Chapter 8

THAILAND, MALAYSIA AND THE PHILIPPINES

Thailand, Malaysia and the Philippines suffered similar exchange rate, interest rate and stock exchange shocks in 1997 and 1998. They are pursuing similar reform agendas and responding to similar financial sector problems, albeit at different scales and over different time frames. While Malaysia and Thailand did not suffer a systemic breakdown like Indonesia's, they face serious non-performing loan, NPL, problems; NPLs also rose in the Philippines. All three economies are consolidating their fragmented banking systems, upgrading prudential controls and developing capital markets. Malaysia and Thailand have larger, more developed financial markets than the Philippines, but the Philippines has implemented reforms driven by earlier financial crises. Policy makers in all three economies are conscious of impending regional and global liberalisation of financial services, potentially by 2003, and the need to upgrade the competitiveness and stability of their financial systems.

This chapter discusses the impact of major financial sector regulatory and legal reforms undertaken before and during the crisis, and assesses the impact of the financial crisis on financial markets in these three South East Asian economies. It also examines the progress in restructuring and recapitalising banks in Thailand and Malaysia, and their financial sectors' medium to long term prospects, including further opening to foreign investment. The chapter then analyses the ongoing opening of the Philippine banking system to foreign competition, and some major challenges it faces including increasing competition and reducing intermediation costs.

THAILAND

While Thailand's financial crisis is not as severe as Indonesia's, the major depreciation, capital flight and corporate insolvencies since 1997 have wrought havoc on the financial sector. The crisis eroded most of the banking system's capital, undermined nascent capital markets and highlighted serious shortcomings in the financial sector's regulatory, supervisory and legal framework. The Government opted not to bail out the banking system with public funds or impose tight recapitalisation and provisioning timetables, but mainly left bank owners to determine their own solution. This policy approach has delayed financial and corporate restructuring, the resumption of lending and a return to self-sustaining economic growth. Political manoeuvring by vested interests and cultural factors have frustrated the Government's reform agenda.

Nevertheless, the Thai Government has undertaken significant reforms in a reasonably short time, and financial and corporate restructuring seems to have accelerated since March 1999.

PRELUDE TO THE CRISIS

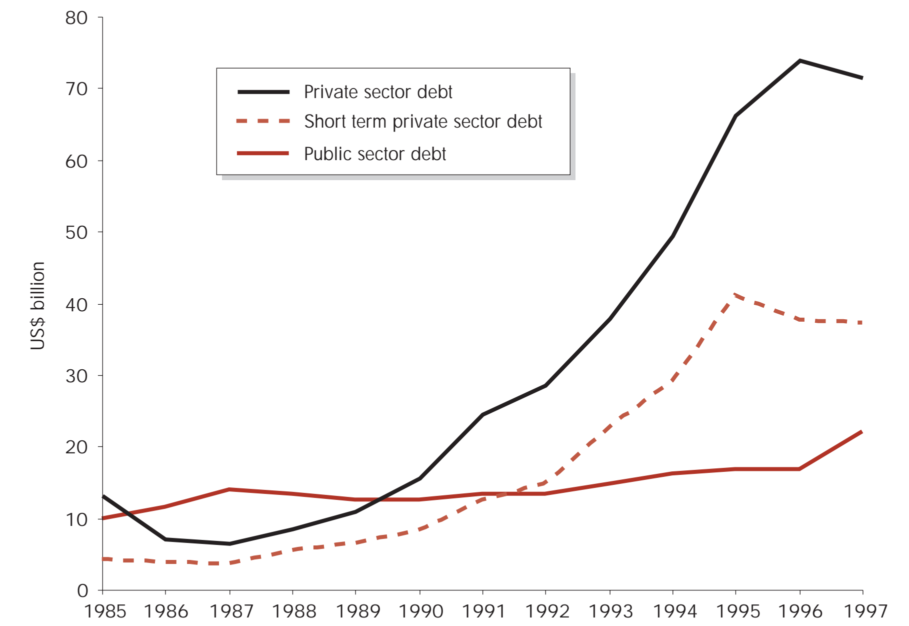
After experiencing considerable economic success in the 1980s, Thailand's economy became increasingly vulnerable from 1993 due to a build up in short term foreign debt, strong credit expansion and asset booms. In 1996 and 1997, conditions deteriorated rapidly after the Thai baht appreciated in real terms, export and GDP growth slowed sharply, and the current account deficit widened to 8 per cent of GDP. Heavy foreign borrowing pushed external debt to 50 per cent of GDP. Growing difficulties in the property sector, a sharp stock market correction and a weaker government fiscal position compounded problems. The financial system, particularly finance companies, showed serious weaknesses. Corruption scandals in government also restricted economic and political reforms, undermining investor confidence.

In the 1990s, while Thailand's public debt fell, private sector foreign debt expanded rapidly. For nine years, government budget surpluses reduced public sector debt from over 50 per cent of GDP in 1987 to under 16 per cent of GDP by 1996. However, over the same period, private sector foreign debt rose from US$6 billion to over US$70 billion; 40 per cent of this was short term foreign borrowing (Figure 8.1) (World Bank, 1999b). Thailand experienced external pressure from foreign creditors refusing to roll over short term bank loans and currency speculation. A lending boom, mainly to real estate, and a history of poor risk management and credit assessment by domestic and foreign financial institutions, accentuated this vulnerability.

Figure 8.1

Short Term Private Sector Debt Outstrips Public Debt

External Private and Public Debt, 1985-97



Source: World Bank, 1999a.

In early 1997, as the economy slowed and asset prices fell, concerns deepened about the health of banks and finance companies, resulting in a series of speculative attacks on the baht. In early 1997, the Thai central bank sold a large proportion of Thailand's foreign exchange reserves to defend the pegged exchange rate. On 2 July 1997, the Thai Government abandoned the peg and introduced a managed float, allowing a 20 per cent depreciation. Net usable reserves had fallen to only US$1 billion, a few weeks of imports, when the Thai Government negotiated an emergency support package with the IMF (Nomura Securities, 1999). However, weak political leadership, reports borrowers were having difficulty rolling over short term debt and indecisive treatment of 58 suspended finance companies precipitated a widespread loss of confidence in the Thai economy. Over the second half of 1997, the baht's value halved. In November 1997, the new, reformist Chuan Government embraced a stronger IMF program, calmed markets and eventually enabled currency and financial stability to return.

IMPACT OF THE CRISIS ON FINANCIAL MARKETS

By the third quarter of 1997, the currency crisis had quickly become a major financial crisis. Bank assets, already poor due to excessive credit growth and weak credit analysis, weakened dramatically after devaluation, and Thailand faced systemwide financial sector problems. High corporate and financial sector exposure to unhedged, short term foreign borrowing undermined corporate and financial institution viability. This and the high interest rates needed to defend the baht caused the economy to contract sharply, in turn raising banks' NPLs, eroding bank capital and constraining new lending. The Government incurred huge liabilities supporting insolvent financial institutions through the Financial Institutions Development Fund. New bank lending almost ceased; interest rates rose dramatically; consequently investment collapsed, causing the real economy to contract 9.4 per cent in 1998.

MAJOR POST-CRISIS REFORMS

In July 1997, Thai authorities abandoned their unsuccessful defence of the baht, and announced they would replace its peg to a basket of currencies with a managed float system. The pegged exchange rate system had encouraged unhedged foreign borrowing, which, with yen depreciation from mid 1995 contributed significantly to Thailand's declining export competitiveness, weaker GDP growth and diminishing creditor confidence.

In October 1997, to prevent major bank runs, the Government extended depositor guarantees to all domestic bank and non-bank customers via its Financial Institutions Development Fund. Once the banking system stabilises, the Government will replace this blanket guarantee of financial system liabilities with a limited, self-financing deposit insurance system (World Bank, 1999c).

