

Privatisation, consolidation and the increased role of foreign banks

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Introduction

This paper discusses three major structural changes - privatisation, consolidation and an increased role of foreign banks - that have been taking place in banking systems of emerging market economies, focusing on the period since 2000. It assesses, on the basis of standard indicators, how far the banking systems studied have increased intermediation efficiency as a result of these changes. In this regard the paper looks at both the productive efficiency of the banking industry itself and some aspects of allocative efficiency, focusing on changes in the composition of lending to different sectors of the economy. The issues of dynamic efficiency - the impact of changes in banking systems on economic growth and financial stability - are not discussed. The paper also identifies some challenges that the evolving banking structure might create for market discipline and supervisory oversight.

When these issues were last discussed at a meeting of deputy governors in 2000, many emerging market economies were still recovering from financial crises of the second half of the 1990s (Hawkins and Mihaljek (2001)). Deregulation of financial services at the national level and opening-up to international competition were just beginning. Although privatisation was well advanced in central Europe and Latin America, many state-owned banks in these regions as well as Asia had yet to be privatised. The global financial industry was in the midst of an unprecedented boom in the use of information technology. Changes in corporate behaviour such as the growing use of debt markets and increased emphasis on shareholder value were also beginning to spread worldwide.

Changes in the structure of the banking industry that have taken place over the past five years are important but perhaps less spectacular than what was expected in December 2000. Trends in privatisation, consolidation and the increased role of foreign-owned banks have continued, but the banking systems in many countries - particularly large Asian economies - have yet to be integrated fully with the global financial system. Improvements in the efficiency of intermediation have been more uniform, suggesting that benefits to industry and consumers from greater competitive pressure in banking have been widespread. But questions continue to be raised about the effectiveness of banking systems in Asian countries with high saving rates in steering funds towards the most productive uses from the global economy perspective (Bernanke (2005), Clarida (2005)). Banks in many Asian and central European economies have shifted lending from the public sector and corporations towards households and smaller firms, but in some Latin American countries the share of bank credit to the government has actually increased.

The paper is organised as follows. Section 1 reviews broad changes in the structure of banking systems in emerging market countries since 2000, focusing on trends in privatisation and bank consolidation. Section 2 looks at the effects of these changes on the composition of bank lending and on bank efficiency. Section 3 concludes with a discussion of some policy challenges facing central banks and supervisory authorities in this new environment.

1. Structural changes in the banking sector since 2000

Structure of the banking system

Two main elements of the structure of banking systems that are considered in this section are the degree of government versus private domestic or foreign ownership of banks, and trends in

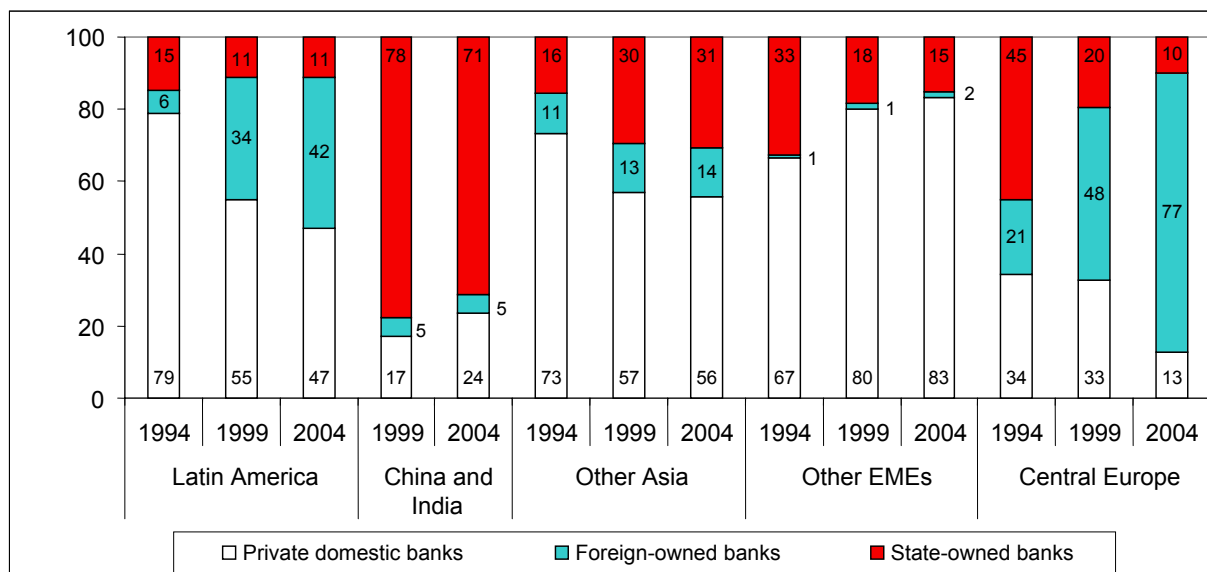
¹ The author thanks David Archer, Philip Turner and Bill White for valuable comments, and Marc Klau for help with the data.

consolidation in the banking industry. There is a large literature on benefits and costs associated with privatisation and foreign ownership of banks in emerging market economies.² In general, studies suggest that productive, allocative and dynamic efficiency tend to be lower in banking systems dominated by state-owned banks, while privatisation and an increased role of foreign banks helps to improve at least some aspects of efficiency. There has been less research on bank consolidation in emerging market economies, partly because the relevant problem in many banking systems is excess fragmentation rather than excess concentration (see below). Research on industrial countries suggests that concentration in banking plays a more complex role than would be suggested for traditional industries such as manufacturing and trade.

Commercial banks retain a dominant role in providing credit in emerging market economies (see the paper by Mohanty et al in this volume). Outside Latin America and a few Asian economies, non-bank financial institutions supply negligible amounts of aggregate credit.³ Within the banking sector, commercial banks provide on average 90% of total credit. This share has actually increased over the past five years, in particular in Latin America, but also in some crisis-hit countries in Asia, where many fringe financial intermediaries have collapsed. Deposit-taking institutions other than commercial banks play a more important role only in Korea, Malaysia and Thailand, where they supply roughly a quarter of total credit.

Changes in the ownership structure of banks have been more significant. As indicated in Graph 1, the share of state-owned commercial banks in total bank credit has declined or remained stable in all emerging market regions since 1999.⁴ Except in China, India and Indonesia, state-owned banks are no longer major providers of credit to the economy. The declining role of state-owned banks has been particularly pronounced in central Europe, where bank privatisations have essentially been completed.

Graph 1
Commercial banks by type of ownership
 Share in total bank credit, in per cent



Source: National data (BIS questionnaire).

² See, for example, the review article by Barth et al (2004).

³ Unless otherwise indicated, the country groupings used in this paper are as follows: Latin America (Chile, Colombia, Mexico and Venezuela); other Asia (Indonesia, Korea, Malaysia and Thailand); central Europe (Czech Republic, Hungary and Poland); and other emerging market economies (Israel, Saudi Arabia and Turkey).

⁴ The small increase in the share of state-owned banks in total credit in other Asia in 2004 is due entirely to Indonesia, where the majority of commercial banks that failed during the 1999 crisis were nationalised and subsequently gradually privatised.

There have also been major shifts in the relative importance of domestic and foreign private banks. Continuing a trend that was observed five years ago, since 1999 the share of private domestic banks has declined in Latin America and central Europe (to 60% and 13% of total bank credit, respectively) while that of foreign-owned banks has increased significantly. But in some Asian countries (Indonesia, Malaysia and Thailand) and other emerging market economies (Israel, Saudi Arabia and Turkey), there has been no further penetration of foreign-owned banks since 1999.

In terms of total assets, the share of foreign ownership ranges from nil in Saudi Arabia to 96% in the Czech Republic. The share is higher in central Europe and Latin America, and lower in Asia, Israel, Saudi Arabia and Turkey; it also tends to be higher in smaller economies than in larger ones. Upper middle income countries (eg Chile, Hungary, Mexico, Malaysia and Poland) tend to have a higher proportion of foreign ownership of bank assets. Interestingly, foreign banks own about the same percentage of bank assets in many high-income economies (eg Israel and Korea) as in lower-income economies (eg India and Indonesia). Overall, these comparisons do not reveal a simple relationship between country characteristics and degree of foreign ownership of banking assets.

Table 1 provides some preliminary evidence on the extent of bank consolidation. Since 1999, the number of commercial banks has increased only in China, Saudi Arabia and Colombia, while in other economies mergers, acquisitions and liquidations have resulted in a decrease in the number of banks ranging from 10 to 30%. Graph A1 in the Appendix reveals another common pattern: after an initial increase - for instance, in Hong Kong SAR, Indonesia, the Czech Republic and Poland during the first half of the 1990s - the number of commercial banks has subsequently retrenched. The number of bank branches has also decreased in most countries over the past five years; large expansions in branch networks have taken place only in Chile, Colombia and Malaysia. As indicated in the second column of Table 1, bank consolidation had already started in the mid-1990s, but at that time the branch network was still growing in most countries, in particular in Asia and Latin America. With few exceptions, this has also resulted in a decrease in the number of bank employees per branch (Graph 2). Given that economies in the sample differ widely in terms of market size and level of financial development, it is hard to generalise about the future direction of change in banking density.

Table 1
Number of commercial banks and branches¹

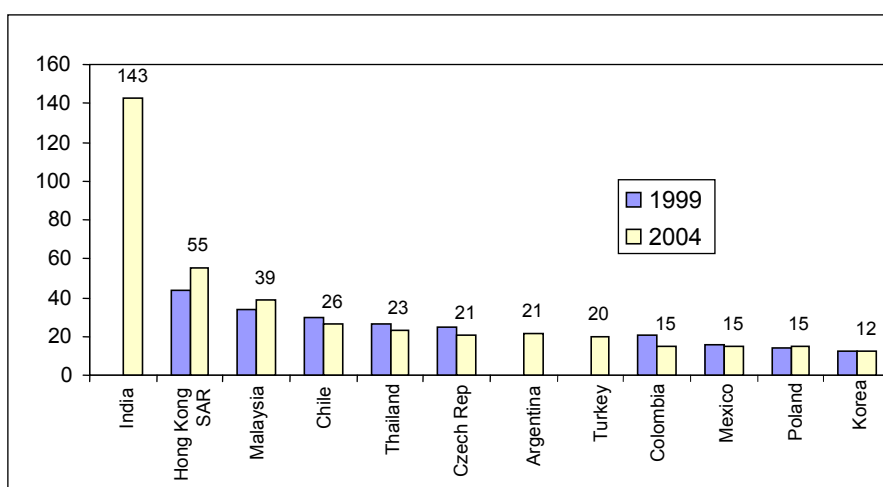
1990-94			1994-99			1999-2004		
Country	Banks	Branches	Country	Banks	Branches	Country	Banks	Branches
Czech Rep	511	-41	Thailand	17	35	China	92	...
Hong Kong SAR	132	...	Mexico	13	60	Saudi Arabia	20	2
Indonesia	43	22	Singapore	8	35	Colombia	13	20
Colombia	19	...	Venezuela	8	18	Chile	-10	10
Saudi Arabia	0	18	Hungary	-2	...	Thailand	-12	2
Thailand	-3	...	Poland	-6	-16	India	-13	4
Singapore	-6	12	Malaysia	-8	47	Hungary	-15	-3
Chile	-8	23	Israel	-13	-2	Venezuela	-17	2
Turkey	-8	-7	Korea	-17	44	Czech Rep	-17	-11
Venezuela	-10	24	Saudi Arabia	-17	-2	Korea	-19	-5
Malaysia	...	29	Chile	-19	15	Singapore	-19	-38
			Turkey	-19	14	Argentina	-20	-12
			Colombia	-23	-3	Indonesia	-21	-5
			Czech Rep	-24	...	Mexico	-21	-3
			Hong Kong SAR	-25	2	Israel	-23	-10
			Indonesia	-33	3	Turkey	-23	-11
						Hong Kong SAR	-27	-17
						Malaysia	-29	11
						Poland	-30	-16

¹ Change in the number of commercial banks/bank branches during period, in per cent.

