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by
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Post-Crisis Changes in Banking and Corporate Landscapes in Dynamic Asia

This study investigates the changing relations between banks and their business customers in selected Asian emerging economies. These changes are manifest in declining bank lending growth and can be attributed to three major driving forces: cyclical factors, the fallout from the 1997 Asian crisis and structural factors affecting both the supply of and demand for bank credit. In response to declining lending growth and profits, banks have been diversifying their customer base and scope of activities. Alternative strategies to restore profitability and stay afloat in the global competition arena are consolidation and branching overseas. Faced with more stringent bank lending conditions in some cases, and seeking to reduce their debt loads, larger firms have been turning to capital markets as part of an effort to diversify their sources of funding. The measures taken by banks and firms to recover from the crisis and the 2001 downturn can be considered effective, but not sufficient to survive in the global arena. Banks have not adequately addressed the non-performing loans (NPL) problem and have not restored profitability. Firms are still over-leveraged in many economies and corporate debt restructuring has been progressing at a slow speed. At present, diversification may seem to be the solution for both banks and firms, but given the limited possibilities of diversification, in the near-to-medium term banks and firms will remain highly dependent on each other in most economies examined. Therefore, to restore bank lending, the NPL problem should be addressed and corporate debt restructured. At the same time, financial reforms should be implemented to support diversification efforts of banks and firms.

JEL Classification: G21, G31, G34, E44, O53
Keywords: banking behaviour, corporate financing policy, restructuring, financial markets, Asia

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Les Changements après la Crise dans le Paysage des Banques et des Entreprises en Asie Dynamique

Cette étude analyse les relations changeantes entre les banques et leurs clients dans certaines économies émergentes d'Asie. Ces changements sont manifestes dans le déclin de la croissance des prêts et peuvent être attribué à trois facteurs majeurs : des facteurs cycliques, les retombées de la crise asiatique de 1997 et des facteurs structurels affectant l'offre et la demande du crédit bancaire. En réponse au déclin de la croissance des prêts et des profits, les banques ont diversifié leurs champs de clientèle et d'activités. Les stratégies alternatives pour restaurer la rentabilité et rester à flot dans le contexte global de compétition sont la consolidation et l'extension à l'étranger. Confrontées à des conditions de prêts bancaires plus rigoureuses dans certains cas, et cherchant à réduire la charge de leurs dettes, les grandes firmes se sont tournées vers les marchés de capitaux comme un effort pour diversifier leurs sources de financement. Les mesures prises par les banques et les entreprises pour récupérer de la crise et de la récession de 2001 peuvent être considérées comme efficaces, mais pas assez pour survivre dans le contexte global de compétition. Les banques n'ont pas abordé le problème des prêts non productifs et n'ont pas restauré la rentabilité. Les entreprises sont encore surendettées dans de nombreuses économies et la restructuration des dettes des entreprises a progressé lentement. A présent, la diversification semble être la solution pour les banques et les entreprises, mais étant donné les possibilités limitées de la diversification, dans le court et moyen terme les banques et les entreprises vont rester mutuellement très dépendantes dans la plupart des économies étudiées. Par conséquent, pour restaurer le prêt bancaire, le problème des prêts non productifs doit être abordé et la dette des entreprises restructurée. En même temps, des réformes financières doivent être exécutées pour soutenir les efforts de diversification des banques et des entreprises.

Classification JEL: G21, G31, G34, E44, O53
Mots clé: comportement banquier, politique de financement des entreprises, restructuration, marchés financiers, Asie

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1. This study investigates the changing relations between banks and their business customers in selected Asian emerging economies. These changes are manifest in declining bank lending growth and can be attributed to three major driving forces: cyclical factors, the fallout from the 1997 Asian crisis and structural factors affecting both the supply of and demand for bank credit. These three major driving forces are examined from the banking and the corporate sector's point of view and across seven emerging Asian economies.

2. Cyclical factors such as the Asian crisis and the economic downturn in 2001 have reduced corporate loan demand. The fallout from the 1997 crisis (and more recent downturns) in the form of non-performing loans (NPLs) and foreclosed properties have made banks more cautious in their lending decisions. These factors along with other factors of a more structural nature such as increasing competition from multinationals and capital markets have squeezed bank profits. In response to declining lending growth and declining profits, banks have been changing their strategies. They have been diversifying their customer base and scope of activities. Individuals and small and medium-size enterprises are among the fastest growing customer segments of the banks. Banks are also expanding the scope of their activities and the firewall between banking and securities business -- where it existed before -- is disappearing. Another strategy to restore profitability and stay afloat in the global competition arena is consolidation. Mergers and acquisitions brought about by restructuring, lead by government guidelines or driven by market initiatives, have resulted in further concentration of the banking sector in most emerging Asian economies. For the soundest banks that suffer from limited domestic markets, branching overseas is becoming an alternative strategy to boost profits and stay afloat.

3. The corporate sector has been hard hit by the Asian crisis, the more recent downturns in 2001 and the resulting debt load and over-capacity in many sectors. These problems are inducing shifts in corporate strategies that are affecting their demand for loans and other products from banks. Faced with more stringent bank lending conditions in some cases, and seeking to reduce their debt loads, larger firms have been turning to capital markets as part of an effort to diversify their sources of funding. The development of the corporate bond market, facilitated by the establishment of pricing benchmarks, has been spectacular, especially in Thailand and Malaysia. In other economies such as Indonesia or the Philippines the lack of pricing benchmarks and high real interest rates have made bond financing less attractive *vis-à-vis* equity financing. Large privatisation moves in several economies across emerging Asia are expected to contribute to the revival of equity markets.

4. As a conclusion from the above analyses, the measures taken by banks and firms to recover from the crisis and the 2001 downturn can be considered effective, but not sufficient to survive in the global arena. Banks have been diversifying their asset portfolios and participating in M&As, but have not adequately addressed the NPL problem and have not restored profitability. Partly as a result of more cautious bank lending, firms have diversified into non-bank sources of financing. They are, however, still over-leveraged in many economies and corporate debt restructuring has been progressing at a slow speed. At present, diversification may seem to be the solution for both banks and forms, but given the limited possibilities of diversification, in the near-to-medium term banks and firms will remain highly dependent

on each other in most DAEs. Therefore, to restore bank lending, the NPL problem should be addressed and corporate debt restructured. At the same time, financial reforms should be implemented to support diversification efforts of banks and firms.

1. INTRODUCTION

5. Bank-firm ties that have traditionally been strong in Dynamic Asian Economies (DAEs)[1] have started to loosen in recent years. This is manifest in decelerating bank lending growth. The deceleration of the growth rate of bank lending after a steady rising trend during the past decade is attributable to a business cycle downturn following the 1997 crisis and the 2001 slump in Information and Communication Technology (ICT) markets, the fallout from the 1997 crisis and more persistent structural changes in bank and firm behavior. While discussing the relative importance of these three factors from the point of view of loan demand and supply, this study outlines the major differences among DAEs. Cyclical factors have been important in reshaping bank-firm relationships in economies hardest hit by the 1997 crisis and in economies adversely affected by the recent ICT or property market downturns. The hangover from these cyclical effects have been present in the form of high non-performing loans (NPLs) in banks' balance sheets and mounting corporate debts. More persistent structural changes have partly been driven by countermeasures adopted in response to the downturns and the 1997 crisis, partly by more global forces such as competition from multinationals.

6. Given that structural factors have had a more persistent effect on reshaping bank and firm behavior, the study gives special emphasis to these factors. Post-crisis regulatory changes across the region, including removal of entry barriers to the domestic banking market and more stringent regulations concerning capital adequacy and loan loss provisioning, have led to a change in bank behavior. Amid the new environment, banks have become increasingly cautious with new loan decisions, which, in some cases, have resulted in economy-wide credit crunch. Decelerating corporate lending growth coupled with steadily increasing deposits have squeezed bank profits. To stay afloat, banks have been venturing into lending to new customers such as small and medium-size enterprises (SMEs) and individuals and have been expanding their scope of business. In some cases, especially where there is a complementarity in activities or branching networks, merging has been an alternative solution to restore profitability and strengthen banks' position to prepare for competition in the global arena. Some banks have chosen the strategy of branching overseas to boost earnings where the causes of deceleration of domestic bank lending have been more on the demand side.

7. In parallel with changing bank behavior, there have been changes in firm behavior too, often reinforcing the former. To accelerate the resolution of NPLs, the legal framework has been improved and government assistance provided to banks where necessary. As high NPLs are perceived to be partly the result of high leverage ratios, reducing corporate debt-equity ratios is an important step to prevent the occurrence of new NPLs. In response to limited access to bank credit, firms have started to rely on alternative ways of financing. Firms with higher reputation and faster clearing of loan obligations have been turning to debt and equity markets for fresh funds, thereby leaving banks with smaller and riskier borrowers. This in turn has been forcing banks further to diversify into new activities. Firms that were hard hit by the downturns, especially in the property, construction and ICT sectors, have been struggling with restructuring and repaying their debt. To make up for their decreased borrowing from banks, they either have been suspending their new investments, or have resorted to retained earnings or less traditional ways

1. Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; the Philippines; Singapore; and Thailand.

of financing such as open account trading or factoring. These changes in bank and firm behavior have been reflected in diversification of banks' asset portfolios and firms' capital structures.

8. The study is structured as follows: Section 2 gives an overview of the cyclical factors, fallout from the 1997 crisis and major structural changes in the banking and corporate sectors, both in general and for each of the seven DAEs. Then in Section 3 it discusses these three factors in detail from the supply side's point of view and identifies the main challenges banks face in responding to them. In the fourth section, the three factors are examined from the demand side's point of view and major changes in bank lending to various sectors and major trends in the diversification of firms' capital structure are traced. Section 5 summarizes the major findings of the study.

2. DECLINE IN BANK CREDIT GROWTH – AN OVERVIEW

9. Bank-firm ties have been loosening across Dynamic Asia as a result of three basic factors. These are the cyclical downturns following the 1997 Asian crisis and the subsequent one in 2001, the high levels of non-performing loans left by the Asian crisis, and longer-term structural trends. These structural trends stem from banks' diversification of asset portfolios and firms' diversification of sources of financing. Though the main trends might seem to be similar across Dynamic Asia, the factors underlying these changes show some variation across economies.

10. Five years after the Asian crisis bank lending growth is lower *vis-à-vis* pre-crisis growth rates in all DAEs (Figures 1 and 2). Thailand and Indonesia, the hardest hit economies by the Asian crisis, experienced a sharp decline of bank lending growth in 1998-1999. In Indonesia, re-capitalization and restructuring of banks brought about an acceleration in bank lending growth, which reached positive levels at end-2000. In Thailand bank lending growth has been negative since end-1998. In the Philippines and Chinese Taipei, bank lending growth has recently started to decelerate, and in Hong Kong, China it has been showing a steadily declining trend since the 1997 crisis. Bank lending growth has also sharply decelerated in Singapore as a result of the 2001 ICT downturn, though it has recently started to pick up. The only exception is Malaysia, where bank credit growth has been positive for most of the time, though it has decelerated after the crisis.

11. The main reasons for subdued bank lending in DAEs post-1997 can be traced to both demand and supply factors. Among cyclical factors, the financial crisis adversely affected both the demand and supply of loans, while the 2001 ICT downturn and the consequent excess capacity in many sectors mainly constrained enterprise loan demand. The major fallout persisting from the 1997 crisis is the still only partially resolved NPL problem, which affects both the banking and the corporate sector. Foreclosed assets on banks' balance sheets have further been constraining bank lending and still high firm leverage in many economies represent a possible source of new NPLs.

12. Changes of a more structural nature include removal of entry barriers to the domestic banking market, more stringent requirements concerning capital adequacy and loan loss provisioning and availability of alternative ways of financing for firms. These structural changes have been manifested as diversification of banks' asset portfolios and firms' financing sources. On one hand, due partly to decreasing loan demand and partly to more cautious lending behavior, banks have increasingly been relying on non-corporate customers and non-interest income. NPLs and strengthened regulations concerning capital adequacy, provisioning and other prudential requirements have been constraining bank lending. Lower interest rates (prime or interbank rates) and abundant liquidity should be favorable for fund raising. Due to the high costs of restructuring and meeting regulatory requirements, however, these low interest rates are not always passed on to borrowers in the form of lower lending rates. Banks have become more cautious in extending new loans and as a result, a 'credit crunch' has become a common phenomenon in the region.