Prudential Reforms

As part of the IMF program, the Thai Government has introduced many new reforms to tighten prudential regulations and supervision, ensure systemic stability and increase financial sector transparency and competition. In October 1997, it amended the commercial banking law; now the Bank of Thailand can take prompt corrective

action including changing management, recapitalising distressed financial institutions and ultimately suspending their operating licences.[1] In March 1998, the Government determined banks needed to classify all their loans according the standard international five tier system by the end of 1998; stop accruing interest income on NPLs in January 1999; and meet tighter capital provisioning for classified loans by the end of 2000.[2] The Government also tightened eligibility guidelines for owners and managers of financial institutions (Bank of Thailand, 1998). These reforms increased confidence in the banking system, but were introduced gradually to reduce the negative effects on bank liquidity and lending capacity.[3]

In July 1998, to increase transparency, the Government announced all financial institutions must review their on and off-balance sheet loan portfolios; at the end of each quarter, they must submit results, including data on loan classifications and provisioning to the Bank of Thailand.

International Competition

The most important reform to promote financial institution competition and efficiency was to allow 100 per cent foreign ownership of Thai financial institutions for a ten year period.[4] When international banks buy a major share in distressed or nationalised Thai banks, the Bank of Thailand typically agrees to pay around 85 per cent of the losses incurred by banks' asset management companies in disposing of NPLs.

Before the crisis, 15 domestic banks and 91 finance companies held 85 per cent of household savings and extended 90 per cent of loans (Bank of Thailand, 1998; and Nidhirabha and Warr, 1999). Some analysts believe as few as six of the original 15 banks will survive in Thai ownership in the medium term (Noruma Securities, 1999). Of the 15 banks, Thai Danu and Bank of Asia already are foreign owned; deals have been agreed for foreign takeovers of Nakornthon and Radhanasin banks; and two more banks are for sale by the end of 1999. Most other banks are seeking strategic foreign partners, although some may remain Thai controlled.

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[1] This initiative required the authorities to develop standard exit procedures for failing banks and introduce new legislation to close and liquidate financial institutions.

[2] The new classifications and provisioning requirements are pass (1 per cent), special mention (2 per cent), sub-standard (20 per cent), doubtful (50 per cent) and loss (100 per cent or write-off). Previously only loans overdue by more than 12 months were classified as NPLs; now ones overdue by three months are classified as sub-standard.

[3] Other regulatory changes are designed to make finance companies subject to the same regulatory standards as banks and encourage financial sector consolidation. For example, larger finance companies now can amalgamate and apply for banking licences. The Government's new financial institutions law will upgrade the regulatory framework to cover both banks and finance companies, and replace existing commercial bank and finance company laws. The new law will cover licensing, supervision, ownership, governance and other aspects of financial institutions' activities. Restructuring of government-owned, specialised financial institutions like the Thai Savings Bank also is underway.

[4] After ten years, new capital injections must come from Thai entities unless the foreign holding has fallen to below 49 per cent. However, international financial liberalisation agreements between 1997 and 2007 may well make these sell-down provisions redundant.

Debt Restructuring

In June 1998, the Government issued regulations covering debt restructuring procedures, and defining debtor and creditor responsibilities and accountability (Bank of Thailand, 1998). The Government's 'Bangkok approach' involved establishing a more informal, out-of-court mechanism to restructure debt, based on the London approach, widely used in out-of-court debt workouts. The Government established a Corporate Debt Restructuring Advisory Committee and legislated tax and other incentives to encourage debtors and creditors to reach market based debt workouts under Bank of Thailand supervision. Most foreign and local banks have signed debtor-creditor agreements and inter-creditor agreements to speed up the process of restructuring syndicated loans.[5] The Government has targeted around 690 major corporate debtors with debts of nearly Baht 1.5 trillion for this process, 56 per cent of total NPLs (World Bank, 1999d).

Despite these initiatives, corporate debt restructuring initially was slow, inhibiting NPL write-offs and recovery. By August 1999, banks had restructured only 26 per cent of reported NPLs (World Bank, 1999d). Corporate restructuring completions and loans under negotiation started to accelerate in the second half of 1999. However, many analysts are concerned that many debt rescheduling deals may be inappropriate; many completed deals just could reschedule loans which will become non-performing when payments become due.

IMPROVING FINANCIAL AND LEGAL INFRASTRUCTURE

Reforming the legal framework to stipulate creditors' foreclosure rights and provide debtors with bankruptcy protection is a key component of the IMF support package and the Government's reform agenda. Serious failings in legal and financial infrastructure contributed to foreign creditors losing confidence in Thailand's financial system, and constrain the recovery of collateral from NPLs and the resumption of credit flows.

Bankruptcy and Asset Recovery

In March 1999, after much prevarication, the Thai Senate passed four new bankruptcy reform bills, significantly reforming the bankruptcy framework.[6] They also provide a stronger framework for voluntary debt restructuring and eventually should reduce transaction costs during debt workouts. The pre-crisis framework for enforcing security and bankruptcy strongly favoured debtors (Thomasic and Little,

5 Signatories to debtor-creditor agreements and inter-creditor agreements agree to defined procedures for case entry, information sharing, negotiations and 75 per cent majority voting approval. The agreements provide options for mediation and arbitration (World Bank, 1999a).

6 Changes include improved security for new lending to financially distressed companies, voting by creditor class, rescission of related party transfers, limits to discretion for court action, and conversion of currency denominated claims (World Bank, 1999b). Further reforms are planned to improve creditors' access to collateral, including a law to establish a centralised registry of mortgage collateral.

1998).[7] Under the pre-crisis bankruptcy system, debtors could prolong proceedings almost indefinitely, so debtors could stall restructuring negotiations and make their loans strategically non-performing, even if they were able to pay (Flatters, 1999).[8]

In June 1999, the Government created a special commercial court to handle bankruptcy cases. However, this court will need time to establish its record as creditor-friendly. While the pace of reorganisation and bankruptcy filings has increased since the March amendments, new filings still stand at only two to three per month, suggesting creditors remain reluctant to use the court process (World Bank, 1999b).

Implementing the new law in the courts has been slow and some analysts argue, largely unsatisfactory. The new foreclosure law would only reduce the time required to resolve a claim from ten to five years, still too long to apply real leverage on uncooperative debtors.[9] However, the improved legal framework probably increases incentives for debtors to reach out-of-court settlements.

Other Legal Reforms

In October 1999, the Thai Parliament passed a new alien business law, the last of 11 key economic laws the Government undertook to revise in its agreement with the IMF.[10] The new law reduces the sectors restricted to majority Thai-owned companies and requires an annual review of remaining restrictions, making future liberalisation easier. The land law also has been amended to allow foreigners to own and mortgage land.

RECAPITALISING THE BANKING SYSTEM

In late 1999, Thai banks still were struggling to raise sufficient new capital to meet required capital adequacy ratios while providing for and writing off NPLs. As existing bank losses have depleted the banking system's capital, banks must attract new capital to write off debts without breaching capital adequacy rules.[11] This encourages banks to enter debt workouts, including extending debt maturity and reducing interest rates, rather than writing off loans and recognising losses. Bank liquidity is no longer a problem as the Government's deposit guarantee ensures a surplus of deposits. However, while bank capital remains low, banks cannot undertake new lending.

[7] The courts have not yet successfully prosecuted former executives of failed financial institutions. Even executives implicated in the infamous Bangkok Bank of Commerce loan scandal of several years ago have not been convicted.

[8] One analysis estimates one third of bank NPLs are strategic bad debts; debtors could repay but refuse to do so because of the weak insolvency laws and lack of progress in debt restructuring negotiations (Nidhirabha and Warr, 1999).

[9] Furthermore, the courts currently interpret insolvency as liabilities exceeding assets, rather than a company's inability to meet its debts as and when they fall due, as is common in western jurisdictions. This allows debtors to avoid insolvency by over-valuing assets and under-valuing liabilities. However, the Government plans follow-up legislation, which would streamline summons procedures for taking debtors to court (*Far Eastern Economic Review*, 4 November 1999, p. 11).

