Annex III

Developments in International Banking

The major international banking systems, including those in many emerging markets, have been engaged in a process of restructuring and consolidation in recent years that is profoundly changing the nature of the banking industry. Changes in regulation and technological developments have increased competition in traditional banking activities while simultaneously opening up new markets for expansion. In many countries, banking crises or the failure of important individual banks have provided additional impetus for restructuring. Continuing advances in information technology and the ongoing globalization of capital markets and the risk management business have resulted in consolidation in the investment banking industry. These issues are discussed with examples of recent important transactions in industrial countries and emerging markets in the first section of this annex.

Many of the catalysts of financial system restructuring have led to a reassessment of supervisory and regulatory practices. A consensus is emerging in policy circles that a functional approach must give way to supervision and regulation on a legal-entity basis to align the reporting requirements and inspection systems with the management structures of financial conglomerates. However, the most efficient method of implementing this approach remains undetermined. In many countries, the architecture of supervision itself would have to be changed, and the question of if or how to retain a role for the central bank in the supervision of money center banks considered. At the same time, bank supervision is moving away from the auditing of financial condition reports toward an emphasis on assessing the adequacy of systems, including those for risk management and internal controls. There is also increasing discussion of the role that could be played by disclosure and other market-based systems of supervision. Developments in supervision and regulation in industrial countries, and the international effort to improve financial supervision and regulation in emerging markets, are discussed in the second section.

These structural changes do not occur in isolation from the condition of the banking systems. Indeed, profitability and asset quality will affect the speed and nature of such developments. Banking systems that are dealing with the urgent resolution of asset-quality problems will have a restructuring dynamic that is very different from that in countries where such immediate pressures are less important, resulting in different patterns of mergers and acquisitions and perhaps a delay in responding to the longer-term structural issues. Recent developments in the banking systems of most of the systemically important industrial countries and emerging markets are discussed in the final two sections. Table 30 gives one indicator of relative strength of banking systems around the world, the Bank Financial Strength Ratings assigned by Moody's. The industrial country banking systems are deemed to be stronger on a stand-alone basis than those in the emerging markets, but there is considerable diversity of conditions within the two groups, with some of the emerging market banking systems faring well in comparison with the industrial country group, while some of the latter are considered to be in serious difficulty.

Restructuring and Consolidation of International Banking Systems

The restructuring and consolidation that are under way in international banking systems have been motivated by a number of developments in the past decade or so, among which four stand out: (1) the deregulation of international and domestic financial markets; (2) improvements in communications and computational technology; (3) significant asset-quality-driven problems in many banking systems; and (4) a growing recognition of the costs and distortions associated with official support for banking institutions. These mutually reinforcing developments have both provided the impetus for banking sector restructuring and in turn been affected by this restructuring.

Changes in the supervisory and regulatory framework have been an important source of pressure for industry consolidation and restructuring. Such changes include the liberalization of domestic and cross-border banking activities, the easing of segmentation barriers within national financial systems,[1] and the reorienta-

[1]For example, restrictions on the combination of commercial and investment banking activities in one institution or holding company have been eased in both Japan and the United States. Japanese commercial banks were permitted to open securities and trust subsidiaries in 1993, while U.S. bank holding companies were granted limited scope to deal in "ineligible" securities in 1987.

Table 30. Bank Financial Strength Ratings for Selected Countries, June 2, 1997[1]

	A	B+	B	C+	C	D+	D	E+	E	Average
Industrial countries										
Australia	0	0	4	0	6	2	0	0	0	C–C+
Austria	0	0	0	4	2	2	0	0	0	C
Belgium	0	2	2	2	1	0	0	0	0	B
Canada	0	1	5	4	0	0	0	0	0	B
Denmark	0	0	1	1	1	0	0	0	0	C+
Finland	0	0	0	0	0	3	0	0	1	D
France	0	2	5	6	4	6	2	1	1	C
Germany	1	4	4	9	8	3	0	0	0	C+
Greece	0	0	0	0	2	2	2	1	0	D+
Ireland	0	0	2	1	1	3	0	0	0	C
Italy	0	0	2	7	6	2	1	1	2	C
Japan	0	0	2	2	10	10	15	6	4	D+
Liechtenstein	0	0	1	0	0	0	0	0	0	B
Luxembourg	0	0	5	0	0	1	0	0	0	C+–B
Netherlands	3	1	1	1	1	0	0	0	0	B+
Norway	0	0	0	0	3	1	0	0	0	C
Portugal	0	0	0	1	3	1	0	0	0	C
Spain	1	3	5	1	2	0	0	0	0	B
Sweden	0	0	1	1	3	0	0	0	0	C–C+
Switzerland	1	1	2	2	1	0	0	0	0	B
United Kingdom	3	4	8	5	6	3	1	0	0	C+
United States	3	20	68	129	63	9	3	0	0	C+
Emerging markets										
Asia										
China	0	0	0	0	0	1	12	3	0	D
Hong Kong, China	0	0	2	0	7	2	0	0	0	C
India	0	0	0	0	0	2	3	0	1	D
Indonesia	0	0	0	0	0	3	5	2	2	D
Korea	0	0	0	1	1	4	7	4	1	D
Malaysia	0	0	0	1	1	0	0	0	0	C–C+
Philippines	0	0	0	1	1	5	2	0	0	D+
Singapore	0	3	0	1	2	0	0	0	0	B
Taiwan Province of China	0	0	0	1	4	4	0	0	0	C
Thailand	0	0	0	1	2	1	4	3	0	D–D+
Europe										
Croatia	0	0	0	0	0	0	1	0	0	D
Cyprus	0	0	0	0	2	0	0	0	0	C
Czech Republic	0	0	0	0	0	3	2	1	0	D
Hungary	0	0	0	0	0	3	3	0	0	D–D+
Israel	0	0	0	0	2	3	0	0	0	D+
Poland	0	0	0	0	0	3	3	1	0	D
Romania	0	0	0	0	0	0	2	1	1	E+
Slovak Republic	0	0	0	0	0	0	3	0	0	D
Slovenia	0	0	0	0	0	2	0	0	0	D+
Turkey	0	0	0	0	2	2	6	4	0	D
Latin America										
Argentina	0	0	0	0	2	3	4	1	0	D+
Brazil	0	0	0	3	5	10	4	1	2	D+
Chile	0	0	0	5	4	1	0	0	0	C
Colombia	0	0	0	1	3	0	2	0	0	D+–C
Mexico	0	0	0	0	0	0	3	4	2	E+
Panama	0	0	0	0	1	0	0	0	0	C
Peru	0	0	0	0	1	3	0	0	0	D+
Puerto Rico	0	0	0	0	0	1	1	0	0	D–D+
Uruguay	0	0	0	0	0	1	1	0	0	D–D+
Venezuela	0	0	0	0	0	2	3	0	0	D

Table 30 *(concluded)*

	A	B+	B	C+	C	D+	D	E+	E	Average
Middle East and Africa										
Bahrain	0	0	0	0	1	2	3	0	0	D+
Egypt	0	0	0	0	1	1	1	0	0	D+
Jordan	0	0	0	0	0	1	1	0	0	D–D+
Kuwait	0	0	0	1	1	1	3	2	0	D–D+
Oman	0	0	0	0	0	3	1	0	0	D+
Pakistan	0	0	0	0	0	0	0	2	2	E–E+
Qatar	0	0	0	0	0	1	2	0	0	D
Saudi Arabia	0	0	0	1	2	4	4	1	0	D+
South Africa	0	0	0	0	3	3	0	0	0	D+–C
United Arab Emirates	0	0	0	0	0	2	1	1	0	D

Source: Moody's Investors Service.

[1]The Bank Financial Strength Rating is Moody's assessment of whether a bank is likely to require financial support from shareholders, the government, or other institutions. The ratings range from A (highest) to E (lowest). Note that the coverage of banking systems is not generally complete, so that the ratings are not necessarily representative of the credit quality of the entire system.

tion of the emphasis of bank supervision toward capital adequacy. The deregulation of financial markets allowed for greater disintermediation from banking, as depositors searched for higher yields in investment funds and securities, and corporate borrowers found access to financing at competitive terms in the securities markets by selling bonds to institutional investors. Table 31 provides some evidence for these trends by presenting data on two indicators of disintermediation, the ratio of institutional investors' financial assets in total financial assets of domestic financial institutions, and the share of household assets represented by claims on institutional investors. Both ratios have increased sharply since the mid-1980s for most industrial countries. For example, in France the assets of institutional investors rose from 11 percent of total financial system assets in 1985 to 23 percent in 1995; the share of household assets held by institutional investors also rose, from 16 percent in 1985 to 27 percent in 1995. Disintermediation is most advanced in the United States, where in 1995 institutional investors accounted for 55 percent of financial system assets and held 45 percent of household assets. These indicators suggest the difficulties banks have faced in responding to the deregulation of financial markets.

The move toward risk-based capital requirements in the late 1980s marked a significant change in the supervision of banks and led to a reorientation of bank management objectives toward maximizing risk-adjusted returns on capital, rather than increasing gross measures of performance such as total revenues, profits, or market share. The need to increase capital as the scale of bank operations expands or as its activities become more risky reinforces the incentives to maximize shareholder value in order to maintain access to sources of capital. Mergers and acquisitions (M&A) have been viewed as one way to increase shareholder value, although it is notable that there is little evidence to support the existence of economies of scale or scope for banks or for improvements in efficiency resulting from mergers or takeovers.[2]

It may be, however, that recent technological developments will make improvements in shareholder value arising from M&A transactions more significant, even for so-called mega-mergers of very large banks. Developments in computational and communications technologies have been an important catalyst for restructuring both by possibly changing the scale and scope economies within banking and by increasing the effectiveness of competition from nonbank financial institutions. These developments have already revolutionized the products and services offered by banks, and the ways in which these are delivered. They have also increased the efficient scale of a number of operations, including check processing and other payment operations, the processing of loan applications (e.g., through the adoption of credit scoring models for mortgage loan applications), risk management and treasury operations, trading, and the centralization of most data back-office activities. More recently, and most visibly, the employment of electronic banking technology—automated teller machines, point-of-sale debit machines, telephone banking, and Internet banking—is more cost effective if the bank has a very large customer base. It is possible, therefore, that consolidation among very large banks can allow a more efficient adoption of these new technologies than is possible for smaller banks.

For many banks, the most effective incentive for restructuring has been a sudden decline in profitability, and this is true also for banking systems as a whole.

[2]See Berger and Humphrey (1997). Empirical studies have generally not found evidence of statistically significant economies of scale except for small banks. On average, mergers and acquisitions do not appear significantly to improve cost efficiency, but there is some evidence of increased profit efficiency arising from mergers of large banks in the United States.

Table 31. Distintermediation in Selected Industrial Countries

	Assets of Institutional Investors[1]		Institutionalization of Household Savings[2]	
	1985	1995	1985	1995
Canada	26.4	35.9	24.5	31.4
France[3]	11.4	23.4	15.7	27.3
Germany	12.8	19.0	19.6	28.9
Japan[4]	10.2	22.6	32.2	34.8
Norway[5]	13.0	21.9	25.1	37.5
Spain	3.2	15.0	2.9	24.4
United Kingdom[6]	26.7	31.6	. . .	52.0
United States	43.8	54.6	33.4	45.3

Source: Organization for Economic Cooperation and Development.

[1]Financial assets of insurance companies, pension funds, and investment companies as a proportion of total financial assets of domestic financial institutions.

[2]Outstanding claims of households on institutional investors as a proportion of total household financial assets.

[3]Data include financial assets of insurance companies and investment companies only.

[4]Earlier data are for 1990, not 1985. Data include financial assets of insurance companies, investment companies, and trust accounts of trust banks (excluding investment trusts) only.

[5]Later data are for 1993, not 1995.

[6]Earlier data are for 1988, not 1985.

The past decade or so has seen the emergence of serious banking difficulties in a large number of industrial countries and emerging markets, and their resolution has often provided an opportunity for consolidation or acquisitions by outside investors. Takeovers by strong banks of relatively weaker ones is a common pattern in bank mergers and acquisitions and can hasten the resolution of asset-quality problems by improving bank management, reducing the constraint on cash flow posed by nonperforming assets by combining them in a portfolio with a higher average quality, and providing greater income flows or capital with which to set aside loan loss reserves or to write off problem loans; for these reasons such takeovers are often encouraged by bank supervisors.[3]

Another factor that has contributed to the dynamics of restructuring in banking systems has been the declining role of the state in financial systems due, in part, to the growing pressure for fiscal consolidation and the allocation of scarce budgetary resources to other priorities, including pension finance, for example. As it becomes more difficult for governments to justify the expenditures necessary to bail out failed banks[4]—government owned or not—the direct ownership stake that governments have had in individual institutions has gradually been withdrawn in many countries.

Banks have responded to these pressures with a variety of strategies, including concentrating on core activities in which they have a strong comparative advantage and expanding vertically (to exploit economies of scale) or horizontally (to capture economies of scope). The expansion strategy has been in many ways the most visible, as the past few years have seen a seemingly unprecedented wave of mergers and acquisitions within the international financial markets. One strategy that some large institutions appear to have adopted is to become a globally competitive actor. The liberalization of international financial transactions over the past two decades made most markets contestable to firms willing to expand geographically. With the asset-quality problems associated with the 1980s debt crisis and then the early 1990s real estate crisis behind them, many of the large banks in the major industrial countries have begun to compete for business on an international level.

The pace of consolidation in industrial country banking systems slowed slightly in 1996 after a hectic year. In the *United States*, where mergers and acquisitions are far more common than in other mature systems, activity slowed significantly in 1996 after a record volume of transactions in 1995. A total of 442 deals were announced in 1996, with a total value at announcement of $44 billion, compared with 537 deals for $73 billion in 1993.[5] More important than the volume of transactions, however, has been the types of deals announced. In the past two years, the five largest U.S. bank mergers ever arranged have been announced—Wells Fargo and First Interstate ($13.7 billion); Chemical Bank and Chase Manhattan Bank ($13.3 billion); NationsBank and Boatman's Bancshares ($9.5 billion); First Bank and U.S. Bancorp ($8.4 billion); and First Union and First Fidelity ($6.1 billion)—and a bid for the third-largest savings and loan institution (Great Western Financial Corp.) appears to have been won by the second-largest thrift (Washington Mutual) in a deal that might cost $6.7 billion. The banking industry has embarked on an almost unprecedented process of consolidation leading to the creation of a small number of institutions that are dominant on a national scale.

Most of this M&A activity has been truly consolidation of commercial banking within or between geographical areas as restrictions on interstate banking have been progressively relaxed, culminating in their widespread elimination under the Riegle-Neal Act of 1994. However, with the liberalization of banking regulations on sales of insurance and on securities underwriting and sales, the focus of attention has recently

[3]O'Keefe (1996) found, for example, that for unassisted bank acquisitions in the United States during 1984-94, target banks tended to have higher loan loss provisioning requirements, lower profitability, higher noninterest expenses, and higher liquidity (i.e., a smaller proportion of assets invested in loans) than the acquiring institutions.

[4]For estimates of the magnitude of such expenditures in recent years, see Lindgren, Garcia, and Saal (1996).

[5]Elstein (1997). First quarter 1997 data suggest that activity has picked up considerably, with a total of $22 billion in deals announced.

turned toward acquiring complementary skills as in, for example, the 1995 Mellon Bank acquisition of Dreyfuss, the $7.3 billion Bank One acquisition of First USA, or the more recent takeover of Alex. Brown by Bankers Trust. Increasingly, in response to the gradual relaxation of constraints on their nonbanking activities, banks are expanding their securities and asset management capabilities. Nor has such activity been restricted to the banking industry, as reflected in the $10.2 billion merger between Dean Witter, Discover and Morgan Stanley (which had itself acquired Van Kempen America in 1996) creating the largest credit card issuer and fifth-largest asset manager in the world.

The *U.K.* banking system also saw some important repositioning by individual institutions in 1996, but of a more varied nature than is possible in the United States. Lloyds Bank and TSB Bank merged in 1996, creating the third-largest bank in the country. NatWest sold its U.S. and Australian banking subsidiaries, but acquired Gartmore, a U.K. asset management company. Three building societies (Alliance and Leicester, Halifax, and Woolwich) renounced their mutual status and took bank licenses, and Halifax also acquired a life insurance company. *Canadian* banks have been engaged in acquiring securities and trust subsidiaries since they were permitted to do so under the 1987 and 1992 revisions of the Bank Act. Similarly, some of the banks have acquired U.S. financial institutions: in 1996, the Bank of Montreal acquired a U.S. thrift, Household Bank, and Toronto Dominion Bank bought Waterhouse Securities in New York. In addition, Canadian banks continued to invest in emerging markets in 1996–97, as discussed below.

French banks also have responded to recent asset-quality difficulties and highly competitive markets in part by engaging in heightened merger and acquisition activity within the past year. This has included the mergers of Banque Française du Commerce Extérieure and Crédit National, and of Crédit Local and Crédit Communal de Belgique; the takeover of Banque Indosuez by Crédit Agricole; and the takeover of Banque Hydro-Energie by Crédit Commercial de France in 1996. In early 1997, Société Générale had acquired a majority stake in Crédit du Nord, which had last year acquired Banque Laydernier. Unlike mergers elsewhere, however, the elimination of redundancies is not usually a major objective in French bank mergers, since strict labor laws and high unionization within French banks make it difficult to reduce staff. M&A activity is geared more toward identifying complementary specializations or risk concentrations.