13. On the other hand, corporations have also been struggling with debt restructuring. In economies hit by the 1997 crisis or the recent global economic downturn, besides subdued domestic and external demand, corporate debt restructuring has remained a key obstacle to new borrowings. To avoid further

occurrence of NPLs, debt-equity ratios need to be reduced in some economies of the region. In specific sectors which weathered the crisis and the global downturn relatively well, or where demand has shown fast recovery, corporations with good rating have been issuing debt to profit from low interest rates. Stock issues are less common except in economies where public interest in Initial Public Offerings (IPOs) escalated amidst historically low interest rates. Diversification of firms' capital structures and the resulting decline in loan demand have been reinforcing the changing trend in bank behavior, *i.e.* seeking new types of customers, getting engaged in new activities and diversifying asset portfolios. Where these measures are still insufficient to restore bank profitability and competitiveness, bank consolidation is another alternative.

Figure 1. Growth of Commercial Bank Loans in Malaysia, the Philippines, Thailand and Indonesia (y-o-y, in %)

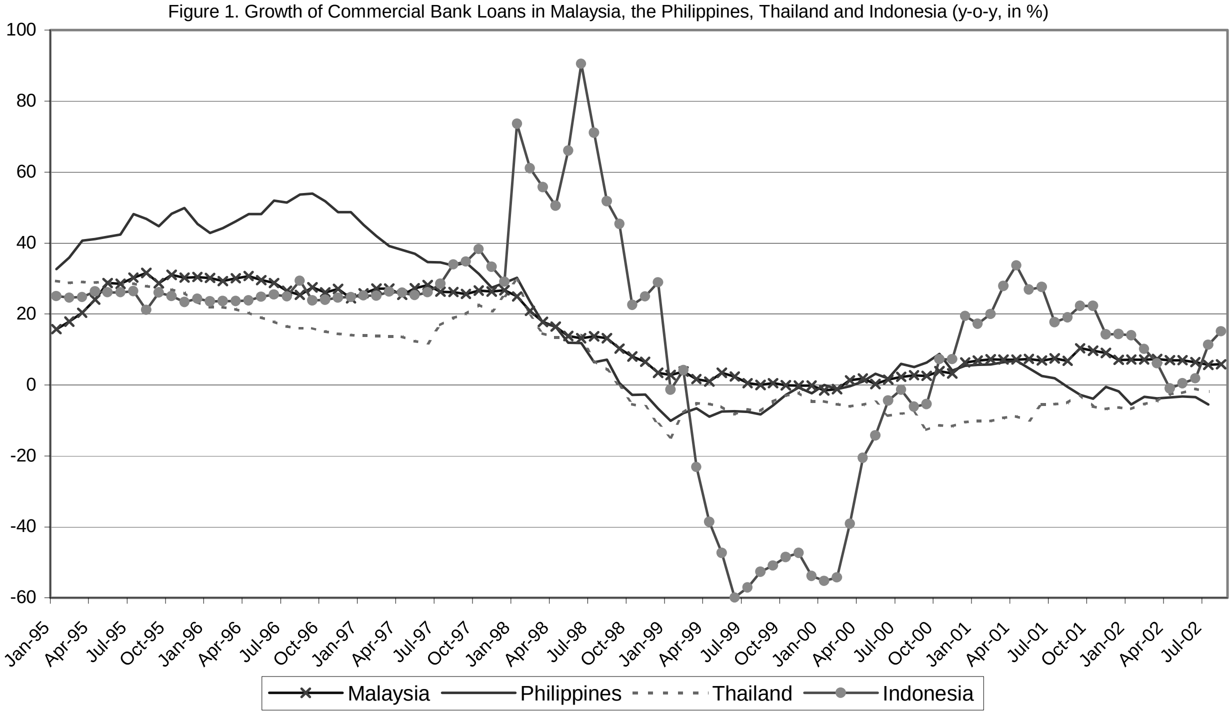
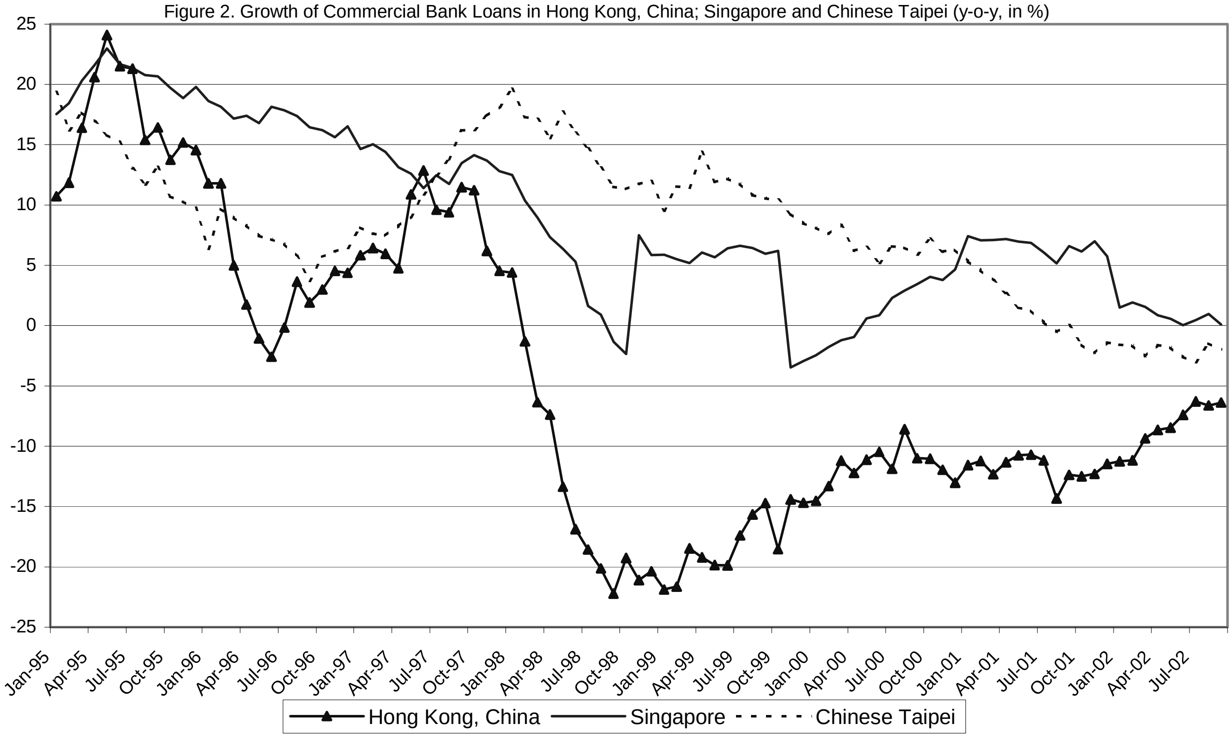


Figure 2. Growth of Commercial Bank Loans in Hong Kong, China; Singapore and Chinese Taipei (y-o-y, in %)



Economy-Specific Trends

14. The recovery of banks' lending activities seems to be most delayed in Thailand, where there are no signs of a pickup. Thai banks are still saddled with substantial NPLs and corporate debt restructuring is progressing at a slow pace. Notwithstanding historically low deposit interest rates and ample liquidity in the interbank market, banks are unable to lower their lending rates due to the heavy burden imposed by provisioning and loan restructuring costs. As banks can not turn down depositors, they have started to diversify the asset side of their balance sheets and have increasingly become involved in off-balance sheet activities. On the other hand, retail investors are not happy with the returns they get on bank deposits, which has pushed up stock prices and resulted in a revival of public interest in IPOs. Companies with a good reputation have increasingly been turning to the debt market for financing and refinancing. These trends indicate a diversification of the capital structure on the corporate side, and increase of non-interest income on the banks' side.

15. In Indonesia though bank credit declined sharply until January 2000, a gradual pickup started thereafter. Interest rates kept high by inflation and a large risk premium are an obstacle to a stronger resurgence of credit growth. Corporate restructuring is extremely slow, as most debt is owed to foreign financial institutions. With the lack of business borrowers, government bonds and Bank Indonesia SBIs (*Sertifikat Bank Indonesia,* central bank certificate) dominate the asset sides of banks' balance sheets. The bond market does not constitute a viable option for corporations due to high interest rates, but the equity market is expected to rebound as a result of a recently started privatization wave. As domestic financing has so far been scarce and costly, well-regarded companies have been obtaining financing from overseas financial institutions or have been tapping the international bond market. Over-investment during the bubble years, and the resulting excess capacity in several sectors, represent a further constraint on the demand for loans.

16. Bank lending growth to customers both inside and outside the economy has been steadily declining in Hong Kong, China. Outside lending is impeded by the 2001 economic slump in the region, while the decline of lending to domestic customers reflects weak domestic loan demand, particularly for mortgage loans as a result of declining property prices. Under the pressure of the 1997 Asian financial crisis, some foreign financial institutions have left Hong Kong, China or have cut back their lending in the economy. Other structural factors that have adversely affected lending include the availability of renminbi funding, which reduced the need for mainland Chinese corporations to borrow from banks in Hong Kong, China and an increase in open account trading,[2] which has reduced demand for trade financing loans. On the corporate side, bank lending remains a major way of financing, though debt market financing is seen as an increasingly attractive alternative to traditional bank lending. Equity market financing on the other hand is not considered as a substitute for bank financing, as the IPOs have mostly been launched by firms in the ICT sector lacking a track record to apply for bank loans.

17. Bank lending growth in the Philippines has been slightly declining since the Asian crisis even though the country was relatively less affected by the crisis.[3] After a short recovery in 2000, bank lending growth started to decline again in 2001, reaching negative areas since mid-2001. This fall in the growth rate of bank lending is due to the slump in real growth in response to the ICT downturn. There are also indications of a credit crunch as a result of banks' "extra cautiousness" in taking risks. Authorities have not intervened directly in bank loan restructuring, and the banking sector has now one of the highest NPL to loan ratios in the region.[4] In a bid to get banks lending again, so-called special purpose asset vehicles

2. Open account is a trading method in which goods are dispatched to a buyer and paid for after they have been received.
3. On the effect of the Asian crises on the Philippine economy see *Noland (2000).*

4. Commercial banking sectors in the region have registered NPL ratios of 16.5 per cent in the Philippines, 10.8 per cent in Indonesia, 9.6 per cent in Malaysia, 10.2 per cent in Thailand in September 2002, 7.8 per cent in Chinese Taipei in June 2002, and 4.7 per cent in Hong Kong, China and 4.5 per cent in Singapore as of end-2001. These figures are based on a 3-month classification standard except

(SPAVs) bill[5] has been put forward. An SPAV would function as the third party, purchasing and disposing of NPLs and real and other property owned and acquired (ROPOA) assets. This would inject fresh liquidity into the banking sector, spur loan growth and boost profits.

18. In Chinese Taipei, bank lending growth has been declining since the 1997 crisis with pick-ups in 1999 and mid-2000. Since mid-2000 the growth rate has been decelerating, reaching negative levels since mid-2001. The cyclical downturn in the ICT industry has undoubtedly contributed to the decline in domestic lending, but there are, however, concerns that the problems may be of a more deep-rooted, structural nature.[6] The hollowing out of industry has reduced loan demand and with an increasing number of firms moving their operations to the Chinese Mainland an increasing amount of loans has been turning sour. Banks are saddled with high levels of NPLs and similarly to the Philippines, the NPL problem has not been adequately addressed yet.

19. Malaysia is the single crisis-hit economy where bank lending has exceeded pre-crisis levels and notwithstanding cyclical downturns and temporary shocks -- such as the one associated with the September 11 attack -- has been rising unabated. Bank loan growth has been propelled by soaring consumption loan demand, while demand for loans from the manufacturing sector has remained flat. The ambitious infrastructure projects nurtured by the government have also been fuelling domestic demand for credit. Malaysian banks were able to resume lending straight after the Asian crisis due to prompt government action to remove NPLs from bank balance sheets and facilitate corporate restructuring.