Source: National data (BIS questionnaire).

In sum, banking systems in emerging market economies have generally continued to evolve towards more private and foreign-owned structures, with fewer commercial banks and often smaller numbers of bank branches. As discussed below, in some countries these trends have been the result of post-crisis weeding-out of weak financial institutions, and mergers encouraged by the authorities under financial sector “master plans” (eg in Indonesia, Malaysia and Thailand). Elsewhere, these developments have been mostly market-driven (eg central Europe, Mexico). However, the pace of structural change has slowed compared with the second half of the 1990s. Three main reasons come to mind: first, banking crises have been less widespread - Argentina’s and Turkey’s crises being the only major ones after 2001. Second, the transition towards market-based systems had been largely completed in central Europe by the early 2000s. And third, in the favourable macroeconomic and financial environment that has prevailed over the past five years there has been less urgency to reform banking systems.

Graph 2
Employees per commercial bank branch



Source: National data (BIS questionnaire).

Privatisation

Since 2000 there have been 51 partial or full privatisations in the 19 emerging market countries studied in this paper (Table 2). The major privatisations took place in Indonesia, Korea, Thailand and central Europe. In Indonesia, 15 banks accounting for 70% of total banking sector assets were sold in initial public offerings by the bank restructuring agency between 2000 and 2004. The Korean authorities privatised four banks nationalised during the 1997-98 crisis, representing 18% of total banking sector assets at the time of privatisation (see the paper by the Bank of Korea in this volume). In Thailand, the authorities reduced their shareholdings in three out of five major domestic banks taken over by the Financial Institutions Development Fund during the 1997 crisis. The government still retains large holdings in three major domestic banks - including Krung Thai Bank, one of the largest in the country - and is waiting for favourable market conditions to sell these stakes.

Privatisations have largely been completed in the Czech Republic and Hungary, but have yet to run their course in Poland. In the Czech Republic, the government sold holdings in two major banks (accounting for 38% of total banking sector assets in 2001) to strategic foreign investors in 2000-01. In Hungary, three smaller banks with a combined market share of 7% were sold in 2003. In both countries, government ownership is now restricted to special purpose institutions which provide support to exporters, small firms and municipalities (Czech Republic), or were set up to develop the mortgage bond market (Hungary). In Poland, the government sold 30% of shares in the country’s largest retail bank, PKO BP, at the Warsaw Stock Exchange in late 2004. However, the government still retains a majority stake in the bank.

Table 2

Commercial bank privatisations, 2000-05

Country	Number and main characteristics of privatised banks	Guarantees extended		Residual state ownership
Colombia	0 But privatisations initiated for 2 banks intervened in late 1990s	Yes	In the past; depositors, employees' pensions	3 banks acquired during crisis in late 1990s
Mexico	2 smaller banks intervened in 1999 auctioned off in 2000 and 2001	Yes	Assets not adequately valued; hidden liabilities	None; minority holdings in previous privatisations
Venezuela	0 Privatisations were carried out during 1992-98			2 state-owned banks; no privatisation plans 1 failed bank taken into state ownership in 2000
China	14 joint stock commercial banks sold shares to foreign investors. No plans to initiate widespread privatisation, but shares of 2 state banks to be sold in public offerings	Yes	Implicit guarantees to depositors	Majority state holding of shares in all major banks; plans to reduce shareholdings in the long run
India	0			28 public sector banks; government shareholding cannot fall below 51%
Singapore	0			Less than 1/3 shareholding in former development bank
Indonesia	15 banks, accounting for 70% of total assets, sold in IPOs	Yes	Guarantees to depositors; gradually reduced	Minority ownership in a number of banks; to be sold
Korea	4 banks nationalised during 1997-98 crisis sold through private placement, tender and auction	Yes	Deposits; bad loans; contingent liabilities (subject to limit; none in some cases)	Plan to sell 32% in one major bank; privatise holding company with 4 state bank subsidiaries
Thailand	3 large banks out of 5 taken over during 1997-98 crisis sold through public offering to strategic partners	Yes	Limited compensation for NPL losses	Holdings (incl majority) in 3 major banks, waiting for market opportunity to sell
Czech Republic	2 major banks (38% of total assets) sold in 2000-01 through tender to strategic foreign investors	Yes	Impaired assets guaranteed or transferred to a special purpose entity	2 special purpose banks (state support of exporters, small firms, municipalities)
Hungary	3 banks (7% of total assets) sold through public offerings, tender or auction	Yes	Impaired assets; contingent liabilities	Residual shares in several banks (mostly small); full share in mortgage bank
Poland	5 banks with majority or minority state ownership were partially privatised to domestic and foreign investors	No	Employment guarantee schemes (2-3 years) as part of privatisations	1 fully owned state bank; 1 major and 3 smaller banks with majority share; 8 banks with minority share
Russia	1 bank set up in 1993 to implement priority investment projects			State ownership in banking sector remains dominant
Turkey	0 Initiated restructuring ahead of privatisation of 2 major banks			12 banks taken over during 2001 crisis; 11 since sold, merged or liquidated
Israel	2 One small bank privatised; one major bank (16% of total assets) currently being privatised	No		Plans to privatise major state-owned bank (30% of total assets)
Saudi Arabia	0 Partial privatisations in 1980s and 1990s of banks rescued during the 1960s crisis			Shareholdings of 10-80% in 4 out of 11 domestic banks; held largely by 3 govt funds as passive investors

Note: There were no privatisations in Chile, Hong Kong SAR or the Philippines.

Source: Central bank answers to BIS questionnaire.

Elsewhere, progress in privatisation has been mixed. The authorities in China are focusing on four large state-owned banks, which control 60% of the market. The goal is to diversify their ownership rather than privatise the banks. Since 2003, three state-owned banks have become joint stock companies in preparation for partial privatisation. The authorities have exposed their non-performing loans and allowed foreign strategic investors to buy shares. Bank of Construction has been listed on the Hong Kong Stock Exchange, while Industrial Bank and Bank of China could be listed in 2006. As with the large state-owned banks, one goal of reform with respect to other joint stock banks with part local government, part private ownership is to expand foreign ownership and participation in management. Presently, 17 joint stock banks have 22 foreign strategic investors and a large number of foreign professionals work in these banks (see the contribution by The People's Bank of China in this volume). Another important area for China is cooperative banks. As 60% of the population lives from agriculture, China has over 30,000 credit cooperatives. The government has invested large sums of money in restructuring with a view to ensuring that cooperative banks become profitable, commercially oriented and founded on mixed ownership.

In India, no state-owned commercial bank has been privatised since 2000, nor are there any plans for divesting government shareholdings. India's 28 public sector banks account for 80% of total commercial bank credit and by law the government's shareholding in these banks cannot fall below 51%. There is a new roadmap for opening up the banking sector which envisages a greater role for foreign banks after 2009, by which time the consolidation process of domestic banks is expected to be completed.

Russia privatised one state-owned bank in the period under review, in June 2005. The government's strategy for the banking sector does not set out any significant steps to reduce the dominance of state-owned banks (Lohmus and Teo (2005)). Russia's largest bank, Sberbank, accounts for 28% of total banking sector assets, 42% of total deposits and 30% of credit to the economy. The gradual decline in Sberbank's dominance - its share in total household deposits declined from 75% in 2000 to 60% in 2004 - has been offset by the expansion of other state-controlled banks.

The Turkish authorities have initiated restructuring of two state banks which they plan to privatise in 2006. The only privatisations in the four Latin American countries for which data are available are those of two smaller banks in Mexico, which were acquired during rescues in 1999.

As in the 1990s, the primary motive for privatisations over the past five years has been to sell the stakes held by the government to investors with the skills and experience necessary to complete the restructuring of banks and transform them into viable business-oriented organisations. More specifically, governments of emerging market economies have generally wanted to strengthen banks' capital and overall stability, increase their profitability and competitiveness, broaden the range of products and services offered and increase the overall efficiency of financial intermediation. Considering the huge fiscal costs of banking crises in the 1990s, many governments also wanted to limit the size of any potential future intervention in the banking system.

Regarding privatisation methods, in the late 1990s impaired assets of many banks nationalised during the crisis in Asia were disposed of by asset management companies, while in central Europe and Latin America state-owned banks were often sold to strategic foreign investors. By contrast, during 2000-04 several different methods were used, including the sale of shares through initial and subsequent public offerings; sale of shares through tender or auction; and, in some cases, sale of shares through private placement, often to strategic investors. These changes in privatisation methods have reflected normalisation of the banking industry after the crises and, in central and eastern Europe, the completion of the systemic transformation towards a market-based economy in the late 1990s.

So far, there have been no comprehensive analyses of net costs of bank rescues and privatisations for taxpayers.⁵ Cost-benefit considerations seem to be largely absent when banks are rescued during systemic crises. Limited evidence from individual bank cases suggests that, even under the best of circumstances - a rescue quickly followed by successful privatisation - the net costs are very large, which perhaps explains why governments prefer not to know exactly how much money taxpayers lose when the state restructures and recapitalises distressed banks before selling them to new owners.⁶

⁵ On aggregate costs of banking crises see eg Honohan and Klingebiel (2001) and Sherif (2004).

⁶ One well documented case is the rescue of Hungary's Postabank in 2000. The rescue cost the state around HUF 150 billion (about EUR 580 million), and the bank was sold for HUF 100 billion at end-2003, implying a net loss of 33%. Another

Several central banks observed in this context that recapitalisation rarely solved banks' problems, but many governments nonetheless saw it as necessary because banks could not have otherwise found strategic partners.

With the exception of Israel and Poland, governments extended guarantees to depositors in privatised banks and to purchasers of state-owned banks, covering various impaired assets and contingent liabilities. In many countries, limits on guaranteed deposits were reduced over time and guarantees for contingent liabilities were subject to a ceiling.