German banks have been perhaps the most active among continental banks recently in expanding into international investment banking and asset management (e.g., Deutsche Bank acquired Morgan Grenfell in 1989, and Dresdner Bank acquired Kleinwort Benson in 1995). This activity continued in 1996, as Commerzbank acquired American Martingale Asset Management, and Bayerische Hypotheken-und Wechsel Bank acquired management control over U.K.-based Hypo Foreign & Colonial Management Holdings by increasing its equity stake to 65 percent, and entered into a cooperation agreement with a U.S.-based asset management company, Massachusetts Financial Services.

In *Italy*, bank restructuring has involved consolidation among the smaller institutions, often through mergers with larger banks, and through changes in bank ownership. Banco di Napoli was formerly 71 percent owned by a private charitable foundation. Such foundations had been important owners of banks in Italy, but under the Amato Law of 1990, incentives were given to these foundations to sell their stakes. This has been achieved gradually, most recently with the sale of 45 percent of the shares in Istituto Bancario San Paolo di Torino by its owners. Italy also has a large number of very small banks, many of which have low capital levels. While such institutions are gradually being merged with or taken over by larger banks, the labor laws and practices in Italy make it very difficult for banks to realize large efficiency gains from mergers. Banks still seem to view these mergers as mechanisms for increasing market share rather than increasing profits. It is not uncommon for merged banks to continue to operate under their own names in competition with each other, with almost no apparent effort to rationalize their structures or products.

Japan has seen a large number of bank takeovers in the last two years as this has been an integral element in the official response to asset-quality problems. Since the emergence of the current banking sector problems, at least 20 institutions, mostly credit unions and credit cooperatives, have been merged with healthier institutions, in many cases with assistance from the Deposit Insurance Corporation (DIC). The major institutions have not been left out of this process. In October 1994, Mitsubishi Bank took over Nippon Trust in an assisted transaction of the troubled bank, and in April 1997, Hokkaido Takushoku Bank and Hokkaido Bank agreed to merge. The only recent merger that does not appear to have been motivated by portfolio weakness in either of the participants was the merger between Bank of Tokyo and Mitsubishi Bank that took effect in 1996, creating the largest commercial bank in the world. By combining two banks with different traditional emphases—Bank of Tokyo had a relatively small branch network and did little domestic lending in Japan—this transaction appears to have been motivated more by international developments than by domestic asset-quality concerns.

The restructuring of the banking sectors in each of the *Nordic* countries continued in 1996. In Norway, Den Norske Bank acquired Vital Försikring, the second-largest life insurance company in the country, and Christiania Bank acquired Norgeskreditt. In Sweden,

Svenska Handeslbanken acquired 98 percent of the shares in Stadshypothek, a leading housing finance institution, and in February 1997, a merger of Swedbank and Föreningsbanken—the central banks of the cooperative bank system and the savings bank system respectively—was announced. Further consolidation is to be expected. The Nordic banks are experiencing the same increased competition, disintermediation, and narrower interest margins as the other banking systems in Europe.

The emerging market banking systems have also experienced an increase in the pace of restructuring and consolidation. In fact, banking crises have precipitated a remarkable restructuring of banking systems in some Latin American countries. Among most of the Asian emerging market countries, until very recently, the absence of a crisis atmosphere had prevented any sense of urgency about the need for restructuring, although many supervisory authorities had actively encouraged consolidation. An important element in the restructuring of Latin American and European emerging market banking systems has been the use of M&A transactions by foreign banks as a means of penetrating the market. Domestic shareholders, often lacking the means to recapitalize the banks, or seeking to reorganize the corporate structure of mixed financial/nonfinancial conglomerates, have increasingly been willing to sell controlling stakes to foreign financial institutions. Also, governments in many countries have reconsidered the benefits of public ownership of financial institutions and have privatized large proportions of financial sector assets. While most of the foreign purchasers have been from Europe (especially Spain) and North America, it is significant that there are a number of Latin American financial institutions that have regional ambitions (for example, Chile's Infisa group, and Argentina's Banco de Galicia). Foreign investment not only brings new competition, and therefore greater pressure for consolidation, but their more advanced practices and technology, broader range of products, and deeper capital base put pressure on the local banks to modernize and become more efficient.

The 1995 liquidity crisis and ongoing restructuring in response to the stabilization of inflation since the early 1990s have resulted in a significant reorganization of the *Argentine* banking system. Since the end of 1994, 11 government-owned banks and 36 privately owned banks and cooperatives have closed or been privatized or merged with other institutions.[6] As in other countries in the region, there has been a surge in foreign investment in the banking system in recent months. In October 1996, Banco Bilbao Vizcaya acquired a controlling interest in Banco Frances del Rio de la Plata, and in May 1997 the latter took over Banco de Credito Argentino. Also in May 1997, Banco Santander acquired control over Banco Río, the Bank of Nova Scotia took control of Banco Quilmes, and a group of investors including Chile's Infisa, Chase Manhattan Bank, and National Bank of Canada was approved to take over Banco Union Comercial e Industrial, which had been experiencing capital adequacy problems, in December 1996. In June 1997, HSBC Holdings increased its 30 percent stake in the holding company of Banco Roberts to 100 percent. Further consolidation and foreign investment in the banking system are expected—including the privatization of more government-owned banks, among them the national mortgage bank, Banco Hipotecario Nacional.

The restructuring of the banking industry in *Brazil* is also well under way. Since July 1994, some 30 financial institutions have been closed, merged, or liquidated, including some quite large private and publicly owned banks (e.g., Banco Econômico, Banco Nacional, and Banerj). Foreign participation in the industry has increased, both in terms of new entry and in investment in existing banks. For example, in March 1997, HSBC Holdings bought the domestic banking operations of Banco Bamerindus, and Banco Santander acquired a controlling stake in Banco Geral do Comercio. These developments are likely to continue since a large number of small private banks are thought likely to need assistance or want to increase their chances of survival by merging or attracting new investors (six small commercial banks had been shut down by the central bank by end-July 1997). This process will likely be a costly one, as long as the central bank is prepared to make liquidity funding available and as long as the federal government is prepared to reschedule the state governments' debts as a means of ensuring that their banks are restructured.[7]

The *Mexican* banking system has also seen its share of foreign investment, associated with the sales of banks that were taken over by the central bank and efforts by the surviving banks to increase their capital and improve their management and product availability. Since early 1996, foreign banks have acquired important stakes in eight Mexican banks. In 1996, the Bank of Montreal acquired a 16 percent stake in Ban-

[6]In the first 10 months of 1996, 7 provincial banks (the provincial banks of Tucumán, Misiones, Salta, Río Negro, San Luis, Santiago del Estero, and Banco de Previsión Social in Mendoza) were privatized, 3 private banks were purchased by other banks (Banco Commercial de Tandil by Banco de Crédito Provincial, Banco Popular Argentino by Banco Roberts, and Banco Popular Financiero by Banco Sudecor Litoral), Chase Bank and Chemical Bank merged, and 2 other banks lost their licenses.

[7]Central bank financial assistance to government-owned banks has increased steadily since July 1994, reaching R$44 billion at end-January 1997. Assistance to private banks has likewise increased (but at a much faster rate, having started at negligible amounts) to R$27 billion over the same period. Both levels dipped slightly in February 1997.

comer, the Bank of Nova Scotia increased its stake in Inverlat, Banco Santander acquired Grupo Financiero Invermexico (the holding company of Banco Mexicano), Banco Bilbao Vizcaya took over Multibanco Mercantil Probursa and acquired the branch network of Banco Oriente, and Banco Comercial Portugues and Banco Central Hispanoamericano both invested in Banco Internacional. In 1997, this process has continued, with HSBC Holdings taking a 20 percent stake in Grupo Financiero Serfin and GE Capital acquiring Banco Alianza. Domestic banks have also recently taken an interest in growing by acquisition, especially as a means of diversifying into insurance and other nonbanking activities. For example, Grupo Financiero Banorte acquired two insurance subsidiaries of Banco Obrero and will participate in the auction for Banpais in July 1997.

The immediate future for *Venezuelan* banks is also strongly influenced by the sudden emergence of foreign competition. For the past two decades foreign banks have not been permitted in Venezuela, but that ended in December 1996 when foreign financial institutions were allowed to acquire controlling stakes in three of the four largest Venezuelan banks—two of which were acquired in privatizations. Banco Santander successfully bid for Banco de Venezuela when the latter was privatized in December 1996, and Banco Bilbao Vizcaya reached agreement to purchase 40 percent of Banco Provincial (including a 17.6 percent stake held by Crédit Lyonnais), the largest private bank. At the same time, a Chilean investment group, Infisa CA (which controls Chilean bank Banco Concepcion), won control over Banco Consolidado. Infisa plans to sell part of its 93 percent stake to a group of investors including Chase Manhattan Bank and National Bank of Canada. Most recently, Banco República was sold in June 1997 to a Colombian savings bank. With these sales, there remain two banks to be privatized: Banco Andino Venezolano and Banco Popular.

The *Czech* banking system has already undergone a fundamental restructuring in the transition from a highly centralized, exclusively government-owned system to a market-oriented system. However, this transformation is not complete. The industry is highly concentrated, and many banks rely heavily on the interbank market and on institutional funds for liquidity. Two new foreign banks were given licenses in 1996 (the first new banks of any kind since 1994), joining the 23 existing foreign banks and joint ventures. In addition, the privatization of two banks, Investicni a Postovni Banka and Ceskoslovenska Obchodni Banka, is under way.

Restructuring has also continued in the *Hungarian* and *Polish* banking systems, where privatization continues to dominate the structural changes. In Hungary, Magyar Hitel Bank, one of the three banks that were carved out of the National Bank of Hungary in 1987, was privatized, with 89 percent of its shares sold to ABN Amro, joining Budapest Bank, which was privatized in 1995. Both banks are being restructured by their foreign majority shareholders into retail-oriented banks, which will involve a significant reduction in size, especially for Magyar Hitel Bank, which has been dominant in lending to large enterprises. The state privatization agency (APV) has also announced plans to privatize the last of the government-owned banks, Kereskedelmi es Hitelbank (KHB), in a two-round sale in 1997. (KHB itself acquired a smaller Hungarian bank, Ibusz Bank, in 1996.) In the first round, a 25 percent stake will be sold, after which the remaining shares will be distributed to social security funds, management, employees, and small shareholders. In April 1996, the Deutsche Genossenschaftsbank received approval to purchase 61 percent of the shares of the central bank of the cooperative banks in Hungary, Takarekbank. Finally, the APV has announced that it will reduce its 25 percent ownership stake in the National Savings and Commercial Bank (OTP) to 10 percent in 1997, and the National Bank of Hungary has announced that it will seek to sell its 34 percent stake in Central European International Bank in 1997.

After a relatively slow start, in which only five of the *Polish* state-owned banks were privatized over as many years, the government in 1996 adopted a revised bank privatization strategy envisaging the consolidation and privatization of most remaining state-owned banks by the year 2000. As a first step, in late 1996 three of the remaining state-owned regional banks were merged into Bank PKO-SA, with a view to privatizing the consortium in 1998. In 1997, three banks are being privatized: first, in June, Bank Handlowy was sold in a complex transaction involving a public offer to individuals (29 percent of share capital), institutional investors (30 percent), three major "core shareholders" (foreign financial institutions expected mainly to strengthen the bank's know-how in different areas of financial services, 26 percent), employees (7 percent), and the Polish Treasury (8 percent). In addition, the bank is to issue so-called convertible bonds, initially to the treasury, for the equivalent of about 35 percent of its current share capital. These bonds are to be used later to help finance the reform of Poland's pension system. Second, the National Bank of Poland is finalizing the sale of its 100 percent stake in the Polish Investment Bank; and third, the government will shortly complete the sale of a 65 percent stake in the Warsaw-based Powszechny Bank Kreditowy SA (PBK). After that, the last of the nine state-owned regional banks (Bank Zachodni), the State Agricultural Bank (BGZ), and the Polish Development Bank are slated for sale in 1998–99. This would leave only two banks in state hands: the large domestic savings bank (PKO-SA), to be privatized eventually, and Bank Gospodarska

Komunalna (BGK), the only bank to remain government-owned in the future.

Supervisory and Regulatory Developments

Regulatory Structure

The technological advances noted above have allowed an increase in the sophistication of finance and the introduction of new products and innovative delivery mechanisms, and have also reinforced the blurring of divisions between different segments of the financial system in most countries. Improvements in risk management have allowed the portfolios of larger, more complex corporate organizations to be managed centrally. These trends call for a change in the structure of supervision over financial firms to reflect their changing internal organizations. Supervision along functional lines is not efficient in the presence of centralized risk management by financial conglomerates.

The problem of how best to organize supervision and regulation of financial conglomerates in a global marketplace is being examined by the Joint Forum, a group made up of bank, securities firm, and insurance regulators, previously called the Tripartite Group. The Joint Forum has made some headway over the last year in facilitating the exchange of information among the groups of supervisors and in outlining the responsibilities of a regulatory "coordinator" for conglomerates. A number of smaller countries, including Hungary, Norway, and Sweden, have implemented a centralized system of supervision, in which one agency, independent of the central bank, is responsible for supervising all types of financial institutions. Such a structure has been proposed too in Korea. This has not yet been implemented in any of the major industrial countries. However, in May 1997, the Chancellor of the Exchequer in the United Kingdom proposed a reorganization of financial supervision in which eventually all financial supervisory and regulatory authority will reside in the Securities and Investments Board (SIB). In addition to reducing the role of the self-regulatory organizations and their oversight agencies, the government proposes to remove responsibility over bank supervision and regulation from the Bank of England and transfer it to the SIB.

As the U.S. financial system evolves toward one in which there may be few restrictions on banks' activities in the securities and insurance businesses (and reciprocally for securities and insurance firms), there is now considerable debate on the need for a change in the regulatory structure. While a bid to consolidate the supervision of financial institutions in one agency did not win approval in 1996, banks' powers to sell insurance and to engage in the underwriting and trading of "ineligible" securities have been expanded.[8] The main issue being debated is the form of corporate organization that will be preferred. While in the European Union, for example, banks often have the choice of undertaking insurance or securities business in-house or through bank subsidiaries, the U.S. Federal Reserve Board has proposed allowing such activities only through bank holding company subsidiaries, suggesting that such a structure facilitates the supervision of insured deposit taking and related banking activities separately from other activities. The Office of the Comptroller of the Currency has argued that the holding company structure may not be the most efficient and that banks should have the option of engaging in securities dealing within the bank rather than through subsidiaries.

During 1996, the Japanese authorities announced a number of important policy initiatives. In June, three financial laws were passed by the Diet that implemented 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 (3) increased resources for the deposit insurance corporation to pay off depositors of failed banks, including a fourfold increase in deposit insurance premiums (to 0.048 percent of insured deposits), the temporary addition of a special premium of 0.036 percent, and a ¥2 trillion line of credit from the Bank of Japan. The special premium, implemented by a provisional amendment to the Deposit Insurance Act, was introduced to provide insurance for all deposits, including those in excess of the statutory ¥10 million limit. This additional guarantee, and an all-encompassing official guarantee that none of the banks with international activities would close, terminate at the end of the 2000/2001 fiscal year.

The PCA measures, which take effect April 1, 1998, require banks to classify their loan portfolios more rigorously by repayment risk and to set aside adequate reserves thereby providing a more accurate measure of economic capital in the bank; they also allow the authorities to intervene by forcing banks to take corrective measures or ultimately by closing them down based on their risk-weighted capital ratios. While these rules represent a move in the direction of market

[8]In December 1986, the Federal Reserve Board of Governors interpreted the Glass-Steagall Act's requirement that bank holding companies could not own subsidiaries that were "principally engaged" in underwriting and dealing in "ineligible" securities (i.e., corporate debt and equity) as restricting such activities to 5 percent or less of the revenue of the subsidiary. In 1989, the revenue ceiling was raised to 10 percent, and in December 1996 the ceiling was again raised, to 25 percent (effective March 1997). In March 1996, the U.S. Supreme Court ruled that states must allow nationally chartered banks to sell insurance as permitted under the National Bank Act.

discipline of the banking system, the measures prescribed for the supervisory authorities are less forceful, and allow for a greater deterioration of capital, than those implemented in the United States by the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (Table 32). For example, while the FDIC is required to intervene in a bank by demanding recapitalization plans and restricting asset growth and new activities for banks once their total risk-weighted capital ratio falls below 8 percent, similar restrictions in the Japanese system would be introduced only after the capital ratio fell below 6 percent. Restrictions on deposit taking and managerial compensation are introduced in the U.S. system when the capital ratio falls below 6 percent, but under the Japanese regulations these are introduced only when the capital ratio falls below 4 percent. Finally, regulators have more discretion under the Japanese PCA rules than they do under the U.S. rules. For example, in Japan suspension of activities can be avoided if the bank's net income is expected to be positive as a result of implementing a restructuring plan, while in the U.S. system, once a bank is "critically undercapitalized" the regulators are required to close it down. More generally, in the U.S. PCA system, regulators have discretion to strengthen the required response to a decline in capitalization, while under the Japanese rules, they have discretion to scale down the required response.

A change in the structure of financial supervision has also been initiated in Japan. The responsibilities for bank, insurance, and securities supervision currently assigned to the Japanese Ministry of Finance will be transferred to a new agency, the Supervisory Agency for Financial Entities (provisional translation) in mid-1998 (the Bank of Japan will retain its bank examination powers). The ministry will retain responsibility for the formulation of bank regulation policy and will be consulted by the supervisory authorities in cases of systemic importance. The Securities Exchange Surveillance Commission will be merged into the new agency, creating a consolidated banking/securities supervisory agency.