20. In Singapore bank lending growth declined after the 1997 crisis, recovered temporarily in 1999, declined again and recovered in mid-2000. Since mid-2001 the growth rate of bank lending has been declining. This recent deceleration of bank lending growth is attributable to the ICT downturn. Notwithstanding the recent downturn, Singaporean banks have been profiting from the position of the economy as a regional financial center and from the inability of many banks in the region's economies to meet domestic loan demand (especially in Indonesia).

Chinese Taipei, where it is based on 6-month classification (under the 3-month classification the NPL ratio is estimated to be between 15 and 20 per cent in Chinese Taipei).

5. The SPAVs Bill represents a unique way in Southeast Asia of resolving the almost 600-billion peso NPL problem as SPAVs would be purely privately owned without using government funds. On July 24, 2002 the House of Representatives passed the Bill but on September 4, 2002 the Senate failed to pass it. Another flagship bill is SPAVs' companion Securatization Act. The two securatisation bills are also considered to be important because they would pave the way for the sale of foreclosed properties on banks' balance sheets (estimated to be worth of P70 billion) to government that would support the low-cost mass housing programme of the government.

6. *Montgomery (2002a)* and *Montgomery (2002b)* draw an interesting parallel between banking sector problems in Chinese Taipei and Japan. It is pointed out that poor asset market performance was a major factor contributing to the deterioration of banking sector health in both economies. Dropping stock and real estate prices hurt banks by reducing the market value of their securities investments on their balance sheets and by eroding collateral values. Besides asset price developments, financial liberalisation has also adversely affected the banking sector. Removal of entry barriers and loosing the best customers to debt and equity markets has exposed banks to more intense competition and ultimately to a test of survival both in Chinese Taipei and Japan. The author points out that though Chinese Taipei has not experienced a major bank failure so far, risk of a banking crisis does exist.

3. NEW CHALLENGES AND RESPONSES OF THE BANKING SECTOR

21. In post-1997 Dynamic Asia banks are facing new challenges such as sluggish demand for loans, restructuring of NPLs, more stringent regulation and stronger competition from foreign counterparts and from revitalized capital markets. To improve the capacity of banks to withstand adverse shocks in face of the Asian crisis, minimum capital requirements were increased, with the exception of Singapore and Hong Kong, China,[7] where banks maintained high capital adequacy ratios (CARs) before the 1997 crisis. Banks in the region have built up their capital, CAR ratios have reached 14.5 per cent in Thailand (July 2002), 14 per cent in the Philippines (August 2002) and 13 per cent in Malaysia (August 2002). Indonesia lags somewhat behind other economies in the region in terms of CAR ratios, but by March 2002 CARs have reached 8 per cent.

22. General loss provisioning requirements were introduced in those economies where they were non-existent and were raised particularly for classified loans. These efforts to bolster financial position are an essential element of banks' broader effort to meet the longer-term structural challenges they have been and will continue to face. The remainder of this section will focus on these challenges and their effects on bank behavior. The major challenges banks have been facing are foreign competition, competition from capital markets, and profit squeeze. They have started to target new lending segments, to venture into new activities, to consolidate or to branch overseas to meet these challenges.

Foreign Competition

23. The removal of entry barriers to the banking market for foreign competitors and the sharp increase in foreign ownership of the banking system through restructuring has exposed domestic banks to even more fierce competition. Entry to the banking market has been or is being liberalized in most economies, though the form of entry might be limited to participation in existing banks. This is the case in Thailand where 100 per cent foreign ownership (versus 49 per cent pre-crisis) is allowed for a limited period of ten years and in Indonesia where the upper limit on foreign holding of domestic banks' equity capital is 99 per cent. In the Philippines foreign bank entry was liberalized in 1994, leading to the establishment of 10 new foreign bank branches in 1995.[8] The General Banking Act allows 100 per cent foreign ownership for a limited period of time, but it also stipulates that 70 per cent of the total resources of the banking system must be held by majority Filipino-owned domestic banks. Singapore opened up the domestic banking market in 2003 and Malaysia is expected to liberalize the entry of foreign banks by 2007. In Malaysia foreign ownership of banking institutions is presently limited to 30 per cent but those foreign banks already in Malaysia will be allowed to open branches after 2004. Chinese Taipei represents the least liberalized example in the region in terms of foreign entry to the banking system. Foreign banks are not allowed to buy domestic ones and their branch networks are also restricted.

7. At end-2001 CAR ratios of major banks in Hong Kong, China stood at relatively high levels: Hong Kong Shanghai Banking Corporation registered 13 per cent, Shanghai Commercial Bank 22 per cent, CITIC Kah Wah 20.8 per cent, Wing Lung 20.6 per cent, Wing Hang 16.6 per cent, Liu Chong Hing 20.9 per cent, Dah Sing 18.7 per cent, Chekiang 30 per cent, Hong Kong Chinese 27.1 per cent and Asia Commercial 20 per cent.

8. For a more detailed analysis of bank liberalisation in the Philippines see *Abola (1998)* and *Milo (2001).*

24. Among Dynamic Asian economies, Thailand experienced the most significant increase in foreign competition after the 1997 crisis with the arrival of ABN AMRO, United Overseas Bank (UOB), Development Bank of Singapore (DBS) and Standard Chartered.[9] Some of the newcomers have been moving from small niche players to become price setters in the market. Expectations, however, about enhanced competitiveness of the domestic financial sector and acquisition of new technology and management know-how has so far not been realized.[10] In the literature there have been some observations such as in *Weller (2000* and *2001)* that increased competition from multinational banks (MNBs) leads domestic banks to reduce their loan exposure, especially in the low-risk segment of the market, in the early stages of international financial competition. This phenomenon is driven by the fact that MNBs "cherry pick" the best customers, leaving domestic banks with borrowers of lesser quality. These studies, however, also pointed out that when MNBs have acquired a large market share, domestic bank lending tends to rise with or complement MNB lending. Putting these observations into the context of Dynamic Asia, most economies seem to be at the early stage of international bank competition, where MNBs have explored the domestic market to a limited degree. MNBs' market share is still low in most DAEs nevertheless they have been attracting an increasing number of first-class borrowers due to the better quality of service and international networks. This may provide part of the explanation for decreasing lending by domestic banks and for increasing NPL ratios.

Competition from Capital Markets

25. Banks' corporate customers' base has further decreased due to the government's fostering of capital markets and switching the best customers to debt and equity financing.[11] Losing the best customers to capital markets or foreign competitors[12] has left domestic banks with second-class borrowers posing higher credit risks. Higher credit risks, in turn, are translated into higher interest rates, higher loan loss provisioning and a rise in new NPLs. Banks already saddled with large amounts of NPLs have become more selective in credit extension, leading to an economy-wide credit crunch in some DAEs.

Profit Squeeze

26. These new challenges of losing the best customers and searching for new ones amid subdued demand, meeting the requirements of new regulations, handling NPLs and foreclosed assets and facing increasing competition have substantially reduced bank profitability. The reduction of bank profitability *per se* can be a positive phenomenon if it is driven by competition and leads to higher efficiency. These outcomes, however, seem to be limited to the case of Hong Kong, China, Singapore and to a certain extent Chinese Taipei.

27. Low cost efficiency has long been a problem at banks in most Dynamic Asian economies. The large spread between commercial banks' deposit and lending rates is partly attributable to high intermediation costs mainly in the form of taxes and reserve requirements. High operating costs and insufficient competition have been other contributing factors to high intermediation costs, while

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9. ABN AMRO acquired a 75 per cent stake in the Bank of Asia, a medium-size bank in September 1998, UOB purchased a 75 per cent share of Radanasin, Thailand's smallest bank, DBS acquired majority stake in Thai Danu, Standard Chartered started with a small stake in Nakornthon Bank in the summer of 1999, with a provision to increase its share to 80 per cent over a five-year period.

10. Bids for the remaining two banks on sale, Bangkok Metropolitan Bank and Siam City Bank by Hong Kong and Shanghai Banking Corporation (HSBC) and Newbridge Capital, respectively, were rejected and the new prime minister closed the door on any further sales of banks to international investors.

11. Depending on issuance costs and recovery of equity markets, in some economies, however, bank borrowing still remains the cheapest way of raising funds.

12. While foreign banks have traditionally been financing foreign companies' activities, in crisis-hit countries many trade-related domestic firms switched to foreign banks simply because domestic banks were not creditworthy enough on international banking markets to open L/Cs. This is especially true in Indonesia.

macroeconomic factors have also played their role. In particular, the overvalued exchange rates before the 1997 crisis encouraged foreign borrowing and dollar intermediation by banks, which decreased the competition for local-currency deposits and thus prevented upward movements in the deposit rate. On the other hand, high interest rate policies to defend the exchange rate caused banks' lending rates to remain high. These regulatory and market structure components coupled with a risk premium component to account for uncertainty in the macroeconomic environment have had significant effects on bank net interest margins. Despite the high intermediation costs, before 1997 banks had been profitable, which might partly be attributable to the lack of competition and in some cases high concentration in the banking sector. However, banks had been concentrating on getting big rather than staying profitable. Robust economic growth rates masked the risks of default and fuelled credit growth to levels often exceeding the growth rate of the economy. The crisis and the recent economic downturn, however, have left banks with weak balance sheets.

28. Performance indicators such as returns on assets (ROAs), returns on equities (ROEs) and net interest margins (NIMs)[13] have been deteriorating. Tables 1 and 2 indicate ROAs and ROEs of the ten largest banks in the seven economies examined. ROA ratios have been low -- compared to the rest of the sample -- in Chinese Taipei, the Philippines, Thailand (with the exception of Krung Thai Bank, which is the largest state-owned bank in Thailand) and Indonesia (with the exception of Bank Central Asia, which got the "Best-Managed Bank" award in 2001). The underlying reason for low ROAs may be still high non-performing loans on banks' balance sheets, which is the case in all these four economies, or may be intense competition, which may probably be limited to the case of Chinese Taipei. ROAs have not just been low but have been deteriorating. ROA ratios have deteriorated from 0.73 per cent in 1997 to 0.53 per cent in the third quarter of 2001 in Chinese Taipei and from 0.9 per cent in December 1998 to 0.47 per cent in June 2001 in the Philippines. For trends in ROAs of Indonesian banks see Table 3. In Indonesia ROAs sharply deteriorated as a result of the 1997 crisis, reaching the lowest levels in 1998-99, then started to recover. In most cases, however, ROAs are still lower than in before 1997. ROEs, on the other hand have been relatively low in Chinese Taipei, the Philippines and Thailand, albeit not particularly low in Indonesia. This can be attributed to the fact that many Indonesian banks had not met capital adequacy requirements as of 2001. In Chinese Taipei and the Philippines, ROEs have not just been low, but have been deteriorating. ROEs have decreased from 11.4 per cent in December 1997 to 7.51 per cent in the third quarter of 2001 in Chinese Taipei and from 6.5 per cent in December 1998 to 3.2 per cent in June 2001 in the Philippines. For trends in ROEs of Indonesian banks see Table 4. By 2001, ROE ratios of Indonesian banks have got close to or exceeded pre-1997 levels, which can be attributed to lower equities in 2001 compared to 1996 or 1997.

29. The recent liberalization of foreign bank entry is aiming at increasing competition and improving efficiency in the domestic banking sector. Nevertheless, foreign bank entry has had limited impact so far, which may be because of a period of adjustment for foreign banks, a different business profile of foreign banks or the limited scope of liberalization. Restoring bank profitability involves cutting expenses through downsizing the labor force, reducing branches and promoting lower-cost deposits.

13. NIMs deteriorated from 2.4 in March 2000 to 2.03 in December 2001 in Hong Kong, China and from 5.1 in December 1998 to 4.1 in June 2001 in the Philippines. For comparison, NIMs stood at 2.49 in the third quarter of 2000 in Thailand, at 2.9 in December 2000 in Indonesia and at 3.2 in the third quarter of 2000 in Malaysia. NIMs have been contracting in Singapore as a result of on-going pricing pressure and higher funding costs associated with the Tier 2 capital raised to fund acquisitions.

