I. Banks and the Crisis

The banking sector can be seen as the relatively innocent victim of processes leading to the currency crises of 1997-98, which then rebounded through the banking system and the real economy in Thailand, Indonesia, Korea and Malaysia. More often, the banking sector has been fingered as a principal culprit implicated in the financial crises, as the behaviour of banks and other financial intermediaries directly created, or contributed to, an over-indebted corporate sector highly vulnerable to exchange rate risks. This is despite the fact that many analyses have pointed to other problems besetting crisis-hit economies: production over-capacity, current account deficits, over-valued real exchange rates, perverse monetary policy, mis-timed capital

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account deregulation and multiple governance failures that distorted processes of capital accumulation and investment.\textsuperscript{2}

Such problems may not all have originated in the banking sector but commercial banks and other financial intermediaries – both foreign and local – played a significant role in translating many of them into the proximate cause of the financial crisis: rapid over-expansion of credit, much of it foreign currency-denominated, followed by an abrupt reversal of lending. Reforming practices in the banking sector thus became a means for dealing with problems that stemmed from broader political economy conditions such as the relationship between business and government (corruption and cronyism, for example) or issues relating to corporate structure and governance. And of course, the currency crises swiftly manifested themselves in the banking sectors of affected countries. The resulting extraordinarily expensive public bailouts to deal with bad debt, compensate depositors (and some creditors) and recapitalize banks and other financial intermediaries ensured that the local banking sector became a primary focus of reform.

Even accounts which attribute the crisis largely to other factors agree that not all was well in the banking systems of most Asian countries before the crisis. There is wide consensus that both the policies governing intermediated finance and policy enforcement were flawed. In the scholarly realm, however, there remains disagreement as to the nature of the policy problems. In one broad camp are those who cite problems relating to too much government intrusion: barriers to entry that created a protected, inefficient banking sector; implicit or explicit guarantees of banks and borrowers that created moral hazard; state-owned banks; and controls on banks such as directed lending and interest rate guidance, which meant that banks were unable to develop proper risk management practices even if they had wanted to.\textsuperscript{3} In another broad camp are those who cite the opposite problem: deregulation and the withdrawal of government guidance that opened the door to a banking sector boom, as banks exploited new freedoms and helped fuel rapid asset price inflation in stock and property markets.\textsuperscript{4}

\textsuperscript{2} An overview of different explanations for the crisis is provided in Noble and Ravenhill 2000a.
\textsuperscript{3} For example, Krugman 1998; Haggard 2000.
\textsuperscript{4} For example, Jomo 1998; Bello 1998.
In one sense, both camps are correct, in that all the crisis-affected banking systems suffered from both types of problem, at least to some degree. Perhaps more pertinently, it was precisely this mixture that produced such potent crises. In Korea (as in Japan) the old system of industrial policy supported by controlled, bank-based financial systems had broken down well before the crisis but ‘asymmetric and unbalanced’ liberalization meant that a market-based financial system failed to emerge. Thus continuing controls on bank lending and episodic political intervention were combined with deregulation of corporate issues of commercial paper and the non-bank financial institutions, producing a precarious financial situation (Hahm 2004: 173-75; Noble and Ravenhill 2000b: 92-95). In Thailand, the country’s largely family-owned and conglomerate-affiliated banks that had operated with reasonable stability in a system characterised by financial restraint (lack of price-based competition) and little capacity for offshore borrowing proved highly dysfunctional once incentives for competition and offshore borrowing were created by partial liberalization in the early 1990s (Pasuk and Baker 1999). In Indonesia, the country’s previously sluggish and highly controlled banking system dominated by corrupt state banks was transformed into a dynamic, rapidly growing one after deregulation in the late 1980s, yet the broader context of regulatory failure, corruption and high levels of particularistic state intervention in the economy remained, producing a particularly toxic mix of incentives (MacIntyre 1993; Cole and Slade 1996; Hamilton-Hart 2002: 45-65). In Malaysia, where the banking sector experienced much lower levels of stress in 1998 than in the other crisis economies, a relatively effective regulatory agency was partially successful in containing problems arising from political intervention, particularistic ties between the government and banks and banking sector booms following deregulation in the 1980s and 1990s (Hamilton-Hart 2002: 119-127). Nonetheless, the worst problems in the Malaysian banking system, which were concentrated in a small number of institutions, can be directly traced to the combination of de-control and ongoing selective state intervention.

Although there were identifiable policy errors in both directions, post-crisis reform programmes have eschewed, in terms of declaratory policy at least, any return to protected, state-controlled finance. For a variety of reasons – the weight of policy orthodoxy, the preferences of the IMF, the political interests involved and the profound
changes in both national and international economic conditions since the heyday of state-led industrial finance systems – policymakers across the region appear to concur that it is impossible and undesirable to put the clock back and return to pre-deregulation policies. Even Malaysia’s capital controls, which provided its banking system with temporary insulation, were imposed in a policy context that advocates preparing Malaysia’s banks for greater international competition. The goal espoused across the region is to create market-based, competitive and internationally-open banking and financial systems. In practice, banking systems and the broader economy in all countries remain subject to varying and in some cases considerable government intervention for other than prudential purposes. Nonetheless, after a period of markedly increased government intervention due to the nature of restructuring and recapitalization programmes, the direction of movement across the region is towards more competitive, internationally open banking systems.

The other major policy lesson that emerged from the crisis was that systems of prudential regulation and policy enforcement needed considerable reform. Whatever the problems inherent in the policy mixes pursued by crisis-affected countries, there is widespread acceptance that these countries suffered from serious problems in policy enforcement, particularly in the area of prudential regulation. While prudential standards themselves have been subject to criticism in some cases, the bigger problem was that the rules that did exist, on issues such as related party lending, concentrated credit risks, financial reporting, provisioning and capital adequacy, were not enforced consistently, or at all in some cases. Political interference in the operations of regulatory agencies, regulator unwillingness to recognize the problems in the financial system, personalized and discretionary relations linking regulators, politicians and bankers, corruption and technical incapacity have all emerged, in different proportions, as factors behind regulatory failure in the crisis-hit countries.\(^5\)

As discussed in the next section, post-crisis reforms across the region aimed to strengthen banking systems through broadly similar programmes of restructuring, recapitalization and regulatory reform. The guiding declared intent behind these reforms has been to emerge with more market-oriented and competitive financial systems

\(^5\) This also applies to Japan as well as the countries which experienced currency crises prior to their banking crises in 1997-98. See Amyx 2004.
buttressed by strong prudential regulatory oversight. Prudential regulations have been overhauled in all countries, which have uniformly endorsed the major international financial standards governing bank regulation. With the exception of Malaysia and Thailand, the regulatory agencies themselves have been subject to significant reforms. How much these aims have been realized varies across countries and over time. As outlined in section three, the actual changes to the structure of banking systems show that the needs of crisis management tended to push outcomes towards much more heavily managed banking systems in the first few years, as the state took over distressed banks and banking assets and directed programmes of consolidation. Mergers and closures of financial institutions produced significant changes to the structure of the banking system in all countries. In the longer term, privatisation and a markedly increased role for foreign investors and foreign financial institutions have characterised the banking systems of all crisis countries except for Malaysia. The resilience and effectiveness of these post-crisis banking systems has also undergone change in two phases, with credit contractions, fragility and low profits marking the first phase, followed by a resumption of lending, improved non-performing loan (NPL) ratios, larger capital bases and a return to profitability, although again performance varies noticeably across the region.