[10] The economic laws proposed and enacted by the Chuan Government included the bankruptcy, foreclosure and commercial court laws; a state enterprise corporatisation law; amendments to the civil and commercial code; amendments to the laws on property leasing and condominiums; and an amendment to the application of the land law to foreigners.

[11] In 1998, the ten main commercial banks recorded a combined loss of Baht 262.3 billion (US$7.1 billion) by writing off loan losses.

Under its August 1998 recapitalisation program, the Thai Government announced it would provide matching public funding to recapitalise private banks, subject to certain conditions.[12] However, this program has not been successful. So far only one commercial bank and one finance company have applied for government assistance.[13] Most large bank owners are reluctant to ask for government support, fearing loss of control. This delays recapitalisation and NPL write-offs, increasing the overall cost of bank recapitalisation, as most banks operate at or close to negative margins (World Bank, 1999b).

Up to late 1999, banks have recapitalised mainly by raising new capital through innovative hybrid capital instruments called 'SLIPs' and 'CAPs', which target depositors.[14] While they can be counted as bank capital for prudential control purposes, they are short term and costly with interest rates of between 12 and 22 per cent per year. Hence most banks cannot become profitable until they retire these instruments (Nomura Securities, 1999). Furthermore, such hybrid capital cannot absorb losses as well as equity capital can, and therefore is of lower quality (Standard and Poor's, 1999).

Some Thai banks have begun attracting foreign partners to assist them recapitalise. ABN Amro took a majority share of Bank of Asia; Development Bank of Singapore took a 58 per cent share in Thai Danu; in September 1999, Standard Chartered finalised the purchase of 75 per cent of Nakornthon Bank; United Overseas Bank of Singapore won the tender for the government-owned Radhanasin Bank; and several other bank takeovers and joint ventures are being negotiated. With insufficient capital available in the domestic market to meet recapitalisation needs, recapitalisation cannot occur without further major foreign capital injections or participation in the government-sponsored recapitalisation scheme (Standard and Poor's, 1999).

Cost of Recapitalisation and Depositor Guarantees

The cost of financial restructuring and recapitalisation is high. Estimates of the capital required for full loan loss provisioning of surviving financial institutions range from Baht 300 billion to Baht 400 billion (US$8.1 billion to US$10.8 billion) (Ministry of Finance, 1999) to Baht 700 billion to Baht 1 trillion (US$18.9 billion to US$ 27 billion) (Flatters, 1999). The total cost of supporting banks and finance

12 The package provides for up to Baht 300 billion (US$8.1 billion) in capital injections to viable private financial institutions. The Ministry of Finance matches funds raised by new or old shareholders by providing ten year government bonds in return for equity in the bank. Bank owners can buy back these shares at some future date, if they can recapitalise from other sources. For tier-1 capital injections, banks must adopt up-front year 2000 loan loss provisioning requirements; financial institutions unable to recapitalise will be nationalised (Ministry of Finance, 1999).

13 Siam Commercial Bank raised Baht 32 billion of new investor capital which the Government will match (Nomura Securities, 1999). Tisco Finance also has received approval for a government capital injection. Thai Military Bank had sought approval, but has delayed its recapitalisation plans until 2000.

14 Stapled Limited Interest Preferred Structures, SLIPS, are non-cumulative preferred shares, which qualify as tier-1 capital when calculating bank capital adequacy, while Capital Augmented Preferred Securities, CAPS, are subordinated debentures. The securities usually are non-voting and do not dilute banks' existing ownership structures, and have a maturity of up to seven years, although issuers can repay them after three years. Holders receive fixed payments for the life of the security. Banks cannot hold more than one third of tier-1 capital in this form (World Bank, 1999b). Thai Farmers Bank, Bank of Ayudhya, Bangkok Bank and Thai Military Bank issued such securities in 1998 and 1999.

companies and repaying depositors could reach Baht 2 trillion (US$54 billion) or 35 to 40 per cent of projected 1999 GDP (Fitch IBCA, 1999). Privatising nationalised banks and liquidating closed financial institutions' assets will provide part of this cost; however, Thai taxpayers will bear most of it. To date, the Government has issued bonds to finance:

- the Financial Sector Restructuring Agency which manages the affairs of the failed finance companies
- the Asset Management Corporation, which purchased the lowest quality assets of the failed finance companies
- capital injections to Nakornthon Bank
- the Financial Institutions Development Fund, which supplied huge amounts of liquidity support to weak financial institutions.[15]

The state enterprise privatisation program will not be large enough to repay the capital costs of bonds issued. The IMF/Thai Government's latest estimate of the annual interest cost of financial restructuring bonds is 4 per cent of GDP (Flatters, 1999).

RESOLVING NPLS

NPLs appeared to peak in May 1999 at around Baht 2.7 trillion (US$73 billion), 48 per cent of outstanding loans and 54 per cent of 1998 GDP (World Bank, 1999b). In the second half of 1999, NPLs started to fall due to lower interest rates and some debt restructuring; in August NPLs were 46.7 per cent. A return to growth, the Government's fiscal stimulus and corporate restructuring should help reduce NPLs further towards the end of 1999 (Figure 8.2).

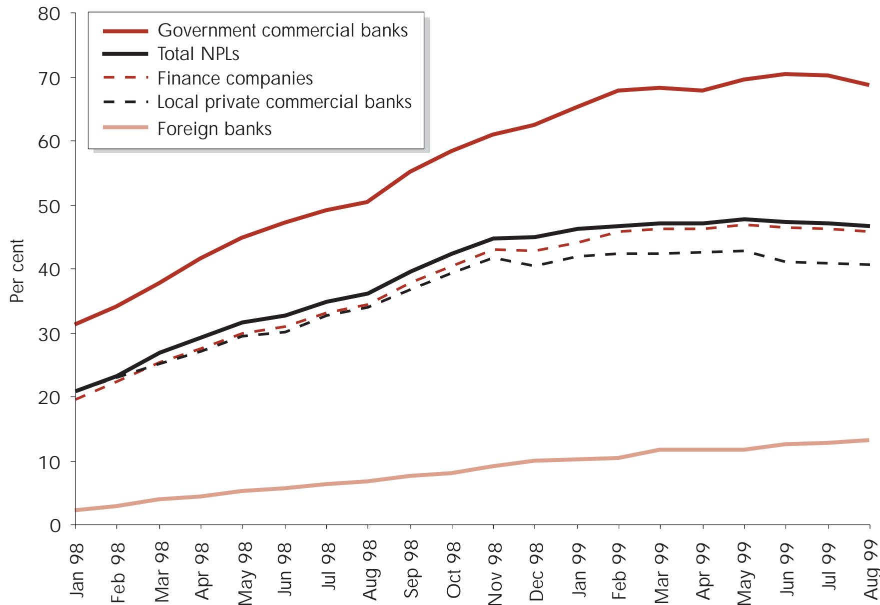
The Government established the Asset Management Company to dispose of the NPLs of closed finance companies; however, existing privately-owned banks are encouraged to set up their own asset management companies to dispose of their NPLs. The Government offers exemptions from taxes and transfer fees to encourage this process. However, unlike the Korean Government, the Thai Government does not purchase surviving banks' NPLs through a central, government-owned asset management company (Fitch IBCA, 1999; and East Asia Analytical Unit, 1999). To remove NPLs from bank balance sheets, these special purpose companies must be majority-owned by third parties. However, banks have no guaranteed source of funds for this process; consequently progress is slow. Banks had disposed of less than 15 per cent of their NPLs by April 1999, mainly by write-offs (Fitch IBCA, 1999).

[15] The Financial Institutions Development Fund also guaranteed ailing financial institutions' deposits and other liabilities. Financial institutions with excess liquidity had to deposit it with the Financial Institutions Development Fund. In the eight weeks before mid July 1997, the fund lent financial institutions Baht 160 billion (US$5.2 billion). By November 1998, the fund had accumulated liabilities of over Baht 1 trillion (over US$30 billion) on behalf of the Government (Ministry of Finance, 1999). Analysts expect the Government will recover no more than half of these funds (Flatters, 1999).