Table 1. **Return-on-Assets Ratios of the Top 10 Banks in 2001**

Hong Kong, China		Indonesia		Malaysia		Philippines		Singapore		Chinese Taipei		Thailand	
HSBC	1.5%	BANK MANDIRI	0.8%	MALAYAN BANKING	1.1%	METROPOLITAN BANK & TRUST	0.3%	DBS	1.2%	BANK OF TAIWAN	0.5%	BANGKOK BANK	n.a.
HANG SENG BANK	2%	BANK NEGARA INDONESIA	0.3%	BUMIPUTRA-COMMERCE BANK	0.7%	BANK OF THE PHIL. ISLANDS	0.8%	UNITED OVERSEAS BANK	1.4%	TAIWAN COOPERATIVE BANK	0.1%	KRUNG THAI BANK	7.7%
BANK OF EAST ASIA	1.1%	BANK CENTRAL ASIA	1.9%	RHB BANK	0.8%	EQUITABLE PCI BANK	0.2%	OVERSEAS-CHINESE BANKING CORP.	1.4%	LAND BANK OF TAIWAN	0.6%	THAI FARMERS BANK	0.2%
DAO HENG BANK	1.2%	BANK RAKYAT INDONESIA	0.5%	PUBLIC BANK	1.6%	LAND BANK OF THE PHILIPPINES	0.2%	OVERSEAS UNION BANK	1.2%	FIRST COMMERCIAL BANK	0.3%	SIAM COMMERCIAL BANK	0.5%
NANYANG COMMERCIAL BANK	1.2%	BANK DANAMON INDONESIA	0.5%	HONG LEONG BANK	1.2%	PHILIPPINE NATIONAL BANK	n.a.	KEPPEL TATLEE BANK	1.2%	HUA NAN COMMERCIAL BANK	0.4%	BANK OF AYUDHYA	n.a.
WING LUNG BANK	1.5%	BANK INTERNASIONAL INDONESIA	0.7%	HSBC BANK MALAYSIA	1.8%	RIZAL COML. BANKING CORP.	0.2%	INDUSTRIAL & COMMERCIAL BANK	0.8%	CHANG HWA COMMERCIAL BANK	0.2%	THAI MILITARY BANK	n.a.
SHANGHAI COMMERCIAL BANK	1.7%	BANK TABUNGAN NEGARA	n.a.	SOUTHERN BANK	0.6%	DEVELOPMENT BANK OF THE PHIL.	0.7%	FAR EASTERN BANK	1.2%	TAIWAN BUSINESS BANK	0.3%	SIAM CITY BANK	n.a.
CITIC KA WAH BANK	0.9%	BANK LIPPO	1.1%	OCBC BANK (MALAYSIA)	1.3%	UNITED COCONUT PLANTERS BANK	0.7%	BANK OF SINGAPORE	3.5%	INTL. COML. BANK OF CHINA	0.5%	BANKTHAI	n.a.
WING HANG BANK	1.7%	BANK NIAGA	0.4%	STANDARD CHARTERED BANK MAL.	1.6%	ALLIED BANKING CORP.	0.7%			CHINATRUST COMMERCIAL BANK	1%	BANGKOK METROPOLITAN BANK	n.a.
PO SANG BANK	1.9%	BANK PANIN	0.2%	CITIBANK	1.7%	SECURITY BANK CORP.	0.6%			UNTD. WORLD CHINESE COML. BANK	1%	BANK OF ASIA	n.a.

Source: Asiaweek

Table 2. **Return-on-Equity Ratios of the Top 10 Banks in 2001**

Hong Kong, China		Indonesia		Malaysia		Philippines		Singapore		Chinese Taipei		Thailand	
HSBC	31%	BANK MANDIRI	24.3%	MALAYAN BANKING	13.1%	METROPOLITAN BANK & TRUST	3.2%	DBS	13.20 %	BANK OF TAIWAN	5.4%	BANGKOK BANK	n.a.
HANG SENG BANK	24.7%	BANK NEGARA INDONESIA	3.5%	BUMIPUTRA-COMMERCE BANK	11.3%	BANK OF THE PHIL. ISLANDS	6.2%	UNITED OVERSEAS BANK	13.50 %	TAIWAN COOPERATIVE BANK	4.2%	KRUNG THAI BANK	116%
BANK OF EAST ASIA	12.6%	BANK CENTRAL ASIA	25.7%	RHB BANK	8.70%	EQUITABLE PCI BANK	1.4%	OVERSEAS-CHINESE BANKING CORP.	10.30 %	LAND BANK OF TAIWAN	10.60%	THAI FARMERS BANK	4.9%
DAO HENG BANK	14%	BANK RAKYAT INDONESIA	10.5%	PUBLIC BANK	16.2%	LAND BANK OF THE PHILIPPINES	3.1%	OVERSEAS UNION BANK	10.60 %	FIRST COMMERCIAL BANK	5%	SIAM COMMERCIAL BANK	5.9%
NANYANG COMMERCIAL BANK	9.3%	BANK DANAMON INDONESIA	7.5%	HONG LEONG BANK	16.6%	PHILIPPINE NATIONAL BANK	n.a.	KEPPEL TATLEE BANK	10.80 %	HUA NAN COMMERCIAL BANK	6.2%	BANK OF AYUDHYA	n.a.
WING LUNG BANK	14.8%	BANK INTERNASIONAL INDONESIA	11.4%	HSBC BANK MALAYSIA	30.4%	RIZAL COML. BANKING CORP.	2.6%	INDUSTRIAL & COMMERCIAL BANK	4.1%	CHANG HWA COMMERCIAL BANK	3.2%	THAI MILITARY BANK	n.a.
SHANGHAI COMMERCIAL BANK	12.4%	BANK TABUNGAN NEGARA	n.a.	SOUTHERN BANK	6.70%	DEVELOPMENT BANK OF THE PHIL.	7.1%	FAR EASTERN BANK	7.2%	TAIWAN BUSINESS BANK	4.6%	SIAM CITY BANK	n.a.
CITIC KA WAH BANK	9.3%	BANK LIPPO	9.7%	OCBC BANK (MALAYSIA)	14.9%	UNITED COCONUT PLANTERS BANK	6.1%	BANK OF SINGAPORE	4.3%	INTL. COML. BANK OF CHINA	7.8%	BANKTHAI	n.a.
WING HANG BANK	16.6%	BANK NIAGA	6.1%	STANDARD CHARTERED BANK MAL.	25.5%	ALLIED BANKING CORP.	5.5%			CHINATRUST COMMERCIAL BANK	10.6%	BANGKOK METROPOLITAN BANK	n.a.
PO SANG BANK	9.8%	BANK PANIN	1.1%	CITIBANK	24.5%	SECURITY BANK CORP.	4.9%			UNTD. WORLD CHINESE COML. BANK	10.8%	BANK OF ASIA	n.a.

Source: Asiaweek

Table 3. **Return-on -Assets Ratios of Indonesian Commercial Banks 1990-2001**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bank Bali	1.4%	1.6%	1.7%	1.5%	1.5%	1.5%	1.6%	0.6%	-26.8%	-31.5%	-9.9%	1.7%
Bank Danamon Indonesia	1.0%	1.0%	0.8%	0.6%	0.9%	1.0%	0.9%	0.0%	-140%	-27.0%	0.6%	0.5%
Bank Duta	n.a.	n.a.	n.a.	n.a.	1.2%	1.2%	0.9%	0.7%	-69.3%	-158%	n.a.	n.a.
Bank International Indonesia	1.9%	1.7%	1.7%	1.6%	1.5%	1.5%	1.5%	1.0%	-30.6%	-5.2%	1%	-11%
Bank Niaga	0.9%	0.6%	0.7%	1.0%	0.9%	1.0%	1.2%	0.4%	-32.5%	-84.3%	0.4%	0.9%
Bank Nisp	n.a.	n.a.	n.a.	1.3%	2.9%	3.0%	2.5%	2.3%	0.9%	0.5%	1.2%	n.a.
Bank Pan Indonesia	1.6%	1.4%	1.3%	1.2%	1.4%	1.2%	1.5%	1.3%	0.0%	0.3%	0.2%	0.01%
Bank PDFCI	2.3%	1.6%	1.5%	n.a.	1.2%	1.5%	1.5%	n.a.	-452%	n.a.	n.a.	n.a.
Bank Tiara Asia	-0.4%	1.6%	1.9%	1.5%	1.8%	2.5%	1.9%	-2.3%	-201%	2.6%	n.a.	n.a.
Inter Pacific Bank	1.9%	2.0%	2.3%	2.3%	1.5%	n.a.	1.6%	0.9%	-57.7%	-29.1%	0.2%	0.7%
Lippobank	0.7%	0.7%	0.8%	0.9%	1.0%	1.1%	1.1%	0.9%	-57.9%	-6.9%	1.1%	1.1%

Note: The ratio equals to net income divided by total assets.
Source: Jakarta Stock Exchange

Table 4. **Return-on-Equity Ratios of Indonesian Commercial Banks 1990-2001**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bank Bali	16.6%	18.4%	17.9%	17.8%	18.9%	16.7%	20.5%	8.3%	150.6%	54.5%	-228%	42%
Bank Danamon Indonesia	11.3%	12.2%	12.7%	6.5%	12.8%	15.5%	11.0%	-0.3%	106.7%	-406%	7.5%	7.5%
Bank Duta	n.a.	n.a.	n.a.	n.a.	7.4%	9.6%	10.6%	10.7%	121.5%	48.8%	n.a.	n.a.
Bank International Indonesia	18.8%	18.0%	19.2%	21.6%	16.8%	19.1%	20.8%	9.6%	130.0%	-108%	14%	184%
Bank Niaga	18.9%	11.8%	13.5%	17.1%	18.0%	20.7%	16.0%	6.3%	127.0%	66.6%	5.9%	17%
Bank Nisp	n.a.	n.a.	n.a.	24.7%	25.3%	21.1%	21.2%	22.6%	8.0%	6.0%	15.9%	n.a.
Bank Pan Indonesia	22.5%	9.1%	9.5%	12.2%	13.3%	9.7%	13.8%	9.8%	0.1%	1.2%	1.1%	0.1%
Bank PDFCI	15.4%	13.7%	12.9%	n.a.	8.9%	12.5%	15.4%	n.a.	105.9%	n.a.	n.a.	n.a.
Bank Tiara Asia	-6.0%	13.6%	10.8%	7.9%	13.5%	13.7%	15.2%	-32.9%	104.4%	9.9%	n.a.	n.a.
Inter Pacific Bank	10.4%	13.0%	14.4%	14.6%	11.0%	n.a.	15.8%	10.0%	113.9%	-396%	2.8%	4.2%
Lippobank	11.3%	12.2%	15.7%	11.1%	15.0%	16.6%	12.9%	11.8%	146.8%	-70.9%	9.8%	9.7%

Source: Jakarta Stock Exchange.

Targeting New Lending Segments

30. These challenges are making banks reformulate their business strategies and find new customers and new activities or merge to restore profitability. Amidst these developments, banks are venturing into new segments such as small and medium-size enterprise (SME) financing and retail banking. These are areas of comparative advantage for local banks due to their informational advantages and branch networks, while they lag behind foreign competitors in technology and management. In some crisis-hit economies like Thailand and Indonesia, SMEs are sometimes among the limited number of creditworthy customers with healthy balance sheets mainly due to their limited access to credit during the boom years. The importance of SMEs as prospective customers is reflected in the increasing number of banks establishing SME loan departments. SMEs, however, tend to have no explicit credit rating due to the high costs of acquiring information and no collateral, making it difficult for banks to assess their financial situation. To bridge this information gap and secure financing for SMEs, governments have been establishing credit guarantee corporations and special financial institutions.

31. Home mortgages represent the largest share in personal loans reflecting low property prices in the region. Competition is strengthening in this segment and is not limited to price competition but is manifested in increasing product differentiation, location advantages and aggressive sales promotions.[14] Economies where credit cards were not widespread before have been experiencing credit-card-related lending booms.

Venturing into New Activities

32. In parallel with gaining new customer groups, banks are also expanding their scope of activities and the firewall between banking and securities business -- where it existed before -- is disappearing. At the same time, they are matching the increasing deposits on the liability side with securities investments on the asset side and meeting liquidity demand imposed by deposits through loan-related off-balance sheet items.[15] Venturing into derivatives or securities investments requires acquisition of new skills, and this “switching” cost might be too high for smaller domestic banks. These new directions are also reflected in income statements: the share of non-interest income is showing a rising trend.