As already indicated, the public sector still has a major residual role in many emerging market banking systems, in particular in large economies such as China, India and Russia. Expectations expressed in Hawkins and Mihaljek (2001) that this role would diminish relatively quickly have proved to be overly optimistic. Outside of central Europe, Mexico, Hong Kong and Singapore, policymakers in many countries apparently still see a useful role for state-owned commercial banks, not just in serving customers in remote areas or certain types of customers (farmers, small firms), but more generally, as necessary for socio-economic development. In view of the strong conclusions reached in the empirical literature on the inefficiency of using state ownership of banks as a social and development tool, why such perceptions are still held remains an open question. As discussed below, one reason might be that the remaining state-owned commercial banks have been subjected to greater market discipline and have become less inefficient than in the past.

Consolidation

In the late 1990s, the banking systems of many emerging market economies were highly fragmented in terms of the number and size of institutions, ownership patterns, profitability and competitiveness, use of modern technology, and other structural features. Very often, three or four large commercial banks coexisted with a large number of smaller urban and rural banks, many of them family-owned (especially in Asia) or under the influence of the public sector (as in Latin America and central Europe). In general, few commercial banks, even larger ones, were listed on a stock exchange. Profitability varied widely, with some banks earning high gross returns but operating very inefficiently, and others competing fiercely for a narrow segment of the market. Likewise, while some banks used advanced technology and financial innovation, many were still struggling with basic operations such as credit risk assessment and liquidity management.

In this environment, bank mergers were considered to be a potentially important vehicle for improving the structure and efficiency of the banking industry. They were expected to derive both cost reductions (from economies of scale, improved organisational efficiency, lower cost of funding, greater risk diversification, and economising on capital) and revenue gains (by exploiting economies of scope, making large deals possible, etc). In many crisis-hit countries, mergers and acquisitions were seen as an exit strategy for weak banks; while in others, officials wanted domestic banks to be large enough to compete with foreign entrants.

The drive towards consolidation has continued. The number of mergers and acquisitions has declined since 2000, but only slightly. As shown in Table 3, during 2000-04 there were 99 M&A deals between domestic institutions and 45 deals between domestic and foreign-owned institutions. The corresponding figures for 1995-99 were 108 and 31 deals, respectively. In addition, domestic banks from Hungary, Malaysia and Singapore acquired a total of 11 banks abroad during 2000-04; while subsidiaries of foreign-owned banks in Colombia, Hungary, the Philippines and Turkey were involved in a total of eight mergers and acquisitions in these host and other countries. Moreover, the total value of assets of institutions merged since 2000 now exceeds USD 270 billion, compared with USD 170 billion in the second half of the 1990s. One should note that the figures on the value of mergers do not include data for several countries with significant M&A activities, such as the Czech Republic, Hong Kong SAR, Poland, Russia and Turkey.

The largest numbers of deals were completed in Hong Kong, Korea, Malaysia, Poland and Russia. By far the biggest deals involved Mexican banks, followed by Thai, Korean and Philippine banks. Mergers and acquisitions in Poland and Russia have involved mostly smaller banks. In central Europe, merger

exception to the lack of transparency about costs and benefits of bank rescues is the Czech Republic - Barta and Singer (in this volume) calculate costs of both bank crises and delays in privatisation.

activity was strong in both periods. During the 1990s, however, this activity was mostly domestic; while since 2000, many mergers and acquisitions have also involved domestic and foreign banks, reflecting merger activity among parent banks from the European Union. Despite numerous mergers and acquisitions, the number of commercial banks in Indonesia and central Europe remains large (see Appendix Graph A1).

Table 3
Mergers and acquisitions (M&As) in commercial banking sectors

Type of M&A	1995-99			2000-04		
	Country	Number of M&As	Value (USD m) ¹	Country	Number of M&As	Value (USD m) ¹
M&As between domestic institutions	Colombia	6	20	Colombia	7	10
	Chile	2	480	Chile	2	530
	Mexico	6	64,600	Mexico	1	18,600
	Singapore	2	1,700	China	1	...
	Indonesia	1	...	Hong Kong SAR	14	...
	Korea	10	13,500	Singapore	2	8,000
	Malaysia	2	20	Korea	5	23,480
	Philippines	2	6,900	Malaysia	15	40
	Thailand	1	47,700	Philippines	9	16,400
	Czech Rep	4	...	Thailand	2	28,000
	Hungary	5	3,000	Czech Rep	1	...
	Poland	9	...	Poland	11	...
	Russia	58	...	Russia	29	...
				Turkey	9	...
	<i>Total</i>		<i>108</i>	<i>137,920</i>		<i>99</i>	95,060
M&As between domestic and foreign-owned institutions	Colombia	2	20	Colombia	1	10
	Chile	2	380	Chile	4	690
	Mexico	2	17,300	Mexico	4	152,000
	Korea	1	860	Korea	2	3,930
	Thailand	4	10,000	Philippines	3	300
	Czech Rep	5	...	Czech Rep	2	...
	Hungary	2	4,700	Hungary	2	12,200
	Poland	13	...	Poland	19	...
			Turkey	8	...	
<i>Total</i>		<i>31</i>	<i>33,260</i>		<i>45</i>	<i>169,130</i>
Cross-border M&As by domestic institutions ²	Chile	1	10	Singapore	6	3,400
	Singapore	6	1,200	Malaysia	1	2,980
				Hungary	4	...
<i>Total</i>		<i>7</i>	<i>1,210</i>		<i>11</i>	<i>6,380</i>
Cross-border M&As by foreign-owned institutions ³	Colombia	1	0	Colombia	3	30
	Hungary	4	920	Philippines	1	1,040
	Poland	1	...	Hungary	3	5,790
				Turkey	1	...
<i>Total</i>		<i>6</i>	<i>920</i>		<i>8</i>	<i>6,860</i>
All M&A activities		152	173,310		163	277,430

¹ Value of assets of merged institutions, rounded up to the nearest USD 10 million. ² Acquisition by domestic institutions of banks in other countries. ³ Acquisition by foreign-owned institutions in host country of banks in host and other countries.

Source: Central banks (BIS questionnaire).

Mergers in Latin America, central Europe and Hong Kong seem to have been by and large market-driven. This is evident from central bank responses to the BIS questionnaire. The central bank, the supervisory authorities and the competition authorities in these countries generally have a neutral stance vis-à-vis mergers and acquisitions in the banking sector, which are considered to be private business deals. The authorities fulfil their respective duties if financial institutions apply for registration of such deals by considering, among others, standard industrial organisation criteria to assess the impact on competition and concentration in the banking industry. However, the authorities take a neutral stance towards the broader impact of such deals on financial market development and the economy - market forces are presumed to work, and the satisfaction of standard prudential and competition criteria is regarded as sufficient to assure favourable effects on the market and fiscal development.

By contrast, in many Asian countries (including Indonesia, Malaysia, the Philippines and Thailand), mergers and acquisitions have been more or less actively promoted by the authorities. The Thai approach is illustrative in this respect (see the paper by Bank of Thailand in this volume). Since January 2004, the Bank of Thailand has, together with the finance ministry, started to implement the Financial Sector Master Plan, a medium-term development plan for Thailand's financial sector. The purpose of this plan is to develop a "competitive, efficient, stable, and balanced financial system, capable of servicing both sophisticated and unsophisticated users". One of the key policies under the plan is a new licensing regime, which foresees only two types of deposit-taking institutions - commercial banks and retail banks - in lieu of the current four. In line with this new regime, existing financial institutions have to apply for a change in their licensing status. For instance, finance companies or real estate (credit foncier) companies may merge with one another to become commercial banks; if they do not wish to merge, they can submit an application to become retail banks on their own. In Indonesia, where bank mergers have also been actively encouraged, there has been little dynamism in M&A activity so far, partly because owners of small banks have been reluctant to give up ownership without special incentives (see the paper by Goeltom in this volume).

Singapore has pursued a different, facilitative approach. Recognising that increasing globalisation of financial markets and cross-border competition offered Singapore the opportunity to become an Asian financial hub, the authorities launched a phased opening-up of the domestic financial market in 1999. The policy involved encouraging the local banks to engage in mergers and takeovers in a bid to realise economies of scale, as well as to strengthen their capability to invest in technology and management systems and to attract talent. However, the authorities did not seek to influence the outcome of mergers and takeovers, letting the new configuration be determined by market forces.

How effective the different approaches to consolidation will in the end prove to be remains to be seen. So far, there have been no unintended consequences of either the neutral or the more active stance vis-à-vis bank consolidation. A key reason might be that issues of excessive concentration have not yet arisen in emerging market banking industries.⁷ By and large, central banks and other authorities have not yet seen an increase in market concentration resulting from domestic bank mergers sufficient to raise concerns about market competition. However, concerns have emerged about increased regional concentration of banks' activities in some countries. Moreover, as will be discussed in Section 3, cross-border mergers among large institutions that own subsidiaries in emerging market countries with an already large presence of foreign-owned banks could bring such issues to the fore of the policy agenda in the near future.

2. Impact on financial intermediation

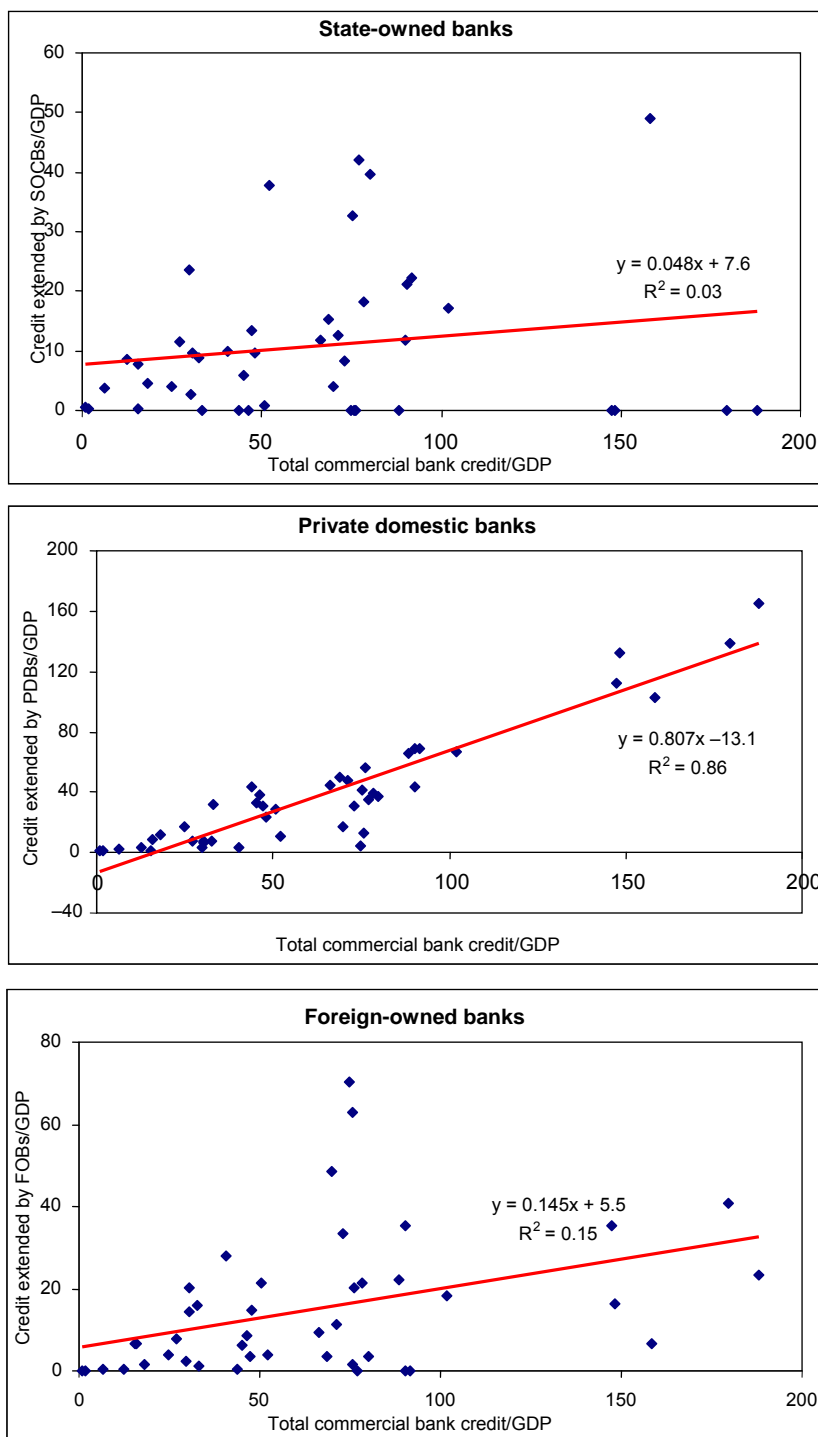
At the time of the Deputy Governors meeting in 2000, the impact of structural changes in the banking industry on financial intermediation could not yet be discerned. Growth of bank credit to the private sector was weak in most countries and falling sharply in those that had experienced a banking crisis in the late 1990s. Newly established domestic and foreign-owned banks were in many cases in the midst