Figure 8.2

Thai NPLs Decline Only Gradually

Non-performing Loan Ratios of Thai Financial Institutions (Per cent)



Source: CEIC, 1999.

In early 1999, Thai Farmers Bank announced it would set up the first asset management company and transfer its NPLs at 55 per cent of book value.[16] Joint-venture partners, Goldman Sachs and GE Capital, will help the bank maximise the value realised from these NPLs. In late 1999, more banks were establishing their own asset management companies; others will have to follow soon (Collins, 1999).[17] Consequently, a significant increase is expected in late 1999 (World Bank, 1999b).

DISPOSING OF NATIONALISED BANKS AND FINANCE COMPANIES

Since the crisis began, the Government has closed 69 finance companies and nationalised seven mostly small or medium sized banks pending recapitalisation and sale (Table 8.1).[18]

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16 However, some analysts believe 15 per cent of book value may be more realistic, given the extent of asset price depreciation and the difficulty of securing assets under Thailand's bankruptcy laws. This divergence probably explains why asset management companies are slow to take on NPLs.

17 In September, Bangkok Bank and Bank Ayudhya announced plans to establish asset management companies (AFX-Asia, 24 September 1999).

18 The nationalised banks are Siam City Bank, Bangkok Metropolitan Bank, Bangkok Bank of Commerce (absorbed into the 95 per cent state owned Krung Thai Bank), First Bangkok City Bank, Laem Thong Bank (absorbed into the newly created Radhanasin Bank), Bank Thai and Nakornthon Bank.

Table 8.1

Many Banks Are Nationalised and Finance Companies Closed

Government Intervention in Financial Institutions 1997 to October 1999

Pre-crisis number of banks and finance companies		Commercial banks	Finance companies
		15	91
1997	56 finance companies closed	Taken over by the Financial Restructuring Authority. Assets auctioned during 1998 and 1999	
1998	12 finance companies closed	Taken over by the Financial Restructuring Authority. Assets auctioned during 1998 and 1999	
	6 banks nationalised	Small and medium sized banks (20 per cent of banking system assets)	
1999	1 bank nationalised	Nakornthon Bank	
	1 finance company closed	Bank of Thailand appointed a liquidator for the small and insolvent Ocean Finance	

Post-crisis number of banks and finance companies			
Commercial banks		Finance companies	
Original owners	Merged or new ownership	Surviving	Taken over or closed
6	9	22	69

Source: Ministry of Finance, 1999a; World Bank, 1999b; and Fitch IBCA, 1999.

The nationalised banks still face major problems. The seven nationalised banks are severely undercapitalised and have high NPLs. Thailand's largest bank, the 70 per cent government-owned Krung Thai Bank, has NPLs exceeding 60 per cent of outstanding loans; another report estimates NPLs exceed 80 per cent of outstanding loans.[19] A rule holding state bank directors liable for losses caused by their business decisions constrains progress in restructuring state bank NPLs, transferring them to special purpose vehicles and realising losses. This rule also encourages illegal accounting practices.

The Government plans to sell the nationalised banks as soon as possible, realising some of the funds it has injected into them since 1997, and using these to recapitalise surviving banks. In doing so, it hopes to encourage banking sector consolidation and new foreign investment. However, so far privatisation has been slow.[20] Deals have been agreed for Nakornthon and Radhanasin Banks; and under Thailand's eighth Letter of Intent to the IMF, Siam City and Bangkok Metropolitan Banks should be sold by the end of 1999. The Government also hopes to privatise Krung Thai Bank within two or three years; this will present a major challenge, requiring significant modernisation and inroads into the bank's NPLs.

[19] A report by PricewaterhouseCoopers, commissioned by Krung Thai Bank and leaked to the press in August 1999, estimated the bank's NPLs at 84 per cent of total loans, raising questions over the NPL estimates the bank itself made, and the resultant recapitalisation cost.

[20] The original deadline of December 1998 to privatise Siam City and Bangkok Metropolitan Banks was not met due to delays in recapitalising banks and gaining government approval of loss-sharing arrangements with new buyers.

THAILAND'S FINANCE COMPANIES

The Thai Government's decision to close 69 finance companies was particularly courageous as powerful political interests and former bureaucrats partly owned or controlled these companies (Nomura Securities, 1999).

Before the crisis, the Bank of Thailand poorly supervised these finance companies; many were used as a means to avoid regulations imposed on banks (Pakorn, 1999). They could not legally take deposits, but issued promissory notes returning investors 12 to 15 per cent per year. They also often borrowed unhedged foreign funds and on-lent them to Thai customers in baht, exposing themselves to considerable foreign exchange risk. To cover their high capital costs, they lent to very risky projects, often ones that could not obtain bank loans. Most banks had their own finance companies; riskier borrowers were referred to these.

Since the crisis, most surviving finance companies have faced rising NPLs, falling earnings and increasing competition, with only a few strong companies showing good prospects. The remaining 22 finance companies now hold less than 10 per cent of financial system assets.

Disposing of failed finance company assets also presented a challenge. The Ministry of Finance's Financial Restructuring Agency ran five large auctions between July 1998 and August 1999 to liquidate finance company assets such as cars, construction loans and mortgages worth Baht 584 billion. In a protracted and at times controversial process, most assets eventually were sold, netting around 25 per cent of their book value.[21]

PRUDENTIAL CONTROL PROSPECTS

Inadequate financial system regulation and supervision reinforced Thailand's financial crisis. The Thai Government liberalised financial markets in the late 1980s and early 1990s, lifting interest rate ceilings and allowing financial institutions greater flexibility in their domestic and international activities (Bank of Thailand, 1998). However, it failed to substitute prudential regulation when it removed controls on asset allocation and foreign borrowing. With weak supervision, malpractice was frequent; risky connected lending and unhedged foreign borrowing were excessive (Pakorn, 1999). Supervisory skills were low and political intervention often compromised enforcement.

Improving Bank of Thailand Supervision

While the Government has introduced many prudential regulation reforms, it recognises it must strengthen the Bank of Thailand's capacity to enforce these regulations in supervising financial institutions. This requires training, reorganisation and outside expertise. The Bank of Thailand already has been reorganised and

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[21] Local and foreign finance companies and banks bought assets; Goldman Sachs and GE Capital (Thailand) were the biggest single purchasers in the fifth and final auction on 11 August, 1999.

improved its recruitment; staff exchanges between it and local financial institutions, and multilateral and bilateral assistance training programs should build supervisory skills; the new central bank law should clarify its role and responsibilities.

The Bank of Thailand and World Bank recognise prudential aspects requiring strengthening include:

- methods and procedures for off-site monitoring and on-site examination
- requirements for consolidating supervision
- revision and streamlining of commercial bank reports
- design of bank and finance companies' public disclosure data
- improved enforcement (Ministry of Finance, 1999).

FINANCIAL SYSTEM PROSPECTS AND OPPORTUNITIES

The post-crisis banking system will have fewer banks, be more competitive and have a much greater foreign presence. As family controlled banks decline, competition and foreign presence is increasing, bringing greater pressure for higher standards. Top bankers realise the basis of lending must change from connections and collateral to balance sheet and cash flow analysis. Competition already is raising credit requirements and accounting standards. Credit approval is more closely scrutinised and more arms-length than before; several banks now approve credit through committee rather than individual decisions (Nomura Securities, 1999).

International banks will be the single most important force increasing competition and improving efficiency, risk management, transparency and technological development. New prudential controls and improved bankruptcy proceedings also will be crucial in improving the sector's performance and reducing exposure to future crises. Together these factors should help the Thai banking system gradually achieve international standards in transparency and efficiency. These developments also should expand opportunities for Australian suppliers of banking system technologies, as local banks seek to compete with new foreign entrants and foreign owners attempt to upgrade local systems.

Capital Markets

The Thai equity and bond markets are relatively underdeveloped. The equity market had recovered by late 1999, but remains small and vulnerable to volatility and competition from Internet based stockbrokers. The floating of Baht 500 billion in government bonds to refinance the Financial Institutions Development Fund's short term debt is forcing the development of a government bond market, including what promises to be a large secondary market. Capital market prudential controls require strengthening to develop these markets. Many opportunities should arise for foreign fund managers and suppliers of financial system technologies, as local institutions seek to compete with new foreign entrants.