33. The prospects for non-interest income in Asia are considered good. With young but aging population, reaching the peak of their earnings power in the coming decades, the region is adapting to a new economic reality: low inflation, low wage rises, stagnant house prices and lower job security. These factors are forming a favorable environment for banks to move into non-interest income streams. Cross-selling opportunities are enormous if banks can profit from their unique position of possessing a whole myriad of information about their customers’ earnings, asset holdings and other characteristics. The main constraint may be that most banks in Dynamic Asia haven’t invested sufficient amounts in customer relationship management and data mining.

Consolidation

34. Besides gaining new customers and venturing into new activities, the third strategy to restore profitability and stay afloat in the global competition arena is consolidation.[16] Mergers and acquisitions

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14. Taking the example of Thailand, commercial banks have designed their own, specific home-loan schemes offering a large choice for home-buyers. These schemes include Bangkok Bank’ s home loan scheme of 4-5-6 per cents in the 1st, 2nd and 3rd year, respectively, Thai Danu Bank’ s Home Plus with 4.75 per cent in the first year, MLR (minimum lending rate) minus 2 per cent in the 2nd and 3rd years and MLR for the rest and Bangkok Metropolitan Bank’ s housing loan 3.75 per cent in the first year, 4 per cent in the 2nd year and MLR from the 3rd to the 20th year.

15. Such as loan guarantees, loan commitments, L/Cs etc.

16. For a more detailed analysis about driving forces and constraints to consolidation see Box 1.

brought about by restructuring, lead by government guidelines or driven by market initiatives, have resulted in further concentration of the banking sector (measured by assets or loans). In the Philippines, concentration in the banking system began to decline in 1995 as a result of deregulation and entry of new foreign banks, but this trend reversed in 1998 as a series of mergers and acquisitions (M&As) resulted in increasing concentration. Mergers can substantially reduce costs through downsizing of the labor force and closing down branches. They are, however, not just a way of achieving cost efficiencies. Mergers are also a way of achieving a specific growth strategy and preparing for competition in the global arena. The consolidation move that has been completed to date has resulted in further concentration of the commercial banking sector.

35. Measured by the Herfindahl-Hirschman Index[17] (HHI), as Table 5 indicates, concentration in the banking sector in terms of assets has increased in Chinese Taipei (from 501 to 524), in Singapore (from 1718 to 2906), in Malaysia (from 854 to 899), in the Philippines (from 559 to 776) and in Hong Kong, China (from 847 to 968) in 2001 compared to 2000. The HHI has decreased in Thailand (from 1081 to 1044) and in Indonesia (from 1022 to 983) in 2001 *vis-à-vis* 2000. In terms of loans, the HHI has increased in Thailand (from 835 to 1074), in Chinese Taipei (from 464 to 557), in Singapore (from 1978 to 4077), in Hong Kong, China (from 945 to 1289), in Malaysia (from 937 to 1043) and in the Philippines (from 551 to 1361) and decreased in Indonesia (from 530 to 512) during the same period. The banking sector had already been highly concentrated in Singapore, with the Development Bank of Singapore (DBS) having 32 and 34 per cent market shares in terms of assets and loans, respectively. With the acquisition of Dao Heng bank (DHB) DBS's market share rose to 39 and 42 per cent in terms of assets and loans, respectively during 2000-2001. All banks in Singapore have been involved in M&As during the years of 2000-2001, either as an acquirer or an acquisition target.[18] Applying the "rule of thumb", except for Singapore, no other economy can be considered to have a highly concentrated banking sector in 2001. If, however, looking at the increases in the HHI as a result of M&As, trends in the Philippines and Hong Kong, China -- where concentration in terms of loans has substantially increased in 2001 compared to 2000 -- may raise concerns.

Table 5. Concentration in Banking Sectors in Dynamic Asian Economies

	In terms of assets		In terms of loans	
	2000	2001	2000	2001
Hong Kong, China	847	968	945	1289
Indonesia	1022	983	530	512
Malaysia	854	899	937	1043
Philippines	559	776	551	1361
Singapore	1718	2906	1978	4077
Chinese Taipei	501	524	464	557
Thailand	1081	1044	835	1074

Note: Concentration is measured by the Herfindahl-Hirschman Index

17. The Herfindahl-Hirschman Index is calculated by squaring the market share of each firm competing in the market and then summing the squared values. As a rule of thumb, an HHI value of more than 1 800 is considered highly concentrated and a post-merger increase of 50 points raises concerns. Applying the HHI, any four-firm market share of 70 per cent would fall in the moderate to highly concentrated category, depending on the distribution of individual market shares.

18. DBS's 2001 financial statements reflect the full contribution from DHB, the Overseas Chinese Banking Corporation's (OCBC) includes 4.5 months of Keppel Capital (KCH) and United Overseas Bank (UOB) has captured 3-months contribution from Overseas Union Bank (OUB).

Box 1. **Driving forces and constraints of consolidation**

Notwithstanding the differing lending market situation and soundness of financial institutions, consolidation in the banking system seems to be a common trend in Dynamic Asia. This consolidation is being facilitated by government regulations that provide tax incentives and in some cases relief from full compliance with provisioning and other requirements for merging financial institutions. Consolidation is not solely driven by motives of economies of scale, economies of scope or geographic and product diversification but also by the motive to prepare for competition in the global arena. Either as a result of the financial crisis or under pressure from neighbors, all economies in the region are relaxing entry restrictions for foreign banks.[1] The motive of enhancing competitiveness is best illustrated by the recent mergers in the Malaysian financial sector, where the originally 54 banks have been merged into 10 anchor groups in preparation to opening up the domestic banking system to foreign competition by 2007.[2] The government of Malaysia designated the six anchor banks, though the mergers are said to have been achieved on market-based principles.[3]

The consolidation in Indonesia was substantially government-driven but with the more pressing necessity to shore up confidence and restore the stability of the banking system. So far, 17 private and four government banks have been involved in two mandatory government-sponsored mergers and three voluntary mergers.[4] Bank merger decisions in Indonesia are said to be dependent on the amount of capital (or the capital adequacy ratio), the scale of business and the degree to which the strategic position of the participants adds to the value of the merged bank.[5] In Thailand consolidation of smaller, less profitable banks would be desirable to create a more competitive banking environment, though due to lack of incentives it is not foreseeable in the near future. Given that at present the larger banks are healthier, the merger of smaller and weaker ones would not necessary result in a single stronger bank.

In Chinese Taipei and the Philippines, there are too many small banks but governments in both countries are reluctant to intervene in the consolidation process. In the Philippines, banks experiencing difficulties in meeting higher capital requirements could benefit from merger or consolidation with other institutions. However, in practice, mergers tend to occur between strong banks that want to further prepare themselves for global competition. So far, mergers involving fifteen commercial banks, three thrift banks, two rural banks and four nonbank financial institutions have been completed and several others are in the pipeline. In Singapore, the consolidation process is supposed to be driven by market forces. However, the Monetary Authority’s May 1999 announcement that it saw only enough room for two strong local banks to compete suggests the government intends to have an influence on the process.[6]

The consolidation process, though seen as an effective way to address capital inadequacy, non-performing loans, lack of competitiveness and other structural weaknesses, and although promoted by governments, is still not progressing in some economies at the speed initially envisaged. Apart from Malaysia, where banks were given a clear mandate and deadline to find merging partners, elsewhere in the region some degree of resistance from the part of bank owners has been seen. Many bank owners are not attracted by the idea of consolidation due to the following considerations: The biggest constraint on consolidation seems to be the lack of sufficient value-maximizing merger opportunities. For banks of different scales and with similar geographical distribution of networks it is hard to find motives to merge. This is more so if one of the merging banks has a large ratio of problem loans. If the larger bank has more problem loans, the smaller, healthier one might not be able to absorb it. If the smaller bank is weaker, the larger one may be busy with cleaning up its own balance sheet and may not have additional resources to help out the smaller bank. Alternatively, if the banking market is already considered to be concentrated, further absorption of small banks is not desirable even if the large, absorber bank is healthier. One or more of these factors are present in most economies and constitute an obstacle to consolidation. In Chinese Taipei the largest and most problematic banks are state-owned and the most profitable ones are private, small and reluctant to be absorbed by larger banks, but stand to reap limited competitive advantages from mergers among themselves. In Indonesia the remaining private banks after the crisis are well capitalized and profitable, while the larger banks are state owned and have had their balance sheets cleaned substantially by government actions. There have been some government attempts to make the newly created largest state bank take over some smaller and weaker banks. However, this has led to strong opposition from other market players who fear that their competitive position versus the larger state banks would be weakened as a result. In Thailand, it would be desirable from the perspective of the banking system as a whole for some of the smaller banks to merge. But the incentives for such mergers are limited since, given their lower profitability ratios, and even after merging, they could not possibly challenge the might of the three largest players.

A further considerable constraint on consolidation in Asia is the family ownership of banks. Owners, who are often the founders as well, are reluctant to give up market identity in exchange for enlarged market share and larger expected profits. They tend to be more sensitive to the immediate costs of linking computer systems, consolidating data and reports and to the difficulties in merging cultures and dismissing excess staff, and are less attracted by the benefits of synergies and cost reductions from eliminating overlapping branches that can only be realized in the longer term. This helps explain why many small and weak banks in the Philippines are not ready to merge or consolidate but prefer another option instead: downgrading or conversion to a lower category. This option requires minimal or no additional capital, while they can maintain their ownership and market identity.

Box 1. **Driving forces and constraints of consolidation *(cont'n)***

It will take a while to assess the effectiveness and benefits of these mergers that have occurred in dynamic Asia. A merger can be beneficial to the overall banking system if a large and well-capitalized bank absorbs NPLs from small and weak banks and then improves the quality of management. Alternatively, merging banks may be able to benefit from some kind of synergy, regardless of their size. It is still questionable whether merging two or more weak banks can create a strong single bank. Domestic mergers and takeovers are considered to constitute the least costly way of restructuring the banking sector, but if all banks are saddled with problem loans it is not a panacea. Besides domestic M&As, cross-border mergers and acquisitions[7] are on the rise also, and the foreign share of total banking assets is increasing in most cases.[8] While some weaker and/or cash-strapped banks were sold to foreign investors,[9] the sheer size of funds required for recapitalization and NPL restructuring has forced even some of the healthiest banks in the region to increase foreign ownership. Foreign entry to the banking sector has been further liberalized recently in most economies and foreign partners are welcome to help domestic banks to increase their capital and to transfer technology and management know-how.

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1. Thailand allows 100 per cent foreign ownership (versus 49 per cent pre-crisis) for a limited period of ten years in an effort to help recapitalization and the acquisition of management skills and technology. Indonesia set the upper limit at 99 per cent, the Philippines amended the General Banking Act to allow foreign ownership of local banks up to 100 per cent for a limited period of time, Malaysia plans to open up its market by 2007 and Singapore by 2003.

2. Those foreign banks already in Malaysia will be able to open branches after 2004.

3. In the second round of mergers, there is a possibility that the left-alone third largest RHB Bank (after stalled negotiations with a smaller Bank Utama) will merge with the second largest, Bumiputra-Commerce, thus challenging the might of Malayan Banking (Maybank) which is way ahead in terms of assets.

4. The first mandatory merger involving four state banks which suffered negative capital and huge losses created the largest bank in Indonesia (Bank Mandiri with 29 per cent market share in terms of loans at the time of its creation in 1999). The second mandatory merger involving nine small and medium-sized private banks created a large private bank bearing the name of the largest participant (Bank Danamon). The remaining voluntary mergers between seven private banks seem to have been driven by foreseen synergies and improved efficiency. A further merger of five banks (Bank Bali, Bank Universal, Bank Artha Media, Bank Prima Ekspress and Bank Patriot) that were unable to meet the risk-weighted capital-asset ratio of 8 per cent by end-2001 has occurred (except for Bank Bali).

5. There were some exceptions, however, when for instance previous foreign joint venture banks merged as a reflection of the ongoing consolidation of the corresponding parent banks. Namely Sanwa Bank merged with Tokai Lippo Bank, and the Industrial Bank of Japan with Daiichi Kangyo Bank and Fuji Bank to become Bank Mizuho Indonesia.