II. Regulatory Changes

Regulator Status and Structure

Major changes to the structure and status of regulatory agencies have been implemented in Korea, Indonesia and Japan. The changes are aimed at creating unified financial sector supervisory agencies that will have greater independence from the rest of the government than their pre-crisis predecessors, changes that mirror moves to consolidate financial sector supervision in many OECD countries. While in practice these goals have not been fully realized, changes to regulator status have been more than cosmetic. In contrast, in Malaysia and Thailand, no major changes to the status and structure of bank regulatory agencies have occurred, although some internal reforms to increase capacity have been pursued.
Changes in Japan and Korea were broadly similar. In Japan, authority over monetary policy was transferred from the Ministry of Finance to the Bank of Japan in April 1998, making the central bank more formally independent. New laws also broke up the finance ministry and established a separate Financial Supervisory Agency (FSA, renamed as the Financial Services Agency in 2000, when it took over another finance-related bureau from the Ministry of Finance). Japan thereby consolidated financial sector supervision in one agency, which was separate from the monetary authority. The new FSA showed itself willing and able to take a proactive and resolute approach to banks that were experiencing difficulties: in addition to nationalizing two major banks and imposing administrative penalties for regulatory violations, by May 2001 it had issued fifty-nine ‘corrective action’ orders requiring banks to raise additional capital and make management changes (Amyx 2003b). On a number of measures, the FSA has been able to demonstrate that it is decisively more independent from both industry and politicians than the finance ministry had been, although it has also been accused of both forbearance and over-zealous enforcement in support of what could be described as political agendas (Amyx 2004; Chey 2006). FSA staff have legal immunity from suits by banks or financial institutions (Barth 2005: database, 2003 survey).

In Korea, a new financial sector supervisory body responsible for the entire financial sector, the Financial Supervisory Commission, was established in 1998. Its executive arm, the Financial Supervisory Service, was created in 1999. This officially marks a step towards a more consolidated system of financial supervision, since before the crisis responsibilities had been shared between the Bank of Korea and the Ministry of Finance and Economy (itself the result of a merger between the Economic Planning Board and the Ministry of Finance in 1994). However, in practice, the Ministry had dominated in both monetary policy and financial sector regulation (including exercising directive oversight of the private commercial banks) and the 1998 reform actually carved up its responsibilities among three agencies. As the Ministry puts it, before the crisis ‘over-concentration of policy decision-making tended to undermine the checks and balances required for effective government’ (MOFE n.d). The Bank of Korea also retains the authority to inspect banks, as does the Korea Deposit Insurance Agency, although this is the responsibility of the FSC.
The FSC/FSS were set up to function independently, free of MOFE and political influence. The head of the FSC is appointed by the President for a fixed three year term and is responsible to the parliament, which can remove the head. Assessing the true independence of the FSC difficult, in part because the meaning of ‘true’ independence is hard to pin down. In some accounts, interventions in support of government attempts to promote corporate restructuring or discretionary forbearance in the interests of stability have been considered as evidence of compromised independence (Walter 2006 [check if can cite]). But there is more evidence that, on the whole, the FSC did not use its influence over the banks to push for aggressive restructuring in line with government goals, but prioritized the preservation of bank balance sheets and capital ratios, often to the detriment of corporate workouts and credit provision (Park 2003; Haggard and Kim 2003). The FSC/FSS is empowered by the prompt corrective action framework introduced after the crisis, which allows regulators to mandate management changes or other actions by financial institutions that fail to meet regulatory standards. Its staff are legally liable for their actions and can thus potentially be sued by banks (Barth 2005: database, 2003 survey).

In Indonesia, the primary bank regulator before the crisis was the central bank, Bank Indonesia, but it did not have full authority for all financial regulation. Finance companies were regulated by the Ministry of Finance and a separate capital markets authority was responsible for securities firms. The Ministry of Finance also made decisions on the issue of banking licences. Bank Indonesia was not legally independent of the government: in theory it was governed by a monetary board of cabinet-level officials and in practice its actions were subject to presidential preferences. Political intervention frequently undermined its regulatory functions and was also blamed for massive issues of emergency liquidity credits to banks during the crisis, when total central bank credits issued ostensibly to stay bank runs far exceeded the entire deposits of the banking system (Soedradjad 2004).

In 1999, a new Central Bank Act, required under the terms of Indonesia’s agreement with the IMF, made Bank Indonesia legally independent. Governors and their deputies are now appointed by the legislature for fixed terms and can only be removed under extreme circumstances. The Bank’s new-found independence was dramatically
demonstrated in 2000-2001, when the government failed in its efforts to remove the governor, who served out his term despite being convicted in connection with a 1999 banking scandal.\textsuperscript{6}

Critics have pointed to the politicisation of the appointment process of central bank governors and directors, as appointments are made by Indonesia’s legislature. Not only does this allow political parties to push for their preferred candidates, but the process has also allegedly been tainted by corrupt payments to legislators by candidates and their supporters. However, these criticisms do not really speak to the issue of political independence. While it is always possible to speculate that particular decisions of the central bank were influenced by pressure from the government, there is no clear evidence of such influence. Indeed, what has been noticeable is that despite facing periodic parliamentary criticism, public differences of opinion with the finance ministry and calls to lower interest rates, Bank Indonesia has publicly defended its policy and prerogatives, all the while maintaining a fairly consistently stable monetary policy (\textit{Jakarta Post}, 20 October 2001; \textit{Kompas}, 11 February 2003; \textit{Kompas}, 6 May 2004). For better or worse, Bank Indonesia appears to enjoy quite a robust level of independence.