Insurance

Thailand's insurance industry is progressively opening and liberalising; 12 new licences were issued in 1997 including several with minority foreign participation. Licences have a maximum of 25 per cent foreign participation, but this will be lifted to 49 per cent in 2000.

Insurance penetration in Thailand remains low; premiums are 1.2 per cent of GDP, compared to Malaysia's 2.2 per cent. While the sector grew by 15 per cent per year over 1992-97, it fell by 25 per cent during the crisis. After the crisis began, some insurers developed solvency problems from losses on property and equity investments. However, these were limited to some extent by restrictive government investment regulations; furthermore Thai policies are payable in baht, not in US dollars as in Indonesia.[22]

Future Prospects

Since the crisis began, the Thai Government has adhered to its IMF program and made significant structural reforms in a relatively short period. In doing so it has overcome significant domestic political resistance. It has overhauled financial sector prudential requirements, enacted basic economic laws, including strengthening the bankruptcy law, and opened the financial sector to foreign investment. By mid 1998, the Government had started to relax fiscal and monetary policy, expanding the budget deficit and allowing interest rates to fall. Consequently, by the third quarter of 1999, GDP growth was starting to recover.[23] In late 1999, it announced it would not require the last tranche of disbursements agreed under its IMF program.

However, concerns remain about the pace and extent of bank NPL write-offs and refinancing, and the effectiveness of new bankruptcy laws. Unless addressed rapidly, these problems could undermine sustainable growth once the effects of the Government's fiscal stimulus package are exhausted. Successful bank recapitalisation and corporate debt restructuring and effective implementation of new laws and prudential controls are essential to foster a more robust financial sector and underpin sounder, more sustainable long term growth.

MALAYSIA

Malaysia's comparatively small foreign debt and modest exposure to short term borrowing helped it avoid the most severe problems of the 'three IMF economies', Indonesia, Thailand and Korea. Nevertheless, the Malaysian Government had to intervene to restore health in the banking system and stimulate financial sector restructuring. It also raised interest rates and eventually introduced capital controls to defend the ringgit. To resolve banks' high NPLs, the Government followed the Korean and Japanese approach, establishing an asset management company to buy NPLs from the banking system and injecting government funds to boost banks' capital adequacy ratios.

[22] Insurance is regulated by the Ministry of Commerce, which currently is segregating life and non-life businesses. The life insurance sector is inhibited by regulations guaranteeing policy benefit levels to policyholders, negatively affecting industry viability.

[23] In November 1999, the Bank of Thailand expected 1999 GDP growth to reach 3.5 per cent, well up on its earlier estimate of 1 per cent (*Far Eastern Economic Review*, 4 November 1999, p. 11).

IMPACT OF THE CRISIS

Before the Asian financial crisis, Malaysia had one of the region's most diversified financial sectors. While bank finance still dominated funding, domestic debt markets raised around 33 per cent of net financing (Figure 8.3). Malaysia's economy also had many other strengths including high national savings, large fiscal surpluses, low external debt and low inflation (World Bank, 1999b).

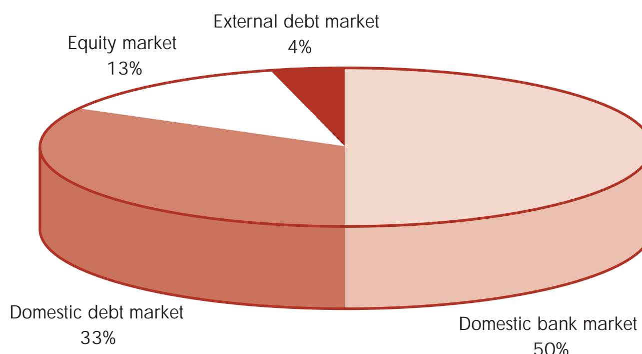
After Singapore, pre-crisis Malaysia had the strongest banks in South East Asia. Balance sheets were sound; NPLs were low; and banking supervision exceeded average regional standards (*Fortune*, 24 November 1997). Pre-crisis NPLs officially were only 3.6 per cent of total bank loans, while the banks' average risk weighted capital adequacy ratio was 11.8 per cent, well above the Bank for International Settlements' 8 per cent minimum (Ministry of Finance, 1998). While Malaysia's current account deficit was high at 5.8 per cent of GDP, it had a relatively good match of foreign liabilities and assets, and foreign reserves exceeded short term debt.

However, like Indonesia, Thailand and Korea, Malaysia had high pre-crisis rates of private sector credit growth, a rapidly growing economy with increasing real estate and equity price inflation, real exchange rate appreciation and slowing exports (World Bank, 1999b). New credit expanded over 25 per cent per year between 1995 and 1997; property and business services were the biggest destinations (Delhaise, 1999). Consequently, Malaysia's corporate sector became highly leveraged; by 1997, bank loans were around 170 per cent of GDP, similar to levels in Korea and Thailand.[24]

Figure 8.3

Pre-crisis Domestic Debt Markets Important

Share of Net Funds Raised in Malaysian Financial Markets, 1996



Source: Thillainathan, 1998.

24 Leverage, measured by the average corporate debt to equity ratio, rose from around 90 per cent in 1991 to close to 200 per cent by 1996.

In late 1997, liquidity concerns in smaller banks caused a flight to quality as depositors switched to foreign banks and major local banks. The situation began to stabilise in January 1998 when Bank Negara issued a statement guaranteeing it would pay principal and accrued interest on deposits at financial institutions it supervised.[25] Although Malaysia did not seek an IMF program, the Government voluntarily adopted many elements of programs in the three IMF economies, initially including a tight monetary policy.

Throughout 1998 and 1999, NPLs grew to levels where, without external assistance, some banks' capital adequacy ratios would have fallen below the mandated 8 per cent. By the end of 1998, the banking system's gross NPLs reached 20 per cent of outstanding loans (Fitch IBCA, 1999).[26]

PRUDENTIAL REGULATION AND SUPERVISION REFORMS

Bank Negara is considered one of the best regulators in Asia, renown for its strict interpretation of rules and transparency (Delhaise, 1999). *The Banking and Financial Institutions Act 1989* vested Bank Negara with wide ranging responsibilities and powers to oversee banks, finance companies and insurance companies. In April 1997, the Government introduced measures to restrain excessive bank lending to real estate, shares and units in unit trusts (Delhaise, 1999).

After the crisis began, the Government further tightened many prudential regulations, although some subsequently were relaxed temporarily to ease the severity of the ensuing credit crunch (Bank Negara Malaysia, 1999a).

Loan Classification and Provisioning

From late 1997, the Government strengthened many prudential regulations. In September 1997, it tightened loan classifications so NPLs became loans overdue by three months instead of six months. It required provisioning of at least 1.5 per cent of total loans and 20 per cent of the uncollateralised portion of sub-standard loans; it strengthened bank disclosure requirements and introduced a monthly stress test of bank credit positions (Malaysian Ministry of Finance, 1998). Bank Negara instructed all banking institutions to establish loan rehabilitation units to separate the management of NPLs from daily credit management and administration (Bank of America, 1999).

However, in September 1998, as a result of the unexpectedly severe recession and credit crunch, the Government temporarily relaxed the NPL classification system to six months and allowed restructured and rescheduled loans to be re-classified as performing loans (Malaysian Ministry of Finance, 1998). The Government judged tighter provisioning rules were deterring banks from lending and undermining viable businesses and projects. The new provisions also gave borrowers more time to restructure loans before they were classified as non-performing. As in Indonesia, the Malaysian Government plans to tighten prudential controls as the economy recovers.

[25] Malaysia did not have a formal deposit insurance scheme. Now a scheme is being considered.

[26] Malaysia defines NPLs as those that have not repaid interest or capital for over three months and include NPLs sold to Danaharta, the government asset management company.

