VI

Developments in International Banking

Industrial Countries

As was the case in 1995, the performance of commercial banks in industrial countries differed markedly in 1996 between countries, depending upon their relative position in the credit cycle. For banks in Canada, the United Kingdom, and the United States, which had resolved their asset-quality problems relatively quickly in the early 1990s, profitability and capitalization levels remained at or near historic highs, with nonperforming loan ratios at correspondingly low levels. For banks in France, Italy, and Japan, performance has lagged, although the worst of the asset-quality difficulties appears to be past. The overall condition of the banking systems in these countries has improved, but differences between stronger and weaker institutions have sharpened. Emphasis is increasingly placed on the resolution of serious problems in individual institutions and on the longer-term structural issues that confront the industry, such as the effects of EMU on competition within European banking systems, discussed in Chapter III.

Banks in *Canada,* the *United Kingdom,* and the *United States* again led the major industrial country banks in terms of profitability and asset quality in 1996.[35] Net income increased in all three banking systems, reaching an average return on equity of 15 percent in Canada, 19 percent in the United Kingdom, and 14 percent in the United States. These profits were earned despite a narrowing of net interest margins in each country and reflected an increase in noninterest earnings and a decline in loan loss provisions and write-offs. Asset quality remains strong, with the ratio of nonperforming loans to gross loans falling to historic lows in the United States (1 percent) and Canada (0.6 percent) and also to a very low level in the United Kingdom (2.5 percent). In addition, reserve coverage for current nonperforming loans appears to be more than adequate, with coverage ratios well in excess of 100 percent in Canada and the United States, and approaching that level for some of the banks in the United Kingdom. The peak in asset quality, however, may have passed. Banks have expanded their consumer lending and other high-margin lending in order to compensate for declining margins on corporate loans, but in each country the quality of the consumer loan portfolio declined in 1996. Finally, the banks' capital ratios remain strong. At end-1996, Canadian banks had an average total risk-weighted capital ratio of 9 percent; U.K. banks' capital ratios averaged 11 percent; and U.S. banks' core capital ratio was almost 8 percent. These high capital levels were achieved despite significant volumes of share repurchases in all three countries, financed in part in the United States by issues of tax-exempt, trust-preferred securities that are eligible as Tier I capital under U.S. bank capital adequacy regulations.

The regulatory environment for banks in the United States has allowed a significant broadening of commercial banks' involvement in the securities and insurance businesses, and both the Federal Reserve Board and the U.S. Department of the Treasury have proposed repealing the Glass-Steagall Act's restrictions on affiliations between banks and securities dealers. The structure of financial supervision and regulation is also being reconsidered in the United Kingdom. The U.K. government has proposed to integrate all financial supervisory and regulatory authority, including that over banks currently exercised by the Bank of England, in the Securities and Investments Board. Such a consolidation of supervisory authority in one agency is occurring in response to the emergence of a unified financial services industry and is being incorporated in the regulatory structure in an increasing number of countries, including Japan.

Unlike banks in many other countries, *German* banks have not experienced a significant deterioration in asset quality in recent years. The five largest private banks reported a 19 percent increase in net income in 1996 (for a return on equity of 10 percent) due mainly to a sharp rise in noninterest income. The banking sectors in *France* and *Italy,* however, showed another year of moderate earnings on loan portfolios. For the first time in six years, all of the seven major banks in France reported positive net profits for 1996—earning a return on equity of 8 percent—owing mainly to exceptionally high income from capital market activities and from lower loan loss provisions. The same factors

[35]Banking system developments in these countries are based on the performance of the Schedule I banks in Canada, the six largest clearing banks in the United Kingdom, and the commercial banks insured by the Federal Deposit Insurance Corporation (FDIC) in the United States.