The structure of financial supervision in Indonesia was also meant to change according to the 1999 Central Bank Act, which called for an integrated financial sector supervisory agency to be established as a separate entity from the central bank by 2002. Partly as a result of Bank Indonesia’s open opposition to this loss of its functions, later amendments to the law extended this deadline to 2010. There are political and administrative obstacles to the creation of an effective unified financial supervisory agency, and it is not clear how far plans for its establishment have progressed (Siregar and James 2006). In the meantime, bank supervision continues to be the responsibility of

\textsuperscript{6} The case against the governor, Syaril Sabirin, dragged on for over two years, during which time he was detained for 6 months. After his conviction and sentencing to 3 years imprisonment in March 2002 (well after President Wahid, who had been suspected of holding a personal grudge against Syaril, had been ousted from office), the head of the parliament’s finance commission also called for Syaril’s resignation. \textit{Tempo Interaktif}, 31 October 2001; \textit{Business Times}, 14 March 2002. The conviction was overturned on appeal in August 2002. While some commentators have sympathised with Syaril’s claims of innocence, many Indonesians saw the overturning of his conviction as a setback in anti-corruption efforts \textit{Straits Times} 31 August 2002.
Bank Indonesia, which has received technical assistance to improve its capacity from both bilateral and multilateral sources since 1998.\(^7\)

The status of Thailand’s bank regulator, the Bank of Thailand, has not changed decisively since the crisis. The central bank was found to have suffered from both internal weaknesses and political interference in the years leading up to the crisis, with both factors seriously damaging its performance as a regulator and a monetary authority (Nukul Commission 1998). There is no provision for central bank independence under the terms of the 1942 Bank of Thailand Act, which does not provide for fixed terms of office for the governor or deputy governor, or spell out causes for their removal. A central bank official has noted that of the previous nine governors only two had retired from office, ‘the other seven were either fired or pressured to leave by the Government’ (Pakorn 2002). The turnover of governors was especially rapid from 1996 to 2001 (during which time 5 people served), but the current appointment has served since 2001.

Under the terms of the IMF programme, Thailand was supposed to amend its law to provide for central bank independence, and the Bank of Thailand had by 1999 drafted a bill containing standard provisions such as fixed term appointments for the governor and deputy governor, as well as other protections and powers. Central bank officials, strong supporters of the bill, had expected it to be enacted in early 2000, but due to ‘long legal and parliamentary processes’ later revised this estimate to mid 2003 (Sirivedhin and Rungsun 2000; Pakorn 2002). Despite continuing promotion of the bill by the central bank, it had not been passed as of mid 2006.\(^8\)

The Bank of Thailand is the primary banking regulator but shares some powers with the Ministry of Finance. It also does not have authority over insurance or securities companies, or some specialized government banks. Unlike most other central banks in the region is has not had its supervisory authority strengthened since the crisis. A draft Financial Institutions Business bill was proposed after the crisis as part of the reforms agreed to under the IMF programme. It would have unified the regulatory framework and strengthened the central bank’s powers of monitoring and enforcement. Despite having

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\(^7\) Until it was wound up in 2004, the bank restructuring agency, set up in 1998 to deal with problem banks, also had responsibility for banks that had been nationalized.

\(^8\) According to its website, the Bank of Thailand had identified pushing for the ‘formalization’ of the new law in 2004 as an important task for it under its Strategic Plan.
been ‘in the final stages of enactment’ in August 2002 it was not approved. In May 2005 the Bank of Thailand redrafted the bill after the Ministry of Finance had failed to submit it to the parliament on time, and as of mid-2006 it still had not passed (Chandler and Thong-Ek Law Offices 2006). Rather than its regulatory powers being strengthened, the government announced in May 2005 that it intended to balance the power of the central bank by removing supervisory control of financial institutions from the Bank of Thailand to the Finance Ministry, and transferring the supervision of insurance companies from the Commerce Ministry to the Finance Ministry (Chandler and Thong-Ek Law Offices 2006). This announcement was greeted with public criticism and had not been implemented as of mid 2006. Bank supervisory staff are legally liable for their actions and can be sued by financial institutions (Barth 2005: database, 2003 survey).

Malaysia’s financial sector regulator is the central bank, Bank Negara Malaysia. Prior to the crisis it already consolidated most financial sector supervision, being responsible for finance companies, merchant banks and insurance companies as well as commercial banks. It also advises the Securities Commission on the regulation of securities companies. As a financial supervisor, Bank Negara enjoys robust legal authority and its staff are immune from suits arising out of their supervisory actions (Barth 2005, database, 2003 survey). Despite having a reasonable degree of operational autonomy, Bank Negara is not independent by most standards of central bank independence. Unlike almost every other central bank in the region, it openly declares its functions to be ‘carried out within the context of the broader goals of promoting economic growth, a high level of employment, maintaining price stability and a reasonable balance in the country's international payments position, eradicating poverty and restructuring society’ (Bank Negara Malaysia, ‘Objectives and Functions’).

According to the central bank act, the governor is appointed (and terminated) by the constitutional head of state, the deputy governor by the finance minister. In practice, the head of state defers to the Prime Minister. Although some previous governors have been very influential, not all have been.\(^9\) The Central Bank of Malaysia Act was not changed after the crisis, having undergone its last revision in 1994.

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\(^9\) The incumbent governor was effectively forced to resign just prior to the announcement of Malaysia’s capital controls in 1998.
Liberalization

The overall direction of policy change in the crisis-affected economies is towards encouraging more competitive banking sectors. Given the degree of pre-crisis deregulation of banking activities in all countries except Korea, the aim of increasing competition is largely to be met through allowing greater foreign entry to the banking sector and mandating privatization of state-owned banks. However, as discussed in the next section, actual changes to the structure of ownership in the banking sector have only recently begun to reflect these goals.

In the countries under IMF programmes, Korea, Indonesia and Thailand, limits on the foreign ownership of domestic banks were eliminated during the crisis. However, in the case of Indonesia and Thailand, the elimination of the foreign ownership ceiling was for a 10 year period. After this period, in Thailand foreign investors may not acquire additional shares until the ownership stake is maintained below 49% of total shares (Polsiri and Wiwattanakantang 2004: 7). Agreements with the IMF also targeted the early privatization of banks nationalized as a result of the crisis and the eventual privatization of state banks in Korea, Thailand and Indonesia. Financial sector plans announced in Thailand and Korea set out roadmaps for greater liberalization and competitive performance in the banking sector (Bank Indonesia 2003; Bank of Thailand 2004). Japan has also begun to allow the takeover of domestic banks by foreign institutions and accelerated its earlier financial liberalization programme in its 1998 financial sector reforms (Amyx 2004).

Policy change in Malaysia has been less dramatic. It did not lift ceilings on foreign ownership of domestic banks in the wake of the crisis and continues to restrict foreign entry to the banking sector. Before the crisis, the foreign presence in the banking sector through foreign bank subsidiaries was already relatively high by pre-crisis regional standards, although limits on foreign bank expansion curtailed the degree of competition they presented. Malaysia is working towards promoting a more competitive financial sector in line with its commitments for liberalization under the WTO. In addition to its Financial Sector Master Plan, which largely deals with making domestic banks more resilient and competitive, it has also begun to allow foreign banks more freedom to
operate, such as partially lifting branching restrictions (Bank Negara Malaysia 2005, 2006).

In contrast to policies to introduce more market-based competition, there remain a number of policy-based government interventions in the banking sector for other than prudential purposes. Exhortations and guidance with regard to lending targets for small and medium enterprises or specific social groups are common in all the countries discussed here with the exception of Japan. While targeted levels of directed lending are generally low and, with the exception of Malaysia, not enforced consistently, they do represent a continued propensity to see the banking system as needing some direction in order to serve social purposes. Again with the exception of Japan, all the countries retain either full or partial state ownership of some financial institutions.