A more far-reaching set of reforms was announced in November 1996. Described as Japan's "Big Bang" these measures include (1) the elimination of most 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 latter three measures are expected to lead to a significant restructuring and consolidation of the financial services industry, as they allow financial holding companies to be established combining all types of banking, securities, and insurance activities, while at the same time making each type of activity more competitive and responsive to market forces. It is the first measure, approved in May 1997 and to take effect in May 1998, however, that is potentially the most significant. Liberalization of the foreign exchange controls may allow foreign financial institutions to compete more effectively and to offer more services to Japanese customers. Indeed, this is the central element of the reform plan, as increased foreign competition is expected to force domestic firms to be more innovative and efficient and to provide better services and higher returns to retail investors.

Capital Requirements

Following a lengthy debate about the appropriate form of regulatory capital requirements for market risk, bank supervisors in the major industrial countries are taking a step back to evaluate the entire concept of regulatory capital. The Basle Committee on Banking Supervision ("Basle Committee") has formed a working group to examine the issue from a fresh perspective. Part of the impetus for doing so is a recognition that the complexities and interrelationships among the various sources of risk (credit, market, operational, legal, and so on) in bank portfolios makes it difficult to prescribe specific rules for the calculation of capital that appropriately capture the risks against which it is meant to insure. For example, even before the latest amendment to the Basle Capital Accord to incorporate market risks had been finalized, members of the Basle Committee were cognizant that even with fairly strict initial assumptions the use of a value-at-risk (VAR) model could result in different measures of regulatory capital for different banks. This "implementation risk" has important implications for regulators: clearly, it is insufficient for supervisors to vet the theoretical version of a bank's internal model, yet it would consume enormous resources if supervisors were to attempt to verify each bank's model by running a benchmark set of portfolios. Backtesting may emerge as the only way to gauge the effectiveness of a bank's VAR model.

Put forth as a possible solution to the problems associated with the inflexibility of the Basle Committee's rule-based approach to measuring market risk, the precommitment approach, in which each bank agrees not to violate its "precommitted" level of market risk capital, continues to elicit heated discussions. A one-year pilot study involving some 10 banks started on October 1, 1996, under the auspices of the New York Clearing House whereby these banks will, on paper, precommit to maintaining a certain minimum amount of capital and any violations will be recorded. Despite its potential lack of realism (there are no penalties applied to banks whose capital falls below their precommitted amount), the pilot study has at least forced those banks involved formally to allocate an amount of capital and to think carefully about whether to use their VAR model or some other technique for calculating that

Table 32. Japan and the United States: Summary of Prompt Corrective Action Provisions

Japan		United States		
			Actions	
Capital levels[1]	Actions	Capital levels[2]	Mandatory	Discretionary
n.a.	n.a.	"Well capitalized" Total ≥10 percent, and Tier 1 ≥6 percent, and Leverage ratio ≥5 percent.	None	None
n.a.	n.a.	"Adequately capitalized" Total ≥8 percent, and Tier 1 ≥4 percent, and Leverage ratio ≥4 percent.	Disallow brokered deposits, except with FDIC approval.	None
International capital ratio <8 percent; National capital ratio <4 percent.	Order formulation and implementation of management improvement plan.	"Undercapitalized" Total <8 percent, or Tier 1 <4 percent, or Leverage ratio <4 percent.	Suspend dividends and management fees. Require capital restoration plan. Restrict asset growth. Require approval for acquisitions, branching, and new activities. Disallow brokered deposits.	Order recapitalization. Restrict interaffiliate transactions. Restrict deposit interest rates. Order other measures necessary to carry out prompt corrective action.
International capital ratio <4 percent; National capital ratio <2 percent.	Order recapitalization plan. Impose restraints on asset growth. Impose ban on new activities and branches and limits on current activities. Impose ban on new subsidiaries and overseas affiliates and limits on the current activities of such entities. Limit payment of dividends. Limit payment of bonuses to directors and management. Limit deposits, interest rates.	"Significantly undercapitalized" Total <6 percent, or Tier 1 <3 percent, or Leverage ratio <3 percent.	Same as above. Order recapitalization. Restrict interaffiliate transactions. Restrict deposit interest rates. Restrict pay of officers.	Same as above. Order conservatorship or receivership if bank fails to submit or implement a plan to recapitalize. Impose any provision for "critically undercapitalized" banks if necessary.
International capital ratio <0 percent; National capital ratio <0 percent.	Suspend whole or part of banking business. This order can be replaced with lesser actions if: (1) the net value of assets, including unrealized gains, is positive; (2) the net value including unrealized gains is negative but expected to be positive after considering: (a) the implementation of management improvement plans and other specific measures; (b) business income and profitability; (c) the bad assets ratio. A business suspension order can be issued at any time when the net value of assets, including unrealized losses is, or is expected to be, negative.	"Critically undercapitalized" Tangible equity to total assets ratio of ≤2 percent.	Same as for "Significantly undercapitalized" banks. Order receivership/ conservatorship within 90 days. Order receivership if critically undercapitalized for four quarters. Suspend payments on subordinated debt. Restrict certain other activities.	n.a.

Sources: Japan, Ministry of Finance; and United States, Federal Deposit Insurance Corporation.

[1]The international capital standards (BIS capital adequacy standards) apply to banks with international operations. The adjusted national capital standards apply to banks with purely domestic operations.

[2]The total capital ratio cited is the total risk-weighted capital; the leverage ratio is the ratio of Tier 1 capital to total assets.

amount. In fact, several banks have augmented their VAR number to take account of risks that are not included in their VAR models.

While a discussion of the management and measurement of market risk continues to dominate the lives of many regulators and practitioners, attempts to measure and manage other risks, most notably operational risk, are emerging as the next major issue. Banks are beginning to take a hard look at the operational risks in their business, and some of them are developing methods by which such risks can be measured and capital allocated against them. In the forefront is Bankers Trust which, after the collection and examination of appropriate data, discovered that their hierarchy of risks has been altered to first, credit risk, followed by operating risk, and lastly, market risk. Other banks have also found that unexpected losses can result from the application of sophisticated pricing systems, including recently NatWest Bank and Tokyo-Mitsubishi Derivative Products. The importance of internal controls and the measurement of risks incurred due to their failure is only now becoming fully appreciated.

Another important element in the discussion of capital and its purpose has been spurred by the development of credit derivatives (see Appendix 1 at the end of this annex) and the new progress achieved in analyzing credit risk. The international regulatory community has arrived at a consensus that these developments warrant a rethinking of credit risk capital requirements. The Bank of England has requested comments on a discussion paper regarding a possible supervisory approach to credit derivatives, and the Securities and Futures Authority has provided its first formal pronouncement regarding credit derivatives. In the United States, the three federal regulatory agencies have issued guidance notes on credit derivatives. However, all these documents stress the preliminary nature of the guidance regarding regulatory treatment and the quickly evolving characteristics of tradable credit risks. In addition to the impetus from credit derivatives, international regulators are also aware that the credit risk categories assigned within the original Basle Accord were based on relatively crude, qualitative assessments of relative risk and these should be reevaluated in light of the newer analysis.[9]

Supervision and Regulation in Emerging Markets

The soundness of the financial system, and especially the banking system, is increasingly recognized as an important part of any evaluation of the economic prospects of an emerging market. The role of the financial sector in propagating the crisis in Mexico illustrated the complicated implications for the conduct of macroeconomic policy that newly liberalized financial sectors raise. Investors in emerging markets are now provided with much more analysis of the health of the financial systems and of the potential relationships between financial fragility and macroeconomic performance in these countries.

In addition, the official international community has stepped up efforts to support improvements in financial infrastructure and to incorporate analysis of financial market developments in the monitoring of developing countries' macroeconomic performance. Thus, international attention has turned to the economic consequences of inadequate bank supervisory and regulatory capacity in emerging markets. Such concerns motivated a broad-based effort by the international financial community in 1996–97 to provide a basis for support for emerging market governments in this area. The Basle Committee released a set of *Core Principles for Effective Banking Supervision* (April 1997) and a G-10 Working Party on Financial Stability in Emerging Market Economies released its own paper (*Financial Stability in Emerging Market Economies*) 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, in which the IMF would promote the adoption and implementation of these principles and practices. An early proponent of this approach, Goldstein (1997), has called for the establishment of International Banking Standards, based on the principles developed by the international agencies, to which bank supervisors would voluntarily adhere.

Developments in Profitability and Asset Quality in Selected Industrial Countries

The banking systems in the major industrial countries performed strongly in 1996: most of the banks in the G-7 countries reported higher earnings and improved asset quality. The banks have benefited from a sustained period of declining interest rates and from an increase in economic growth rates that have raised loan volumes and provided the means to finance loan loss provisions and write-offs. Aside from a few individual institutions in certain countries, the problems that banks in these countries face are medium-term structural problems, not the immediate solvency threats they confronted in the early to mid-1990s.

Performance by Country

The performance of commercial banks in the industrial countries in 1996 differed markedly between

[9]One of the most obvious problems has arisen with the assignment of a zero credit risk weight within the weighted credit risk capital requirement for sovereign debt of OECD countries, requiring banks to allocate more capital to a loan to triple-A-rated Singapore than to Korea, which is rated AA⁻.

groups of countries depending upon their relative position in the credit cycle. For banks in Canada, Norway, Sweden, 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 high levels in 1996, with nonperforming loan ratios at correspondingly low levels. Asset quality may have peaked in these countries, and some deterioration can probably be expected. However, the banks have high loan loss reserves and are well capitalized, so they are generally well equipped to deal with such a development.

For banks in Finland and France, there is now reason to believe that the worst of their asset-quality problems are over. The overall condition of the banking systems in these countries has improved, and the emphasis is increasingly on the resolution of problems in individual institutions and in France on the longer-term structural issues that confront the industry, such as the effects of European monetary union on competition within European banking systems, as is discussed in Annex IV. The situation in Italy, however, remains difficult, especially for banks in the central and southern regions, while the Japanese banks continue to face serious asset-quality problems. The German banking system, alone it seems among the major industrial countries, has not experienced a serious decline in asset-quality due to real-estate-related loans, although some segments of the property market in Germany have weakened.

Supported by a strong increase in noninterest earnings and a 24 percent decline in provisions, the Schedule I banks in *Canada* reported a 22 percent increase in net income in the fiscal year ending October 1996, an average return on equity of 15 percent.[10] Canadian banks compensated for a tightening in net interest margins—the fifth consecutive year of tightening—by increasing the share of consumer lending and other relatively high-margin lending in their loan portfolios (including the contribution of some of the banks' Latin American subsidiaries). To date, this has not led to a deterioration of average loan quality. At the end of the fiscal year, only 0.6 percent of loans were nonperforming, down from 1.2 percent in 1995 and a peak of 3.2 percent in 1992. Reserve coverage is generally very high, in excess of 270 percent of nonperforming loans, although the ratio of reserves to gross loans fell to 1.6 percent, the lowest level in at least eight years. Canadian banks are also well capitalized by international standards, with an average total risk-weighted capital ratio of 9.4 percent (a Tier I ratio of 6.8 percent) even after share repurchases by at least four of the banks.

Most banks in the *United Kingdom* also enjoyed record profits in 1996, bolstered by a sharp reduction in loan loss provisions, and despite a slight narrowing of the net interest margin. Aggregate net income for the five largest commercial banks rose 2 percent, for an average return on equity of 19 percent.[11] Banks compensated for declining interest margins on corporate loans by increasing both the volume of loans and the share of consumer loans and mortgages in their loan portfolios. After having peaked in 1992, asset-quality problems eased significantly, with the end-1996 incidence of impaired lending representing 2.5 percent of loans (compared with 9.8 percent at end-1992)[12] and loan loss reserves covering 85 percent of impaired lending. Capitalization remains high, with a total risk-weighted capital ratio of 10.9 percent, 7.26 percent of which was Tier I capital.

Banks in the *United States* continued their string of record earnings levels in 1996, as total net income of FDIC-insured commercial banks increased by more than 7 percent for a return on equity of 14 percent. Despite slightly lower net interest margins, net interest income increased by 5 percent, supported by strong loan growth. The diversification of banks' income sources continued in 1996, with noninterest income contributing 36 percent of gross operating income—the highest proportion ever for U.S. banks. While overall asset quality continued to improve in 1996—total noncurrent loans (i.e., loans that are 90 days or more past due or on nonaccrual status) fell to 1.05 percent of gross loans—consumer lending and domestic syndicated lending have been a source of concern. At end-1996, 3.6 percent of loans to individuals were past due, reflecting in particular a continuing deterioration of credit card loans.[13] Concerns about potential asset-quality problems were reflected in an increase in loan loss provisions for the second consecutive year. Overall, banks are well covered against potential losses on existing problem assets—loan loss reserves rose to 182 percent of noncurrent assets—although the ratio of reserves to total loans declined to 1.9 percent, the lowest ratio since 1986. While reserves may not provide a significant buffer against a sudden increase in loan losses, U.S. banks are well capitalized, with a core capital ratio of 7.6 percent at end-1996, its high-

[10]The Schedule I banks are Royal Bank of Canada, Canadian Imperial Bank of Commerce, Bank of Montreal, Bank of Nova Scotia, Toronto Dominion Bank, National Bank of Canada, and Canadian Western Bank. As is the case in all discussions of banking system developments in this annex, unless otherwise noted the description of the banks' performance is based on their financial statements as provided by IBCA Ltd.

[11]The banks included in this survey of recent developments are National Westminster Bank, Barclays Bank, Lloyds Bank, Abbey National, and Midland Bank.

[12]Impaired lending includes loans on nonaccrual status, doubtful loans, and potential problem loans, where disclosed. U.K. banks are not required to disclose nonperforming loans according to a uniform definition.

[13]Most consumer loans were only 30–89 days past due; only 1.7 percent of consumer loans were noncurrent, although this represents a deterioration from 1.2 percent at end-1995.

est level in at least nine years, despite a relatively high volume of share repurchases by many of the banks.[14]

For the first time in six years, all of the major banks in *France* reported positive net profits for 1996.[15] However, this outcome was due mainly to exceptionally high income from capital market activities and from lower loan loss provisions. The core banking operations continue to suffer from low loan demand, poor asset quality, and aggressive competition, which have limited net interest income and reduced the capitalization of the banks. Thus, while noninterest income rose by 23 percent in 1996, net interest income declined by 2 percent. A 10 percent reduction in loan loss provisions allowed net income to rise by 140 percent, albeit from a relatively low base, for a return on equity of 7.7 percent. Not all French banks disclose their nonperforming assets, but it is generally believed that the worst of the asset-quality difficulties is past. While a large number of loans to small and medium-sized firms are nonperforming, the banks are believed to have set aside sufficient reserves to cover anticipated loans. With the caveat in mind that it is difficult to judge the asset-quality position of the banks, the published figures on capitalization indicate that the leading banks are reasonably well capitalized, with total risk-weighted capital ratios of between 8.7 percent and 11.4 percent.[16]

Property markets, a key source of nonperforming loans in France, continued to deteriorate in 1996, with the vacancy rate on prime office space in the center of Paris, for example, rising to 9.2 percent at end-1996 from 8.4 percent a year earlier, and rents falling by 3.8 percent over the same period.[17] Since the market peaked in 1990–91, commercial real estate prices have declined by about 50 percent. As a result, some of the banks have had to seek assistance from their shareholders either to move real estate assets off their balance sheets or for capital injections.[18] Until the end of 1995, these operations had not resulted in significant sales of real estate. However, in 1996, some of the French banks began in earnest to reduce their exposure to property markets after having opted in earlier years simply to increase provisions against potential losses. In 1996, sales of real estate by bank shareholders helped to boost the volume of property investment transactions to F 12 billion, more than twice the 1995 turnover. The banks also began selling off large portions of their real estate loan portfolios, much of it to U.S. investors. The process began with the sale of F 870 million in real estate loans by Barclays Bank in late 1995, followed in 1996 by Créditsuez (F 4.75 billion), and UAP (F 3.2 billion). Créditsuez has announced its intention to sell off a further F 4.9 billion in real estate loans by 2001, and the Consortium de Réalisation (CDR) has proposed to sell F 1 billion. The first securitization of real estate loans in France was accomplished in January 1997 with the sale of F 1.5 billion in commercial mortgage backed securities (CMBS) backed by mortgage loans of Banque SOFAL, a subsidiary of Union Industrielle de Crédit.[19]

The French government announced a three-point resolution plan for Credit Foncier de France (CFF) in July 1996: (1) the Caisse des Depots et Consignations (CDC) would launch a public offer on behalf of the government for a sale of at least two-thirds of CFF; (2) a new public entity, the Caisse National du Credit Foncier, wholly owned by the state, would be established and acquire these shares from the CDC and wind down CFF's business over the next 10 years; and (3) Credit Immobilier de France, a mutual institution, would take over the management of CFF's portfolio of F 110 billion in subsidized home loans as well as its branch network and 1,500 of its 3,300 employees.[20] The government has estimated the costs of this plan at F 2.5 billion. While the share issue went ahead as planned, with the government now owning more than 90 percent of CFF, the creation of Caisse National du Credit Foncier and the transfer of CFF assets to Credit Immobilier de France have not. CFF remains in business and reportedly earned F 1 billion in profit in 1996, but has virtually no capital (its total capital ade-

[14]In 1996, the Federal Reserve Board of Governors conferred Tier I capital-eligibility status on a class of tax-exempt trust-preferred subordinated securities known by various acronyms (e.g., TOPRs, MIPs, QUIPS, TRIPS). Banks are reported to have issued at least $30 billion of such securities, some of it used to repurchase shares, thereby leveraging up shareholder equity.

[15]This description of the results of the French banks is based on the financial statements of the seven largest commercial banks (Crédit Agricole, Crédit Lyonnais, Société Général, Banque National de Paris, Banque Paribas, Compagnie Financière de CIC et de l'Union Europèenne, and Crédit Commercial de France).

[16]Not including Banque Paribas, whose capital ratios are assessed at the holding company level.