⁷ One concentration issue that has arisen in a number of countries is provision of non-bank financial services by commercial banks. In Israel, for instance, commercial banks have typically been advisers to and providers of mutual funds, putting them into conflict of interest situations. In 2005, the authorities required the banks to divest such non-banking activities (see the paper by Sokoler in this volume). In many central and eastern European countries, commercial banks own leasing companies, which provide increasing amounts of credit to consumers.

of restructuring and were reluctant to extend credit to customers other than large corporations or the government. Intermediation margins were very wide, and lending to households and small and medium-sized enterprises (SMEs) was largely absent. In many emerging market countries policymakers complained about “cherry-picking” by foreign-owned banks, and some even lamented the diminishing role of state-owned banks, which were seen as key providers of credit to small firms and households. They also referred to evidence that lending by state-owned commercial banks was less procyclical than lending by private domestic and foreign-owned banks.

Graph 3
Credit growth and bank ownership

As a percentage of GDP



Source: National data (BIS questionnaire).

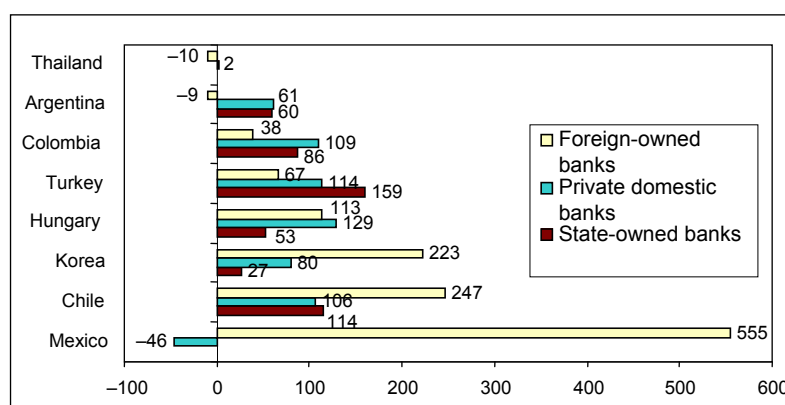
Since late 2000 there has been a sea change in the bank lending landscape, so much so that policymakers in many emerging market countries have started to worry about - and in several cases seek to limit - too rapid growth of bank credit to the private sector, and in particular to households. The factors explaining the resurgence of private sector credit are discussed in the paper by Mohanty et al in this volume. This section will focus on the evolving composition of private sector credit and bank performance by different types of banks (state-owned, private domestic, foreign-owned), rather than on the performance and impact of banking systems as a whole.

Impact on bank lending

Graph 3 assesses how far banks with different ownership structures have participated in the process of financial deepening observed over the past 10 years. Points in this graph match total commercial bank credit as a percentage of GDP in 1994, 1999 and 2004, with the corresponding shares of state-owned, domestic and foreign-owned bank lending (as a percentage of GDP) for 14 emerging market economies for which data were available. Over the past 10 years, private domestic banks have participated in total credit expansion to a considerably greater extent than either foreign- or state-owned banks: for every 10 percentage point increase in the credit to GDP ratio, credit extended by private domestic banks has expanded on average by 8% of GDP, while the share of foreign-owned banks has increased by about 1½% of GDP, and that of state-owned banks by less than half a percentage point.

Over the past five years, however, foreign-owned banks have expanded lending more rapidly than private domestic banks in several countries, including Chile, Korea and Mexico (Graph 4). In Brazil, by contrast, the share of foreign-owned banks stabilised at about 20% of total loans and their role in the domestic banking system has not grown, as private domestic banks seemed more capable of profiting from the growing domestic market. Private domestic banks also led the credit expansion in this period in Argentina, Colombia and Hungary. The contrast in lending by different types of banks is particularly stark in the case of Mexico, where foreign-owned banks expanded credit fivefold, while credit by private domestic banks contracted by almost 50% during 2000-04. Turkey is one of the few examples of state-owned banks dominating credit expansion in recent years.⁸

Graph 4
Cumulative growth of bank credit, 2000-04
 Per cent, in real terms



Sources: IMF; national data (BIS questionnaire).

Further insights can be obtained from the data on the composition of bank lending (Table 4 and Graph 5). Focusing first on credit to the government, it is interesting that, on average, both state- and foreign-owned banks increased their lending to the government relative to lending to other sectors between 1999 and 2004, in particular in Argentina, Colombia and Turkey (state-owned banks) and Argentina,

⁸ Other examples would include China and India, for which the same breakdown of credit expansion is not available.

Colombia, Hungary, Korea, Mexico and Thailand (foreign-owned banks). While fiscal dominance seems a plausible explanation for the increased lending by state-owned banks (especially in Argentina and Turkey, which experienced crises in 2001), why foreign-owned banks would increase lending to the government in countries such as Colombia, Korea, Mexico and Thailand is puzzling.

Table 4
Composition of lending¹

State-owned banks

	Government ²		Corporate		Household	
	1999	2004	1999	2004	1999	2004
Korea	6.3	4.9	76.1	58.6	15.6	36.5
Argentina	35.8	77.4	31.0	9.7	33.2	12.8
Chile	0.1	0.4	53.2	47.9	46.7	51.7
Colombia	20.0	50.6	44.5	34.3	35.5	15.1
Hungary	49.4	30.4	48.4	30.4	2.2	39.3
Turkey	30.3	65.2	64.9	27.7	4.8	7.1
Israel	34.7	33.9	52.1	52.7	13.1	13.4
<i>Average</i>	<i>25.2</i>	<i>37.5</i>	<i>52.9</i>	<i>37.3</i>	<i>21.6</i>	<i>25.1</i>

Private domestic banks

Korea	8.4	5.2	61.1	42.7	30.5	52.2
Thailand	4.5	4.9	68.1	66.9	27.4	28.2
Argentina	25.6	64.8	32.2	18.4	42.2	16.8
Chile	1.0	0.6	64.0	66.6	35.0	32.8
Colombia	14.4	30.7	62.2	55.6	23.4	13.7
Mexico	45.4	23.6	33.0	56.2	21.6	20.2
Hungary	39.2	18.8	36.9	29.7	23.9	51.4
Turkey	27.2	22.6	64.2	60.6	8.5	16.9
Israel	10.8	7.2	89.2	92.8	9.0	18.2
<i>Average</i>	<i>21.0</i>	<i>21.7</i>	<i>56.2</i>	<i>55.9</i>	<i>23.9</i>	<i>24.8</i>

Foreign-owned banks

Korea	8.1	23.1	75.2	41.2	16.8	35.7
Thailand	5.6	13.0	89.7	75.0	4.7	13.0
Argentina	26.2	60.1	45.5	25.9	28.3	13.9
Chile	1.6	1.4	86.0	73.6	12.4	24.9
Colombia	9.5	32.6	73.7	47.6	16.8	19.8
Mexico	36.3	55.2	51.1	22.7	12.7	22.0
Hungary	14.2	14.6	80.5	65.1	6.4	20.3
Turkey	59.2	15.8	38.4	57.2	2.4	27.0
<i>Average</i>	<i>20.1</i>	<i>27.0</i>	<i>67.5</i>	<i>51.0</i>	<i>12.6</i>	<i>22.1</i>

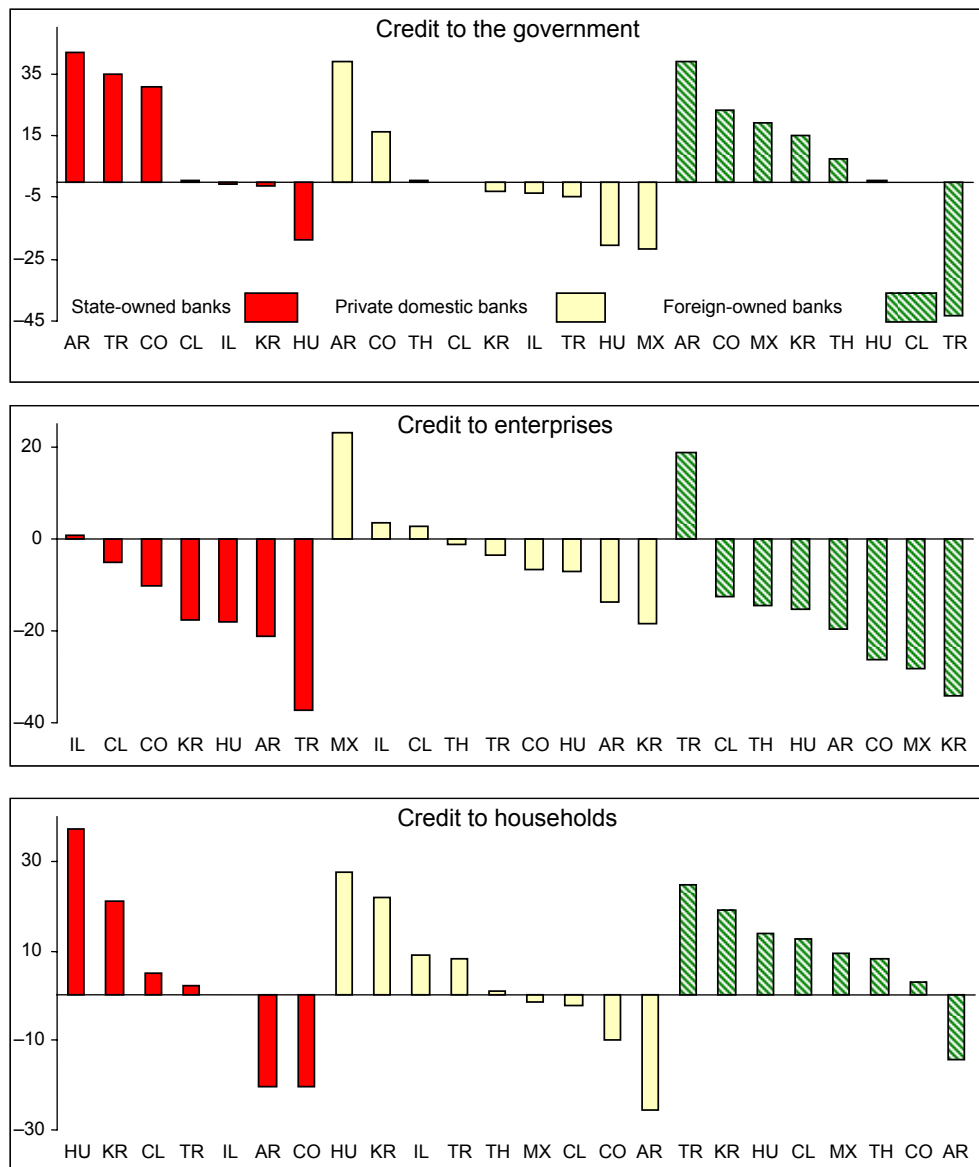
¹ As a percentage of total credit, excluding interbank credit. ² Net claims on the government for most countries.