contributed to a 7 percent increase in operating profits for Italian banks. In both countries, banking operations continue to be affected by weak loan demand, narrowing interest margins due to aggressive competition and increasing disintermediation, and poor asset quality. The French and Italian authorities continue to provide support to individual institutions with serious asset-quality difficulties, which has translated into an increasingly large amount of contingent liabilities, albeit with limited immediate budgetary impact. Nevertheless, it is generally believed that the worst of the asset-quality difficulties in France and for the Italian banks in the center-north of the country are past. The banks are now reasonably well capitalized, with total risk-weighted capital ratios of between 8.7 percent and 11.4 percent for the major banks in France and 13 percent for banks in Italy. Several banks in southern Italy, however, continue to struggle with worsening asset quality. The ratio of bad loans to total loans in the region has been in excess of 20 percent with a rising fraction estimated to be irrecoverable. Countrywide, the stock of bad loans reached 10 percent of total loans at end-1996, up from 9 percent at end-1995, and the estimated loss rate increased to 38 percent from 33 percent at end-1995. However, the percentage of loans granted to firms considered to be at risk has decreased across sectors and regions, thus slowing down the growth in the ratio of bad loans to total loans.

The banking crisis in *Japan* continues to move toward a resolution. In the 1996/97 fiscal year, the 20 major banks again set aside loan loss provisions far in excess of operating profit, financed by realizing net gains on their equity investments. At the end of March 1997, aggregate nonperforming loans (loans to bankrupt borrowers and loans that were six months or more past due) were ¥13.2 trillion, essentially unchanged from a year earlier. However, total problem loans, including loans restructured at interest rates below the official discount rate and loans made to support customers, fell significantly, from ¥26 trillion to ¥19 trillion; net of specific reserves, problem loans fell from 4 percent of gross loans to 3 percent.

Although the definition of problem loans has been gradually widened in the last two years, it is still less comprehensive than, for example, U.S. bank supervisory definitions. The Japanese definition does not include loans that are past due for 90–180 days, loans that have been sold to the Cooperative Credit Purchasing Company (CCPC), special-purpose vehicles, or other affiliates, or loans restructured at interest rates above the official discount rate. Many of these loans would likely be considered nonperforming loans under U.S. practices. Applying a broader definition of nonperforming loans to the Japanese banks would yield an estimate for aggregate problem loans somewhat higher than the official estimate. Of course, the ultimate losses that the banks are likely to sustain are much smaller than the stock of problem loans, and depend upon the probability of default and the value of the collateral that is recovered.[36]

The decline in interest rates in Japan since 1995 has been beneficial to the banks. As interest rates fell, banks earned large returns on their bond portfolios, trading activities, and loan spreads, all of which contributed to very high pre-provision income. Furthermore, at current interest rates, the yield difference between a performing loan and a nonperforming loan is relatively small, so the bad loans have not depressed earnings or capital as much as they would have if interest rates were higher. The benefits to the banks of low interest rates are believed by many market participants to have been among the factors that have influenced the Bank of Japan's interest rate policy—since the banks have positioned themselves to benefit from a steep yield curve, an increase in short-term interest rates might reduce cash flows, with the magnitude and timing varying among banks depending upon the structure of their portfolios. This concern is reinforced by the banks' underlying weak profitability compared with banks in other industrial countries. During 1985–94, the average pre-provision return on assets for Japanese banks was 0.5 percent, compared with about 1.7 percent for Canadian, U.K., and U.S. banks. Even if all of their operating costs were eliminated, Japanese commercial banks would have earned a return on assets of only 1.4 percent.

During 1996, the Japanese authorities adopted a U.S.-style bank resolution framework built around (1) increased powers for regulators to intervene in problem banks, including declaring them insolvent; (2) prompt corrective action (PCA) measures for intervening in weak banks and maintaining a sound financial system; and (3) increased resources for the deposit insurance corporation, including a special premium to finance insurance coverage of deposits in excess of the statutory limit until end-March 2001. The prompt corrective action measures, which take effect April 1, 1998, require banks to classify their loan portfolios rigorously and to allow the authorities to force them to take corrective measures or ultimately to close them if their risk-weighted capital ratios fall below certain thresholds. A change in the structure of financial supervision has also been initiated. The Japanese Ministry of Finance's responsibilities in the area of bank supervision will be moved to an independent agency, the Supervisory Agency for Financial

[36]Adding the book value of loans sold to the CCPC increases total problem loans to ¥29 trillion. The 20 major banks began setting aside provisions against their contingent liabilities to the CCPC in 1996 because the collateral value on many of the loans they had sold to the CCPC has declined below the value at which they were sold, and the banks must make up this difference when the collateral is sold. IBCA Ltd. estimates that the total value of problem loans among the major banks at end-March 1997 was ¥40 trillion, of which the estimated uncovered loss was ¥4.5 trillion.