6. The merger frenzy started by Overseas Chinese Banking Corporation (OCBC) acquiring Keppel Tatlee Bank followed by the Development Bank of Singapore (DBS) making an offer to Overseas Union Bank (OUB) and a counter-offer by United Overseas Bank (UOB) and finally resulting in a fall in the number of domestic banks from five to three (DBS, UOB-OUB and OCBC-Keppel).

7. One complication that arises in cross-border M&A deals is exchange rate risk. This will increase the demand for currency derivatives, as the parties involved will look to manage their exchange rate exposures with the most sophisticated instruments

8. It should be noted that although foreign participation in the banking business in general is considered a positive change, the preponderance of financial rather than strategic investors -- whose strategy is to buy cheap, boost earnings and sell with a profit after a few years -- can be counterproductive. This is said to be a danger in Indonesia, where the government expects that its ambitious privatisation programme would solve banking sector problems. In Thailand, however, the fears of "foreign overtaking" appear to have been overestimated. With the failure of two acquisitions (of Bangkok Metropolitan Bank by HSBC Holdings and of Siam City Bank by Newbridge Capital), the Thai banking sector has switched from one extreme of fear of foreign competition and foreign takeovers to the other extreme of concern over lack of competition and technological and management spillovers that foreign banks could have introduced. Without further acquisitions, the combined share of foreign banks will remain at around 7 per cent, hardly enough to challenge the might of Bangkok Bank, Krung Thai Bank and Thai Farmers. So far, as of end-2001, only four local banks have majority foreign ownership, and of the new arrivals only Standard Chartered is recognised as a major international player.

9. Thailand succeeded to sell two of its ailing banks to foreign counterparts (Nakornthon to Standard Chartered and Thai Danu to the Development Bank of Singapore, DBS) and two are still waiting for strategic investors (though the present government would welcome more domestic investors). In Indonesia the sale of 51 per cent of Bank Central Asia (BCA), the biggest retail bank, to the winner of the bid (ahead of Standard Charters), Farallon, a US investment firm, has recently been completed. BCA's disposal is said to be the first of a series of local banks to be offered for privatization. In Hong Kong, China, the acquisition of Dao Heng by the Development Bank of Singapore is accomplished on a rather profit-driven base.

Branching Overseas

36. For the soundest banks that rather suffer mainly from limited domestic markets or demand, there exists an alternative strategy to boost profitability and stay afloat, which is branching overseas. This phenomenon has mostly been seen in Chinese Taipei, where the domestic market is often said to be overbanked. The major market banks in Chinese Taipei are mainly interested in Mainland China,[19] though other emerging markets in the region are also among the targets.[20] This move partly reflects the shift of manufacturing facilities to Mainland China and other economies and the need for provision of banking services for them, and partly the inability of domestic Chinese banks to meet domestic loan demand and/or to provide proper banking services. There are still, however, administrative barriers and legal uncertainties that hold back banks in Chinese Taipei from following their corporate customers or penetrating into markets where there would be a need for their services.[21]

19. As of mid-2002, eight banks in Chinese Taipei applied to the Ministry of Finance in China to set up representative offices and two have been granted permission (the government-owned Changhwa Commercial Bank and the private World Chinese Commercial Bank).

20. Among them are Vietnam, Indonesia and other Asian emerging economies.

21. The major barrier is the lack of recognition of legitimacy of supervision by Chinese Taipei supervisory authorities in Mainland China.

4. CORPORATE CHALLENGES AND RESPONSES

37. Cyclical factors, fallout from the financial crisis and the ICT downturn and structural changes have been reshaping not just the financial architecture but also corporate landscapes. As a result of the pre-crisis easy-money policy and the resulting over-borrowing and over-investment syndrome,[22] many firms in DAEs have been suffering from overcapacity in industry, which has been accentuated by the downturn in cyclical sectors and sluggish external demand. The hardest hit are the real estate and construction sectors in DAEs that were most affected by the crisis such as Thailand, Malaysia and Indonesia, and in Hong Kong, China due to the property market downturn. The ICT downturn has adversely affected corporate investments in Chinese Taipei, Singapore and Malaysia and to a lesser extent in the Philippines. Heavy debt repayment obligations that are the fallout from the 1997 crisis have been constraining the recovery of corporate investments. Debt repayment constitutes a sizeable obstacle to the recovery of investment in Thailand, Indonesia and the Philippines.

38. Besides cyclical factors and fallout from the 1997 crisis, changes of a more structural nature have been reshaping corporate behavior. Structural changes largely stemming from government efforts to facilitate economic recovery have been significant in most DAEs. To facilitate debt settlement, a legal framework has been established. This includes amendment of bankruptcy laws, establishment of bankruptcy courts and frameworks for out-of-court debt settlement. Further, public funds have been channeled to help resolution of NPLs and corporate restructuring. To avoid the reoccurrence of NPLs, corporate leverage needs to be reduced in some of DAEs. With lower debt-to-equity ratios, the vulnerability of corporations could be reduced. It should be noted, however, that there are large differences in leverage among Dynamic Asian economies. Thai and Indonesian firms have the reputation of being highly leveraged, while corporations in Chinese Taipei traditionally have very low debt-equity ratios. Malaysian, Singaporean and Philippine firms are moderately leveraged and leverage of corporations in Hong Kong, China tends to be in between the high and moderate categories (Thailand-Indonesia and Malaysia-Singapore-Philippines).[23]

39. A major structural change in firms' behavior is the diversification of financing sources[24] driven by tight credit conditions, governments' effort to nurture domestic corporate bond and equity markets and to a limited extent by increased integration of financial markets. As a result, those firms with good rating have increasingly been turning to bond or equity market financing.[25] The diversification of sources of financing has secured access to fresh funds in times of tight credit conditions. The traditional bias in the financing structure of firms towards bank financing underlined the urgency to push forward the

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22. *Molnar (2002)* tested empirically the existence of borrowing constraints for a large sample of Indonesian firms. It found that in Indonesia over-borrowing was rather a result of political connections than an overall phenomenon.

23. To illustrate the differences in leverage: Thailand registered a debt-to-equity ratio of 4.5, Indonesia 2.6, Hong Kong, China 1.6, the Philippines 1.6, Malaysia 2.4, Singapore 3.2 and Chinese Taipei 0.8 in 1996 (Source: *ARIC Database* and *Pomerleano (1998)).* By 2000 the debt-equity ratio has risen in Thailand to 5.2, in Indonesia to 3.7, in the Philippines to 1.9, it has stayed at a similar level of 2.4 in Malaysia and has slightly dropped in Singapore to 2.8.

24. *Claessens et al. (1998)* provide on financing patterns and other characteristics of East Asian corporations over the past decade.

25. It should be noted, however, as pointed out in *Shirai (2001)*, that for most DAEs it will take a while until bond and/or equity financing becomes dominant on economy-wide scale.

development of domestic debt markets.[26] In economies where the debt market is relatively developed, low interest rates facilitate the issuing of bonds and debt instruments. Even where debt markets were nearly non-existent pre-1997, the huge costs of restructuring have partly been financed by government bonds, whose growth has helped establishing benchmarks for yield curves and thereby facilitated the pricing of corporate debt.

40. Thailand registered the fastest development of the corporate debt market, but Malaysian companies have also been increasingly relying on the relatively well-developed domestic market, while tapping international bond markets as well. In Malaysia the government-guaranteed bonds issued by Danaharta[27] in exchange for NPLs boosted liquidity in the bond market and helped create pricing benchmarks for bonds. In Chinese Taipei, though the commercial paper (CP) market has long been active, issues have decreased recently due to the cyclical downturn and partly to a new requirement of rating for issuers (in 2000). The bond market on the other hand is more restrained due to limited secondary markets as local bond funds tend to buy and hold securities until maturity. The 0.1 per cent transaction tax constitutes a further burden on the development of the corporate bond market. In Indonesia and the Philippines, notwithstanding government efforts, debt markets have remained relatively underdeveloped. Indonesia has long pursued a balanced budget policy, making deficit financing unnecessary. Thus a risk-free benchmark yield curve has been missing and there has been no credit rating agency, either. Further, high real interest rates had made bond financing less attractive relative to equity financing. The position of Singapore and Hong Kong, China as international financial centers makes it cheaper for firms to rely on bank financing as there is a dense network of banks and sufficiently strong competition to make loans attractive *vis-à-vis* corporate debt.

41. Large bank recapitalization moves were originally expected to boost equity markets, but the results, however, have so far been mixed. Banks were often not able to acquire the required funds to build up their capital and needed government capital injections. Capital injections, though, were made on the condition of matching a certain percentage (varying by economy) of government funds with own funds. These funds, however, largely came from foreign investors, property sales, loans from shareholders or recalled loans, and thus did not contribute to the revival of equity markets. On the other hand, large-scale privatisation programmes just started in Thailand (public utilities and other large state-owned enterprises) and Indonesia (banks, telecoms and other state enterprises) are expected to play their role in boosting equity markets. High issuing costs and a preference towards debt are major constraint on the development of equity markets. Family ownership[28] of corporations -- implying reluctance to lose control over the company's operations -- and tax allowances make debt financing more attractive *vis-à-vis* equity financing.

Declining Bank Borrowing by Business Sector

42. Amid declining bank lending growth in most economies, different business sectors show different patterns. The sharpest decline is observed in the real estate and construction sectors regardless of whether the economy was hit by the Asian crisis or weathered it relatively well. The exceptions are Singapore and Malaysia where credits to these sectors seem to have been rising. In terms of decline, the real estate and construction sector is followed by manufacturing and trade in the crisis-hit economies and Hong Kong, China. Lending to agriculture was less affected in economies with large agricultural sectors

26. *Lamberte (2002)* provides a thorough analysis of characteristics of debt securities markets in ASEAN economies and addresses the key remaining issues.

27. Danaharta, the National Asset Management Company was established in June 1998 with the purpose to help removing of NPLs from banks' balance sheets to enable them to resume their lending activities. Besides Danaharta, the other two special purpose vehicles (SPVs), Danamodal (an interim funding vehicle to inject capital into ailing banks in the form of equity or hybrid instruments) and the Corporate Debt Restructuring Company (CDRC) have also helped accelerate the development of the bond market.

28. *Suehiro (1993)* and *Suehiro (2001)* provide an insight into ownership patterns and corporate behaviour of Thai firms by analysing a large sample.

such as the Philippines, Indonesia or Thailand, and in some cases it has even been slightly rising. Loans extended to utilities and other activities such as professional services and personal loans have been rising in most economies. The decline in lending to some sectors such as utilities, construction, manufacturing and services may partly be attributed to large privatization moves in Thailand and Indonesia, where companies under privatization either temporarily curtailed new investments or have recently gone public and have been financing new investments through the capital market.

43. In the Philippines, commercial bank lending (Figure 3) has risen to trade (wholesale and retail) and community, social and personal services while dropping to manufacturing, transportation, storage and communication sectors and financial, real estate and business services. The miscellaneous category has changed little as rising loans to agriculture, electricity, gas and water and mining and quarrying cancel out the fall in lending to construction. This is in line with the common pattern in the region except for lending to trade, which has in general declined across Dynamic Asia.

44. Chinese Taipei (Figure 4) appears to exhibit a similar pattern, as lending to the manufacturing, construction, real estate, trade and services has been declining, though only since 2000. Lending to the miscellaneous category (which includes transport, storage, communications, utilities, agriculture and mining), on the other hand has been steadily rising. In Indonesia (Figure 5) total credit outstanding has been showing signs of recovery since 2000, though has not reached pre-crisis levels. Manufacturing, trade and services have experienced the sharpest decline and the recovery of loans has been driven by the “others” category, a large part of which is made up by consumer loans.

45. Commercial bank lending has been sharply declining in Hong Kong, China (Figure 6), led by the building, construction and property sector, which has traditionally been a main driver for both corporate and personal lending. Lending to other sectors like manufacturing and trade has also been declining slightly. In Thailand (Figure 7) real estate, manufacturing and construction have registered the sharpest decline in bank lending. Similarly to most other DAEs, lending to industries in the miscellaneous category (including services, agriculture, mining, utilities and personal lending) has been rising.