Source: Central banks (BIS questionnaire).

Graph 5

Change in the composition of lending between 1999 and 2004

Percentage points of total bank lending



Source: National data (BIS questionnaire).

The share of loans to the corporate sector declined in all three types of banks in almost all countries between 1999 and 2004, with the largest average declines occurring for state- and foreign-owned banks. The exceptions are few: Chile, Israel, Mexico (private domestic banks) and Turkey (foreign-owned banks). Much of this decline is healthy, reflecting deleveraging by large firms and diversification of their sources of finance (to corporate bonds, equity and, in some cases, borrowing from banks abroad). Data for countries in central Europe indicate, for instance, a strong increase in lending to SMEs in recent years, which in several countries rivals lending to households in terms of the pace of credit expansion. Some of the decline in corporate lending also reflects post-crisis risk aversion and balance sheet repair on the part of banks.

The most significant change in the composition of bank lending in the last five years has been a shift towards lending to households. Foreign-owned banks in particular have offset the large decline in the share of corporate loans (by 17 percentage points) with a rise in the share of household loans in total loans. Even state-owned banks increased lending to households between 1999 and 2004 (with the exception of Argentina and Colombia). The increase in the share of loans to households has been most pronounced in Hungary, Korea and Turkey.

Comparing the composition of loans across banks, household loans accounted for roughly one quarter of total lending for all three types of banks in 2004 (Table 4). The big differences are in lending to corporations and the government. Private domestic banks lend mostly to the corporate sector (60% on average) and relatively little to the government (with the exception of Argentina, 15% on average). For state-owned banks, government and corporate loan portfolios are on average of the same size. Foreign-owned banks also lend primarily to the corporate sector, but unlike private domestic banks, the government accounts for over a quarter of their loan book; moreover, with the exception of Chile, Hungary and Turkey, this share has increased significantly since 1999.

These differences in the composition of loans probably reflect the different business strategies, risk attitudes and histories of state-owned, private domestic and foreign-owned banks. Today's state-owned banks for the most part inherited a large portfolio of loans to the public sector and corporations, including in several countries not just large corporations but also SMEs, which are supported by various government credit schemes (Mihaljek (2004)). Initially, they did not lend much to households, except in some cases under subsidised housing schemes. But over time, as competitive pressures have increased and state-owned banks have become more business- and profit-oriented, they have increasingly turned to the household sector, in many countries providing both consumer and housing loans. Korea and Hungary are clear examples in this respect. Nonetheless, state-owned banks still lend disproportionately to the government. From a governance point of view, one might argue that the lack of independence of state-owned banks from their owners is similar to connected lending practices in the private sector, with similar risks to profitability and soundness, and in principle would have to be sanctioned as such by independent supervisory authorities.

Private domestic banks, on the other hand, emerged from the crises and restructuring of the late 1990s holding portfolios that consisted mainly of corporate loans (about 60%) and roughly equal proportions of claims on the government and the household sector. As macroeconomic conditions improved, they shifted their business towards households to a greater extent and more quickly than did state-owned banks. The fall in corporate lending shares also reflects an overextension of corporate lending in the past. As a result, both supply side (a pullback of banks from corporate lending) and demand side factors (weak corporate borrowing) have been at play.

Russia's experience is particularly interesting in this regard. A few years ago foreign-owned banks accounted for only 5% of total bank loans in Russia (including cross-border loans); in 2005, the figure had risen to 40%. The main customers of foreign banks have become big Russian exporters, which used to be serviced by large domestic banks in the past. These domestic banks have reoriented their lending towards SMEs, which used to be serviced by medium-sized banks in the past. These banks, in turn, have reoriented lending towards households, which used to be served by small banks. As a result of this domino effect, many small banks are being taken over or closed.

Foreign-owned banks that entered emerging markets by buying local state-owned banks also inherited a large portfolio of loans to the government and the corporate sector. Like private domestic banks, these foreign-owned banks initially focused on the corporate sector (see the paper by Pruski and Zochowski in this volume). Other foreign banks, which entered emerging markets either as greenfield operations or by buying local mid-sized state-owned banks, were from the start more oriented towards households. As the financial position of large firms strengthened over time and many of them started to issue bonds and equity, foreign-owned banks that serviced them also started to turn to the household sector in search of higher margins. And as competition in consumer and housing credit markets has intensified, foreign-owned banks in some countries - in particular in central Europe - have turned to the next underserved segment of the market: SMEs. More recently, larger corporations in countries such as Hungary and Mexico have again begun to borrow from domestic banks, partly because the banks are offering them new types of loans at lower interest rates, including foreign currency loans. The development cycle of different loan products has thus turned full circle in some countries and a new cycle has begun.

Impact on bank efficiency

In the wake of the emerging market banking crises of the 1990s, a growing number of studies have found evidence that foreign bank entry tends to benefit the host country.⁹ It has been argued in

⁹ See eg Claessens et al (2001) and Demirgüç-Kunt and Huizinga (2001).

particular that foreign bank entry may stimulate competition in the banking industry, leading to higher efficiency for domestic banks, and result in improvements in the quality and accessibility of financial services for host country firms and individuals. Data provided by central banks for this meeting confirm that structural changes in emerging market banking systems have generally led to an improvement in standard prudential and efficiency indicators over the past five years. However, it has not been possible to assess improvements in the quality and accessibility of financial services.

The average share of non-performing loans (NPLs) in total loans declined significantly for all types of banks between 1999 and 2004 (Table 5). The largest improvements were on average achieved by state-owned banks. Israel is the only country where there was an increase in the share of NPLs for all three bank categories. Other exceptions are Hungary and Venezuela for state-owned banks and Turkey for private domestic banks. The improvement in NPL ratios has been fairly uniform across countries and regions.

Table 5
Non-performing loans¹

	State-owned banks		Private domestic banks		Foreign-owned banks		All commercial banks	
	1999	2004	1999	2004	1999	2004	1999	2004
Argentina	23.4	13.7	13.6	12.5	12.0	7.1	16.5	11.1
Chile	1.4	0.8	1.7	1.1	1.8	1.5	1.7	1.2
Colombia	22.8	3.5	7.1	3.8	7.3	2.1	10.0	3.4
Mexico	...	...	10.8	1.2	2.2	2.2	9.2	2.1
Venezuela	24.0	29.5	6.2	1.6	5.1	0.7	6.1	1.7
China ²	22.4	15.6	12.0	4.9	...	...	...	...
India	16.0	8.1	10.3	5.9	7.2	4.9	14.6	7.4
Korea	15.0	1.9	8.7	2.0	20.6	1.6	11.4	1.9
Thailand	55.3	9.6	21.6	12.8	7.5	2.6	31.2	10.9
Hungary	4.3	17.6	4.4	2.0	3.7	2.9	3.9	3.5
Turkey	11.3	11.4	3.8	5.1	2.4	3.3	6.1	6.4
Israel	4.9	6.5	0.6	3.5	...	...	1.7	4.2
<i>Average</i>	<i>18.3</i>	<i>10.7</i>	<i>8.4</i>	<i>4.7</i>	<i>7.0</i>	<i>2.9</i>	<i>10.2</i>	<i>4.9</i>

¹ As a percentage of total loans. ² Based on five-tier classification. Data for private domestic banks are for joint stock commercial banks.

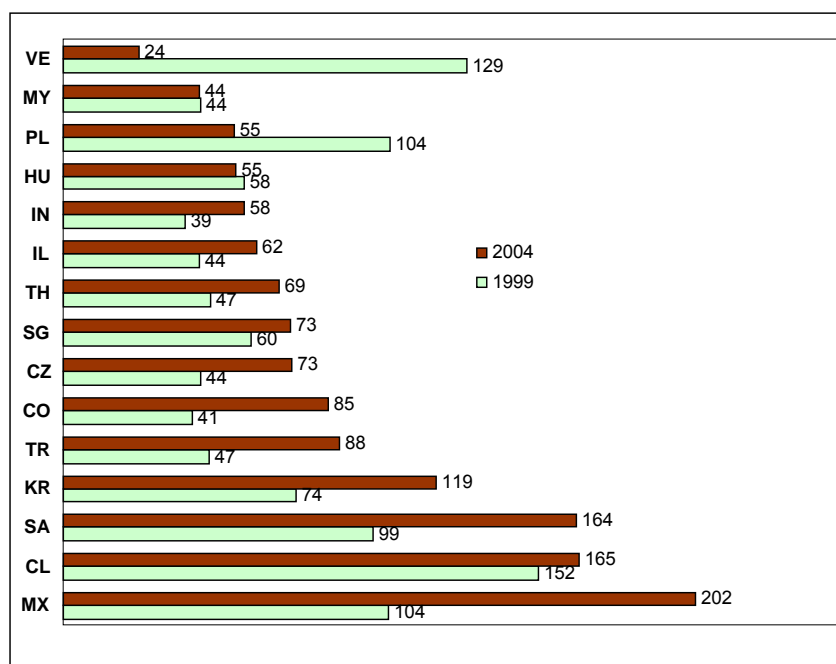
Source: Central banks (BIS questionnaire); IMF.

One should note that much of this improvement probably reflects the business cycle and is not necessarily the result of different behaviour of representative bank categories. In addition, many banks, in particular state-owned ones and those that were sold to foreign strategic investors, unloaded a significant portion of their NPL portfolios to asset management companies and other vehicles for resolution of bank distress. This is partly confirmed by central bank answers to the questionnaire on guarantees offered to buyers of privatised banks (see Table 2 above). Nevertheless, there seems to have been some structural improvement in NPLs, as the 2004 NPL ratios shown in Table 5 are generally below those observed during the previous cyclical upturn in the mid-1990s (cf Hawkins and Mihaljek (2001)).