[17]Jones Lang Wootton (1997).

[18]In addition to the government support for Crédit Lyonnais, Banque Hervet, and Société Marseillaise de Crédit to cover mostly real-estate-related losses, banks have sought assistance from insurance companies that are major shareholders—Banque Worms from UAP, Union Industrielle de Crédit from GAN, and Comptoir des Entrepreneurs from AGF—and from other parent companies—Banque La Hénin from Groupe Suez, BRED from Banques Populaires, and Crédit du Nord from Groupe Paribas.

[19]Securitization of real estate loans was an important ingredient of the resolution of the savings and loans crisis in the United States and of the commercial banks' recent real-estate-related problems. Between 1989 and 1995, the Resolution Trust Corporation sold $17 billion in CMBS. Securitization has now become an accepted means of real estate finance in the United States. Total CMBS issuance in 1996 exceeded $30 billion, more than half of it to finance new construction. In the United Kingdom, securitization of loan portfolios has been undertaken since 1987, with a total of 94 CMBS issued representing a total volume of £18.7 billion. In 1997, NatWest Bank successfully securitized $5 billion worth of corporate loans and £1 billion in government housing association loans.

[20]The events leading up to the rescue of CFF are described in IMF (1996).

quacy ratio at end-1995 was 0.5 percent) and its loan portfolio has fallen by half.

The other institution that was forced to turn to the French government for assistance as a result of asset-quality problems, Crédit Lyonnais, returned to profitability in 1995 and improved on those results in 1996, earning a net profit of F 1.5 billion. However, this was possible only after the French Ministry of Finance agreed to neutralize the effect of the negative interest rate spread on a F 135 billion loan to the Etablissement Public de Financement et de Réstructuration—used to finance the purchase of loans from Crédit Lyonnais by the CDR. The carrying cost of the loan, estimated at F 3 billion in 1996, has been assumed by the government. As part of the EU approval for the recapitalization plan in 1996, Crédit Lyonnais has begun selling its domestic and foreign subsidiaries and investments, including Banque Laydernier, Crédit Lyonnais Bank Sverige, Woodchester Investments, Banco Portugues de Investimento, and Banco Provincial. The total cost of official support to Crédit Lyonnais was recently estimated by the ministry of finance at F 100 billion.

The largest private commercial banks in *Germany* reported substantially higher profits in 1996, owing mainly to strong trading profits and an increase in holdings of securities and other investments. Net income for the five largest commercial banks rose 19 percent (for a return on equity of 9.8 percent), as noninterest income rose by 25 percent.[21] German banks alone among those of the seven major industrial countries have not experienced a severe deterioration in asset quality in recent years, although data on nonperforming loans and specific loan loss provisions are not generally disclosed. Disclosed provisions—which include gains on securities held in the liquidity reserve—declined by 21 percent in 1996. Real estate may become more of a problem in 1997–98, however, with the removal of tax concessions on development in the eastern Länder and a softening of the office rental markets in some key markets, including Berlin and Hamburg.

The banking system in *Italy* continues to struggle with worsening asset quality, increasing labor costs, and an unfavorable tax regime that has contributed to weak profitability. However, the Italian Banking Association and trade unions have recently agreed to a reduction in labor costs to the EU average as measured by the ratio of labor costs to gross income. The costs associated with labor shedding will be borne by the banks without any support from the government. Furthermore, a recent reform of the corporate tax code and an increase in the deductability of loan loss provisions will lower the tax burden on banks. The continuing weakness of the economy, particularly in the southern region, has slowed loan growth, while increasing competition has narrowed interest margins. The steady decline in the level of interest rates contributed to a resurgence of activity in the securities market, resulting in a 61 percent increase in noninterest income, which allowed operating profit to increase by 7 percent.[22] However, asset quality continued to deteriorate in 1996, albeit at a slower pace than in 1994 and 1995. The stock of bad loans (defined as *sofferenze* and protested bills) increased by 11 percent to Lit 128 trillion, or 10 percent of total loans, up from 9 percent at end-1995. The estimated loss rate on these loans also increased, to 38 percent from 33 percent at end-1995.

The relative severity of the economic recession in southern Italy has led to a higher concentration of bad loans in that part of the country,[23] with the result that a number of banks based in the south have experienced serious capital depletion because of loan losses. One of these, Banco di Napoli, incurred net losses of Lit 4.3 trillion during 1994–95. In the first half of 1996, the bank lost a further Lit 700 billion, and by the end of the year, it had lost Lit 1.6 trillion. In July 1996, the government announced a recapitalization package involving (1) the elimination of existing equity and the issue of Lit 2 trillion in new capital; (2) the transfer of about 30 percent of the loan portfolio to a special purpose company (Societa per la Gestione di Attivita); and (3) the sale of a 60 percent stake, which ultimately went in January 1997 to a combined offer from government-owned Banca Nazionale del Lavoro and a private insurer, Istituto Nazionale delle Assicurazioni. In addition, Banco di Napoli has sold much of its performing medium- and long-term loan portfolio; its largest subsidiary will be liquidated; 50 branches in the north have been sold; and agreement has been reached with trade unions to lower personnel costs. However, half of the capital increase obtained by the new share issue has already been drawn down to cover the losses incurred during 1996.

The provision of extensive government support for the *Finnish*, *Norwegian*, and *Swedish* banks in the early 1990s prevented what may have been the complete collapse of the banking systems in these countries. By the end of 1996, the recovery from the crisis was more or less complete in Norway and Sweden—marked by the removal of the government guarantee for Swedish banks in July 1996. Surging loan growth and plummeting loan loss provisions—indeed, many of the banks have been writing back significant amounts of provisions—and a supportive

[21]The banks are Deutsche Bank, Dresdner Bank, Commerzbank, Bayerische Vereinsbank, and Bayerische Hypotheken-und Wechsel-Bank.

[22]Data on the performance of Italian banks are from the Banca d'Italia and cover the entire industry.

[23]At end-1996, the proportion of *sofferenze* doubtful loans in the northern and central regions was 7.9 percent, while in the southern regions, including Sicily, it was 25.4 percent.

capital market environment have provided the stimulus for recovery. For the Finnish banks, however, important weaknesses remain, and the recovery has been uneven. The *Danish* banks, while avoiding an outright crisis, nevertheless endured a serious deterioration in asset quality and earnings in the early 1990s.

Net income for the four largest commercial banks in Denmark declined by 2 percent in 1996, for a return on equity of 16 percent.[24] The stock of nonperforming loans fell for the second consecutive year, by 31 percent, accounting for 1.5 percent of total loans. Despite a decline in provisioning, loan loss reserves at end-1996 equaled 207 percent of the stock of nonperforming loans. The banks in Finland, of all the Nordic banks, have experienced the slowest recovery. After five years of net losses, the three major banks[25] recorded a net profit in 1996 of FM 1.6 billion, a return on equity of 8 percent, due mostly to a 37 percent increase in noninterest income and a 23 percent decline in provisions. Net nonperforming loans declined by 41 percent to 2.5 percent of gross loans, or 26 percent of equity. The four major banks in Norway suffered an 11 percent decline in net income, but nevertheless recorded a return on equity of about 20 percent.[26] Net nonperforming loans declined by 20 percent, to 1.4 percent of total loans, or 20 percent of equity. The five largest commercial banks in Sweden reported sustained high income and lower nonperforming loans.[27] Aggregate operating profit rose 28 percent, owing mostly to strong noninterest income and a 43 percent decline in loan loss provisions and write-offs. Net problem loans fell by 30 percent, to 1.6 percent of aggregate loans. The extent of the recovery was highlighted by the removal on July 1, 1996, of the blanket guarantee that the government had established for the banks.

The resolution of asset-quality problems in *Japan* continued to dominate developments in the banking system. Net interest income rose by 9 percent owing mainly to special circumstances affecting the interest expenses of the long-term credit and trust banks;[28] the city banks' net interest income declined by 6 percent. Without the benefit of declining interest rates boosting the valuation of the banks' large investment bond portfolios, noninterest income declined by 31 percent, while commissions and trading income were flat overall. At the same time, the banks wrote off ¥2,267 billion in unrealized losses on their equity holdings, which offset much of the ¥3,488 billion they had realized in order to finance provisions. As a result, net profits on equity of ¥1,128 billion were used to offset part of the ¥5,555 billion in loan loss provisions and write-offs, leading to a net loss for the 20 banks of ¥146 billion.

At end-March 1997, the 20 major banks had ¥13,193 billion in core nonperforming loans (loans six months or more past due and loans to bankrupt borrowers), ¥3,247 billion in loans restructured at below the prevailing official discount rate, and ¥2,890 billion in loans made in support of customers. This total of ¥19,331 in problem loans represents a 25 percent decline over the previous year's ¥25,663 billion. Total problem loans represented 4.9 percent of gross loans at end-March 1997, compared with 5.4 percent at end-March 1996, but most of this decline was due to writing off loans to the housing loan corporations (*jusen)*, which had been fully reserved but not written off in the previous year. Excluding the *jusen* loans, problem loans fell only 15 percent, while the core nonperforming loans remained unchanged.[29]

While the definition of problem loans has been gradually widened in the last two years it is still less encompassing than the U.S. model for example. The Japanese definition does not include loans that have been sold to the Cooperative Credit Purchasing Company (CCPC) or special purpose vehicles and excludes loans restructured at interest rates above the official discount rate.[30] Most, if not all, of these loans would likely be considered nonperforming loans of a bank under U.S. practices. Applying a broader definition of problem loans to the Japanese banks yields an estimated aggregate problem loan figure somewhat higher than the official estimate.[31]

Five depository institutions failed in 1996—including two regional banks, Taiheyo Bank and Hanwa Bank—some of which required intervention by the

[24]Den Danske Bank, Unibank, Bikuben Girobank, and Jyske Bank.

[25]Merita Bank, Postipankki Bank, and Okobank.

[26]Den Norske Bank, Christiania Bank, Union Bank, and Fokus Bank.

[27]Skandinavska Enskilda Banken, Svenska Handelsbanken, Nordbanken, Swedbank, and Foreningsbanken.

[28]The maximum permitted trust account special reserve was lowered from 3 percent to 0.5 percent, allowing the trust banks to release the ¥1 trillion excess, around half of which was used to charge off problem loans and half was written back to income. The long-term credit banks benefited from the redemption in late 1995 of high interest rate debentures that had been issued in 1990 and had depressed net interest revenue in 1995 as interest rates on assets declined.

[29]The ratio of core nonperforming loans to total loans at end-March 1997 was 3.3 percent, the same as at the end of the previous fiscal year. The same ratio was 3.5 percent at end-March 1995, 3.7 percent in 1994, and 3.4 percent in 1993. Under the broader definition of nonperforming loans that includes restructured loans, the ratio has declined steadily from 5.4 percent of total loans in September 1995 to 4.9 percent in March 1996 and 3.9 percent in March 1997.

[30]The CCPC has announced that it will stop purchasing loans after April 1998 and concentrate on liquidating its portfolio. Between March 1993 and March 1997, the CCPC paid ¥5.4 trillion to acquire loans with a book value of ¥13.6 trillion. By end-March 1997, however, the CCPC had recovered only ¥813 billion.

[31]IBCA estimates, for example, that total problem loans amounted to ¥40 trillion at end-March 1997, of which uncovered losses were ¥4.5 trillion.

Table 33. Major Industrial Countries: Commercial Bank Profitability

	Net Interest Income		Noninterest Income		Operating Expenses		Provisions		Real Return on Equity[1]	
	1985–89	1990–94	1985–89	1990–94	1985–89	1990–94	1985–89	1990–94	1985–89	1990–94
	← *(In percent of total assets)* →								← *(In percent)* →	
Canada	2.9	3.0	1.1	1.6	2.3	2.8	0.8	0.7	7.9	12.1
France[2]	1.9	1.2	0.5	0.8	1.6	1.4	0.5	0.5	. . .	–3.3
Germany	2.3	2.2	1.0	0.9	2.2	2.0	0.4	0.6	6.5	2.7
Italy	. . .	3.0	. . .	0.9	. . .	2.5	. . .	0.6	. . .	–1.2
Japan	1.2	1.0	0.3	0.1	0.9	0.9	. . .	0.1	10.4	1.5
United Kingdom	3.2	2.7	1.8	1.9	3.2	3.0	0.9	0.9	6.1	4.9
United States	3.5	3.7	1.5	2.0	3.3	3.7	0.9	0.7	5.0	8.5

Sources: International Monetary Fund, *World Economic Outlook* database; OECD (1996); and IMF staff estimates.
[1]Calculated as net income after taxes divided by capital and reserves at the end of the previous year, minus consumer price index for the year.
[2]Data for the first period cover 1988–89 only.

deposit insurance corporation. Also, 2 of the 20 major banks reported significant restructuring packages in April 1997. On April 1, 1997, Nippon Credit Bank (NCB) announced that it would: (1) write off ¥460 billion in nonperforming loans, which would result in a pretax loss of ¥350 billion; (2) cut salaries (by 10–30 percent for most personnel, and 50 percent for managers) and personnel (by 900, or 31 percent), and sell off all of its own real estate holdings, including its headquarters; (3) not pay dividends for the 1996/97 fiscal year; (4) cut assets by ¥6 trillion to ¥10 trillion (a 37 percent decline); (5) close its foreign branches and subsidiaries (five branches and seven representative offices); and (6) seek an injection of capital of ¥300 billion to prevent insolvency. This capital injection would come from shareholders and the other long-term credit banks (for a combined ¥70 billion), subordinated debt holders (mostly insurance companies, ¥140 billion), and the New Financial Stabilization Fund (¥80 billion), which was originally established to assist in the resolution of the *jusen* last year. It also announced that its three nonbank affiliates—Crown Leasing, Nippon Total Finance, and Nippon Assurance Finance Service—would file for bankruptcy rather than be bailed out by the NCB. These three institutions had total loans of ¥1.8 trillion, of which only ¥300 billion was owed to NCB. All other creditors would have to write off their loans to these nonbanks (it was reported that agricultural cooperatives had total loans to the nonbanks of ¥240 billion and the seven trust banks had lent a combined ¥430 billion). On April 10, 1997, NCB announced an agreement with Bankers Trust involving collaboration in securitization and international operations. Also on April 1, Hokkaido Takushoku Bank (HTB) announced that it would merge with Hokkaido Bank (the twenty-second largest of the first-tier regional banks) at the end of the 1997/98 fiscal year, forming a new institution, tentatively called the New Hokkaido Bank (NHB). HTB announced that it would also close or transform to representative offices all of its 20 overseas branches and subsidiaries, and the merged entity would close 100 of its combined 340 branches. HTB will also cut 2,000 employees, resulting in expected cost savings equivalent to 30 percent of operating expenses.

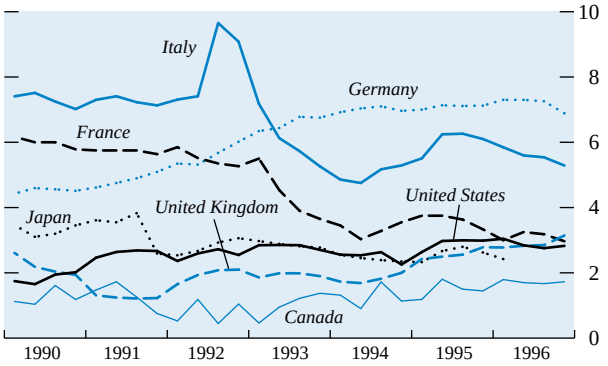
The NCB resolution strategy combined elements of the old approach to bank failures—shareholder banks, the long-term credit banks, and the Bank of Japan (through the New Financial Stabilization Fund) are to provide capital for NCB—and some new ideas, and holders of subordinated debt were also asked to inject capital. More important, the bankruptcy of NCB's nonbank affiliates was a significant departure from the principle of parent responsibility. However, at end-March 1997, NCB had ¥1.3 trillion in problem loans, still 7 percent of total loans. In addition, NCB's total capital ratio has been reduced to 3 percent and its hidden reserves on listed and unlisted securities have been reduced by 86 percent, covering only 3 percent of problem loans. More fundamentally, NCB, like all of the long-term credit banks, suffers from a decline in franchise value. The market for long-term corporate loans has been eroded by competition from other banks, foreign institutions, and capital market funding.

The Next Challenge: Core Profitability

As the major banking systems recover from their asset-quality problems, the focus is turning toward their underlying strength and their ability to respond to the changes in the financial landscape outlined at the beginning of this annex by increasing noninterest income and yielding greater returns to equity holders. Table 33 shines some light on these issues by comparing the income generation and profitability of the banking systems of the major industrial countries over the 10-year period 1985–94. During that time, almost all of these countries have experienced a significant

Figure 53. Major Industrial Countries: Intermediation Spreads

(Average lending interest rate minus average deposit interest rate)



Source: International Monetary Fund, *International Financial Statistics.*

deterioration in asset quality and profitability at some time, which shows up in the reported returns on equity and pre-provision profits (banks with higher nonperforming loans incur greater expenses in managing their loan portfolios). Nevertheless, data reveal some major trends.

Over the 1985–94 period, the Canadian, U.K., and U.S. banking systems were consistently the most profitable in terms of core, pre-provision earnings among the G-7 countries. The average pre-provision return on assets over that period was 1.8 percent for U.S. banks, 1.7 percent for Canadian and U.K. banks, 1.1 percent for German banks, 0.6 percent for French banks, and 0.5 percent for Japanese banks (not shown). The relatively strong recent performance of the Canadian, U.K., and U.S. banks compared to those in, for example, France and Japan, is not, therefore, simply due to their having gone through the recent asset-quality cycle more quickly; banks in the three leading countries have simply been fundamentally more profitable. These profits, however, do not reflect relatively wide intermediation spreads.[32] As Figure 53 shows, loan rate spreads over deposits have tended to be higher in France, Germany, and Italy compared with Canada, the United Kingdom, and the United States. A relatively higher proportion of low-margin securities and other assets, and relatively worse overall asset quality during the period, appear to explain most of the difference.