Entities, which will also exercise surveillance over securities firms, but the ministry will continue to be responsible for setting bank regulations, and the Bank of Japan will retain its bank examination powers.

A far-reaching set of financial reforms, described as Japan's "Big Bang," announced in November 1996, includes (1) the elimination of most remaining foreign exchange controls and ex ante reporting requirements, and the abolition of the authorized foreign exchange bank system; (2) the acceptance of financial holding companies; (3) the abolition of fixed commissions on securities transactions; and (4) the elimination of restrictions segregating securities, trust, and banking activities. The first measure is the central element of the reform plan, as increased foreign competition is expected to force domestic firms to be more innovative and more efficient and to provide better services and higher returns to retail investors, who are often perceived to be ill served under current financial market practices. The latter three measures are expected to lead to some restructuring and consolidation of the financial services industry, since they allow financial holding companies—combining all types of banking and securities activities—to be established, while at the same time making each type of activity more competitive and responsive to market forces.

Banking System Developments in Emerging Markets

Developments in the major emerging market banking systems were influenced in 1996 by the differing patterns of economic performance across regions. The economic recoveries in Latin America allowed banking systems to continue the necessary structural reforms and reorganizations in a less crisis-charged environment. In Asia, lower growth and exports, and weaknesses in property markets, had serious repercussions in some emerging market financial systems, because these conditions uncovered underlying problems—illiquidity and heavy net foreign currency liabilities of the corporate sectors—and directly affected banks' overall asset quality. In many emerging markets, existing measures of asset quality are based on weak accounting practices that do not provide accurate estimates of the true value of loan portfolios. In addition, off-balance-sheet operations, particularly in derivatives, often escape regulatory oversight and can substantially change banks' exposure to different risks.

The growing awareness that an unsound, inadequately regulated financial system can severely disrupt macroeconomic policy and performance led to a broad-based international effort to promote the soundness and stability of financial systems in emerging markets. The relevant international financial institutions and official groupings responded to these concerns by elucidating the general principles of a sound financial system. The Basle Committee on Banking Supervision published its consultative paper, *Core Principles for Effective Banking Supervision,* in April 1997, and the G-10 Working Party on Financial Stability in Emerging Market Economies also released its paper, *Financial Stability in Emerging Market Economies,* in the same month. The latter report called for a "concerted international strategy to promote the establishment, adoption and implementation of sound principles and practices needed for financial stability" in emerging markets and proposed a strategy in which, following the development of an international consensus on what constitutes a sound financial system, the IMF and other multilateral institutions would promote the adoption and implementation of these principles and practices. An early proponent of such an effort, Goldstein (1997), has called for the establishment of International Banking Standards, based on the principles developed by the international agencies, to which bank supervisors in emerging markets would voluntarily adhere.

Asia

Korea's membership in the OECD in 1996 and its commitment to further capital account liberalization lowered funding costs but also increased potential vulnerabilities from foreign competition and surges in capital flows. At present, however, the main risks to the banking system derive from the past practice of government intervention in banks' credit allocation decisions and the resulting large exposures to individual borrowers or high-risk sectors. The lack of a well-developed credit culture within banks and the emphasis on collateral, rather than credit evaluation, have also contributed to a worsening of asset quality as liquidity problems among the large corporations intensified in 1996.[37] While the official estimate of nonperforming loans (defined as loans that are unrecoverable and loans that are six months or more past due) is only about 1 percent of total loans, the Presidential Commission on Financial Reform estimated in April 1997 that under a broader definition, problem loans among the six largest commercial banks amounted to 5 percent of total loans. In addition to declining loan quality, the banks have had to deal with a decline in Korean equity prices in 1996, which produced large revaluation losses on their equity portfolios.