Finance Company Capital Requirements

Many finance companies experienced severe difficulties during the crisis. To stimulate consolidation and raise public confidence in finance companies, the Government significantly raised their minimum capital requirements.[27] In addition, it increased the risk weighted capital adequacy ratio for finance companies from 8 per cent to 9 per cent by December 1998 and to 10 per cent by December 1999. These new policies are forcing mergers and acquisitions among finance companies and with commercial banks.

Rather than adjusting banks' capital requirements, the Government is using official directives and Danamodal, the agency it established to recapitalise and strengthen the banking industry, to force banking sector restructuring and consolidation.

Supervisory Reforms

Since the crisis, Malaysia also has upgraded significantly its financial supervisory practices. Bank Negara's new liquidity requirement policy replaces previous high liquidity ratios with liquidity requirements; these are based on a bank's ability to meet short term liquidity needs arising from its liabilities' maturity profile. Over time, this new approach should improve liquidity management practices. Bank Negara also is introducing consolidated supervision of all financial institutions in accordance with international best practice. (See Chapter 3 - *Prudential Reform.*)

Bankruptcy Reform

As in other crisis affected economies, the Government is upgrading the bankruptcy framework. The Government closed legislative loopholes to stop companies applying for restraining orders against creditors without their knowledge. Companies can seek protection against creditors while restructuring schemes are worked out (Fitch IBCA, 1999). New rules require borrowers to submit a statement of financial condition, so they cannot acquire additional debts or dispose of assets during the period of the restraining order. In addition, to protect creditors' rights, restructuring companies must appoint independent directors to their boards, nominated by a majority of creditors, to oversee the restructuring process. However, unlike in some other regional economies, the bankruptcy regime does not require independent judicial oversight of corporate workout schemes (Fitch IBCA, 1999).

CAPITAL MARKET REFORMS

The Government also recognises the need to reduce reliance on bank lending and upgrade capital market regulation. In 1999, new risk based capital adequacy rules will force brokers who take on risks to have adequate capital protection. The Government also is improving disclosure standards and moving stock market regulation from a merit based to a disclosure based system. Other recent reforms include tightening regulations on related-party transactions, introducing new

[27] The minimum capital requirement increased from Ringgit 5 million to Ringgit 300 million by the end of 1999, and to Ringgit 600 million by the end of 2000.

disclosure requirements for nominee accounts, tightening definitions and penalties for insider trading and increasing Securities Commission inspection and enforcement powers.

Other initiatives will address impediments to capital market development. In 1999, the Securities Commission established a Capital Market Strategic Committee to develop a capital market master plan by early 2000 (AFX-Asia, 23 September 1999).[28] In addition, in February 1999, a high level government finance committee proposed a code of corporate governance and recommended reforms to laws, regulations and rules to improve corporate governance (Finance Committee on Corporate Governance, 1999). Such reforms should improve confidence and market discipline in the share market and corporate bond market. To eventually expand the corporate bond market and enable institutional investors to impose market discipline on corporates, the Government is relaxing restrictions on insurance companies holding corporate bonds.

Bank Negara is revising its guidelines on issuing private debt securities to streamline the corporate bond market and introducing guidelines on securitisation. This development will diversify risks away from the banking system, increase the variety of fundraising instruments in the market and widen the spectrum of papers available for investment.

Malaysian capital markets should start to grow in 1999-2000, stimulated partly by the large bond issues by Danamodal, to recapitalise the banks, and Danaharta, the government agency which purchases NPLs from the banking system. The Government's capital market regulation and supervision reforms, stamp duty exemption on corporate bonds and relaxation of insurance company bond purchases also should assist capital market growth. (See Chapter 5 - *Capital Markets*.)

CAPITAL CONTROLS

On 1 September 1998, the Government introduced controls on international capital inflows and outflows, reversing its relatively open pre-crisis capital market regime. The Government aimed to eliminate the offshore ringgit market, which authorities believed fuelled speculative attacks on the local currency and constrained authorities' ability to reduce interest rates (World Bank, 1999b; and Bank Negara Malaysia, 1998). The Government's capital controls:

- introduced a fixed exchange rate at Ringgit 3.8:US$1
- required all ringgit held abroad to be brought onshore within one month
- imposed a one year holding period on all foreign accounts in Malaysia and the foreigners' proceeds of Malaysian securities' sales
- terminated offshore trading in ringgit instruments and domestic credit facilities for overseas banks and stockbrokers

[28] Impediments include lack of an over-the-counter market, a poor clearing system and lack of foreign participation. Another constraint is the approval process for corporate bonds; sometimes it takes six months and involves Bank Negara, the Ratings Agency of Malaysia and the Securities Commission.

- required all importers and exporters to pay and receive foreign currency for imports and exports[29]
- required those needing foreign currency to seek central bank approval.

The Government believes its controls allowed it to stabilise the currency, eliminate speculative attacks and regain control of interest rates. Between August 1998 and August 1999, lending rates declined from 13 per cent to 8 per cent. Lower interest rates encouraged investment and consumption, and gave relief to corporate borrowers. However, Malaysia possibly could have achieved lower interest rates and a stable currency without capital controls (World Bank, 1999b). From late 1998, most other regional economies' interest rates also fell significantly and currencies appreciated as speculative attacks subsided; capital inflows to the region also resumed in 1999, as investor confidence returned (World Bank, 1999b).

The main risk Malaysia faces from capital controls is negative foreign investor reaction and lower future foreign direct investment, FDI. However, *bona fide* current account and FDI related transactions were exempt from the controls. While FDI did fall significantly, as of November 1999, it is too early to judge whether capital controls contributed to this. The Government also has indicated controls are temporary, and it will remove them when the global financial environment normalises (Bank Negara Malaysia, 1998).

While the controls initially locked foreigners into the market for one year, exit provisions were relaxed progressively, lessening the effect on foreign portfolio investors. In February 1999, the Government introduced a graduated exit levy, or tax on repatriated principal, with tax rates of between 30 per cent and 10 per cent. In September 1999, the exit levy was fixed at 10 per cent, simplifying administration for foreign fund managers (Bank Negara Malaysia, 1999b). This one tier exit levy will help Malaysia achieve a higher weighting when it returns to the Morgan Stanley international share index in May 2000. Malaysia did not experience a massive exodus of foreign funds in September 1999 when, after the first 12 months of controls, funds could be withdrawn without the need to pay the exit tax.

RESOLVING NPLS AND RECAPITALISING THE BANKING SYSTEM

In mid 1998, the Government established three institutions to resolve serious banking sector NPL problems and implement refinancing and restructuring:

- Danaharta purchases NPLs from the banking system and maximises the recovery value of acquired assets
- Danamodal injects capital to strengthen banking institutions
- the Corporate Debt Restructuring Committee facilitates voluntary out-of-court restructuring of corporate debt through voluntary agreements between creditors and debtors (Kawai, 1999).

[29] This provision was considered necessary to curb the offshore market in ringgit, and hence currency speculation.

Danaharta: Managing and Resolving NPLs

In May 1998, to strengthen domestically-owned financial institutions' balance sheets and enhance their lending ability, the Government established an asset management company, Danaharta, to acquire these institutions' NPLs. Using government guaranteed bonds, Danaharta purchases NPLs from financial institutions whose NPL ratio exceeds 10 per cent.[30] If Danaharta recovers more than it pays for a NPL, the financial institution gets 80 per cent of the surplus back.

Danaharta only buys loans above Ringgit 5 million, bidding for NPLs at a discount to book value. While sales to Danaharta technically are voluntary, banks that reject a Danaharta NPL bid must write down the NPL's value to 80 per cent of Danaharta's offer. Banks also have an incentive to sell their NPLs because they can amortise losses over five years.

Danaharta has broad powers, giving it an advantage over banks when restructuring loans and realising collateral. For example, a bank must go to court to begin foreclosure proceedings, but Danaharta only needs to give 30 days' notice that it intends to foreclose (Danaharta, 1999). It also can impose conditions on defaulting debtors to facilitate asset restructuring and rehabilitation, and appoint special administrators to manage the affairs of distressed companies (Bank Negara Malaysia, 1999a).