While most banks have responded to the increased competition in lending activities by expanding their noninterest earnings, banks in Germany and Japan have actually seen a decline in importance of such income. Noninterest income for the Japanese and three continental European banking systems, which is decreasing, remains a much less well developed source of income than it is for banks in Canada, the United Kingdom, and the United States. This lack of diversification in income has meant that the decline in asset quality was particularly costly, since these banks relied much more heavily on interest income. With increasing loan loss provisions and declining interest income, the banks' profitability dropped. The real return on equity, for example, has fallen sharply in Japan and in Germany, and less so in the United Kingdom, while it has risen significantly in Canada and the United States owing to a combination of increasing underlying profitability and declining provisions. As the data in Table 33 indicate, however, it is relatively weak earnings generation that hampers the French, German, Italian, and Japanese banking systems, and which has made their recovery from their asset-quality difficulties in some cases quite difficult.[33]

The issue of core profitability is inextricably linked to the structure of the banking system and, particularly, the advantages that certain types of institutions may have because of different regulatory regimes, subsidies, or ownership structures that place less emphasis on returns to capital. In an environment in which banks are encouraged by the regulatory regime to maximize returns to equity capital, such features of a financial system can make it more difficult for some banks to compete. To be sure, certain of these differences can be to the detriment of the special institutions—a contributing factor to the savings and loan (S&L) crisis in the United States was the more relaxed supervisory and regulatory environment in which they operated, which allowed the S&Ls to run up very large loan losses. Similarly, the lower level of official oversight over the credit unions and credit cooperatives in Japan contributed to difficulties in those sectors. However, often the special treatment of certain types of institutions works to the detriment of the larger, internationally active, commercial banks, in part by reducing the domestic profits on which they attempt to leverage their international activities. (For example, since profit margins on retail banking services tend to be wider than on

[32]Nor are lower costs the explanation, as is often argued. Operating expenses as a percentage of assets have been consistently higher in Canada, the United Kingdom, and the United States, and somewhat less so in Germany, compared with France and especially Japan, where annual operating costs amount to approximately 0.9 percent of assets, compared with about 3.5 percent in the United States over the same period.

[33]Note that the Japanese banks only began to make significant inroads on their nonperforming loans after pre-provision earnings soared to record levels in 1995/96.

wholesale transactions, restrictions on competition in retail markets can prevent access to profitable business by commercial banks.) While few, if any, countries have a perfectly level playing field—for instance, savings institutions often enjoy advantages over commercial banks—some of these distortions have been more prominent in recent years, including the government ownership or mutual ownership of banks in France, Germany, and Italy which, by apparently downplaying the incentive for maximizing shareholder returns, has arguably allowed these institutions to compete aggressively against the private commercial banks in the same countries. Private bankers from France and Germany have argued to the European Commission on Competition that government-owned banks in these countries have been unfairly subsidized by the manner in which they were recapitalized.

In France, a number of the largest commercial banks have criticized the terms of the official assistance given to Crédit Lyonnais. The EU Competition Commissioner approved the recapitalization only after it was agreed that Crédit Lyonnais would divest itself of 35 percent of its foreign affiliates. The private banks in Germany have also questioned the government support that had been extended to some of the Landesbanks in the late 1980s. More generally, the Landesbanks have received higher credit ratings than many of the private banks because they are guaranteed by the government. For example, Moody's rates the major commercial banks' long-term foreign currency debt between Aaa and Aa2 and nine Landesbanks' debt between Aaa and Aa1—with the average Landesbank rating slightly higher than that of the commercial banks—but the stand-alone Bank Financial Strength Ratings are much higher for the commercial banks (B^+) compared with the Landesbanks (C^+). This public guarantee allows the Landesbanks to raise funds domestically and on international markets at more favorable rates than private banks can. At the same time, the Landesbanks earn an interest margin approximately half of that of the major banks and earn a correspondingly small return on equity (averaging 4 percent over 1990–95).

The issue is not necessarily that government-owned or cooperative banks are less efficient than privately owned banks, although that is often the case, but that official guarantees, subsidies, or regulatory advantages that segregate markets—for example, by giving certain institutions exclusive rights to offer certain types of retail deposit instruments or bonds, or certain types of loans—are inherently inefficient. By restricting the scope of competition, such structures can end up supporting an inefficient allocation of capital in the financial system, and worse, allow the accumulation of large losses that ultimately become a claim on the official sector.

Banking System Developments in Selected Emerging Markets[34]

Developments in Asian Emerging Markets

Macroeconomic developments strongly influenced the performance of banking systems in Asian emerging markets. Growth slowed (and current account deficits worsened) partly because of cyclical factors but also because of longer-term fundamentals. Growth in countries such as India, Indonesia, Korea, Malaysia, and Thailand slowed in 1996 compared with 1995 and is forecast to slow further in 1997.[35] Granted that even these slower growth rates surpass all but the highest growth rates in Latin America, the slowdown, nonetheless, has had serious repercussions for the financial systems in some Asian emerging markets, because it has revealed the underlying illiquidity in the corporate sectors and the lack of preparedness among some financial institutions for the slowdown and the resulting worsening of asset quality. Unless growth and export performance improve in 1997 the banks in some Asian countries may face significant challenges to their profitability and possibly their solvency. Given the history in many Asian emerging markets of providing broad support to the financial system by ensuring the survival of individual financial institutions, this vulnerability of the banking sector to further deterioration of macroeconomic fundamentals may become an increasingly important constraint on fiscal and monetary policies.

Property market developments also figured prominently in Asian banking developments in 1996 as key real estate markets deteriorated. Table 34 shows the recent trends in vacancy rates and rents on prime office space in some of the key property markets in Asia. The well-publicized weakness in the Bangkok market appears in the table as a slight increase in the vacancy rate, from an already high 13.2 percent at end-1995 to 13.9 percent at end-1996, and virtually flat rents. Moreover, record amounts of commercial real estate and office space are due to become available in 1997–99, which will further depress values. In Jakarta, a significant increase in vacancy rates was offset at least partly by an increase in rents, but there

[34]This section discusses recent developments in the systemically important emerging markets' banking systems with a view toward assessing the vulnerabilities in these systems and their potential consequences for macroeconomic developments and policies. This analysis draws on publicly available material published by national authorities, banks, and rating agencies. Because of space and resource constraints, this section does not discuss developments in banking systems in all, or even most, emerging markets or even in all countries where there are significant banking problems. Instead, developments in a few of the more important emerging markets in Asia (Korea, the Philippines, and Thailand), Latin America (Argentina, Brazil, Chile, Mexico, and Venezuela) and Europe (Czech Republic, Hungary, and Poland) are discussed.

[35]See the projections in IMF (1997).

Table 34. Selected Asian Property Markets: Vacancy Rates and Changes in Rents[1]
(In percent)

	Vacancy Rate		Change in Rents[2]
	March 1996	March 1997	
Bangkok	13.2	13.9	0.3
Beijing[3]	1.0	22.9	–19.2
Hong Kong, China	4.7	5.1	6.3
Jakarta	10.8	12.4	3.9
Kuala Lumpur	2.8	2.9	0.0
Manila	2.1	2.0	1.9
Shanghai[3]	14.1	24.6	–24.0
Singapore	4.9	6.1	4.5

Source: Jones Lang Wooton (1997).
[1]Prime office space in central business locations.
[2]Change in contracted net rents denominated in local currency, except for Beijing, Jakarta, and Shanghai, which are changes in U.S. dollar values.
[3]The increase in vacancy rates and decline in rents for Beijing and Shanghai reflect both the small initial stock of office space and the comparatively large developments that were completed in 1996.

too the market has underlying weakness. In Kuala Lumpur and Manila (Makati), conversely, vacancy rates are extremely low.

Korea's accession to OECD membership in 1996 focused international attention on its banking system and in particular raised some concern that increasing competition from foreign banks and a surge in foreign capital inflows could put pressure on the system. However, foreign banks already have a presence in Korea and operate on an equal basis with domestic banks (there were 77 foreign branches at end-1995); and while capital account liberalization may have a more important effect, the gradual approach to liberalizing inflows provides an opportunity to strengthen the domestic financial sector. Instead, the vulnerabilities in the Korean banking system have their roots in past practices. Explicit government-directed lending (Industrial Rationalization Loans)[36] has given way to directed lending of a different kind—for example, banks are required to allocate a certain proportion of marginal loans to the small and medium-sized enterprise sector—while political influence on lending decisions appears to continue. Consequently, many Korean banks have not yet developed sophisticated internal credit evaluation systems, placing greater emphasis on collateral than on an analysis of the project being financed.

In the current environment, many banks have built up large exposures to individual corporate groups (*chaebols*), many of which are highly leveraged.[37] The reduction in economic growth and export prices in 1996 heightened the illiquidity of many of these groups. In addition, many Korean firms have taken on increasing amounts of foreign-currency-denominated debt—both by borrowing in the international markets directly and by borrowing in foreign currencies from Korean banks. It is believed by many market analysts that very little of this currency exposure is hedged (the onshore forward foreign exchange market is very illiquid and would provide cover for only about 12 months in most cases), so that as the won depreciated these debts became more expensive to service. In the past year at least four large corporations or groups have defaulted on their debts, and other large companies are rumored to be in difficulty.

The growing liquidity problems among the large corporations have already put pressure on the banks' asset quality. At end-1995, nonperforming loans (those six months or more past due) among the eight largest commercial banks, for example, amounted to 6 percent of total loans.[38] By the end of 1996, the reported nonperforming loans had declined to 4.3 percent of loans for these eight banks, but if the exposures to Hanbo Iron and Steel Company and Sammi Steel are included, this ratio rises to 6.0 percent.[39] Net of reserves, these nonperforming loans equate to 68.9 percent of the banks' equity. However, since only loans six months past due are included, and restructured loans are not included at all, the true asset-quality situation of the Korean banks may be much worse (see Appendix 2 at the end of this annex for a description of asset-quality accounting practices in 20 emerging markets).

As is true among emerging markets elsewhere, much of the collateral that secures problem loans is real estate or specialized fixed capital that may be difficult to repossess or to sell at book value. Also, there are other potential sources of problems for the Korean banks in addition to the loans to the *chaebols*. Consumer loans, including credit cards, have been an important source of expansion for Korean banks in the past few years, and these have emerged as having high ratios of nonperforming loans. In addition to declining loan quality, the banks have had to deal with the collapse of Korean equity prices in 1996, which has imposed large revaluation losses on their extensive equity portfolios.

[36]The commercial banks still had W 4.5 trillion in policy loans on their books at end-1996, 56 percent of which were nonperforming.
[37]The 30 largest *chaebols* accounted for 16 percent of GDP in 1995. Among the 30 largest *chaebols*, 19 have debt-equity ratios greater than 400 percent, and 4 have ratios greater than 1,000 percent.
[38]These asset-quality data are reported by IBCA Ltd., which cites the Economic Research Institute of Korea as the source, and include substandard, doubtful, and loss loans. The Office of Bank Supervision in Korea reports nonperforming loans according to a narrower definition, which includes only doubtful and loss loans. According to this definition, bad loans in Korea average less than 1 percent of total loans. They report that substandard and precautionary loans are generally fully covered by collateral and that the historical loss rates are negligible.
[39]Hanbo Iron and Steel Company, the center of the Hanbo Group, the fourteenth largest *chaebol*, declared bankruptcy on January 23, 1997. Sammi Steel, the twenty-sixth largest *chaebol*, declared bankruptcy on March 20, 1997.

The Korean authorities have responded to the declining asset quality and the losses on banks' equity portfolios in part by engaging in regulatory forbearance. After raising the loan loss provisioning requirement for doubtful loans to 100 percent at the beginning of 1996, the requirement was later lowered to 75 percent. In addition, the banks were allowed to provision for only 30 percent of the securities revaluation losses in 1996, rather than 50 percent as would otherwise have been required. Despite these measures, the 15 largest commercial banks reported a 3.7 percent decline in net income in 1996.

The commercial banking system can be viewed as comprising three groups, the six large, older commercial banks, two government-owned banks, and a number of newer commercial banks.[40] Performance differs greatly between the first two groups and the third. The newer banks, with a shorter history of policy lending, generally have much better asset quality, are believed to have superior credit risk management skills, and are more efficient. The group of older banks have seen net income decline for two years in a row, with the return on equity falling from 5.9 percent in 1994 to 1.8 percent in 1996. With the share of loans at fixed low rates declining, net interest margins have increased slightly, but are still very low, at 2.3 percent in 1996. As an indicator of their relative inefficiency, the cost-to-income ratio for this group of banks rose from 82 percent in 1994 to 94 percent in 1996. Finally, 5.1 percent of their loans were nonperforming at end-1996 (6.9 percent with the exposures to the Hanbo and Sammi groups). For the group of newer banks, net income rose 34 percent in 1996 after a decline in 1995, for a return on equity of 8.8 percent. The net interest margin has fluctuated around an average of 3.1 percent since 1994, and the cost-to-income ratio in 1996 was 84 percent. On all of these measures, they outperform the older banks. Finally, for the two newer banks for which asset-quality data are available, nonperforming loans at end-1996 reached 2.4 percent of loans (only 2.5 percent with the loans to the Hanbo and Sammi groups), marginally higher than in 1995 (since they had fewer policy loans to begin with, and repayments on previously nonperforming policy loans were the main source of improvement in the asset quality of the older banks).

The *Philippines* has been the recipient of a surge in capital inflows since 1991–92 as foreign investor sentiment about the economic fundamentals—and expectations of ratings upgrades (S&P raised its rating for the Philippines in February 1997, and Moody's followed suit in May 1997)—have led to increases both in foreign direct investment and in portfolio investment. The latter has partly fueled a rise in equity prices of almost 200 percent since early 1992. Also, in the last few years, property prices have surged, which has raised concern about the sustainability of asset prices, although as Table 34 indicates, at least some of the increase in prices was due to declining vacancy rates in office buildings.

Partly as a result of the inflows of capital, liquidity in the banking system has been high in recent years, fueling a rapid expansion in bank lending—up by 44 percent a year during the past two years. This doubling of loans in the past two years raises questions about asset quality in the future. While nonperforming assets accounted for only 3.3 percent of total bank assets in 1996, down from 3.6 percent in 1995, some analysts have raised concerns about the expansion in bank lending. The first concern is that, as in other countries in the region, commercial banks in the Philippines have a relatively high direct and indirect exposure to real estate. The central bank has estimated the direct exposure of commercial banks through real estate loans at about 10 percent in March 1997, up from 9 percent in March 1996. The true exposure may be higher since property is a common form of collateral, and the banks have other exposures through investments in property developers. In April 1997, the central bank imposed a limit on real estate loans of 20 percent of a bank's total loans and reduced the maximum loan-to-value ratio to 60 percent from 70 percent. Analysts have also expressed concern that consumer lending, including credit card debt, has increased as a share of total loans.

As is the case elsewhere in the region, foreign currency exposure, particularly of the corporate sector, has been expanding. Philippine banks' Foreign Currency Deposit Unit (FCDU) loans expanded by 110 percent in 1996 alone. Prudential regulations require banks to keep balanced FCDU books, so the direct foreign currency exposure should be small. Moreover, 74 percent of FCDU loans at end-1996 were extended to exporters, oil companies, and public utilities for whom currency risk is not thought to be significant. However, if the remaining borrowers are not hedged, their currency risk could be translated into credit risk for the banks. In addition, much of the expansion in peso-denominated lending has been financed by offshore foreign-currency-denominated borrowing by the banks, whose net foreign liabilities had increased to $6 billion at end-1996 from near zero at end-1995. In response, the central bank introduced a 30 percent liquidity requirement on foreign-currency-denominated assets in July 1997.

The condition of financial institutions in *Thailand* figured prominently in the exchange rate pressures in 1996 and 1997, as the financial system was seen as a

[40]The six older commercial banks are the Korea Exchange Bank, Cho Hung Bank, Hanil Bank, Korea First Bank, Commercial Bank of Korea, and Seoul Bank. The two government-owned banks are the Korea Development Bank and Industrial Bank of Korea. Finally, for reasons of data availability, seven newer commercial banks are grouped together: Kookmin Bank, Shinhan Bank, Daegu Bank, Boram Bank, Dongwha Bank, Hana Bank, and Koram Bank.

source of potential weakness by foreign investors. The banks were thought by some investors to be vulnerable to a depreciation of the baht as a consequence of their own net foreign-currency-denominated liabilities or those of their customers. At the same time, however, the strength of the baht and the high interest rates needed to maintain the exchange rate, combined with a heavily overbuilt Thai property market, have contributed to asset-quality problems for the banks.

In many respects, the performance of the major Thai commercial banks in recent years has been good.[41] While earnings, as measured by the return on equity, have dipped slightly, the return in 1996 was over 20 percent, and the decline has been due to an increase in equity rather than a decline in earnings. Net income has increased steadily for the last eight years, driven by average loan growth of more than 20 percent a year and a gradual widening of net interest margins, although there has been some retrenchment in margins in the past two years. The banks have, however, sharply increased their net foreign borrowing. The Bank of Thailand reports that all commercial banks' net foreign liability increased from B 51 billion (35 percent of capital) at end-1991 to B 1,035 billion (twice capital) in October 1996, but these are not necessarily the banks' true foreign currency positions. Some market participants report that the Thai banks had hedged most of their net foreign liabilities, so that the devaluation had perhaps relatively little direct effect on their balance sheets. The opposite is believed to be true for the Thai corporate sector: market participants report that until doubts about the sustainability of the exchange rate policy grew in late 1996, Thai firms had made little attempt to cover their foreign currency exposure. As a result, the depreciation of the baht could result in an increase in nonperforming foreign currency loans.