The other significant policy-based deviation from market-oriented financial policy in all countries lies in their approach to deposit guarantees for the banking system. Making a guarantee system conform to market principles is, in practice, a very difficult task since it is almost impossible to eliminate expectations of public support during a crisis. However, it is clear that the design of guarantee systems in post-crisis Asia fall quite far from the market-oriented end of the spectrum, in that while all countries have moved to create or strengthen deposit insurance systems these are not adequately funded by industry levies. Pre-crisis, guarantee systems tended to take the form of implicit government guarantees, given that deposit insurance systems, if in place at all, were drastically under funded. The Korea Deposit Insurance Corporation (KDIC), for example, had been established in 1996 but had not developed anything like sufficient coverage by the time the crisis broke. In this situation, early in the crisis, the governments of Korea, Thailand and Indonesia introduced explicit blanket guarantees of all banking system liabilities. These were later meant to be changed into partial guarantees that would eventually be funded through industry payments of deposit insurance premia. The extent to which this has occurred is limited. In Korea, the blanket government guarantee through the KDIC was lifted in 2001 and replaced with coverage of deposits up to 50 million won. In 2004, credit unions were excluded from coverage, but the system appears to remain government-backed rather than industry-funded. In Indonesia, the blanket government guarantee is to be replaced by new system of deposit insurance, but the
system appears to be designed to retain a de facto government guarantee of all deposits and thus ensures that the disastrous over-extension of public payments to the banking system in 1997-98 remains very possible in a future financial crisis.\textsuperscript{10}

**Prudential Regulation**

Prudential regulations governing banks have been overhauled across the region, as most countries have declared an intent to adopt new international standards, including the technically onerous ‘Basel II’ standards enshrined by BIS bank regulators in 2004. Before the crisis, most regulators had already begun to adopt the 1988 Basel Accord on capital adequacy but enforcement was highly variable even before the crisis. Mandated capital adequacy ratios in pre-crisis Malaysia, for example, exceeded the 8 percent Basel guideline and, in the case of most banks, reported CARs were not significantly compromised by unreported bad loans. In Indonesia and Japan, in contrast, many banks reported CARs fell below 8 percent and a huge under-reported NPL problem meant that actual bank capital was in many cases much lower than reported.

Once the crisis broke, the condition of most banks in affected countries deteriorated and pre-existing hidden problems also came to light. Crisis management measures were broadly similar in all countries, consisting of the injection of public funds to take bad loans off bank balance sheets and recapitalize banks. Important differences of scale and detail, however, meant that the process in fact varied considerably.\textsuperscript{11} Simultaneously, the authorities in these countries embarked on a process of increasing the transparency and effectiveness of prudential standards. Of the crisis countries, Korea and Malaysia moved most aggressively to raise bank capital adequacy standards. Korea began to enforce the Basel eight percent CAR in 1998, closing down five banks that failed to meet it. CARs calculated according to BIS guidelines have exceeded 10\% since 1999 (Hahm 2004: 184). Malaysia forced banks to recognize bad loans and recapitalize if their CARs fell below the minimum as a result. In both cases, forbearance was exercised in the definition of NPLs when conditions were at their worst, but recognition and provisioning

\textsuperscript{10} For scathing criticism of Indonesia’s new deposit insurance law see McLeod 2006.

\textsuperscript{11} On crisis management outside of Japan, see Haggard 2000; Drysdale 2000; Robison 20002. On Japan’s very different banking crisis, see Amyx 2004.
requirements were subsequently raised. The risk weighted CAR for Malaysian banks has remained above 12 percent since 2001 (Bank Negara Malaysia 2006: Table A.43).

Given the much worse condition of banks in Japan and Indonesia, authorities were not able to enforce capital adequacy and loan reporting standards until much later, and compliance in practice remains incomplete. While Japan has adopted a much more stringent approach to regulation in line with international rules, some of the changes have been cosmetic, falling short of full substantive compliance (Chey 2006). Bank capital levels remain lower than prescribed by international standards. However, compliance gaps co-exist with substantive changes (Kawai 2005). Japan has changed both the rules and the way they have been enforced. As a result of the reorganization of financial regulatory agencies, there has been a decisive change in Japan’s style of financial regulation: from a personalized system based on opaque networks and informal guidance, regulation has become much more transparent and rule-based (Amyx 2003a).

In Indonesia, in the first phase of bank restructuring an initial minimum CAR was set at 4 percent, and banks below that level were forced to close or recapitalize. After several delays, large numbers of banks did close or were absorbed by other institutions. By 2006 the average CAR across the banking sector was officially 21.5 percent, far in excess of Basel Accord standards. However, banks continue to hold large amounts of government bonds which are unrealistically valued and therefore inflate their capital ratios (McLeod 2004: 103-104; IMF 2005: 30). Nonetheless, real average capital ratios for the private banks still meet or exceed the eight percent Basel standard. Absolute capital requirements have also been increased, although they remain relatively low. The central bank has stipulated a minimum capital requirement of 80 billion rupiah (approximately $9 million) by 2007. As of 2006, it reported that 15 banks did not meet this minimum, down from 29 the preceding year (Coordinating Ministry for Economic Affairs 2006). As part of its ‘Indonesian Banking Architecture’ plan over the next 10 years, national banks will be required to have at least 10 trillion rupiah in capital and an international bank at least 50 trillion rupiah. A large number of Indonesian banks are still a long way from reaching this standard.

Indonesia has made many other changes to its prudential framework since 1999. New prudential rules include a requirement for banks to appoint compliance directors
responsible for ensuring compliance with regulations, strengthening of legal lending limits, increased reporting requirements, application of risk management principles and the imposition of a ‘fit and proper’ test on bank management and major shareholders (Siregar and James 2006: 105). Bank Indonesia has also announced that banks will have to comply with Basel II capital adequacy and risk management provisions by 2008, and has revised its supervision to better assess financial risks. What all these changes mean in practice is not clear, given the long record of failure in actually enforcing prudential rules. While Bank Indonesia tends to issue upbeat reports about the improved quality of its supervision, others judge that ‘prudential regulation and supervision seems no more effective now than it had been before the crisis’ (McLeod 2006: 68). The IMF assessment was that a ‘significant amount of investment in human capital will be required’, along with changes in the supervisory culture and responses from supervised institutions (IMF 2005: 32). Certainly, there have been ongoing revelations of fraud and violations of the banking law by Indonesian banks. The fact that some of these scandals have resulted in sanctions being placed on the banks – including the closure of two relatively small banks in 2004 (Siregar and James 2006: 104-05) – can be taken as evidence of at least partial enforcement, or evidence of ongoing regulator failure.