By June 1999, six months ahead of schedule, Danaharta had largely completed its NPL acquisition plan, purchasing around 35 per cent of banking system NPLs at an average 57 per cent discount on face value (Danaharta, 1999). It now manages almost Ringgit 40 billion (US$10.5 billion) of NPLs acquired from 66 financial institutions.[31] By the end of 1999, Danaharta almost will reduce the banking system's NPL ratio to 10 per cent, which the Government believes is manageable (Figure 8.4).

Managing Danaharta's assets

Danaharta's approach to asset management falls somewhere between that of a rapid disposal agency and a warehousing agency, which stores assets until prices recover.[32] Danaharta's strong powers should enable it to add value to assets before it disposes of them; improving economic conditions also should help increase their value.

Danaharta's approach is quite well tailored to Malaysia's circumstances as:

- Malaysia's NPLs are highly concentrated; 70 per cent of NPLs are in only 2 000 to 3 000 accounts each worth more than Ringgit 5 million
- resolving most NPLs requires industry and business restructuring rather than merely renegotiating interest and payment terms.

[30] Institutions receive government guaranteed zero coupon bonds that are zero risk weighted in capital adequacy calculations.

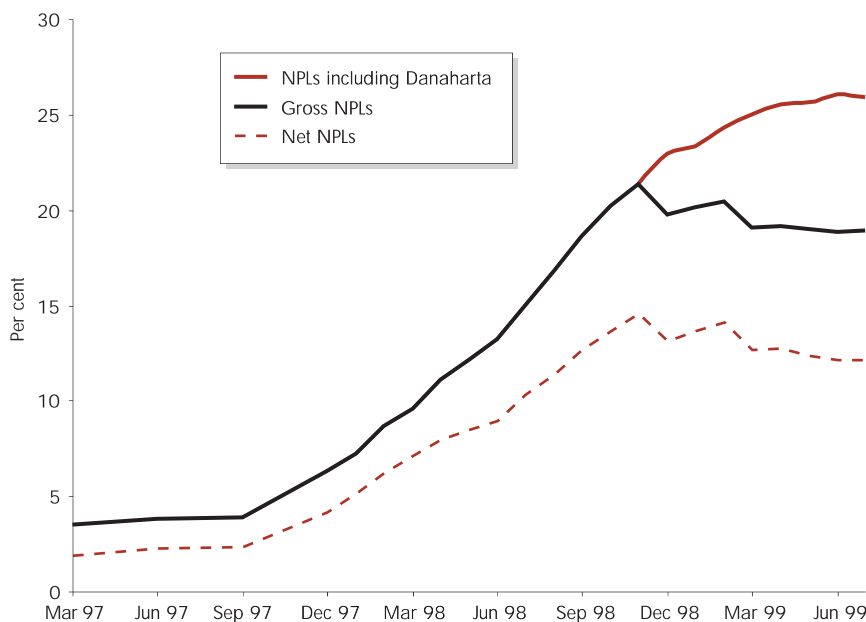
[31] This includes Ringgit 17.8 billion in NPLs acquired from private banks and another Ringgit 21.5 billion of NPLs from government-owned Sime and Bumiputera banks which Danaharta manages for the Government.

[32] The US Resolution Trust Corporation and Thailand's Financial Restructuring Agency are rapid disposal agencies. Mexico used a warehousing agency, holding assets from five to ten years until asset values recovered.

Figure 8.4

Gross NPLs Peak, Net NPLs Fall towards 10 per cent

Non-performing Loans in the Banking System, March 1997 to July 1999



Source: CEIC, 1999; and Bank of America, 1999.

Danaharta started disposing of assets in late 1999 through joint ventures, stock exchange listing, securitisation, asset sales and liquidation (Danaharta, 1999). Subject to foreign ownership limits, foreign companies can bid for NPLs.[33]

Danamodal: Recapitalising the Banking System

Danamodal was established in August 1998 to:

- recapitalise and strengthen the banking industry
- help consolidate and rationalise the banking system to support Malaysia's next phase of economic development (Bank of America, 1999).

By July 1999, Danamodal had injected Ringgit 6.4 billion or 14 per cent of the banking sector's total 1998 tier-1 capital into ten financial institutions. This boosted the banking sector's average capital adequacy to 13 per cent.

As banks also are raising funds from new equity issues, hybrid instruments, domestic and international bond issues, and borrowing, the Government should need significantly less than the estimated Ringgit 16 billion to recapitalise the financial

[33] Foreign ownership is limited to 61 per cent in telecommunications, 30 per cent of listed banks and 51 per cent of insurance companies, but manufacturing enterprises can be wholly foreign owned.

sector. Also, in 1999, several banks began repaying capital injections, and some analysts predict further injections could be unnecessary after 2000, if conditions continue to improve.[34]

Danamodal has two years to complete its recapitalisation task. It then will own a significant portfolio of banking sector shares; it plans to sell these through strategic sales and directly to the public on the stock market.

CONSOLIDATING THE FINANCIAL SECTOR

The Malaysian Government and Bank Negara believe banking sector consolidation is a high priority. They anticipate mergers are necessary to allow Malaysian financial institutions to compete with international banks, and avoid future banking system crises and rescues (Bank Negara Malaysia, 1999c). In July 1999, the Government announced an ambitious plan to consolidate the banking sector: by April 2000, the Government had hoped to merge 55 banking institutions including 20 commercial banks, 12 merchant banks and 23 finance companies into six banking groups, each with an anchor bank chosen by the Government to control the group.[35]

Responding to strong objections from the financial sector in October 1999, the Government modified this approach and tight merger timetable (Bank Negara Malaysia, 1999c). The revised plan allows banks and other financial institutions to choose their own merger partners and leader within each merged group; more than six groups will be permitted. However, Bank Negara can intervene to select merger partners if institutions fail to participate in mergers voluntarily. Institutions must notify Bank Negara of their merger groupings by the end of January 2000, and the merger process should be completed by the end of December 2000.

Investment bank Goldman Sachs estimates the consolidation program could slash operating costs by 20 to 25 per cent (Asian Banker Interactive, 1999). However, merged institutions only could realise such savings through staff reductions and branch closures and the Government has indicated it will not allow forced retrenchments. While the process should consolidate Malaysia's banking system, the likely shape of the industry will only become clear in January 2000.

FOREIGN PARTICIPATION

Foreign institutions dominated Malaysia's financial sector until the 1970s, but then their role diminished as their participation was restricted under Malaysia's 'New Economic Policy'. Now the financial system is significantly undercapitalised, and Malaysia is seeking some strategic foreign investment, albeit subject to significant restrictions. Unlike in Indonesia and Korea, the Malaysian banking system is unlikely to open fully to international investment, although World Trade Organisation disciplines may require some opening by 2003.

[34] Arab-Malaysian Bank repaid Ringgit 500 million of the Ringgit 1.5 billion it received; Rasheed Hussain Bank repaid Ringgit 500 million of the Ringgit 1.5 billion it received; and the Ringgit 317 million loan to United Merchant Finance was repaid as part of the Ban Hin Lee Bank merger with Southern Bank.

[35] The proposed anchor banks were Maybank, Multi-Purpose Bank, Bumiputera Commerce Bank, Perwira Affin Bank, Public Bank and Southern Bank.

Banking

To allow banks to source funds for recapitalisation, the Government has relaxed the long standing 30 per cent cap on foreign ownership of domestic banks. However, approval is given on a case-by-case basis (Fitch IBCA, 1999). Despite restrictions, foreign banks still hold around 21 per cent of Malaysian deposits and advance 23 per cent of commercial bank loans (Delhaise, 1999).

Foreign banks face several other constraints. Wholly foreign-owned banks face restrictions on their branch network expansion and their use of foreign management personnel.[36] Furthermore, local banks must supply 60 per cent of foreign companies' borrowing requirements in Malaysia.

