of the major structural changes in the banking systems in many emerging markets in recent years has been the sharp increase in the degree of foreign ownership, especially in Eastern Europe and Latin America. This change in the ownership structure reflects the desire of both large international and regional banks to enter profitable markets and of the local authorities to improve the efficiency and stability of their financial systems, as well as to help reduce the cost of recapitalizing weak domestic banks.

Directors noted that the entry of foreign banks in the emerging market banking systems presents both benefits and challenges to the host country, in terms of efficiency and stability considerations. With regard to efficiency, they observed that the entry of foreign banks could improve the efficiency of emerging market banking systems, both by increasing the degree of competition and by introducing a variety of new financial products and better risk management techniques. On the other hand, some Directors noted that foreign banks were less likely to contribute to overall efficiency if they follow a strategy of servicing only the most creditworthy corporate and household customers.

As regards the role of foreign banks as a means of helping to stabilize banking systems in emerging markets, Directors offered a range of views. Many Directors argued that foreign banks could play an important role in stabilizing these systems, citing their use of more advanced risk management systems, their better access to international capital markets either directly or through their parent banks, and the likelihood that the local foreign banks will be supervised on a consolidated basis with their parent. Other Directors, however, noted that the potential contribution of foreign banks will depend very much on the circumstances, and may vary. They suggested that recent experience indicates that foreign banks may simply “cut and run” during crisis periods and they are therefore not a stable source of domestic funding. International banks were seen by these Directors as managing their exposures to emerging markets on a consolidated basis; a decision by them to cut exposures to an individual country could involve reductions in both cross-border lending and local operations. Moreover, these Directors argued that the presence of foreign banks opens a new channel for the transmission of disturbances in mature market banking systems to emerging markets. Directors requested the Research Department to undertake further analysis on the impact of entry of foreign banks. Directors agreed that the entry of foreign banks into emerging markets would have the most beneficial efficiency and stability effects if there were simultaneously both a strengthening of prudential supervision in emerging markets, and enhanced cross-border sharing of information between supervisors in mature and emerging markets. In particular, supervisory authorities will need to upgrade their capacity to acquire information on and to analyze the implications of their use of OTC derivatives products.

Some Directors raised concerns about the potential banking system concentration that could arise either as foreign banks acquire local banks or as local banks merge in order to remain competitive. A particular concern is that such concentration could create banks that are too big to fail locally and thereby lead to an extension of the scope and cost of the official safety net. Other Directors argued that any potential problems could be limited by enhanced prudential supervision and appropriate antitrust policies.

In conclusion, Directors have noted that recent developments underscore the importance of timely and comprehensive surveillance of international capital markets. They welcomed the forthcoming publication of the 2000 International Capital Markets report—after the incorporation of appropriate revisions to reflect the discussions of the Executive Board—as an important vehicle for the dissemination to the public of the staff's work on multilateral surveillance.

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