Provisioning against loan losses has also risen significantly (Graph 6). Banks in most countries had set aside provisions for at least two thirds of NPLs at end-2004; in Chile, Korea, Mexico and Saudi Arabia cover exceeded 100% of NPLs. Cover seems relatively low only in central Europe, India, Malaysia and Venezuela, and these provisioning ratios are in many cases considerably higher than prior to the crisis in the mid-1990s (in the case of Turkey, prior to 2001).

Graph 6

**Total provisions against loan losses,
as a percentage of NPLs**



Sources: Central banks; IMF

Capital adequacy has generally improved for state-owned banks, and has stayed relatively high for private domestic and foreign-owned banks (Table 6). With risk-adjusted capital/asset ratios (capital adequacy ratios) of around 32-37%, state-owned banks in the Czech Republic, Hungary, Thailand and Turkey are probably overcapitalised while those in China, with an adjusted CAR of below 7% in 2004, are clearly undercapitalised. In Korea and the Czech Republic, foreign-owned banks have reduced capital adequacy ratios that were perhaps unsustainably high for a competitive banking environment to more normal levels. In most other countries, including India and Turkey, private banks have either increased or maintained relatively high levels of capital adequacy. Again, these levels compare favourably with capital adequacy ratios from pre-banking crisis periods.

Structural changes have also had a visible impact on bank profitability, as measured by returns on assets and equity. State-owned banks in particular have significantly improved both their return on assets (Appendix Table A1) and their return on equity (Appendix Table A2) since 1999, as well as with respect to the mid-1990s. Improvements in these indicators were also pronounced for private domestic banks in Colombia, the Czech Republic, Hungary, Korea, Saudi Arabia and Thailand. For instance, in 2004 the return on equity of private domestic banks in Colombia, Hungary and Venezuela exceeded 30% and the return on assets exceeded 3%, with banks in Saudi Arabia realising slightly lower but still fairly high returns. The improvement since 1999 has been less pronounced for foreign-owned banks, whose profitability was already somewhat higher in 1999 than that of private domestic banks. In Argentina, profitability of foreign-owned banks declined drastically after the 2001 crisis.

Changes in net interest income and other income have been less pronounced. State-owned and private domestic banks generally increased net interest income relative to total assets between 1999 and 2004 (Appendix Graph A2). But for foreign-owned banks net interest income ratios were either constant or declined in most countries, reflecting the narrowing of interest rate margins brought about by greater competition. In Hungary, Turkey, Colombia and Venezuela, net interest income ratios for most banks exceeded 4% in 2004, suggesting that intermediation margins were still quite high. In Hungary, Turkey and Venezuela, high interest margins in addition partly reflected relatively high real interest rates in an environment of rapid disinflation.

Table 6
Capital adequacy¹

	State-owned banks		Private domestic banks		Foreign-owned banks		All commercial banks	
	1999	2004	1999	2004	1999	2004	1999	2004
Argentina	16.5	9.1	31.5	16.3	16.3	11.9	19.7	12.3
Chile	13.3	10.1	11.4	12.0	15.4	16.7	13.5	13.6
Colombia ²	9.1	8.3	11.7	11.1	12.0	11.1	11.2	10.7
Mexico	...	...	16.4	17.8	14.6	13.2	16.0	14.1
Venezuela	15.2	10.9	12.8	12.6	13.6	12.6	13.3	12.5
China ³	5.4	6.8	...	7.6	...	...	...	...
India	11.3	13.2	11.9	11.2	10.8	15.0	11.3	12.9
Korea	9.3	12.5	11.6	11.3	21.9	13.1	12.0	11.8
Thailand	24.4	31.9	16.3	13.7	13.8	12.1	15.0	13.2
Czech Rep	...	31.6	11.5	14.0	18.6	12.1	13.6	12.6
Hungary	24.4	31.9	16.3	13.7	13.8	12.1	15.0	13.2
Poland	8.8	16.3	12.6	15.1	15.0	15.4	12.4	15.6
Turkey	11.7	36.8	17.2	22.3	22.5	26.9	7.0	26.2
Israel	9.6	10.8	9.3	10.7	...	...	9.4	10.8
<i>Average</i>	<i>13.3</i>	<i>13.7</i>	<i>14.7</i>	<i>13.5</i>	<i>15.7</i>	<i>14.4</i>	<i>13.0</i>	<i>13.8</i>

¹ Risk-weighted capital adequacy ratios, in per cent. ² Total capital over total assets. ³ Data refer to end-2001 and June 2004, respectively. Data on private domestic banks are for joint stock commercial banks.

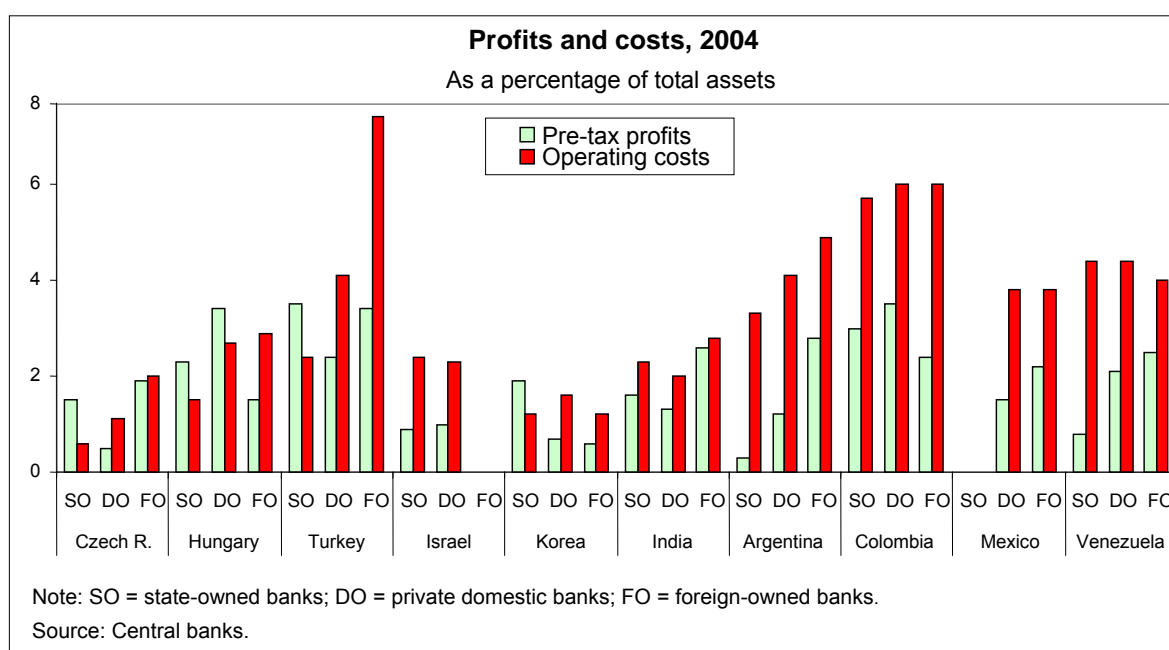
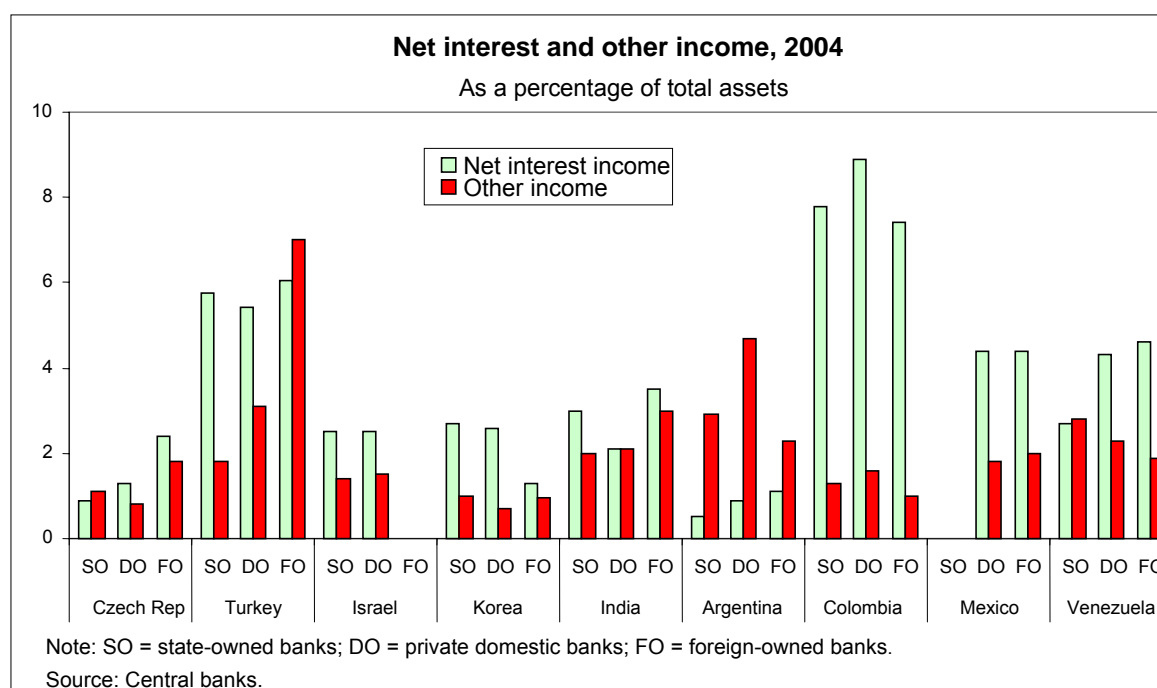
Source: Central banks (BIS questionnaire); OECD.

Graph 7 compares sources of income (upper panel) and profits and costs (lower panel) for different categories of banks in 2004. With the exception of Argentina, net interest income is still the main income source for most banks, regardless of ownership structure. But the share of non-interest income is generally higher for foreign-owned banks than for state-owned or private domestic banks, reflecting the broader range of products offered by foreign banks. For all three types of banks there has been a widespread increase in this share since 1999 (Appendix Graph A2), suggesting an expanding scope of financial intermediation as banks have introduced new fee-based products and services.

Increased competition in the banking industry has also been reflected in generally lower interest rate margins. As shown in Graph 8, with the exception of Hong Kong SAR and Turkey, the spread between representative bank lending rates and customer deposit rates declined from an average of 6.1 percentage points in 1999 to 4.1 percentage points in 2004. The narrowing of interest margins has been particularly pronounced for state-owned banks, suggesting that large rents were extracted in the past from their dominant position in many countries. There has also been a substantial narrowing of interest rate margins for foreign banks, with private domestic banks making on average less progress.