46. In Malaysia (Figure 8) lending has been on a rise notwithstanding the crisis or the recent cyclical downturn in the ICT and related industries, driven by the real estate and construction sectors and personal lending. In Singapore (Figure 9) though bank lending had been adversely affected by the Asian crisis, it had recovered thereafter and had been steadily rising until the recent gradual fall starting at end-2001. Different from most other DAEs, in Singapore the largest decline in bank lending has been registered in business sectors under the miscellaneous category (including agriculture, mining, transport, storage and communications).

Figure 3. Commercial Bank Lending in the Philippines by Broad Sector (in current million pesos)

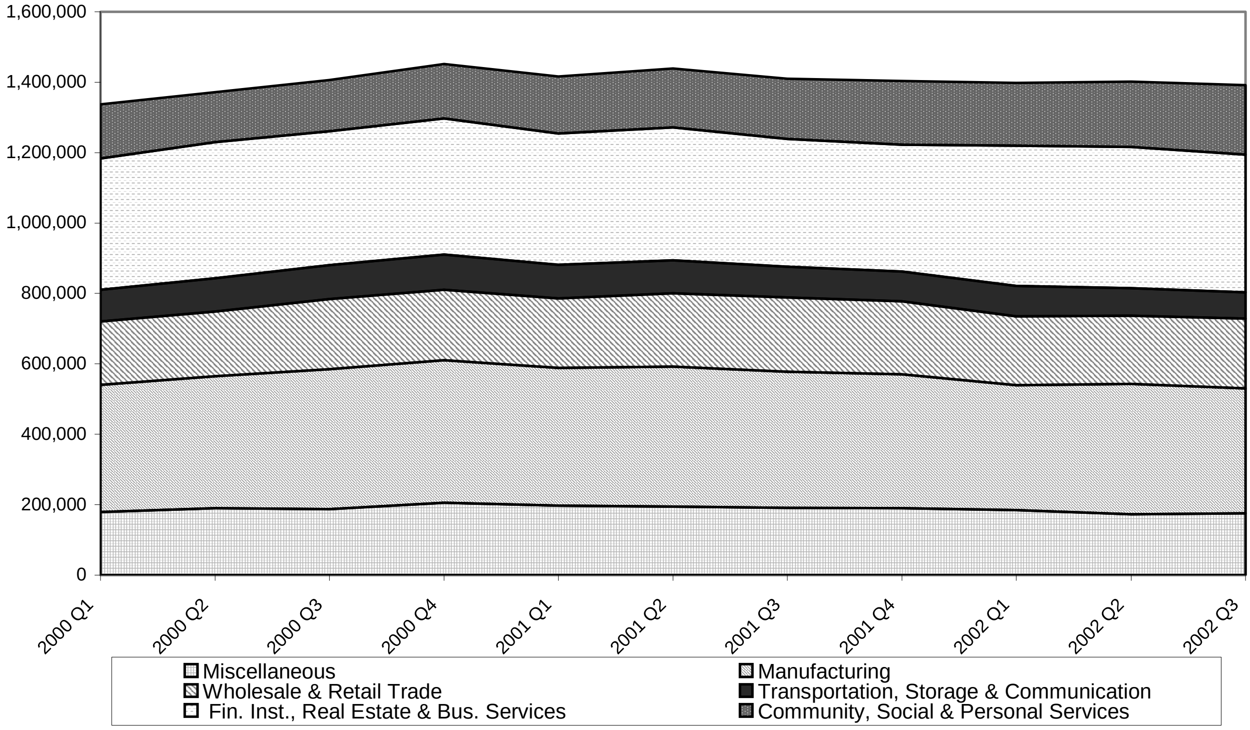


Figure 4. Commercial Bank Lending by Broad Sector in Chinese Taipei (in current million NT dollars)

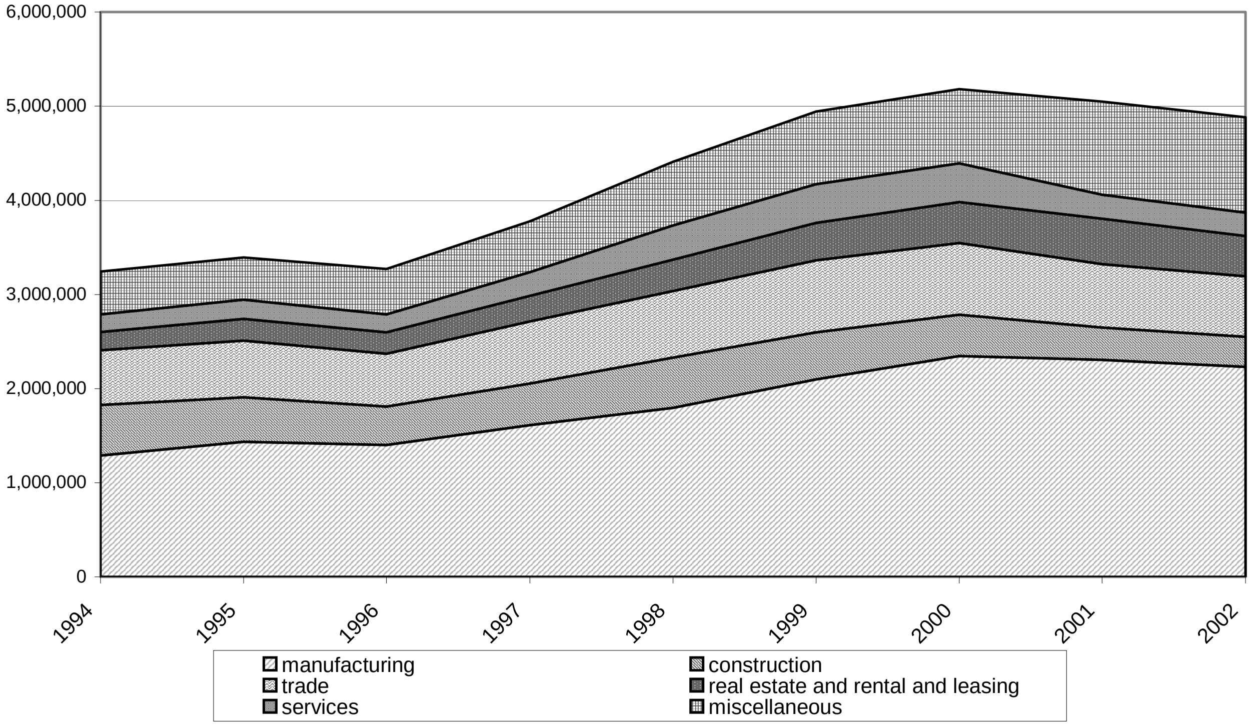


Figure 5. Commercial Bank Lending in Indonesia by Broad Sector (in current billion rupiah)

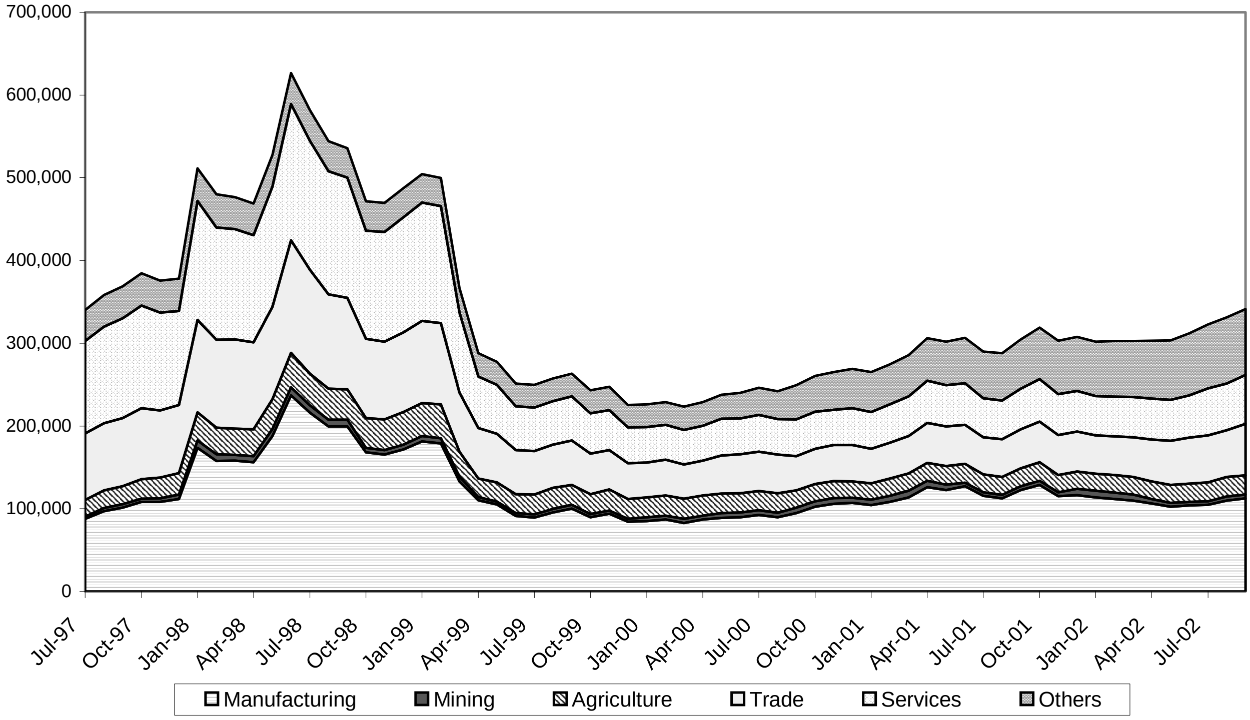


Figure 6. Commercial Bank Lending in Hong Kong, China by Broad Sector (in current million HK dollars)

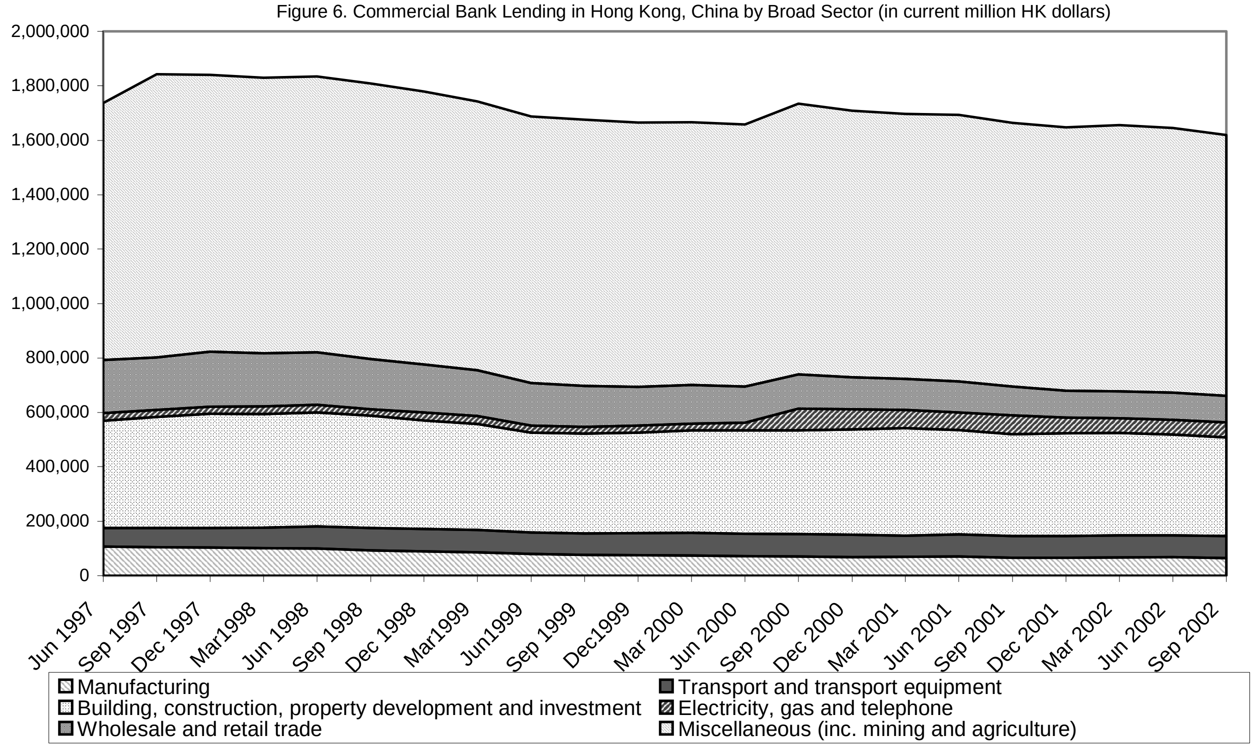


Figure 7. Commercial Bank Lending by Broad Sector in Thailand (in current million baht)