The authorities have responded to the declining asset quality and the losses on banks' equity portfolios in 1996 by tightening bank supervision, including a

[37]The 30 largest conglomerates (*chaebol*) have high gearing ratios by international standards. At end-1996, 19 of them had debt-equity ratios in excess of 400 percent. In early 1997, two of the large *chaebols* defaulted on their debts and are undergoing restructuring and/or liquidation.

recent proposal to create a Finance Supervisory Board, uniting supervision of banks, securities companies, and insurance companies in one agency. However, the authorities have also engaged in some regulatory forbearance. The loan loss provisioning requirement for doubtful loans was lowered to 75 percent from 100 percent, and the banks were allowed to provide for only 30 percent of the securities revaluation losses in 1996, rather than 50 percent as had previously been required. Despite these measures, the leading commercial banks reported a slight decline in net income in 1996.

A surge in capital inflows into the *Philippines* since 1991–92 has contributed to a sharp increase in equity and property prices and in liquidity in the banking system, which have fueled a rapid expansion in bank lending—42 percent a year during the last two years. These increases in asset prices and lending have raised concerns about asset quality, in part because a significant portion of the new lending has been to the consumer sector, which tends to have a relatively high loss rate, and because commercial banks in the Philippines have a high exposure to the property sector. The Central Bank of the Philippines estimated that commercial banks' property loans accounted for 10 percent of total loans at end-1996. However, the true exposure may be higher since property is a common form of loan collateral, and some of the banks have other stakes in property developers. In April 1997 the central bank limited real estate loans to 20 percent of a bank's total loans and lowered the allowed loan-to-value ratio, in an attempt to limit the system's exposure to that sector.

As is the case elsewhere in the region, foreign currency exposure has been increasing in the Philippines. Banks have borrowed in foreign currency to finance domestic lending, and their net foreign liabilities increased to $6 billion at end-1996 (9 percent of total liabilities plus capital) from a nearly balanced position at end-1995. Prudential regulations require banks to limit their foreign exchange exposure to 15 percent of capital. Foreign-currency-denominated lending from the banks' Foreign Currency Deposit Units (FCDUs) has also expanded rapidly—by 110 percent in 1996. While banks are required to maintain balanced FCDU books, the currency risk is borne by borrowers, some of whom may experience difficulties in servicing the loan if the peso depreciates or export revenues decline. To reduce the potential vulnerability of the banking system to foreign exchange risk, the central bank introduced a 30 percent liquidity requirement on foreign-currency-denominated assets in June 1997.

The exposure of the *Thai* corporate and financial sectors to foreign exchange risk is widely believed by market participants to have influenced the authorities' exchange rate policy. At the same time, the strength of the baht and the high interest rates needed to maintain the exchange rate, combined with a deteriorating property market, contributed to an increase in nonperforming loans from 7 percent of loans at end-1995 to 8 percent at end-June 1996. While banks are believed to have hedged most of their net foreign liabilities, the opposite is believed to be true for the corporate sector. The combination of a stable exchange rate and a wide differential between foreign and (much higher) domestic interest rates provided a strong incentive for firms to take on foreign currency liabilities, until doubts about the sustainability of the exchange rate strengthened in July 1996. Hence, in addition to their own foreign exchange exposure, banks may have a large indirect exposure in the form of credit risk to firms that have borrowed in foreign currencies.

The property market in Thailand has been an important source of loan losses both because banks have lent to this sector and because property has often been used as collateral for loans. The vacancy rate on prime office space in Bangkok was 14 percent in March 1997, and the availability of office space is due to increase sharply in 1997–99. In addition, asset quality in the rapidly built-up consumer lending portfolio and in the general corporate lending business has deteriorated.