III. Structural Changes

State and Foreign Ownership

No country presents completely transparent data on levels of state and foreign ownership of its banking sector. However, from the information that is available it is clear that there have been major changes to the structure of bank ownership in Indonesia, Korea, and Thailand, with foreign ownership eventually rising significantly after the crisis and state ownership first rising sharply and then falling back, but probably still remaining above pre-crisis levels. Japan has also seen an increase in the foreign presence in the financial sector. Only Malaysia has avoided major change to the mix foreign, state and local private ownership in the financial sector: no foreign take-overs were allowed, and public capital injections into the banks through the recapitalization agency.
Danamodal were comparatively low and re-paid relatively quickly.\textsuperscript{12} A new foreign commercial bank, the Bank of China, did enter the market in 2000, however.

In Japan, state ownership of banks was already minimal before the crisis and only rose temporarily. The major Japanese banks remain under private Japanese control. However, foreign direct investment in Japanese financial institutions rose from $242 million in 1995 to $8.6 billion in 1998. By 1999 foreign investors had dramatically increased their presence in Japanese financial markets, accounting for almost 25 percent of trading on the stock exchange (Laurence 2001, 183).

In Indonesia, the state share of the banking market has increased from pre-crisis levels. Just before the crisis, in July 1997, state banks (including regional government banks) held 38\% of all bank loans, private Indonesian banks held 53\% and foreign banks held 9\%. By the end of 2005, these figures had changed to state banks holding 43\% of all bank loans, private Indonesian banks 43\% and foreign banks 14\% (Pangestu and Habir 2002: 28; Bank Indonesia 2006). Most of the increase in the state bank share is accounted for by the growth in lending by regional government banks after decentralization. While the government has re-privatized most of its holdings in banks nationalized during the crisis, there is no indication of any serious intent to fully privatize the state banks, despite earlier commitments under Indonesia’s IMF programme.

Based on Bank Indonesia’s official figures cited above, the foreign share of the banking market has increased from pre-crisis levels, but not dramatically. In fact, the foreign presence in the Indonesian banking sector has undergone a much greater increase. Before the crisis foreigners did not hold strategic stakes in Indonesian banks. Now they are the controlling shareholders in the largest private Indonesian banks and hold significant stakes in several medium size banks as well. This presence is not captured by the central bank’s statistics, which continue to classify ‘national’ private banks as non-foreign, even when foreigners are controlling shareholders. The aggregate level of foreign ownership is hard to calculate. One account judged that, at the end of 2005, ‘41 of Indonesia's 131 banks were under the ownership of foreign investors, representing an overall 48\% stake in the banking industry’ (Department of State 2006). Given that there

\textsuperscript{12} Danamodal did not inject new capital into any financial institution after December 1999, and its total capital disbursed declined from RM7.5 billion to RM2.1 billion due to repayments by the end of 2001. Chin 2004: 213.
were 28 officially recognized foreign banks at this time, this suggests foreign control of another 13 banks. This roughly fits the announced record of re-privatizations of the banks that were nationalized during the crisis, in which most of the eventual sales (after highly politicised and delayed processes) went to foreign-led consortia. This included the largest private banks, Bank Central Asia and Bank Danamon. In addition, foreign banks became substantial shareholders in some of the medium size Indonesian banks that were recapitalized without being nationalized during the crisis.

The increase in foreign ownership and presence in the Thai banking sector has been more dispersed and occurred from a much earlier date than in Indonesia, where most sales to foreigners only occurred after 2002. The temporary increase in the state ownership of banking assets was also smaller than in Indonesia. In 1998 the government took over 6 of the smaller private banks as they were insolvent or unable to meet recapitalization requirements. These banks were mostly merged into the three state-owned banks, Krung Thai Bank, Bank Thai and Siam City Bank, with one being taken over by a new bank (Radanasin) established to take over the viable assets of the 56 closed finance companies. Radanasin was then sold to Singaporean UOB (Polsiri and Wiwattanakantang 2004: 3-4). In 2005, a specialist bank to service small and medium enterprises was opened, with the Ministry of Finance as the largest shareholder, in partnership with Bangkok Bank. The state presence thus seems to have increased slightly over pre-crisis levels, although its ownership stakes may be reduced in the future.

The situation changed more dramatically for Thailand’s private banks. Families or family groups had been the single largest shareholders in 12 of the 15 banks operating in Thailand in 1996 (Polsiri and Wiwattanakantang 2004: 9). Of those which escaped nationalization, several were forced to invite in foreign investors in order for them to meet recapitalization targets in 1998 and 1999. In 2000 foreign investors held a significant portion (over 30 percent) of the shares in the four largest of the private Thai banks, has well as majority shares in the four smallest (Suehiro, table 2).

Many of these assets were later transferred to the state asset management company, which mainly absorbed NPLs from the state banks.

In early 2006, the Financial Institutions Development Fund (FIDF) announced it was preparing to publish the requirements for strategic partners interested in buying a stake in state-owned Krung Thai Bank, BankThai and Siam City Bank. FIDF said that the central bank will not sell the banks to foreign investors. FIDF owns 56.4 percent of Krung Thai Bank, 49 percent of BankThai and 47.6 percent in Siam City Bank. (The Asian Banker, 6 March 2006).
By 2006, 17 commercial banks were operating as the result of six new banking licences having been granted and three banks being merged into others. Two of the new entrants were foreign banks (GE Money and the International Commercial Bank of China). Overall, of the 17 banks, six had an identifiable foreign investor as the largest shareholder, four were state owned and seven, including the largest banks (Bangkok Bank, Kasikornbank (the renamed Thai Farmers Bank) and Bank of Ayudhya were controlled by Thais. However, foreign investors as minority shareholders held significant stakes (up to 49%) in many of the Thai-controlled banks.

Korea followed the same pattern of first a rise in state ownership as a result of nationalization then foreign ownership as a result of re-privatization. The first sale was something of a showcase for Korea’s reform programme, as the government disposed of Korea First Bank on generous terms to a U.S. investment firm (Newbridge Capital) at the end of 1999 (Yun 2003: 251-55). The next sale of a majority stake to a foreign investor did not occur until 2003, with the sale of in Korea Exchange Bank to the U.S. Lone Star fund (which had lost out on its bid to acquire a different Korean bank in 2002). Before this time, however, foreign investors had been acquiring significant minority stakes in several banks, including stakes of more than 30 percent in Korea Exchange Bank held by Commerzbank and in Koram bank by a U.S. consortium. In 2004 Koram was sold to a single majority foreign investor, Citibank. Of the eight major ‘nationwide’ banks listed

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15 Two of these banks, Bangkok Bank and Kaisikornbank (then Thai Farmers) had a foreign investor as the single largest shareholder in 2003, according to Polsiri and Wiwattanakantang (2004: Table 7). Family control seems to have been maintained, however, either despite low levels of share ownership or as a result of buying back into the bank. For example, members of the Lamsam family held positions as CEO, Chairman and another directorship of Kaisikornbank in 2006, despite their stake having dropped to less than six percent by 2000 (Kaisikornbank website and Suehiro, table 2). They were not listed among the 10 bank’s largest shareholders in 2006.