Pre-tax profits have risen in most countries and operating costs have generally declined since 1999 (Appendix Graph A3), as well as with respect to the mid-1990s. For both profits and costs, the magnitude of these improvements has been similar across different types of banks. The absence of clear “winners” suggests that increased competition has provided state, private domestic and foreign-owned banks with roughly equal incentives to improve performance. What differences remain probably reflect different starting positions. As shown in the lower panel of Graph 7, foreign-owned banks tend to have slightly higher pre-tax profits (2.2% of total assets on average, compared with 1.8% for private domestic and state-owned banks), but they also have higher costs (3.9% of total assets, compared with 3.2% for domestic banks and 2.6% for state-owned banks). It is not entirely clear what factors have contributed to these differences. One reason might be that, compared with foreign banks, state banks often own real estate in attractive locations (or rent it at low cost from city authorities), and can offer their staff higher state benefits in exchange for somewhat lower salaries.

Graph 7

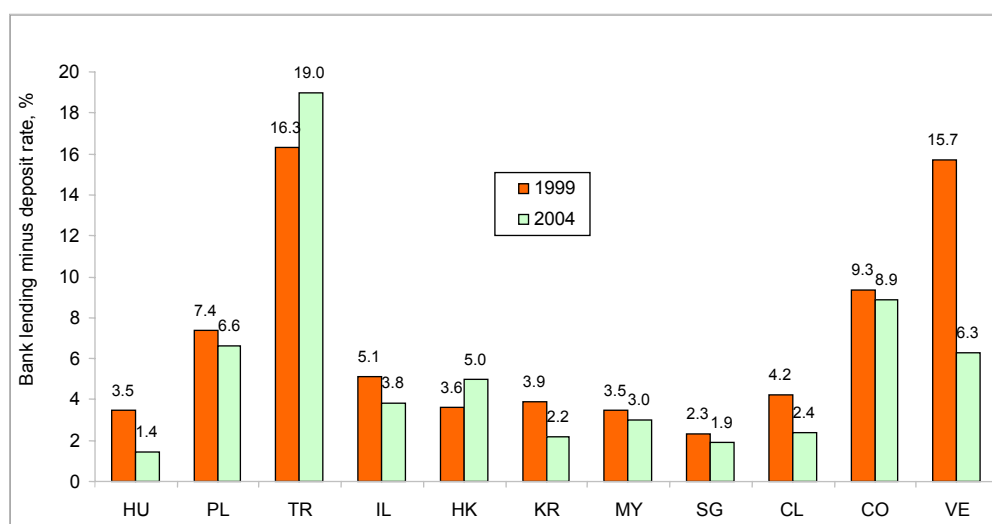


In sum, several indicators point to a positive impact overall of structural change on bank lending and efficiency. The structure of lending has become more diversified, with less credit going to the government and large enterprises and more to households and - at least in central Europe - smaller enterprises. Banks in emerging market countries have by and large also become financially stronger and operationally more efficient. Greater foreign bank participation has helped improve bank governance.

Yet differences between state-owned and other banks still remain. Compared with foreign-owned banks, for instance, state-owned banks have generally been slower in diversifying their lending and reducing non-performing loans; but have been recapitalised to a greater extent (perhaps excessively

so in some countries), and have done more to improve return on equity/assets and narrow interest rate margins, albeit often from worse starting positions.¹⁰ Positive effects of competition on bank performance have also been visible in the case of private domestic banks. This is perhaps the most significant development, considering that in many countries these banks had to cope with restructuring at their own shareholders' expense, whereas the state-owned banks were typically restructured at taxpayers' expense and subsequently sold to foreign-owned banks, in most cases below the cost of restructuring.

Graph 8
Interest rate margins



Source: National data (BIS questionnaire).

3. Challenges for market discipline and supervision

The changing structure of the emerging economies' banking systems has many implications for financial stability and in particular the supervisory regime. This section addresses two specific issues that arise in this context: first, supervision of foreign-owned banks; and second, the impact of delisting of large domestic banks from local stock exchanges after takeovers by foreign-owned banks.

The presence of foreign banks has generally led domestic supervisory authorities to upgrade the quality and increase the size of their staff in order to supervise the more sophisticated activities and new products being introduced by these banks. In addition, supervisory authorities in banking systems dominated by foreign-owned banks have had to cooperate with home country supervisory authorities to a greater extent. In virtually all countries attending the meeting, domestic supervisory authorities have established formal channels of communication with the authorities in charge of financial supervision in parent banks' home countries. In most cases, the framework for cooperation is set out in bilateral memoranda of understanding. Areas of cooperation typically cover: exchange of information on operations of foreign-owned banks in host and home countries; exchange of information on management of foreign-owned banks; and joint consultations and visits to foreign-owned banks. Cooperation is generally judged to be smooth, and the main obstacle in establishing closer working relationships with foreign supervisory authorities is usually seen to be the different legal treatment of confidential data and information in various jurisdictions.

¹⁰ One common complaint about foreign banks in Latin America is that their managers have very short time horizons and tend to act procyclically (see the paper by Betancourt et al in this volume). By contrast, publicly owned banks tend to have longer time horizons.

Yet some central banks have expressed more general scepticism about overly legalistic modes of communication among supervisors. In practice, the consolidated (home) supervisor has tended to dominate the host country supervisor even in the case of subsidiaries. Moreover, comments provided in the BIS questionnaire suggest that some host country authorities were not always fully informed about the situation of parent banks in home countries. One special challenge is governance: foreign-owned banks are managed from their headquarters from a global perspective, which means that different transactions are booked in different banking hubs around the world. As a result, some subsidiaries end up with a greater concentration of certain risks than would otherwise be the case. As reporting lines for different operations often bypass local managers, central banks in host countries might not always be informed in time about issues such as liquidity problems of local subsidiaries. Different accounting standards also create problems, in part because they affect the type of business activities that foreign banks carry out in host countries.

Several central banks noted that foreign bank affiliates are often of marginal importance from the parent perspective, but might well be systemically important for the host country. One issue that arises in this context is what would happen if a foreign-owned subsidiary that was systemically important locally ran into problems. One central bank acknowledged that it did not know what parent banks would do in such a case. There were cases where a parent company had helped its subsidiary immediately, without asking host country authorities for any assistance. But there were also some cases of a parent abandoning its subsidiary.¹¹ The response would seem to depend on financial health of the parent - if the parent was in weak shape, it might care less about reputation costs and abandon its subsidiary. Another central bank attached less probability to foreign parents abandoning their subsidiaries than to foreign owners more generally not acting in the interests of local shareholders.

A related issue in this context is the possible conversion of systemically important subsidiaries of foreign-owned banks into branches. This development has been facilitated in the European Union by the adoption of the single EU banking passport. But the issue is more general, as the centralisation of the decision-making process in global financial institutions has led to a system in which subsidiaries operate more or less like branches anyway.¹² The issue in this case is less whether such systemically important branches (or quasi-branches) might be abandoned in a period of distress - legally, branches cannot be "abandoned" because claims on the bank stay with the parent - and more how the central bank and supervisory authorities in the host country might deal with the loss of liquidity in the domestic banking system and disruptions to the payment system if the parent institution decides to close a branch that is small for the parent, but systemically important for the host country.

Developments in the global banking industry are important for market discipline and supervision in emerging market host countries for yet another reason: mergers between parent institutions in industrial countries might result in a significant increase in concentration in host countries. For instance, the merger between Unicredito and HVB has implications for competition in the Polish banking market, as these two parents own the second and third largest banks in Poland. As noted above, bank consolidation in most emerging economies has not yet been associated with any marked rise in concentration, as most mergers have involved smaller banks. But mergers between large domestic institutions that reflect merger activity outside the borders of the host country might be harder to resist. What could supervisory authorities do in such circumstances if they cannot challenge such domestic mergers on legal grounds?

The delisting of foreign-owned subsidiaries from local stock exchanges raises a different set of concerns. Among countries attending the meeting, such delisting has occurred in the Czech Republic, Hong Kong SAR, Korea, Mexico and Poland. In the Czech Republic, it involved one institution with a 12% share in market capitalisation; in Hong Kong, one very small bank; in Korea, two institutions with a 0.8% share in total market capitalisation each; and in Poland, three institutions with a combined share in stock market capitalisation of 5%.

Delisting has been by far the biggest issue in Mexico (see the paper by Sidaoui in this volume). During 2000-05, five of the largest institutions in Mexico, representing 77% of total bank assets, were

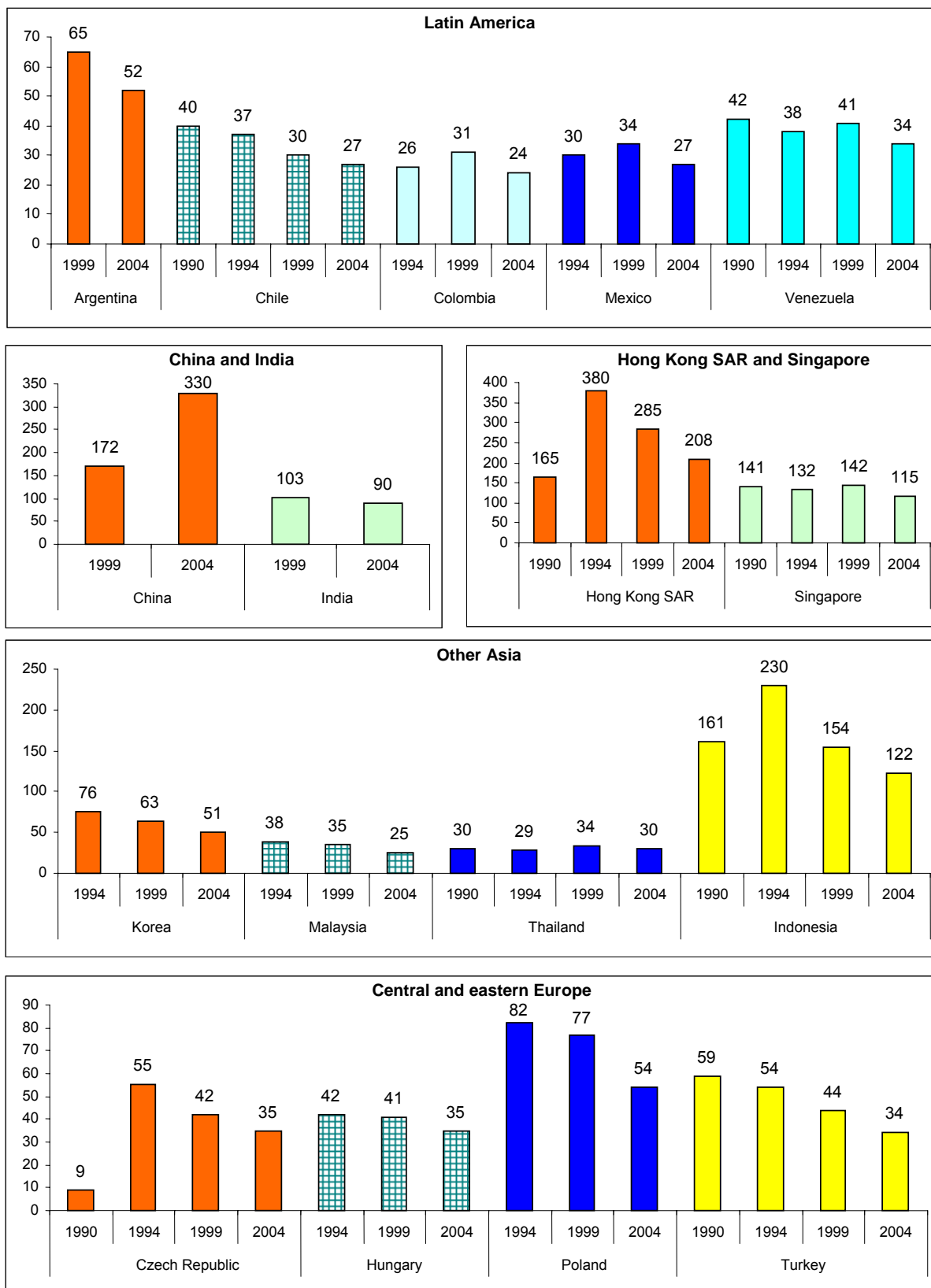
¹¹ One well known case is that of Riječka banka, Croatia's third largest bank, in which a currency trader caused losses of nearly USD 100 million, or three quarters of the bank's capital, in 2002. Germany's Bayerische Landesbank decided to sell its 59% share in the bank for a symbolic price of USD 1 to the Croatian government when the losses were discovered. The government subsequently sold the bank to Austria's Erste Bank for EUR 55 million plus a capital increase.