The official response to the latest concerns about the health of the financial system has focused on improving accounting and disclosure of asset quality and on rehabilitating the property market and the finance company sector. Banks are required to begin disclosing nonperforming loans and provisions with their June 1997 financial statements, and they are required to have set aside additional reserves equal to 15 percent of substandard loans by end-June 1999. The authorities have also introduced measures to support the property market, including the establishment in March 1997 of the Property Loan Management Organization (PLMO). The PLMO was capitalized with B 1 billion from the fiscal budget and authorized to borrow up to B 100 billion to finance the purchase of property-related loans from banks. The authorities have also established a secondary mortgage corporation and have permitted the securitization of financial assets.

The Thai authorities moved resolutely to deal with weak finance companies in late June 1997. The Ministry of Finance ordered 16 finance companies to suspend operations for 30 days and required them to submit, within 14 days, rehabilitation plans involving injections of capital from domestic or foreign investors. Five large and stable finance companies agreed to acquire the net assets of those of the 16 companies that are unable to recapitalize themselves. The Bank of Thailand will provide up to five new banking licenses to such merged entities subject to a minimum size requirement. Promissory notes issued by failed institutions will be rescheduled, while those of the 75 healthy finance companies can be converted to bank certificates of deposits at the investor's discretion. In addition, the Bank of Thailand has temporarily capped deposit rates of finance companies at 14 percent, and those of commercial banks at 12 percent.

Latin America

The economic recovery in *Argentina* continued in 1996 and resulted in a reflow of deposits back into the banking system, which allowed interest rates to ease and boosted lending activity. Nevertheless, net income for the 20 largest banks rose only marginally, and the return on average equity declined slightly to just below 7 percent. The restructuring of the banking system continued in 1996—three private banks were taken over and two others had their licenses revoked—and further consolidation is expected, including privatization and foreign investment in the banking system. This process is supported by the authorities, who modified the role of the deposit insurance fund in 1996 to allow it to assist in the acquisition or merger of banks.

Profitability continued to worsen among a sample including the 50 largest banks in *Brazil* because of a sharp decline in the net interest margin and a rise in administrative costs and despite an increase in noninterest income. With interest rates and margins declining, the banks included in the sample invested a greater share of their assets in investment and trading securities and less in loans—the ratio of securities and short-term investments to loans and advances exceeded 110 percent at end-1996, compared with 77 percent a year earlier. This move away from lending and toward securities investment and trading occurred while average asset quality in the banking system continued to decline. At end-1996, loans in arrears and nonperforming loans accounted for 14 percent of total loans of active commercial banks, up from 7 percent at end-1994.

In Argentina and Brazil, as well as elsewhere, the banking systems are segmented by performance and asset quality between government-owned banks and private banks. In Argentina, the ratio of loans past due more than 90 days to total loans was 19 percent for the federally owned banks at end-September 1996, 27 percent for the provincial banks, and 9 percent for the domestic private banks. The return on average equity for the government-owned banks was only 4 percent in 1996, compared with 11 percent for the large private banks. Similarly, in Brazil, while 14 percent of the financial system's loans were in arrears or liquidation at end-1996, the figure for the 21 largest private banks was only about 2 percent and that for 28 smaller private banks was about 5 percent, leaving the government-owned banks with the lion's share of bad loans. Such problems are illustrated by the R$12 billion in losses incurred by Banco do Brazil over 1995–96, due mainly to more rigorous criteria for classifying nonperforming loans, that led to increasing loan loss provision and weakening income. In April 1996, the government announced a recapitalization plan under which it eventually provided R$6.8 billion. In August 1996, the federal and state governments agreed to reschedule the states' debts in return for which the state banks would be privatized, liquidated, or transformed into development agencies.

Notwithstanding the improvement in the economy, banks in *Mexico* continued to struggle in 1996 with deteriorating asset quality. The commercial banking system, excluding banks that were under central bank intervention or in other special situations, recorded an aggregate net loss of MexN$7 billion (11 percent of equity) in 1996, after a profit of MexN$2.5 billion in 1995. The net interest margin fell to 4 percent from 6 percent in 1995, because of a decline in interest rates and an increase in nonperforming or low-yielding assets on the banks' balance sheets. Nonperforming loans increased by MexN$1.2 billion (2.5 percent) in 1996, despite the sale of MexN$124 billion in (mostly nonperforming) loans by the banks to FOBAPROA,[38] and at the end of the year they equaled 7 percent of loans, compared with 8 percent at end-1995. Since January 1, 1997, the accounting rules for asset quality have been significantly tightened with the application of accounting principles closer to those used in the United States. Under the new accounting principles, at the end of 1996, 12.2 percent of loans were nonperforming.