16 Ownership details in many cases are obscure. The Stock Exchange of Thailand is listed as the single largest investor in Bangkok Bank, Kasikornbank and Tisco Bank, and its fully-owned subsidiary is also listed as owning significant stakes in several banks. Substantial shareholders are not necessarily revealed as several banks only list their 10 largest shareholders, many of which are nominees companies. [CHECK – what does SET ownership mean? is it a proxy? SET itself appears to be state-controlled.]

17 The bank was later acquired by Standard Chartered in April 2005 and renamed SC Jeil Eun Haeng (SC First Bank). At this time it was the 7th largest bank in Korea (Standard Chartered 2005), or one of the smallest of the eight ‘nationwide’ banks.

18 Before the sale Commerzbank already held 32 percent of KEB but did not control the bank. It sold part of its stake to Lone Star in 2003 and disposed of another major block of its remaining shares in 2006, for 703 billion won ($726 million). At the time press reports suggested that Lone Star Fund would also exit from the bank when it had the opportunity (Business Times, 27 Aug 2003; The Asian Banker, 6 March 2006).
by the FSS as operating at the end of 2004,\textsuperscript{19} three were majority foreign owned and one had a foreign investor as the single largest shareholder.\textsuperscript{20} The government no longer held controlling stakes in any of these banks, but continued to run five specialised development-type banks.\textsuperscript{21} By 2006 this was reduced to four specialized banks, and the government announced plans to reduce its stake in one of them, the Industrial Bank of Korea (\textit{The Asian Banker}, 6 March 2006).

\textit{Consolidation}

The number of banks and other financial intermediaries has been significantly cut since 1998 in all the countries considered here. Before Japan’s financial crisis came to a head in late 1997 there had already been a string of closures and takeovers of smaller institutions. Over the decade starting in 1991 more than 170 banks and depository institutions went bankrupt, although 130 of these involved small-scale credit cooperatives (Horiuchi 2003: 89). In 1995 several housing and loan institutions were forced to close and the Ministry of Finance arranged rescues of some larger commercial banks by the major banks from 1996. Since 2000, mergers involving Japan’s largest banks have transformed the financial scene, as five new banks have been created from mergers of fourteen of Japan’s largest banks (Amyx 2003b). [update]

The number of private banks in Indonesia has more than halved. There were 164 private national banks in January 1997, 130 in mid 1998, 93 in March 1999 and 71 in January 2006. Also between 1997 and 2006, the number of foreign and joint venture banks was reduced from 44 in 1997 to 28, while the number of state banks dropped from 7 to 5 as a result of mergers in 1999 (Bank Indonesia 2006). The fifteen largest banks account for about 70 percent of banking assets (IMF 2000: 27). The central bank continues to urge smaller banks to merge, but has had no success in persuading banks to consolidate over the last few years.\textsuperscript{22} In 2006 it announced plans to push consolidation through a ‘single presence’ policy that would require banks with common ownership to

\textsuperscript{19} The government sold Chohung Bank to Shinhan Financial Group in 2003, but the FSS continued to list them separately.
\textsuperscript{20} Singapore’s government-owned Temasek Holdings became the single largest owner of Hana Bank shares in 2004, with a ten percent stake in the bank. \textit{Business Times}, 18 February 2005.
\textsuperscript{21} CHECK KDIC’s holdings of Woori.
\textsuperscript{22} About 75 small banks have assets of less than 1 trillion rupiah. IMF 2005: 28.
merge. However, if this is enforced it will almost exclusively affect the larger foreign-invested banks rather than the small banks with low capital levels.

In Korea, of the 33 banks operating at the end of 1997, five were closed and mergers reduced the number of commercial banks (including regional and specialized banks) to 19 as of June 2004. An even larger change occurred to the merchant bank segment, which was responsible for much of the short term foreign currency debt of Korean firms before the crisis. This category of financial institution has almost been eliminated: from 30 merchant banks at the end of 1999 the number had declined to two in 2004 (Bank of Korea 2004). There has been a corresponding concentration of the banking market. The share of the top three commercial banks rose from 28 percent of total bank assets in 1997 to 53 percent in 2003 (Hahm 2005: 390).

In Thailand, although several banks were closed or merged in 1997-1999, new issues of banking licences have seen the total number of commercial banks rise from fifteen to seventeen (domestic and foreign). The more dramatic consolidation was the closure of 56 finance companies early in the crisis.

In Malaysia, consolidation also began with forced mergers among the 39 finance companies, reducing their number to 23 by the end of 1999 and three by 2005. The major phase of consolidation began in July 1999, when the central bank announced a plan to create a radically streamlined financial sector organized around six ‘anchor’ banks. At the time, there were 21 domestic banks, 25 finance companies and 12 merchant banks. Both the timeline for mergers and the selection of the particular six were heavily criticised for being politically motivated and several bankers tried to resist the forced merger programme (Chin 2004: 217-20). Bank Negara then amended its programme, announcing minimum capital requirements and allowing financial institutions to identify their own partners with the aim merging the financial sector into ten bank-based groups. The merger programme was largely complete by the end of 2001 and finalised in 2002. At the end of 2005, there were ten domestic commercial banks to which were affiliated the three remaining finance companies, two of the six Islamic banks and all ten merchant banks (Bank Negara Malaysia 2006). In 2006, another bank merger was agreed, which would reduce the number of domestic commercial banks to nine. Over the whole period, the
number of foreign banks remained at 13, although this included one new entry and one merger.

Growth and Resilience

All the affected banking systems experienced a slow-down or a reduction in bank lending due to the crisis. The contraction of credit was most dramatic in Indonesia, when total commercial bank lending to the private sector dropped from 360 trillion rupiah at the end of 1997 to 208 trillion rupiah at the end of 1999. The drop in loans by private banks was particularly sharp, from 180 trillion rupiah to a low point of 56 trillion rupiah in November 1999. Loan growth did not pick up until 2001, with banks continuing to hold a high proportion of government securities in their portfolios (Bank Indonesia 2006). Since then, the rate of credit growth to the private sector has increased at an annual average rate of nearly 20 percent, much faster than in the other regional countries (IMF 2005: 28). However, at end 2005 the banking system’s loan to deposit ratio stood at only 53 percent, although this did mark a major rise from 26 percent in 1999, and the central bank announced it was confident that it would increase further in 2006 (Jakarta Post, 1 July 2006). For the present, however, the banks’ intermediation of deposits remains far below the 80-90 percent ratio in other regional countries.

Korean banks also reduced their lending, especially to the corporate sector, and increased their holdings of both government and corporate securities – the former out of preference for safer assets and in order to support their capital ratios, the latter as a result of debt restructuring deals (Hahm 2004: 179-80). Bank assets returned to faster rates of growth after 2000, and consumer lending in particular increased, rising from 20 percent of bank lending in 1996 to 50 percent by 2002 (Hahm 2005: 393).