¹² See CGFS (2004, 2005) and Domanski (2005).

acquired by foreign-owned banks (foreign-owned banks now account for 82% of the country's total bank assets). All of these five institutions were subsequently delisted from the Mexican stock exchange, leading to a significant loss of market prices and scrutiny by independent analysts. Moreover, as these banks represented 15% of total stock market capitalisation at the time of acquisition (11% at the time of delisting), their delisting affected the development of the Mexican capital market more generally. Even though supervisors required subsidiaries to report as if they were listed, that information did not benefit the local market. In addition, the disclosure of timely and meaningful information about developments in institutions accounting for close to 80% of Mexico's banking sector was impaired, making it necessary to significantly improve information flows from parent banks to markets, and from home supervisors to host authorities. The delistings also raise broader questions about financial and corporate development in emerging market economies and possible policy responses.

Appendix

Graph A1
Number of commercial banks



Source: National data (BIS questionnaire).

Table A1

Return on assets

	State-owned banks		Private domestic banks		Foreign-owned banks		All commercial banks	
	1999	2004	1999	2004	1999	2004	1999	2004
Argentina	-0.1	0.3	1.4	1.1	-0.1	-3.0	0.2	-0.5
Chile	0.7	0.5	0.5	1.5	0.8	1.3	0.7	1.2
Colombia	-14.5	3.0	-0.2	3.5	-1.4	2.4	-3.7	3.2
Mexico	...	...	1.8	1.0	0.7	1.1	1.5	1.1
Venezuela	0.7	1.5	2.6	4.2	3.5	4.9	2.9	4.2
China	0.1	0.3	...	...	...	...	...	...
India	0.4	1.1	0.7	1.0	0.9	1.6	0.5	1.1
Korea	-3.7	1.9	-0.0	0.7	-1.0	0.6	-1.2	0.8
Thailand	...	...	-6.0	1.2	-0.2	2.3	-5.2	1.4
Czech Rep	...	0.9	-1.0	0.4	0.7	1.4	-0.3	1.3
Hungary	0.6	2.5	1.5	3.7	0.1	1.7	0.5	2.4
Poland	1.1	1.8	2.0	0.5	1.2	1.4	1.4	2.0
Turkey	1.1	2.5	4.3	1.6	5.4	2.3	-0.7	2.1
Israel	0.5	0.6	0.6	0.7	...	...	0.6	0.7
Saudi Arabia	...	...	1.7	2.7	...	...	1.7	2.7
<i>Average</i> ¹	-1.3	1.5	0.7	1.7	1.0	0.9	-0.1	1.9

¹ Excluding Argentina.

Source: Central banks (BIS questionnaire); IMF.

Table A2

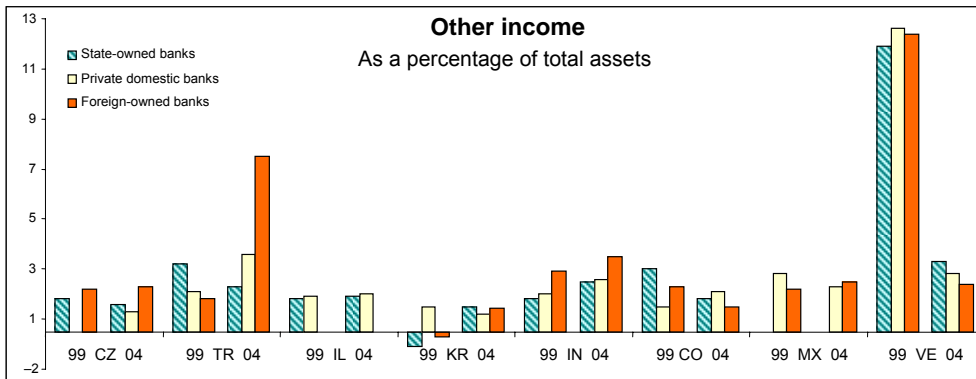
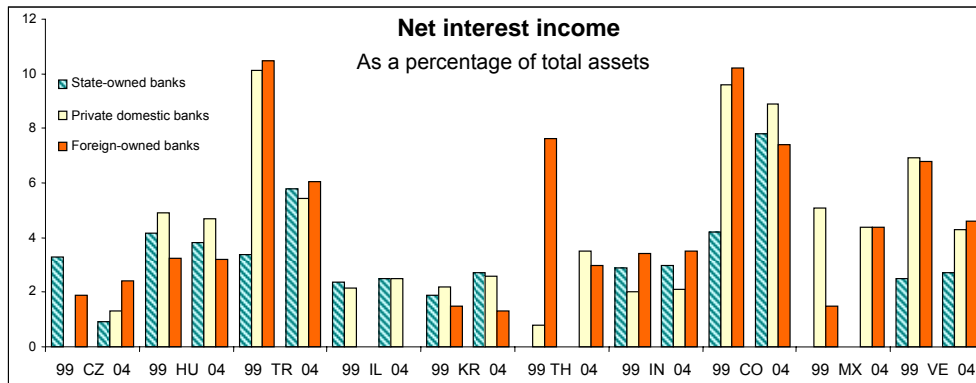
Return on equity

	State-owned banks		Private domestic banks		Foreign-owned banks		All commercial banks	
	1999	2004	1999	2004	1999	2004	1999	2004
Argentina	-1.3	3.6	6.9	8.4	-0.8	-30.3	1.9	-4.9
Chile	12.9	12.1	9.6	21.0	8.6	14.0	9.4	16.7
Colombia	-159.0	36.3	-1.5	31.1	-11.9	21.3	-32.5	29.9
Mexico	...	...	17.6	11.9	10.5	12.4	16.3	12.3
Venezuela	4.3	13.7	20.2	32.7	26.0	38.7	21.7	34.0
India	8.5	20.9	12.5	16.3	9.9	15.4	9.2	19.3
Singapore	...	...	10.5	13.5	...	...	10.5	13.5
Korea	-60.1	29.6	-0.5	15.0	-7.8	11.2	-17.5	16.5
Czech Rep	...	14.9	-16.8	9.6	9.8	25.1	-4.3	23.4
Hungary	4.0	19.1	27.2	41.2	1.2	22.7	6.3	28.5
Poland	18.7	27.3	19.5	8.5	13.7	16.9	16.3	18.3
Turkey	27.6	26.6	33.2	10.3	44.9	-61.9	-14.0	14.0
Israel	10.5	11.4	11.8	11.6	...	...	11.3	13.2
Saudi Arabia	...	...	15.8	26.2	...	...	15.8	26.2
<i>Average</i> ¹	-14.7	21.2	12.2	19.1	10.5	11.6	3.7	20.4

¹ Excluding Argentina.

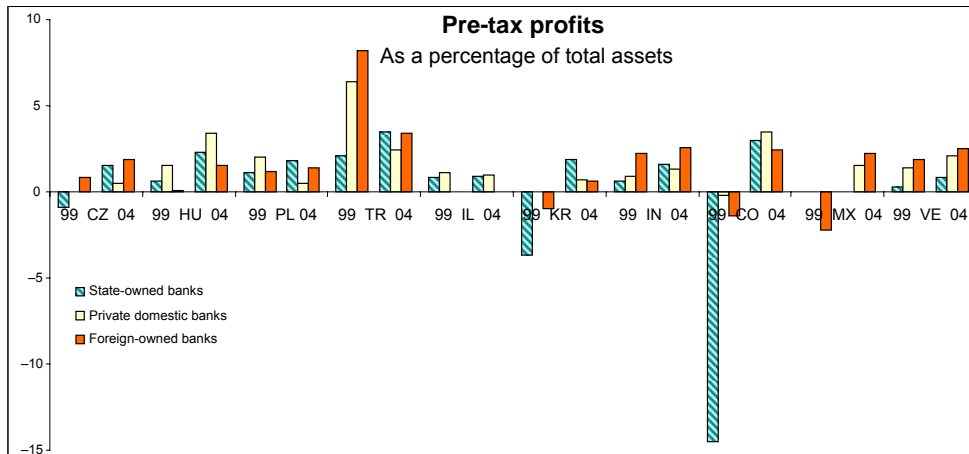
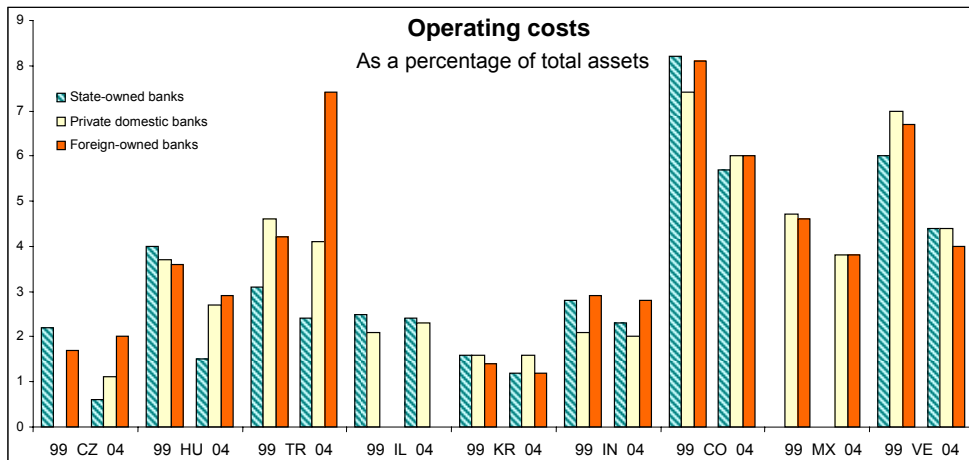
Source: Central banks (BIS questionnaire).

Graph A2



Source: Central banks (BIS questionnaire).

Graph A3



Source: Central banks (BIS questionnaire).

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