Despite the still-growing stock of nonperforming loans, the recapitalization commitments obtained in return for the loan sales to FOBAPROA have resulted in an increase in the ratio of equity to nonperforming loans to 149 percent at end-1996 from 137 percent a year earlier. However, of the total equity of MexN$70 billion at end-1996, only just under half (MexN$32 billion) was paid-up capital. Revaluation gains on equity and fixed assets contributed almost as much (MexN$25 billion), making the true capitalization of the system partially dependent upon asset market developments and property valuations.

The banking system in *Venezuela* began to recover in 1996 after two difficult years, in which 17 banks holding 54 percent of end-1993 deposits were closed or taken over by the deposit-guarantee fund, FOGADE,[39] at a total cost of 30 percent of 1994 GDP. The 13 largest Venezuelan banks' net income increased by a factor of three in 1996, owing mostly to higher net interest earnings from lending—loans increased by more than 80 percent in 1996—income from securities holdings, and profits from long dollar positions held at the time of the devaluation of the bolivar in April 1996. Asset quality also improved in 1996. At the end of the year, banks reported that 4 percent of gross loans were past due or in litigation, with a re-

[38]FOBAPROA is the deposit-guarantee fund (Fondo Bancario de Protección al Ahorro).

[39]FOGADE is the Fondo de Garantiá de Depósitos y Protección Bancaria.

serve coverage ratio of nearly 200 percent, compared with ratios of 10 percent and 121 percent, respectively, in 1995. The Venezuelan banks are similarly well capitalized. As a result of capital injections by FOGADE and bank shareholders, the equity-assets ratio has increased to 13 percent, from 8 percent at end-1994.

The immediate future for the Venezuelan banking system will be strongly influenced by the sudden emergence of foreign competition. After 1975 foreign banks were not permitted in Venezuela, but that ended in December 1996, when foreign financial institutions acquired controlling stakes in three of the four largest Venezuelan banks—two of which were acquired in privatizations. The foreign banks' more advanced practices (including technology), broader range of products, and deeper capital base will put pressure on the other Venezuelan banks to modernize and become more efficient and may lead to further consolidation in the industry.

Eastern Europe and Africa

In the *Czech Republic*, eight banks, including the fifth largest, were subject to intervention by the Czech National Bank in 1996, although in most cases the authorities had been preparing for this move for a number of years. At end-September 1996, 33 percent of credit was still classified below normal but the incidence of nonperforming loans actually declined over the previous year's figures. The larger banks especially have investment grade ratings and are generally believed to be fully reserved against their nonperforming loans, which are declining. Nevertheless, the provisioning needed to meet the required coverage ratio has consumed about a third of operating income in recent years.

Commercial banks in *South Africa* continued their recent pattern of high profitability and strong capitalization in 1996, with an aggregate risk-weighted capital ratio of about 10 percent. Although asset quality declined slightly, the incidence of nonperforming loans remains low and adequately reserved. Overdue loans rose by 17 percent in 1996 but represented only 3 percent of total loans at the end of the year, marginally lower than the previous year-end ratio. After more than a decade of near isolation, the South African banking system has become highly concentrated (the four largest banks hold about 85 percent of industry assets) and heavily exposed to the domestic corporate conglomerates (large credit exposures granted accounted for 1,033 percent of capital and reserves). Both forms of concentration have contributed to the relatively high profits of the banks, and both are likely to come under pressure from the liberalization of foreign capital flows, which will increase the level of competition from foreign banks and capital markets, a process that has already begun. In addition, the ongoing liberalization and development of domestic capital markets are likely to increase the pace of disintermediation. These two forces will induce South African banks to become more cost efficient and will require the bank supervision authorities to monitor the asset quality closely if banks increase their lending to riskier borrowers in search of higher yields.