The incentive to borrow abroad over the past few years reflects the illiquidity in the domestic markets. The Thai banking system has grown at a very rapid pace in the past six years—the average annual growth rate of credit to the nonfinancial private sector over 1990–95 was more than 23 percent—and the loan-to-deposit ratio increased from 103 percent at end-1990 to 141 percent in October 1996. Liquidity concerns were exacerbated by the high interest rates used to prop up the baht, the inability to manage short-term liabilities in the domestic markets actively because these markets are illiquid or underdeveloped, and more recently, the emergence of wider spreads on Thai credit in international markets, including in the international interbank markets at times.

[41]This description is based on the financial statements of 10 commercial banks, including 7 of the 10 largest—Bangkok Bank, Krung Thai Bank, Thai Farmers Bank, Siam Commercial Bank, Thai Military Bank, First Bangkok City Bank, Bangkok Metropolitan Bank, Bank of Asia, Thai Danu Bank, and Union Bank of Bangkok.

The illiquidity of the Thai corporate sector has created difficulties for the banks in terms of declining asset quality. The Bank of Thailand reported in December 1996 that total nonperforming (doubtful and substandard) loans amounted to 6.92 percent at end-1995 and 7.73 percent at end-June 1996.[42] The worsening nonperforming loan problem is frequently attributed to the weakness in the property market.[43] Developments in the property market in Thailand have been an important source of vulnerability both because the banks have lent to this sector—already this year two property developers have defaulted on debts—and because property has often been used as collateral for loans. While the official estimate is that 10 percent of bank loans are to the property sector, one private estimate puts the figure at 20 percent (equal to 33 percent of end-1996 equity). The Government Housing Bank has estimated that 40 percent of the housing stock built during 1992–96 was unoccupied at the beginning of this year. While property prices have not declined significantly, the data in Table 34 show that even the highest-quality office space in Bangkok has a relatively high vacancy rate and flat rents, and the supply of office space is projected to grow by 35 percent by the end of 1998. The excess supply is even worse for apartments and hotels.

A potentially greater danger to the banking system, however, is the possibility that the banks may be expected to supply financial support to affiliated finance companies, even if they are not majority shareholders. Many of the large commercial banks have invested in nonbank financial institutions, which are generally in weaker financial shape than the banks because of their much higher exposure to the property market. Since the Bank of Thailand has already stated its willingness to recapitalize nine very small unaffiliated finance companies through the Financial Institutions Development Fund (FIDF), some market participants suspect that the banks would be expected to do the same for the larger finance companies.

[42]These figures do not include the $3 billion in nonperforming loans held by Bangkok Bank of Commerce, which is under special administration. The definition of doubtful loans varies across banks, but as generally applied it refers to loans that are 12 months past due but fully collateralized, or partially collateralized loans that are more than 6 months past due.

[43]The failure of Bangkok Bank of Commerce (BBC) in May 1996, however, was reportedly due to management failures resulting in unusually high loan concentrations and large trading losses rather than to property-related nonperforming loans. BBC was taken over by the Bank of Thailand, which has contracted with one of the large finance companies to manage the bank for seven years, during which time the nonperforming assets will be segregated and the bank will be prepared for privatization. The Bank of Thailand has already provided an estimated B 20 billion in liquidity assistance, underwritten B 50 billion in BBC commercial paper, purchased B 60 billion in nonperforming loans (at a price of B 48 billion), and, through the Financial Institutions Development Fund, provided B 65 billion in capital and B 25 billion in liquidity assistance—a total provision of B 178 billion of funds.

The Thai authorities' response to the latest concerns about the health of the financial system have focused on improving accounting and disclosure for asset quality and on rehabilitating the property market. On the first front, as of July 1997, banks are required to begin disclosing nonperforming loans and provisions and to report restructured loans as well. Also, by end-June 1999 the banks will be required to have set aside reserves equal to 15 percent of substandard loans. On the second front, the authorities have introduced a number of measures to try to support the property market including (1) the creation of a secondary mortgage market by the Government Housing Bank, which will also provide low-cost mortgages to government employees; (2) increases in the foreign-ownership limit on some types of property; (3) a reduction in the land transfer tax from 2 percent to 0.01 percent; (4) proposed legislative measures to allow the establishment of real estate investment trusts and the securitization of property related loans; and (5) the establishment in March 1997 of the Property Loan Management Organization (PLMO). With a mandate similar to that of the CCPC in Japan, the PLMO was capitalized with B 1 billion from the fiscal budget and authorized to borrow up to B 100 billion (the first B 1 billion bond has already been issued) to purchase bank loans to property developers (or the collateral) at fair market value and restructure the loan or the project.[44] The banks that sell the loans would have to write off any difference between the purchase price and the book value of the loan and guarantee repayment of 50 percent of the loan.

Finally, the Bank of Thailand is encouraging mergers among financial institutions, especially finance companies, as a way to weed out the weak and inefficient firms. In April, a group of seven finance companies announced plans to merge. However, merger talks between the largest finance company, Finance One, and Thai Danu Bank broke down in June 1997. Subsequently, in late June, the Thai Ministry of Finance ordered 16 finance companies to suspend operations and to draw up recapitalization plans within two weeks. Five large finance companies have agreed to take over the good assets of those of the 16 that are unable to comply.

Developments in Latin American Emerging Markets

The economic recovery in *Argentina* in the second half of 1995 continued in 1996 and allowed the banks to recover from the liquidity crisis that developed in the first quarter of 1995 and to proceed with the longer-term process of restructuring in a less crisis-charged atmosphere.[45] This recovery in economic activity was reflected in the growth of bank loans, particularly in the second half of 1996. After declining by just over 1 percent (in nominal terms) in 1995, and rising by less than half a percent through the first half of 1996, loan growth averaged 7 percent for the second half of the year.[46] Deposit growth was even more impressive: the stock of deposits grew by 21 percent in 1996 after falling by 4.5 percent in 1995. Moreover, the growth in deposits in 1996 has been evenly balanced between dollar deposits and peso deposits, and the "flight to quality" that was observed in 1995—wherein the larger banks' deposits actually increased while total banking system deposits declined—was not in evidence through most of 1996: deposits of the 20 largest banks grew only marginally faster than total systemic deposits.

The return to more normal levels of liquidity in the banking system allowed the level of interest rates to fall, fueling loan demand. At the same time, however, net interest margins declined on average, reaching 4.95 percent for 1996 compared with 5.75 percent in 1995. Despite a modest increase in lending, the narrower margins and higher loan loss provisions (which increased by 14 percent in 1996) resulted in only a marginal increase (0.4 percent) in net income for the 20 major banks, with a return on equity of only 6.8 percent compared with 7.3 percent in 1995.

However, a tiering of banks is observed in Argentina, consisting of (1) a group of large private banks that perform better than most other banks in terms of asset quality and profitability; (2) a group of smaller private banks and cooperative institutions; and (3) the government-owned banks (including the two largest banks) whose poor asset quality has necessitated high provisions and write-offs, resulting in poor profitability. The differences between these sectors are immediately apparent in their respective asset-quality data. At end-September 1996, the ratio of loans past due more than 90 days to total loans was 19 percent for the federally owned banks, 27 percent for the provincial banks, 9 percent for the domestic private banks, and 15 percent for the cooperative institu-

[44]Salomon Brothers estimates that B 100 billion could purchase 12.7 percent of the book value of outstanding real estate loans.

[45]The authorities' response to the liquidity crisis in 1995 was documented in IMF (1996). Subsequent developments include the modification of the role of the deposit insurance fund (the Fondo de Garantía de los Depósitos) to allow it to provide liquidity assistance to banks that are not insolvent and to assist in the acquisition or merger of banks by standing ready to purchase assets, and the establishment of a $6.1 billion facility (collateralized by Argentine bonds) from international banks to provide liquidity during a crisis.

[46]Because Argentine banks are not required to have the same fiscal year-end, aggregation and comparison across reporting periods is difficult. The discussion of the performance of Argentine banks here is based on data compiled by Salomon Brothers (1997b) from monthly reports to the central bank. Data from 1996 and 1995 are not perfectly comparable since inflation accounting was ended in September 1995.

tions.[47] Moreover, the return on average equity for the government-owned banks was only 3.9 percent in 1996, compared with 10.9 percent for the large private banks, and the respective overhead costs as a proportion of total revenues were 70 percent and 65 percent.

The banking system in *Brazil* came under pressure during the transition to a post-hyperinflationary economy under the Real Plan, which exposed weaknesses in asset quality and the regulatory and supervisory structures. The Real Plan succeeded in sharply reducing inflation but at the expense of a significant slowdown in economic growth—an outright contraction in activity for much of 1995. Loans in arrears and in liquidation increased from 7.25 percent at end-1994 to 13.4 percent at end-1995 and 14.4 percent at end-1996.[48] These developments have resulted in a number of bank failures and mergers under distress over the past two years, and more consolidation is expected.

The transformation of the economy after June 1994 has created a three-tiered commercial banking system in Brazil. There are, first, the publicly owned banks, including the banks owned by the state governments, which have in the past often been used simply as extensions of state treasuries. These banks did not develop a credit culture upon which to build franchise value from alternative lending, and they accumulated large stocks of nonperforming loans. A second group of institutions includes a large number of small, private commercial and multiple banks with limited branch networks and relatively undiversified product lines that tended to fill niches in the system—such as treasury operations and wholesale banking. Having relied upon "float income" for much of their profit, and lacking the economies of scale necessary to compete in a low-inflation environment, these institutions too have found it difficult to adapt to the new economic reality. Finally, there are a small, but growing, number of well-capitalized and well-run large private commercial banks that are expanding to fill the gaps left by the retreating government-owned banks.

Some insight into the condition of the government-owned banks can be gained by looking at the 12 state-owned banks for which balance sheets and income statements for 1995 and 1994 are available.[49] Between 1994 and 1995, net interest income declined by 24 percent and margins fell by more than half (to 10.4 percent), noninterest income declined by 52 percent, and loan loss provisions tripled, all of which contributed to a net loss of R$862 million in 1995, after a net loss of R$151 million in 1994. The weakest of this group, Banerj, had a negative net capital position at end-1995 of R$1,859 million, or 79 percent of assets. For the seven banks that reported nonperforming loans to the private sector, these amounted to 10.8 percent of private sector loans and leases in 1995, up from 4.4 percent in 1994, and reserve coverage declined from 107 percent to 77 percent. Hence, even excluding nonperforming loans to the public sector (about 5 percent of total loans), asset quality deteriorated seriously in 1995.

The situation is similar among the four federally owned commercial banks. As a group, they earned a net loss in 1995 of R$4.96 billion, although this was mostly owing to the loss incurred by Banco do Brazil. Excluding that bank, the three other federal banks for which data are available saw net interest income fall by 30 percent, interest margins fall to 13.1 percent, but noninterest income double, which compensated almost exactly for the shortfall. However, loan loss provisions rose to 13.7 percent of private sector loans and leases at end-1996 from 8.6 percent at end-1995.

A key development in the government-owned banking sector was the R$12.3 billion loss by Banco do Brazil over 1995–96. In April 1996, the government announced a recapitalization plan for Banco do Brazil in which the government would underwrite a capital injection of R$8 billion in new capital. In the event, the government itself injected R$3.9 billion in new capital and transferred R$2.9 billion in shares of state-owned companies, while the bank's pension fund injected R$1.2 billion.

The group of small private banks is another source of stress in the Brazilian banking system, albeit perhaps less of a systemic threat. Aggregation of a sample of small banks' financial statements for 1994–96 reveals a pattern of declining profitability and capital and rising levels of nonperforming loans.[50] The return on average equity has declined for two successive years, from 42 percent in 1994 to 19 percent in 1996 (the return on assets has declined from 6 percent in 1994 to 3 percent in 1996), while the net interest margin has fallen from 13.7 percent to 8.6 percent.

[47]For the 14 largest private banks, nonperforming loans (C, D, and E loans) represented 6.7 percent of total loans (significantly higher than in 1994) at end-1996, but for the 6 government-owned banks, the ratio was 18.1 percent. The higher incidence of bad loans was combined with a slightly lower coverage ratio for loan loss reserves, resulting in a net exposure to bad loans equal to 32 percent of equity, compared with only 18 percent for the private banks. However, despite having more nonperforming loans, and a smaller revenue base (relative to assets), the state banks set aside only 18 percent of total revenues in loan loss provisions, compared with 25 percent for the private banks.

[48]Data published by the Central Bank of Brazil. These figures do not include the portfolios of the state banks of Saõ Paulo and Río de Janeiro and of the federally owned savings bank, Caixa Economica Federal.

[49]Financial reports for the state banks of Río Grande do Sul, Minas Gerais (two), Paraña, Río de Janeiro, Bahía, Santa Catarina, Espirito Santo, Ceara, Pernambuco, Goias, and Maranhaõ, as provided by IBCA Ltd.

[50]This discussion of the performance of the smaller private banks is based on the financial statements of 28 banks with total assets below R$1 billion and for which financial statements for the last three years are available from IBCA Ltd.

Net interest income has increased significantly since 1994, reflecting the banks' reorientation toward lending and away from the securities trading and interbank lending activities that were so profitable during the high-inflation period. However, operating expenses have also increased, and loan loss provisions have tripled, which contributed to a decline in net income in 1996. At the end of 1996, these banks had nonperforming loans equal to only about 5 percent of total loans (up from 2.8 percent in 1994). While these institutions are still well capitalized, with an equity-to-total-assets ratio of 15 percent at end-1996, they face growing competition from larger competitors, which have expanded to fill the niches these smaller institutions once occupied.

The third group of institutions in Brazil are the larger private banks. Overall, profitability improved slightly in 1996 despite a narrowing of the net interest margin (to 9.8 percent, from 12.3 percent in 1995).[51] Banks offset the declining margins by expanding loan volume by 12 percent and by increasing their noninterest earnings by 39 percent. However, a key source of improvement in the banks' earnings was a reduction in loan loss provisions made possible by a significant improvement in asset quality, after two years of high charge-offs. While differences clearly exist between the banks, asset quality appears at least to have stabilized. The ratio of private sector loans in arrears and liquidation to total gross loans fell from 5.1 percent to 3.7 percent. Improving asset quality allowed room for banks to make lower loan loss provisions, while still increasing reserve coverage to 233 percent of nonperforming loans. This improvement in asset quality may simply be due to the expansion in banks' loan books, but since much of this expansion reportedly went to consumer lending (almost all of it short term), where loan losses are usually relatively higher, it may only be temporary.

Since the inception of the Real Plan, a number of measures or programs have been implemented to improve the process of removing problem banks from operation and to restore confidence in the remaining banks. In August 1995, a private deposit insurance scheme, funded and operated by the larger banks, was established as a temporary mechanism until a formal deposit guarantee fund (FGC) could be established in November 1995. This fund—financed by premiums levied on all financial institutions, charges on returned checks, and the possibility of special levies (up to 50 percent of the ordinary premium) or advances from member financial institutions or the central bank—guarantees repayment of a maximum of R$20,000 to each depositor at each bank.

Also in November 1995, the government announced the PROER program to help promote consolidation in the banking sector by providing fiscal and financial incentives to banks that merge with or acquire all or part of another bank.[52] Funding through PROER has been used on a number of occasions (most notably in the cases of Bamerindus, Banco Economico, Banco Nacional, Banco Mercantil de Recife, Banorte, Banco United, and Banco Martinelli).

In August 1996, the federal and state governments agreed to a program to reschedule the state government's debt in return for the privatization, liquidation, or transformation (to development agencies that would not accept deposits) of the state-owned banks. The first to be privatized was Banco do Estado do Río de Janeiro, which was sold in June 1997. In 1996, the federal government established a program to restructure up to R$7 billion in debt of small agricultural producers (individual loans up to R$200,000).

The banking system in *Chile* is considered to be one of the strongest among the emerging markets. This is reflected mainly in the asset quality of Chilean banks. At end-1996, only 1.03 percent of the total loans of the major Chilean banks were nonperforming, somewhat below the 1992–95 average.[53] This low ratio is not thought to be due to lax accounting practices. On the contrary, the Chilean authorities have one of the most conservative accounting standards among all emerging markets regimes, and they are believed to cross-check the information they receive from the banks on loan performance against information from the tax authorities. On the issue of accounting for bad loans, therefore, the Chilean banks are widely considered to be among the most conservative banks in the world. Like their counterparts elsewhere in Latin America, Chilean banks maintain very high loan loss reserves relative to the stock of bad loans, although at 180 percent at end-1996, this ratio has declined rapidly since end-1993 (when it was almost twice as high).

Chilean banks' earnings have come under pressure from increasing competition in recent years. The net interest margin has declined gradually over the past four years to just over 3 percent, and this shrinkage is not due to a large stock of nonperforming assets. Rather, it reflects declining interest rates, increasing

[51]This discussion of the larger private banks' performance is based on the audited financial statements of 24 private banks with assets of at least R$2 billion and for which both 1996 and 1995 data are available from IBCA.

[52]Program of Incentives to the Restructuring and Strengthening of the National Financial System. In March 1996, PROER was expanded to allow a (solvent) bank to finance a restructuring of its assets and liabilities. Since the introduction of the PROER, liquidity lending (which includes lending under PROER) by the central bank to financial institutions has increased significantly, reaching a peak of R$20.6 billion at end-July 1996 (compared with R$4.3 billion at end-July 1995). As of end-February 1997, the outstanding balance had fallen back to R$5.2 billion.