Both Malaysian and Thai banks heard periodic calls from the government to increase their lending in order stimulate growth. While overall bank lending continued to increase at a moderate rate in Malaysia there has been little growth in loans to enterprises. Instead, growth has been led by a shift in lending to the household sector, which accounted for 43 percent of bank credit in 2001 and 55 percent in 2005, over which time the share of lending to enterprises dropped from 50 percent to 40 percent (Bank Negara Malaysia 2006: Table A.38). Thai banks have been even less responsive to calls to
increase lending. Bank credit to the private sector in Thailand remained almost stagnant over 2000-2004, the lowest rate of growth in the region apart from Japan, where loan growth only turned positive in 2005, as NPLs declined (IMF 2005: 28; PricewaterhouseCoopers 2006: 7). Lending from the offshore banking facility, the BIBF, that played a major role in channelling foreign loans to the Thai economy before the crisis has virtually ceased. In 1997, loans from the BIBF made up 23 percent of total bank credit, in 2005 the share was only 1 percent.

One reason for slow growth is that Thai banks are still carrying high levels of bad debt, due to a much less aggressive approach to carving out NPLs from the banking system during the crisis. The overall level of NPLs in the Thai banking sector was 8.3 percent at the end of 2005.\(^{23}\) This was higher than even Indonesia, where net NPLs were at 4.8 percent in 2005, although the ratio rose to 6.4 percent by April 2006 after a change in NPL classification. As of 2005, state-owned banks’ NPLs accounted for 72% of total NPLs in the Indonesian banking industry, a situation that was officially attributed to their limited powers to restructure loans given the legal definition of the debt of a state-owned bank as a state asset, meaning that state-owned banks cannot write off the principal and interest on such loans (Coordinating Ministry for Economic Affairs 2006). Their condition also had a lot to do with their much poor credit practices and ‘outside interference’ (IMF 2005: 31)

Malaysian NPLs have fallen steadily since 2001 but remain moderately high at 5.7 percent in early 2006. In contrast, banks in Korea are in a much stronger position on this measure. Official NPLs peaked in 1999 at 13.6% but had dropped to 3.3% in 2001, largely as a result of government purchases of NPLs through the Korea Asset Management Corporation, as well as write-offs and debt restructuring (Hahm 2004: 184, 193).\(^{24}\) NPLs for all the major banks have remained at less than 3 percent since then. NPLs were reduced more slowly in Japan but by 2006 the net NPL ratio stood at 1.2 percent of total loans, compared to 6.2 percent in 2002 (PricewaterhouseCoopers 2006: 6).

\(^{23}\) NPLs for Indonesia, Thailand and Malaysia are as reported by their central banks.

\(^{24}\) Government spending to resolve the bad loan problems of the commercial banks came to 24 trillion won between November 1997 and June 2001.
With the increase in the rate of loan growth in most countries, along with lower provisioning levels, banks have returned to profitability. Malaysian banks have maintained positive net growth in profits since 2000 (Bank Negara Malaysia 2006: Table A.42). In Korea, average returns for the banking sector turned positive in 2001, after provisioning levels dropped (Hahm 2004: 184). Profits again suffered as a result of a credit card lending crisis in 2003 but rebounded strongly in 2005, when the aggregate profits in the banking sector were expected to increase by over 50 percent (The Asian Banker, 13 February 2006). Indonesian banks have also reported high profits in recent years and are currently among the most profitable in the region, reflecting relatively high growth (IMF 2005: 29). The major Japanese banks finally returned to profitability over 2004-2005, after years of making losses. While profits and CARs can be taken as indicators of financial health, they are not necessarily correlated with other measures of resilience. For example, Moody’s average bank financial strength index rated Indonesian banks the lowest in the region at 7.3 despite their profits and high CARs. This compares to index figures of 15.8 for Thailand, 18.3 for Korea, 35.2 for Malaysia. Given that Singapore’s banks were rated at 74.7 in the same survey, this suggests that despite improvements, the banking sectors of all crisis countries remain fragile when compared to the strongest in the region.

IV. Actors and Incentives

External and domestic forces have played roles in determining the mixture of change and continuity in each country’s banking sector. External political forces, in the form pressure by the IMF and other IFIs, bilateral pressure and multilateral commitments under the WTO framework, have been pivotal at some decisive moments over the last decade. However, in the absence of either longer term structural incentives or domestic political support, external political factors have not been able to sustain changes that depend on ongoing domestic implementation efforts. External market forces have played a more insistent role in creating incentives or influencing policy viability, but whether

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25 As of December 2004. The higher the index score the higher the financial strength. As cited in IMF 2005: 31.
26 This section and the next are sketches; to be filled out more systematically.
policies respond to these incentives remains subject to the balance of domestic political forces in each country.

The crisis itself represented an acute form of market pressure that forced a policy response in all countries. Some of the commonalities in crisis management across the region, in particular the injection of public funds into the banking sector, reflect the immediate dictates of market pressure. Market-led changes that eroded the viability of earlier bank-based industrial policies by creating alternative channels for investment and savings have also created long-term incentives for policy adjustment. Japan’s extended programme of financial liberalization since the 1980s is a partial response to such structural pressures (Laurence 2001). Similarly, the effectiveness of both Korea’s earlier system of industrial finance and Thailand’s family-based bank and conglomerate structure broke down under conditions of capital account openness and access to global financial markets. Since no Asian country has the capacity to significantly alter the international regime that sustains a system of globalized finance, all have faced incentives to adopt domestic policies that take this context into account.

This structural context makes policies of segmented finance and certain types of directive control highly costly and ineffective, but it is not determinative when it comes to the content of policies governing the financial sector (Blyth 2003). Hence while all regional countries have learnt from experience that the risks associated with open financial systems create incentives to develop monitoring systems and prudential standards, the design and content of these standards are politically determined. The bank regulation standards with international status have been determined largely by European and, in particular, American regulators (Kapstein 1994; Oatley and Nabors 2000; [on Basel II]). Given the status of prudential standards enshrined in agreements such as the first Basel Accord (1988) and the ‘Basel II’ agreement, the prudential reforms adopted in Asian countries over the last decade have taken these international standards as a template. Even though the standards themselves are as much the product of political expediency as technical rationality, their status ensures that individual countries have little incentive or capacity to develop alternative prudential rules except as add-ons that are consistent with international standards. For example, national authorities in countries such as Malaysia and Singapore have held banks to higher capital adequacy ratios than
mandated by the Basel Accord, but their basic regulatory framework follows international norms.