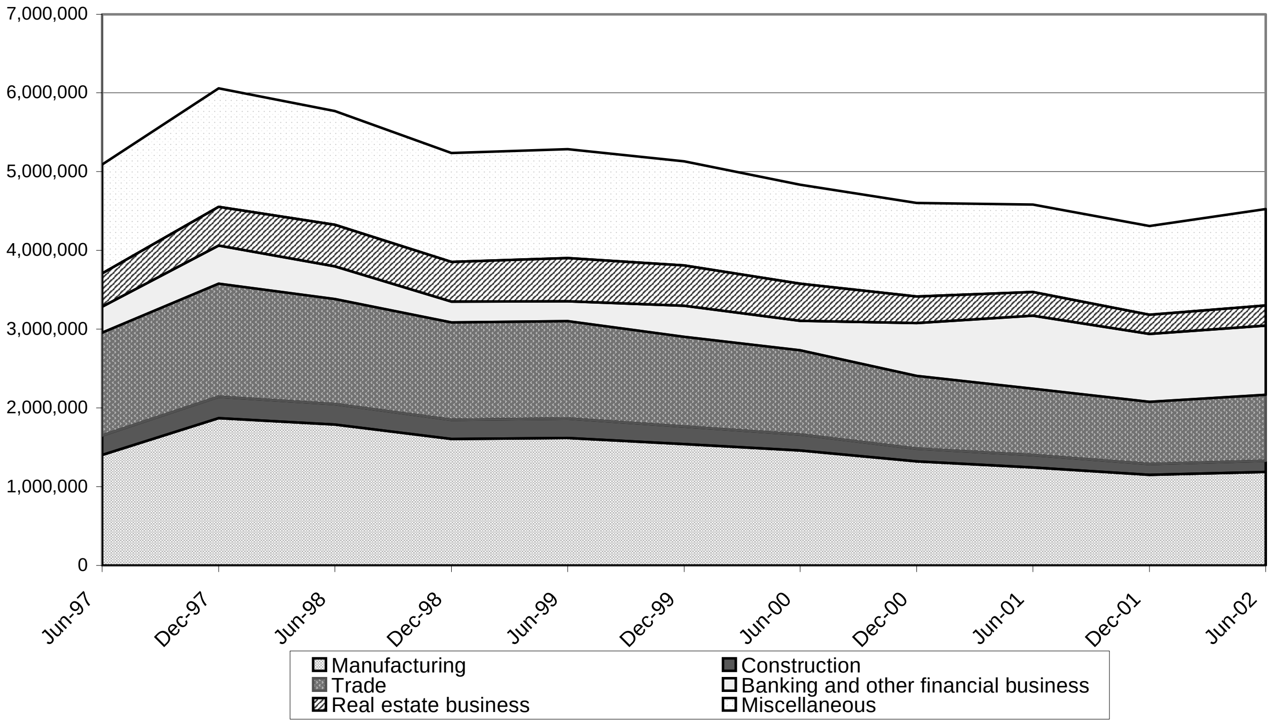
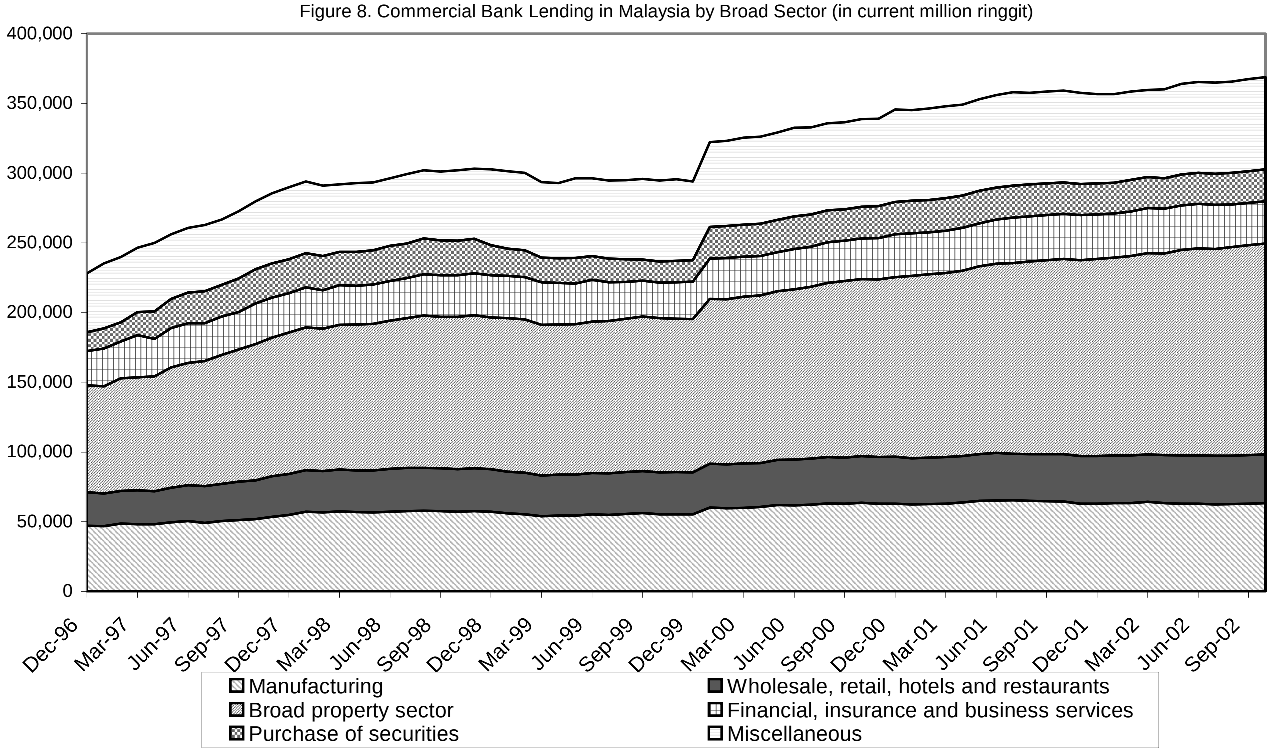


Figure 8. Commercial Bank Lending in Malaysia by Broad Sector (in current million ringgit)



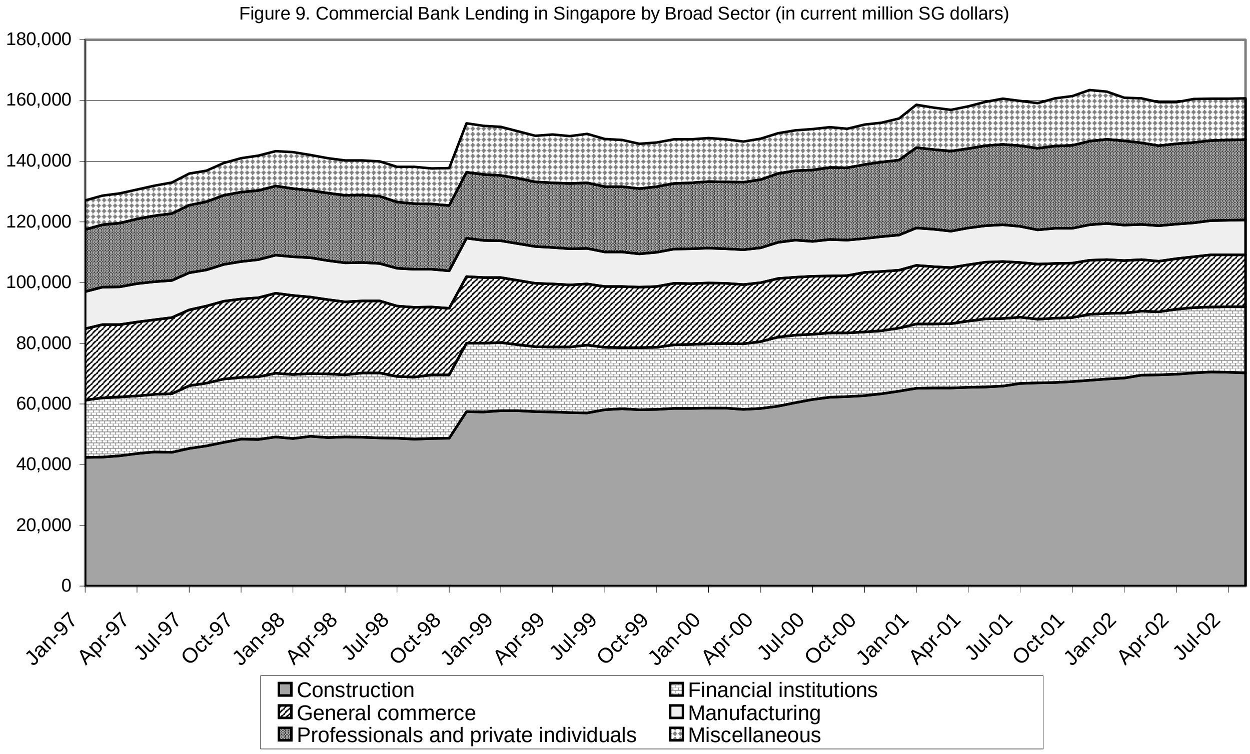


Figure 9. Commercial Bank Lending in Singapore by Broad Sector (in current million SG dollars)
180,000
160,000
140,000
120,000
100,000
80,000
60,000
40,000
20,000
0
Jan-97
Apr-97
Jul-97
Oct-97
Jan-98
Apr-98
Jul-98
Oct-98
Jan-99
Apr-99
Jul-99
Oct-99
Jan-00
Apr-00
Jul-00
Oct-00
Jan-01
Apr-01
Jul-01
Oct-01
Jan-02
Apr-02
Jul-02
Construction
Financial institutions
General commerce
Manufacturing
Professionals and private individuals
Miscellaneous

5. CONCLUSION

47. The study investigated the main underlying factors and consequences of changing bank-firm relationship in Dynamic Asia that is manifested in the decelerating trend of bank lending growth. These changes are attributable to three main underlying factors: cyclical, hangover from downturns and more persistent factors of a structural nature. Banks have been facing the challenge of foreign competition, competition from capital markets and profit squeeze, to which they have been responding by targeting new lending segments, venturing into new activities, consolidation and branching overseas. Firms, on the other hand have been facing more stringent bank lending conditions to which they have started to respond by diversifying their sources of funding. The best-rated firms have been coping with the credit crunch by diversifying their capital structures and tapping bond and equity markets. The most adversely affected are firms with more inferior rating or without rating, especially small and medium-size enterprises, although in economies where larger enterprises accumulated heavy debts before 1997, financial institutions have increasingly been targeting smaller enterprises, which tend to have lower leverage.

48. The major lesson to be drawn from the analyses is that both banks and firms have adopted measures to cope with the ongoing changes, but these measures might not be sufficient to survive in a global arena. Diversification of banking portfolio, including targeting new lending segments and venturing into new activities may reduce banks' vulnerability to changes in loan demand, but without resolving the NPL problem and restoring profitability, domestic banks will face difficulties when foreign entry to the banking sector is liberalized. M&As can be value-enhancing, especially if there is complementarity of merging banks' activities or customer segments, but domestic merger opportunities are limited and family ownership and resistance to foreign ownership constitute a constraint on cross-border mergers. On the corporate side, some firms have successfully diversified into non-bank financing and resumed investments, but in many crisis-hit economies leverages are still high and the restructuring of corporate debt is progressing at a very slow pace. Reducing of leverages may especially be difficult in economies where there are limited choices of non-bank financing and for firms in the real estate and construction sectors, which heavily borrowed before 1997 and were hit by property market downturns. Given the limited possibilities that banks and firms can survive without each other, firms are likely to remain banks' main customers and bank financing is likely to remain the major source of financing for banks in DAEs in the near to medium term. Therefore, a rigorous plan to resolve the NPL problem of banks and restructure corporate debt should be put in place. Further, financial reforms should be implemented to ensure that banks have the choice to diversify their asset portfolios and that firms have access to alternative ways of financing.

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