[53]This discussion of Chilean banking developments is based on data of the Superintendencia de Bancos e Institutiones Financieras collected and published by Salomon Brothers (l997a). The measure of nonperforming loans used includes all past-due loans.

competition, and the concentration of the banks' activity in corporate lending. Only about 24 percent of end-1996 loans were to the consumer and mortgage sectors, where margins are higher than in the corporate sector. The banks are gradually changing this orientation—consumer loans grew at three times the overall growth rate in loans in 1996—and over time this reorientation will tend to boost net interest margins. Similarly, noninterest income has tended to be relatively unimportant for Chilean banks, but such income has increased significantly in the last few years. Faced as they are with relatively low income, Chilean banks are forced to be efficient providers of banking services, as indicated in the low overhead ratio (63 percent at end-1996).

While the Chilean banking sector is fairly efficient and free of the asset-quality problems that plague banking industries elsewhere, it is a relatively capital-poor industry. With the subordinated debt situation essentially resolved (the last bank has just announced an agreement with the central bank to repay its debt), the banks' capital levels have declined (subordinated debt was part of secondary capital). The average equity-assets ratio was only 5.3 percent at end-1996 and has declined steadily since at least 1992. Moreover, the ratio of liquid assets to total assets was only 8.9 percent at end-1996.

Notwithstanding the improvement in the underlying economic environment, banks in *Mexico* endured a very difficult year in 1996. Commercial banks, excluding banks that were under central bank intervention or in other special situations, recorded an aggregate net loss of MexN$6.9 billion in 1996, after a profit of MexN$2.5 billion in 1995.[54] The deterioration in net income stemmed mainly from a 27 percent decline in net interest revenue, reflected in a fall in the net interest margin to 3.83 percent from 6.54 percent in 1995. This contraction in interest income is attributable to the decline in interest rates and an increase in nonperforming or low-yielding assets on the banks' balance sheets. The bulk of the banks' total loans of MexN$698 billion were loans to FOBAPROA, UDI-restructured loans, loans to the government due to the ADE program, and nonperforming loans.[55] These assets, which more than doubled in 1996, earn relatively low yields, which drags down the banks' income.[56] Loan loss provisions, which had been mainly responsible for the deterioration in income in 1995 over 1994 levels, rose by only 20 percent in 1996, to MexN$30 billion.

After the serious disruption to the economy in 1995, asset quality remains a key concern for the Mexican financial system, and recent indications are that the situation has not improved. Nonperforming loans increased by 2.5 percent in 1996, to MexN$47.5 billion, despite the sale of MexN$124 billion in (mostly nonperforming) loans to FOBAPROA by virtually all of the important banks in Mexico in 1996.[57] At the end of the year, nonperforming loans represented 6.8 percent of total loans, compared with 7.8 percent at end-1995. (Of the total classified portfolio of MexN$495 billion, medium-risk, high-risk, and irrecoverable loans represented 17.5 percent at end-1996, compared with 13.8 percent at end-1995.)

The transfer of such a large stock of loans to FOBAPROA (approximately 39 percent of the end-1994 loan portfolio) and the associated recapitalization commitments have placed the system on what appears to be a much sounder footing.[58] At end-1996, the capital adequacy ratio calculated by Banco de México for the banking system was 13.1 percent, up from 12.1 percent at end-1996. However, most of the increase in capital has been in the form of revaluation gains. For example, 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 to equity (MexN$25 billion).

After two turbulent and difficult years—in which 17 banks holding 54 percent of end-1993 deposits were closed or taken over by the deposit guarantee fund, FOGADE, and official assistance to the banking sector amounted to Bs.1.6 trillion (18 percent of 1994 GDP)—the banking system in *Venezuela* recovered significantly in 1996. There were no further actions taken against any bank in 1996, and the authorities began toward the end of the year to privatize the banks that had been taken over. While important weaknesses and vulnerabilities remain, the crisis that began with the failure of Banco Latino in January 1994 appears to have eased.

The major Venezuelan banks' net income increased by more than a factor of three in 1996, resulting in a

[54]The discussion of developments in the Mexican banking system is based on the audited year-end financial statements of the 36 private domestic and foreign commercial banks for which both 1995 and 1996 results have been made available by IBCA Ltd.

[55]FOBAPROA is the Fondo Bancario de Protección al Ahorro; UDIs are Unidades de Inversión; the ADE program is the Programa de Apoyo Immediato a Dendores de la Banca.

[56]In addition to the interest income on UDI-restricted loans, the banks earn income from the UDI trust. In 1996, however, this amounted to only MexN$141 million.

[57]These purchases by FOBAPROA are financed by loans from the selling bank—hence, the operation effectively transforms nonperforming loans into performing loans to FOBAPROA. However, in most cases, the selling banks have retained a 20 percent (or thereabouts) stake in any future losses on the loans.

[58]In mid-1996, the Mexican government established a Resolution Trust-like company, Valuacion y Venta de Activos (VVA), to repackage and sell the loans purchased by FOBAPROA from the commercial banks. A competitive bidding process for the first package of 36 loans, valued at MexN$150 million, closed on June 23. At end-1996, FOBAPROA held approximately MexN$162 billion in loans, so this first auction represents a small fraction of the total to be sold.

return on average equity of 74 percent.[59] While this fell short of the average inflation rate for the year, much of the profit was earned in the second half of the year, during which inflation was considerably lower, which suggests that the banks have recently begun earning positive real profits. The three main sources of higher profits were net interest earnings from lending—loans increased by more than 80 percent in 1996—income from securities holdings, and extraordinary gains. The latter includes for some banks profits from long dollar positions (mostly in Brady bonds) that they had at the time of the devaluation of the bolivar in April 1996.

Asset quality also improved markedly in 1996. At the end of the year, the banks reported past-due loans and loans in litigation equal to 4 percent of the gross loan portfolio, down from 10 percent at end-1995. (If restructured loans are included, the figures are 6.5 percent of the gross loan portfolio, down from 13 percent.) The ratio of loan loss reserves to past-due loans and loans in litigation likewise rose from 121 percent to 196 percent during 1996. The Venezuelan banks are similarly well capitalized. As a result of capital injections by shareholders, the equity-assets ratio has increased to 13 percent, from 8 percent at end-1995.

All is not entirely well, however, with the Venezuelan banks. They continue to invest a large proportion (nearly 50 percent) of their earning assets in securities (mostly government bonds)—only 34 percent of total assets is represented by net loans, although lending has picked up significantly in 1997. Moreover, their current profitability is supported by still very wide net interest margins—19 percent in 1996, compared with 16 percent in 1995 and 14 percent in 1994. Finally, banks do not yet provide a reliable store of value for depositors, who are believed to keep only a small fraction of savings in Venezuelan banks.

Developments in European Emerging Markets

The banking system in the *Czech Republic* endured an eventful year in 1996, in which eight banks were intervened in by the Czech National Bank (CNB), including the fifth-largest bank, which has been supported by an irrevocable blanket guarantee of all liabilities by the CNB. At the end of the year, five banks, accounting for less than 4 percent of banking system assets, were under special CNB conservatorship and two had been liquidated—joining the four other banks that had failed since 1994.

[59]This discussion is based on the financial statements of the 13 largest commercial banks for which data are available for 1995 and 1996. This group of "major banks" includes three of the banks that were taken over by FOGADE: Banco Latino, Banco Consolidado, and Banco de Venezuela, which are, respectively, the third, fourth, and eighth largest banks in the country.

The situation is not as bleak as these facts suggest, however, in part because the authorities had known of these banks' difficulties for a few years—this was not a situation in which a large number of banks suddenly became insolvent. Serious asset-quality problems began to emerge in 1993–94 among the newer private commercial banks that had been established in the Czech Republic during 1991–93 when licensing rules were fairly lax. Two banks were closed because of asset-quality problems in 1994 (and another because of alleged fraud). In 1995, similar problems emerged at a large number of the smaller banks, and the authorities responded by closing the worst affected, placing others under special monitoring, and ensuring that the CNB had sufficient powers to intervene in weak banks. When the financial results for 1995 revealed how weak these institutions were, the CNB exercised these powers in seven banks and closed them or placed them in receivership. An eighth bank required the support of the CNB, including a blanket guarantee for all domestic and foreign creditors, because it had a common shareholder with one of the failed banks and had therefore suffered a serious decline in liquidity. A scheme for restructuring small banks was announced in October 1996.

Although the share of impaired loans remains high, the official data on classified assets indicate a slight improvement in asset quality in 1996. Excluding the Consolidation Bank, classified loans declined from 33.4 percent at end-1995 to 30.1 percent at end-1996 and 29.7 percent at end-March 1997. In addition, the larger banks have seen a decline in nonperforming loans, are adequately (if not fully) reserved against nonperforming loans, and have investment grade ratings; foreign-owned or joint-venture banks are also in reasonably good condition.

However, poor asset quality is still a concern. Even after taking CzK 140 billion in nonperforming loans off the banks' balance sheets (by selling them to the Consolidation Bank) and transferring bonds worth CzK 57 billion to banks to boost their capital, some CzK 339 billion in classified assets remained on banks' balance sheets at end-September 1996. The ongoing provisioning requirements to meet the required coverage ratio and to maintain it as the stock of classified loans rises consumes a third of operating income (although this fraction is declining). The history of high loan loss provisioning and high nonperforming loan ratios has resulted in a system that is not highly profitable or capitalized. While most of the banks exceed the 8 percent minimum capital adequacy requirement, the average capital adequacy ratio at end-1996, excluding the Consolidation Bank, was 10.3 percent.

The banking systems in both *Hungary* and *Poland* continue to recover from the asset-quality problems that plagued them in the late 1980s and early 1990s. Improvements have been due in large part to extensive

restructuring in the context of bank recapitalization and privatization. At end-1996, classified loans in Hungary represented 11.6 percent of total loans, down from a peak of 28.5 percent at end-1993. Similarly, in Poland, at the end of the first quarter of 1996, irregular loans represented 18 percent of the portfolio, compared with 31 percent at end-1993.

Hungarian bank regulations have gradually been brought up to EU standards, including the requirement that banks must publish their financial statements in both International Accounting Standards format and in Hungarian accounting format. The adjustments to the supervisory and regulatory structure accelerated in 1996, with a complete overhaul of the architecture of supervision and important changes to the content of bank regulations. The banking and securities supervisory agencies have been combined into a joint supervisory agency, and approval for banks to engage in securities activities was given in the new banking law implemented at the beginning of 1997. In addition, the new law doubled the minimum capital requirement to Ft 2 billion;[60] and tightened restrictions on ownership, related party transactions, and credit and market risk exposures.

Appendix 1
Credit Derivatives

While credit risk has vexed financial markets since money lending began, the ability to trade and transfer credit risks with ease is a new phenomenon. The first deals done with such structured products, called credit derivatives, were executed in 1992. Steady growth since then has brought the credit derivative market to what is viewed as a critical mass, catching the attention of potential customers and regulators alike. Although official statistics are not yet available, industry estimates put the size of the credit derivative market at about $40 billion of outstanding transactions.[61] While still only a drop in the bucket when measured against the $10 trillion of notional principal outstanding in the over-the-counter derivative market in 1996, the credit derivative market is expected to grow quite quickly.

Participants, Liquidity, Types of Products

Currently, the 10–15 dealers in credit derivatives consist of investment and commercial banks, which act as both intermediaries and end users. Investment banks, in particular, can be constrained by credit exposures obtained within the huge bond and derivatives portfolios they maintain, requiring them to free up credit lines. Large money center banks, with both their traditional expertise in evaluating and managing credit risks and their extensive customer bases, have been in the forefront of the development and pricing of credit derivatives.[62] Moreover, commercial banks are also large holders of credit risk (although it is typically more diversified) naturally leading them to consider altering their credit risk via derivative products.

To date, the end users in this market are predominantly banks. They have an appetite for over-the-counter products and understand credit evaluation, making them easily educated customers. Other institutions, such as corporate treasuries and hedge funds, are making their way into the market. The corporate entities are interested in trading their trade credit concentrations and in lowering their credit exposures to various derivative counterparties. Hedge funds are also interested since credit risk derivatives provide them with an efficient method of obtaining credit exposures. Institutional investors, such as pension funds and insurance companies, are expected to be interested in finding new types of credit exposures other than the ones they have traditionally undertaken through their predominantly fixed-income portfolios.

While the growth in the market has been led by U.S. entities, European institutions have recently become participants. Since European markets are heavily bank intermediated, and long-run client relationships are a large part of banks' franchise value, credit derivatives are likely to provide a particularly apropos method of unbundling credit risk from the client relationship. The Asian market is thought to be the next area of significant growth for credit derivatives as this market is now adopting more sophisticated credit risk extension policies and Asian institutions are becoming more conscious of the credit risks that characterize their balance sheets.

As yet, the market cannot claim to be liquid, as many of the transactions are "one-off" deals that are tailored to the specific needs of a customer. Despite the absence of a generic product, four or so of the most common product designs have been widely adopted, and most derivatives can be marked-to-market, or at least marked-to-model, providing at least some comfort as to their ability to be offset. The liquidity of the credit derivatives is higher for deriva-

[60]Hungarian banks must meet an 8 percent minimum risk-weighted capital adequacy ratio.

[61]A November 1996 survey by the British Bankers Association estimates the London market, about one-half the total market, covers loans worth $20 billion. Another estimate, by CIBC Wood Gundy, a Canadian investment bank, puts the number at $39.2 billion of outstanding transactions, half of which involve the credit risk of developing countries' debt. In the United States, where official data are now being collected on gross positions of U.S. banks, for the quarter ending March 31, 1997, there was a total of $19 billion notional principal worth of credit derivatives outstanding.

[62]J.P. Morgan introduced CreditMetrics™ on April 2, 1997, which provides transparent methodology, data, and software to evaluate credit risks individually or across an entire portfolio.

tives written on more liquid underlying instruments, such as Brady bonds, whose outstanding stock had reached $156 billion by the end of 1996.

There are four principal types of credit derivatives: credit default swaps, total rate of return (TROR) swaps, credit-linked notes, and credit spread options. All credit derivatives transfer credit risk between a credit-risk seller, interested in shifting the credit risk to another party in exchange for paying a premium, and a credit-risk purchaser, interested in obtaining credit risk along with receiving the premium for taking on such risk.

In a credit default swap the buyer of protection (the hedger) pays a fee, which effectively represents an option premium, in return for the right to receive a conditional payment if a specified "reference credit" defaults. The reference credit is the party whose credit performance determines whether payments are made. The amount to be paid is negotiated between the counterparties and may be determined prior to the default event or may be determined based on the observed prices of similar obligations after a default.

A total rate of return swap is structured so that the buyer swaps the "total return" on the reference asset for a regular floating-rate payment (in general based on LIBOR). For example, the buyer agrees to pay the total return on an emerging market Brady bond, consisting of all contractual payments as well as any appreciation in the market value of the bond; the seller agrees to pay the buyer LIBOR plus a spread and any depreciation in the value of the Brady bond. The TROR swap differs from the credit default swap in that a default event need not occur nor be verifiable: the TROR swap protects the buyer against a deterioration of credit quality, which can occur even without a default.

A credit-linked note is an on-balance-sheet structured note in which a credit derivative is embedded in the structure. Often these notes are issued by a special purpose trust vehicle, which is collateralized with high-quality assets to assure payment of the contractual payments due. A purchaser of a credit-linked note assumes the credit risk of the reference credit and the underlying collateral. To illustrate: a special purpose vehicle, rated AAA, issues a credit-linked note based on the credit risk of Corporation XYZ. If Corporation XYZ defaults on its debt, the credit-linked note is no longer redeemable at par value, but note holders receive, say, 60 percent of the par value.

A more recently developed credit derivative is the credit spread option. A credit spread option provides a payout to the buyer when the spread on two underlying assets exceeds a predetermined level. The buyer pays a premium for such protection and the seller pays out based on the spread. Since the credit risk of many fixed-income securities is often measured as a spread over a comparable-maturity "risk-free" security, this derivative product is highly sensitive to the market's assessment of credit risk in these securities and is especially tailored to holders of emerging market debt and other high-yielding debt instruments.

Outstanding Issues

As yet, valuation and risk management methods for credit derivatives are not as analytically developed as those for other financial derivatives, in part, because the information required is more difficult to obtain. Generally, defaults are rare and severe—historical data are spotty, not fulfilling the normal preconditions for modeling: a continuous data series with few large observations. These data constraints are most severe for the relatively illiquid loan market: data are slightly more plentiful regarding the default experience on publicly issued debt for rated companies. However, these data focus on U.S. corporate entities, whereas about half the outstanding credit derivatives are written on emerging market Brady bonds, which have yet to experience a single default. The current paucity of data on the default experiences of emerging market debt instruments may be hindering accurate assessments of credit risk—and there may be a rude awakening for holders of such debt and the related credit derivatives if the economic environment changes for Brady bond countries.

Additionally, effective risk sharing is enhanced when adequate information about the reference credit is provided to the end user who is taking on the credit risk. Adequate information is more easily acquired for reference credits whose securities trade publicly and are subject to reporting requirements. But where no liquid security is traded and financial disclosures are absent, credit-risk purchasers may be at an informational disadvantage relative to the sellers. This may be especially true for credit derivatives related to bank loans, where the banks that originate such loans are thought to have superior information about the credit risk of the borrower. Further, there may be an incentive for a bank to rid itself of its more poorly performing loans when they cannot be easily distinguished from the better-performing loans. Moreover, once the credit risk of a loan has been transferred to a different party, the incentive for the bank to monitor the loan may be diminished, and the safety and soundness of banks may be negatively affected.