There is little evidence that markets themselves play much of a role in disseminating or enforcing international standards governing banks (Walter 2006 [check if can cite]). At the most, they do so inconsistently. External political actors have played more of a role in this respect in post-crisis Asian countries, particularly because the crisis opened the door to influence via IFI lending programmes in Thailand, Indonesia and Korea. This is another factor behind the degree of uniformity in the direction of change towards greater foreign access, liberalization and enhanced regulator status and independence. These changes were all explicitly mandated by the terms of IMF programmes in the region (e.g. Feldstein 1998); and as discussed above, on several measures these programmes have been at least partially implemented and have produced significant changes. On occasion, the IMF has been able to sustain its influence beyond the immediate crisis period. For example, in the course of its attempts to remove the central bank governor in 2001, Indonesia’s government considered legislation that would have weakened the degree of central bank independence provided for by its 1999 central bank law (a product of the country’s IMF programme). In this case, the IMF had the muscle to prevent this attempt from proceeding, as it held up funding instalments to Indonesia until the issue had been shelved (Business Times, 15 March 2001, 17 April 2001). The salience of both market and external pressures for change can also be judged by the course charted by Malaysia, where market and external political pressures have been lowest. While Malaysia has adopted the core international prudential standards and has declared an intention to phase-in the Basel II requirements, it has moved the least of any country in the region on issues of foreign entry to the banking market and regulator independence.

Even in the countries under IMF programmes, however, domestic political factors have been more important in the longer-term, particularly on issues that require ongoing enforcement. For example, IMF pressure could help domestic parties in Thailand in their efforts to draft laws that would have empowered the central bank, but it could not force these bills through the Thai parliamentary process. In the case of Korea’s extensive reform programme, it is clear that the IMF pressure was only able to catalyse as much
change as it did because of the reformist commitments and political capacity on the part of the Kim Dae Jung government (Haggard and Park 2003). The IMF programme was not effective in forcing change on issues where the government was either unwilling or politically unable to implement reform commitments.

V. Implications

The changes that have occurred in Asian banking systems over the last decade have produced somewhat more efficient, more market-based banks and corporate sectors that are less reliant on bank financing. To the extent that the Asian high-debt, high-growth ‘model’ was operating before the crisis, the crisis and its aftermath have effectively extinguished it (Wade and Veneroso 1998). To varying degrees, banking systems now have a larger foreign presence either through direct entry or investment in domestic banks. State ownership of banks has diminished since 2002 but is far from being eliminated in Indonesia, Thailand and Malaysia. Systems of prudential regulation have been brought closer to international norms as regards the content of prudential rules in all countries. Changes to regulator status and structure have also brought Korea and Japan close to having unified, independent regulatory agencies separate from the monetary authority, while Indonesia’s regulator is independent but not fully unified and not separate from the monetary authority. Malaysia’s regulator is unified but not independent and not separate from the monetary authority, while Thailand’s is none of these things.

In terms of their efficiency and stability, regional banking systems have at least on the surface improved their performance: capital levels are higher, non-performing loans are lower, profits have returned and other measures of efficiency have increased, although many domestic banks still score relatively poorly on several tests of efficiency (Williams and Nguyen 2005). In conventional terms, the greater foreign presence and privatization of state banks, to the extent it has occurred, should push banking systems to be more efficient, have better risk management and hence be less vulnerable to instability (Clarke et al. 2005). Market participants and national regulators share a general confidence that foreign entry has beneficial effects, in terms of risk management, technical expertise and organizational innovation (CGFS 2005). Certainly, foreign
ownership has made a difference to bank performance in some cases where there have been high profile takeovers, such as in Korea (Yi and Park 2006). The benefits of foreign entry and privatization are probably contingent, however. The big state-owned banks in Indonesia are clearly the country’s worst performers. But some state-owned banks in other countries, such as Malaysia and Singapore, have relatively good records. And while foreign entry is associated with more competitive financial systems in advanced countries, some empirical studies have found that, in lower income countries, the effects of state ownership are not uniformly negative, and foreign presence is associated with less credit provision to the private sector and not necessarily more efficient financial sectors (Detragiache et al. 2005, 2006).

In some respects it is too soon to tell what the long-term effects of the changes that have occurred will be. Many of the improved indicators registered by regional banking systems reflect the crisis-related injections of public funds which cleaned up bank asset sheets, as well as the return to relatively buoyant economic conditions. Whether the improvements will be sustained over the longer-term, or in the event of external pressure, remains speculative. Some vulnerabilities, such as levels of corporate debt and bank exposure to the corporate sector, have clearly decreased. But the household sector which has taken on a new significance in bank portfolios is not necessarily more stable in the face of a future economic downturn, particularly as levels of household debt (still relatively low in most of the region compared to Europe and the U.S.) begin to rise. On the other hand, to the extent that levels of related lending were a factor behind the poor quality of bank portfolios before the crisis, banks are less vulnerable now because banks in countries such as Indonesia (and merchant banks in Korea) are no longer part of family-owned conglomerates. In addition to limits on related lending having been tightened, this structural change has greatly reduced the potential for related lending.

Over the longer term, the changes to the regulatory agencies’ structure and status may in some countries have made them more effective. Japan now has a fully integrated structure of supervision, and Malaysia and Korea have partially integrated supervisors. A

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27 Officially, there are no state-owned commercial banks in either Malaysia or Singapore (Barth 2005). In both countries, state ownership is below 50 percent in the banks which have significant stakes ultimately held by the government. In both cases, these stakes are held by state-controlled funds or holding companies, rather than directly by the government.
recent review of empirical experiences suggests that integrated supervisory structures are associated with higher quality supervision in some sectors and greater consistency of supervision (Cihak and Podpiera 2006). However, the transition to an integrated structure is not easy, and does not in itself resolve underlying issues of regulator capacity or corruption (Siregar and James 2006). Hence even if the agenda of integrating financial supervision in Indonesia is realized, it is unlikely to redress Indonesia’s broader problems with regulatory effectiveness and consistency.

Similarly, formal regulator independence does not appear to be a major determining factor of regulatory effectiveness. While moves to strengthen the independence of regulatory agencies in Japan and Korea have been associated with better performance, this can also be attributed to increased political commitment to regulatory integrity. In Indonesia, formal independence does not seem to have decisively affected the performance of the central bank, while in Malaysia the clear-cut lack of formal independence of its regulatory and monetary agency has not prevented it from being largely effective in both areas. The wider context of corruption and political commitment to regulatory enforcement therefore seems to be more determinative than the formal status of the regulator.

Overall, the changes that have occurred in regional banking systems over the last decade have reduced some of the specific vulnerabilities they exhibited pre-crisis: levels of connected lending, non-performing loans and capital ratios have all improved at least temporarily. While there is now no longer much scope for connected lending in countries where it was problematic, the healthier financial ratios that banks are currently reporting could deteriorate. Whether there have truly been improvements in the quality of banks’ risk assessment and management processes remains hard to assess. In some cases, banks taken over by foreign institutions appear to have greatly altered their credit culture and internal controls. Given the role of foreign banks and offshore lenders in over-supplying credit to Asia before the crisis, foreign ownership in itself does not ensure that credit decisions will be fault-free. The new regulatory context is meant to ensure that both local and foreign suppliers of credit will be held to better practices through new rules on disclosure and risk management, and most large banks in the region are in the process of upgrading their internal systems to meet Basel II requirements. The burden of ensuring
compliance, however, continues to rest, ultimately, on national regulators with very uneven capacities.

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