Some market participants believe the market's growth is hindered by the lack of regulatory clarity concerning the potential regulatory capital requirements and accounting treatment of credit derivatives. While many practitioners have strong views about the appropriate capital treatment, the debate so far can be characterized as one of intellectual exploration by both practitioners and the bank supervisory community. As of June 1997, regulators had offered little clear guidance regarding capital requirements, although some preliminary rules had been discussed in

both the United States and the United Kingdom. The main issues are whether the hedging benefits of a credit derivative will lower the credit risk capital required on the combined position (derivative plus the underlying credit risk) and whether a credit derivative should be accounted for as product within a marked-to-market trading book or a "held to maturity" instrument within the so-called banking book, an issue that will take on added importance when market risk capital requirements are imposed on January 1, 1998.

At an industry level, issues regarding how the development of credit derivatives will affect banks' main business, the intermediation of savings by taking on credit risk, are yet unanswered. Will the credit derivative market overshadow the secondary loan market? If so, will this development mean more or less efficient credit risk sharing? Many dealers argue that the growth in credit derivatives allows those most willing and able to hold credit risk the opportunity to do so. Does this imply that the presumed special expertise within banks to measure and control credit risk will diminish relative to other institutions? Will bank loan products diminish in importance since increased information and pricing mechanisms for credit risk may permit bank customers direct access to public debt markets?

From a systemic point of view, the growth of credit derivatives could be expected to increase the diversification of credit risk across more types of institutions. This appears, at first glance, to be a net benefit since the cascading of defaults during a crisis period would appear less likely when credit risks are held more broadly. However, credit derivatives also permit more concentrated holdings of credit risk as well—and there is little transparency about the institutions that may be holding the risk. One could imagine a situation in which U.S. pension funds, for example, hold Latin American sovereign credit risk through the use of credit derivatives. How would a debt restructuring be implemented in such a situation, especially if the underlying reference instrument is not owned by those holding the credit risk? Alternatively, would end users attempt to unload their credit derivative positions with the dealers in periods of stress and would this exacerbate an already turbulent period, putting dealers in a precarious position? Put another way, is it reasonable to assume the new participants in credit risk markets are as knowledgeable about the risks they are undertaking as the more seasoned banking institutions? While the answers to these questions depend on future developments in the market, a periodic appraisal of such issues is warranted as credit derivative markets expand.

Appendix 2
Accounting for Nonperforming Loans

Table 35 provides information on loan classification systems and exposure limits in 20 emerging markets. Clearly there is considerable diversity. While some countries have relatively strict classification and provisioning requirements, others have systems that allow for much more discretion on the part of banks to assess asset quality. What cannot be represented in such a table, however, is the monitoring of asset-quality accounting and provisioning regulations. In banking systems where the banks generally have sophisticated internal risk management systems, where these are monitored by auditors and bank examiners, and where there is no presumption of official support in the event of bank failure, it may be less important to have detailed requirements specifying how to classify loans and what level of provisions to hold. Even if banks are subject to rigorous auditing that verifies application of these prudential requirements, few of the systems described in Table 35 address issues such as recapitalization or "evergreening" of loans or the treatment of restructured loans. However, such conditions do not generally apply to most countries. Hence, in the absence of rigorous monitoring by bank supervisors, disclosed asset-quality figures may not accurately reflect the true extent of problem loans, and therefore the true capitalization of banking institutions.

Table 35. Loan Classification in Selected Emerging Markets

		Loan Classification System	Provisioning Requirements
Asia			
Hong Kong, China	Performing	Borrowers are current in meeting commitments and full repayment of interest and principal is not in doubt.	There are no requirements as to provisioning other than that individual banks have their own internal guidelines for maintaining adequate provisions. Interest must be accrued to a suspense account if loans are substandard and not fully secured or overdue by more than 6 months; interest accrual ceases altogether for substandard loans past due more than 12 months and for loans classified as doubtful or loss. Loans must be written off after they are deemed irrecoverable.
	Special mention	Borrowers are experiencing difficulties; ultimate loss is not expected but could occur.	
	Substandard	Borrowers displaying definable weakness; loan losses or rescheduling at concessional terms are possible.	
	Doubtful	Collection in full is improbable; loss of principal and/or interest is expected, taking account of collateral.	
	Loss	Uncollectible after exhausting all collection efforts, including realization of collateral.	
India	Nonperforming	Loans on which interest is overdue for at least six months.	None.
	Substandard	Loans that have been nonperforming for up to two years, term loans on which the principal has not been reduced for more than one year, and all rescheduled debts.	10 percent.
	Doubtful	Loans that have been nonperforming for two to three years and term loans on which the principal has not been reduced for more than two years.	100 percent of unsecured assets; for secured assets: 20 percent if doubtful for less than one year; 30 percent if doubtful for one to three years; 50 percent if doubtful for more than three years.
	Loss	All other assets deemed irrecoverable, where the loss has been identified by internal or external auditors or by the Reserve Bank of India inspectors, but where the amount has not been written off.	100 percent. Interest accrual stops once loans are nonperforming. For loans with balances below Rs 25,000, banks must set aside reserves equal to at least 10 percent of the balance.
Indonesia	Current	Installment credit with no arrears, other credit in arrears less than 90 days, overdrafts less than 15 days.	0.5 percent.
	Substandard	Generally, loans with payments in arrears between three and six months.	10 percent.
	Doubtful	Nonperforming loans that can be rescued and the value of collateral exceeds 75 percent of the loan, or loans that cannot be rescued, but are fully collateralized.	50 percent. 100 percent.
	Loss	Doubtful loans that have not been serviced for 21 months; credit in process of bankruptcy/liquidation.	Loans must be written off 21 months after litigation indicates the loan will not have to be repaid.
Korea	Current	Borrower's credit conditions (including collateral) are good and collectibility of interest and principal are certain.	0.5 percent.
	Special mention	Payments are past due for between three months and six months, but collection is certain.	1 percent.
	Substandard	Loans covered by collateral but borrower's credit conditions are deteriorating and payments are more than six months past due.	20 percent.
	Doubtful	Unsecured portion of the loans that are more than six months past due and losses are expected.	75 percent.
	Estimated loss	Unrecoverable amounts due net of collateral.	100 percent. Loans must be written off within six days of being declared unrecoverable; write-offs in excess of W500 million require Bank of Korea approval.

Table 35 *(continued)*

		Loan Classification System	Provisioning Requirements
Malaysia			For loans less than RM 1 million:
	Substandard	More than a normal risk of loss due to adverse factors; past due for between 6 and 12 months.	0 percent.
	Doubtful	Collection in full is improbable and there is a high risk of default; past due for between 12 and 24 months.	50 percent of net (of collateral) outstanding value.
	Bad	Uncollectible; past due for more than 24 months.	100 percent of net outstanding value.
			Loans must be written off when bankruptcy hearings have finished and/or partial or full repayment is unlikely.
			A general provision of at least 1 percent of total loans net of interest in suspense and specific provisions is also required.
Philippines	Unclassified	Borrower has the apparent ability to satisfy obligations in full; no loss in collection is anticipated.	0 percent of net (of collateral) exposure.
	Special mention	Potentially weak due, for example, to inadequate collateral, credit information, or documentation.	0 percent.
	Substandard	Loans that involve a substantial degree of risk of future loss.	25 percent.
	Doubtful	Loans on which collection or liquidation in full is highly improbable, substantial losses are probable.	50 percent.
	Loss	Uncollectible or worthless.	100 percent.
			Interest is not accrued on past-due loans, which are loans or other credit not paid at the prescribed maturity date or, in the case of installment credit, in arrears by more than a prescribed amount depending upon the frequency of installments.
Singapore	Special mention	Accounts with evidence of potential weakness in creditworthiness, such as untimely repayment.	A provision of 50 percent of the loan value for defaults of over a year; for defaults of 3 to 6 months provision is the difference between the loan amount and 80 percent of collateral; for 6 to 12 months, the difference between the loan amount and 70 percent of the collateral. In aggregate, 100 percent of substandard, doubtful, and bad loans must be provided for, with those graded doubtful to have at least 50 percent provision.
	Substandard	Normal repayment may be jeopardized by continuing adverse trend of severe financial weakness.	
	Doubtful	Repayment of outstanding debt appears questionable; expectation of loss.	
	Bad	Outstanding debt is uncollectible.	
			Loans must be written off in the year that they are recognized as a loss. The Monetary Authority of Singapore has established a minimum (tax exempt) general provision of 2 percent of outstanding loans (including accrued interest) net of specific provisions.
Taiwan Province of China		Nonperforming loans (on which interest is not accrued) are: 1. Short-term loans with principal payments three months past due. 2. Loans with interest payments (or installments) six months past due. 3. Loans to companies for which legal proceedings by the bank have commenced.	Only provisions (general and specific combined) up to 1 percent of loan balance are tax deductible. Specific provisions in excess of that amount are made on a quarterly basis. Interest is no longer accrued after 180 days. Loans must be written off after all legal proceedings have finished.
Thailand		Loans are nonperforming (substandard or doubtful) if they are 12 months past due but fully collateralized or secured, or if they are 6 months past due but not fully secured.	
	Substandard	Loan is in arrears, but there is sufficient security to ensure that full recovery of the debt will be possible.	15 percent (by end-June 1999; at least 7.5 percent by end-June 1998).
	Doubtful	Loan is in arrears, but there is insufficient collateral.	100 percent.
	Irrecoverable	Legal enforcement has been initiated and has been unsuccessful.	100 percent.

Europe			
Czech Republic	Watch	Accounts overdue by 30–90 days.	5 percent of net (after collateral) exposure.
	Substandard	Accounts overdue by 91–180 days.	20 percent of net exposure.
	Doubtful	Accounts overdue by 181–360 days.	50 percent of net exposure.
	Loss	Accounts have been overdue for more than a year, there is little likelihood of repayment, and assets are not adequately secured.	100 percent of net exposure.
		Restructured loans must be classified as substandard for six months after restructuring and then as watch for three years.	
Hungary	Performing	Assumption that interest or principal will not be more than 15 days overdue.	0 percent.
	To be monitored	No loss is assumed, but management is of the opinion that the exposure requires separate monitoring.	0–10 percent.
	Substandard	Risks are higher than average or some loss may be assumed at the time of classification.	11–30 percent.
	Doubtful	A loss will be incurred but the size of the loss is uncertain or where payment is at least 90 days past due or payment delay becomes regular.	31–70 percent.
	Bad	The loss will exceed 70 percent or the company is in bankruptcy.	71–100 percent.
			General reserves (out of net income) must amount to 1.25 percent of the balance sheet total plus 1 percent of guarantees.
Poland	Standard	No arrears or doubts about the borrower's financial strength; receivables guaranteed by the state.	None.
	Substandard	Loans in arrears by more than a month, or loans to a borrower with weakened financial standing.	20 percent.
	Doubtful	Loans in arrears by more than three months, or loans to a borrower with deteriorating financial standing.	50 percent.
	Loss	Loans in arrears by more than six months or the subject of legal dispute, or loans to a borrower who is either in liquidation or whose location is unknown, or whose financial standing makes repayment impossible.	100 percent.
			Approval for lower provisions may be given if the loans are adequately collateralized. General reserves may be set up without limit, although reserves equal to only the first 1 percent of impaired loans are tax deductible.
Turkey	Special follow-up	Loans to uncreditworthy borrowers (defined as borrower whose capital is insufficient to pay the debt when due, or borrower lacks the ability to pay the debt, or the borrower's working capital is insufficient to meet its operating needs).	Initial 15 percent provision. Increased to 50 percent by the end of the first year, 100 percent after two years.
	Administrative follow-up	Loans classified as overdue or one month in arrears.	15 percent provision is required after two months (i.e., when 90 days past due).
	Legal follow-up	Loans in arrears for three months.	25 percent provision is required after 6 months, rising to 50 percent after one year, 75 percent after 18 months, and 100 percent after two years. Banks must cease accruing interest on loans in legal follow-up.
		Loans to state entities (including state-owned enterprises) are not included in the classification system, and provisions are not required for these loans.	

Table 35 *(concluded)*

		Loan Classification System		Provisioning Requirements		
Latin America						
Argentina		*Consumer loans*	*Commercial loans*	*Liquid guarantee*	*Preferred guarantee*	*Without guarantee*
	Normal	Less than 31 days overdue.	No doubt exists.	1 percent.	1 percent.	1 percent.
	Potential risk	31–89 days overdue.	Performing, but sensitive to changes; or more than 30 days overdue.	1 percent.	3 percent.	5 percent.
	Problem	90–179 days overdue.	Problems meeting obligations; or 90–179 days overdue.	1 percent.	12 percent.	25 percent.
	High risk	180–365 days overdue or subject to judicial proceedings for default.	Highly unlikely to meet obligations; or more than 180 days overdue.	1 percent.	25 percent.	50 percent.
	Irrecoverable	More than 365 days overdue.	Obligations cannot be met; more than 365 days overdue.	1 percent.	50 percent.	100 percent.
	Irrecoverable for technical decision	Bankruptcy/liquidation/insolvency.	Bankruptcy/liquidation/insolvency.	100 percent.	100 percent.	100 percent.
Brazil		*Consumer loans*	*Commercial loans*	*Unsecured*	*Partially/fully secured*	*Export/import*
		0–29 days overdue.	0–29 days overdue.	0 percent.	0/0 percent.	0/100 percent.
		30–59 days overdue.	30–59 days overdue.	0 percent.	0/0 percent.	100/100 percent.
		60–180 days overdue.	60–180 days overdue.	100 percent.	50/20 percent.	100/100 percent.
		181–360 days overdue.	181–360 days overdue.	100 percent.	100/20 percent.	100/100 percent.
		More than 360 days overdue.	More than 360 days overdue.	100 percent.	100/100 percent.	100/100 percent.
Chile		*Consumer loans*	*Commercial loans*	*Allowance*		
	A	Current	Probability of default: 0 percent.	0 percent.		
	B	1–29 days overdue.	Probability of default: less than 5 percent.	1 percent.		
	B⁻	30–59 days overdue.	Probability of default: 5–40 percent.	20 percent.		
	C	60–119 days overdue.	Probability of default: 40–80 percent.	60 percent.		
	D	More than 120 days overdue.	Probability of default: 80–100 percent.	90 percent.		
Colombia		*Consumer loans*	*Commercial loans*	*Unsecured principal*	*Interest*	*Secured principal*
	A (Normal)	Current.	Current.	0 percent.	0 percent.	0 percent.
	B (Subnormal)	30–59 days overdue.	30–119 days overdue.	1 percent.	1 percent.	0 percent.
	C (Deficient)	60–89 days overdue.	120–179 days overdue.	20 percent.	100 percent.	0 percent.
	D (Doubtful)	90–179 days overdue.	180–359 days overdue.	50 percent.	100 percent.	0 percent.
	E (Unrecoverable)	180–360 days overdue.	360–719 days overdue.	100 percent.	100 percent.	0 percent.
	E (Unrecoverable)	More than 360 days overdue.	More than 720 days overdue.	100 percent.	100 percent.	100 percent.
Mexico		*Consumer loans*	*Commercial loans*	*Allowance*		
	A	Minimal risk.	Minimal risk.	0 percent.		
	B	Low risk.	Low risk.	1 percent.		
	C	Moderate risk.	Moderate risk.	20 percent.		
	D	High risk.	High risk.	60 percent.		
	E	Noncollectible.	Noncollectible.	100 percent.		
				Loan loss reserves should be at least equal to the greater of (1) reserves calculated according to the above classification; (2) 4 percent of total loans; or (3) 45 percent of past-due loans. The entire amount of an amortizing loan (including past-due interest)		

				is considered past due if any payment is 90 days overdue (180 days for mortgages). Nonamortizing bullet loans are past due if more than 30 days overdue. Credit cards are past due when two minimum payments have been missed. Loans restructured into UDIs are transferred to trusts (consolidated into the bank's financial statements) and attract a 15 percent loan loss reserve.	
Peru		*Consumer loans*	*Commercial loans*	*Unsecured consumer*	*Unsecured commercial*
	A (Normal)	Current.	Current with no doubts.	0 percent.	0 percent.
	B (Potential problem)	10–29 days overdue.	Demonstrated difficulties.	3 (on total balance) percent.	1 (on total balance) percent.
	C (Substandard)	30–59 days overdue.	Serious weaknesses.	30 percent.	25 percent.
	D (Doubtful)	60–120 days overdue.	Making payments, but less than contracted.	60 percent.	50 percent.
	E (Loss)	More than 120 days overdue.	Unrecoverable.	100 percent.	100 percent.
Venezuela		*Consumer loans*	*Commercial loans*	*Allowance*	
	A (Normal)	Fully performing.	Fully performing.	0 percent.	
	B (Potential risk)	1–3 monthly payments overdue.	Performing, but showing signs of potential future problems (e.g., deterioration of financial condition, inadequate documentation).	5 percent.	
	C (Real risk)	4–6 monthly payments overdue.	Experiencing delays in interest and/or principal payments with estimated losses.	10 percent.	
	D (High risk)	7–12 monthly payments overdue.	Interest and/or principal payments three months or more past due and where legal recovery proceedings have been initiated.	50 percent.	
	E (Irrecoverable)	More than 12 monthly payments overdue.	Interest and/or principal payments are 12 months past due or where legal proceedings indicate very scarce possibility of recovery.	100 percent.	
				Once a loan is 30 days past due it is placed on nonaccrual status, and a reserve equal to 100 percent of accrued interest must be created immediately. Loans must be written off after 36 months. Provisioning requirements do not apply to credits guaranteed by the Venezuelan public sector.	
				Consumer Loans Provisioning based on the amount of principal overdue for A–D loans. For E loans, the reserve must take into account the entire outstanding balance.	

Sources: IBCA Ltd.; ING Barings Securities; and J.P. Morgan.