Insurance

Malaysia has a high level of international participation in its insurance sector. However, contrary to the trend in most other regional economies to liberalise insurance markets, Malaysia's 1996 insurance law forced foreign insurers to sell down their shares in locally licensed companies to 51 per cent of equity. It also introduced a 30 per cent limit on new foreign investment in existing insurers. However, five foreign insurers were granted joint-venture licences in February 1999, allowing them to convert their foreign branches into locally incorporated entities with Malaysian equity participation.[37]

Under its 1998 World Trade Organisation financial services commitments, Malaysia agreed to maintain at least 51 per cent foreign ownership of joint-venture companies, grant six new licences for life reinsurance by 30 June 2005, and allow up to 30 per cent foreign shareholding of two government-owned reinsurance companies.

FUTURE TRENDS AND CHALLENGES

Malaysia has strengthened prudential regulation and supervision, and rapidly progressed in refinancing and restructuring the financial sector. The long term effect of capital controls remains uncertain. However, in late 1999, potential negative effects appeared largely offset by increased market confidence due to Malaysia's ongoing structural reforms, generally sound macroeconomic management and recovering confidence throughout East Asia. Furthermore, in 1999, the fixed exchange rate probably prevented appreciation of the ringgit, assisting exports.

In establishing Danaharta and Danamodal, the Government moved decisively to address the banking system's asset quality problems. Efficiently purchasing large volumes of bank NPLs and injecting public capital into undercapitalised banks significantly reduced the potential for systemic bank failure and allowed lending to resume to support economic activity.

[36] Standard Chartered, Hong Kong Shanghai Bank, Overseas Chinese Banking Corporation and United Overseas Bank have the most extensive branch networks (Tan, 1999).

[37] The licencees were Great Eastern Life Assurance Company, Overseas Assurance Corporation, Asia Life Assurance Society, Asia Insurance Company, and Wing On Fire and Marine Insurance Company.

The government driven consolidation of the financial sector is ambitious, but if handled efficiently and fairly, could make the industry more competitive. Recent moves to allow the banks greater flexibility in choosing merger partners were necessary, and well received by the market. Because these consolidated financial groups will own banks, finance companies and merchant banks, the importance of consolidated supervision will increase; Bank Negara already is implementing this. Merging so many financial institutions in such a short time will challenge Malaysian bankers and regulators; difficulties in agreeing on fair valuations are possible, but should be less problematic now voluntary groupings are permitted. Despite these uncertainties, the Malaysian Government's financial system reforms appear to be facilitating the sector's recovery.

THE PHILIPPINES

Massive loan growth, exposure to foreign currency borrowing and the real estate boom came late to the Philippines, and were moderated by an attentive central bank. Pre-crisis reforms to supervision and regulation helped the Philippines survive the Asian financial crisis with its banking system largely intact, although much of the sector is still relatively uncompetitive. After its mid 1980s banking crisis, the Philippines strengthened its banking sector. Consequently, better transparency and accounting practices, a more robust, although far from perfect bankruptcy system, and more highly educated and experienced bankers insulated the Philippines from the worst of the crisis.

PRE-CRISIS EXPERIENCES

Unlike other East Asian countries, the Philippines only experienced high economic growth and substantial capital inflows from 1994.[38] Capital inflows rose with post-1994 economic growth but were not excessive.[39]

After economic crises in 1984-86 and 1991-92, the Government with World Bank and IMF support undertook comprehensive economic reforms. Under the Ramos administration the pace of reform accelerated; major measures included the dismantling of private and public monopolies, international trade, foreign exchange and foreign investment liberalisation, fiscal reform, privatisation and financial sector reforms (East Asia Analytical Unit, 1998). As excessive public sector foreign borrowing had caused several past crises, the Government avoided extensive foreign borrowing after 1994. Many commercial banks also had been exposed to foreign exchange borrowing in 1983-84, making major banks more conservative in the late 1990s boom period (Beltran and Guinigundo, 1999).[40]

....

38 Real GNP growth rose from 1.6 per cent in 1992 to 7.2 per cent in 1996, with inflation remaining manageable, averaging 8.5 per cent during these years.

39 Capital inflows rose from US$2.1 billion in 1993 to US$3.6 billion in 1996 (International Monetary Fund, 1999).

40 Some smaller banks did get into trouble in 1997-98 due to excessive foreign exchange exposure.

After 1994, rising capital inflows strengthened the Philippine balance of payments, improved international reserves and allowed increases in capital equipment and infrastructure investment. Foreign capital inflows also stimulated domestic capital market development. However, higher capital inflows made the economy vulnerable to capital flight. Analysts estimated that in early 1997, foreign funds accounted for 15 per cent of stock market capitalisation and 70 per cent of turnover (Beltran and Guinigundo, 1999). Capital inflows also exposed the economy to serious foreign exchange risks, as a near fixed exchange rate and low world interest rates made unhedged foreign borrowing appear a low risk activity.

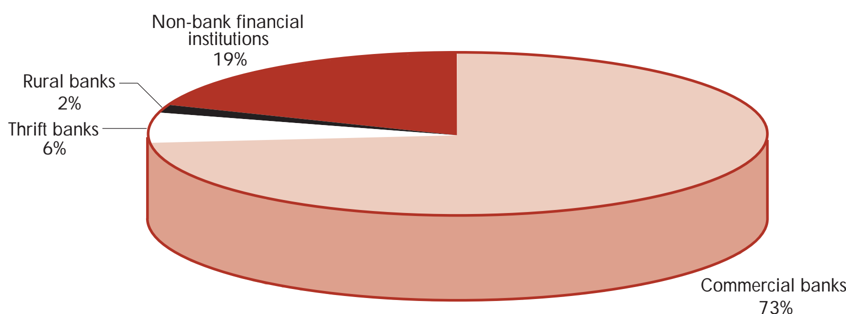
FINANCIAL SYSTEM STRUCTURE

Like most low income developing economies, banks dominate the financial sector, accounting for around 80 per cent of total assets in 1998. The Philippines has 19 universal commercial banks, 34 ordinary commercial banks, 118 thrift banks and 839 rural banks.[41] Universal and ordinary commercial banks hold 80 per cent of bank assets (Figure 8.5). The Government wholly owns two specialised development banks, the Land Bank of the Philippines and the Development Bank of the Philippines. These also undertake some commercial banking functions.

Figure 8.5

Commercial Banks Dominate the Financial System

Share of Financial System Assets, 1998



Source: CEIC, 1999.

[41] Universal commercial banks, also known as expanded commercial banks, can underwrite securities and own equity in non-financial enterprises, while ordinary commercial banks cannot.

After 1993, a result of liberalisation and an improved business environment, the financial sector grew strongly. However, while deposits and loans grew by around 40 per cent per year in 1996 and 1997, the banking sector remained small. In 1998, its total assets were only US$72 billion, less than those of some Asian banks (CEIC, 1999; and Delhaise, 1999). Financial intermediation deepened rapidly, with the ratio of money in circulation and bank deposits to GDP nearly doubling from 34 per cent in 1991 to 61 per cent in 1997. However this ratio is still much lower than elsewhere in the region.[42]

Banks' market share dominates that of non-bank intermediaries.[43] In mid 1999, the non-bank financial institutions held only 19 per cent of the financial system's assets and 9 per cent of its liabilities (CEIC, 1999). Over the 1990s, non-bank financial institutions actually lost market share to banks.[44]

IMPACT OF THE CRISIS ON FINANCIAL MARKETS

Like elsewhere in the region, capital flight during the financial crisis caused the exchange rate to depreciate substantially and interest rates to rise steeply.[45] The stock market also plummeted. Initially, banks profited from increased interest rates on their loans and the higher peso value of their positive net foreign exchange holdings. However, NPLs rose as high interest rates and unhedged foreign exchange exposures increased corporate bankruptcies.

Previous banking sector reforms shielded the Philippine banking system from the more severe effects of the Asian crisis, allowing it to avoid major bank failures.[46] While the central bank, Bangko Sentral ng Pilipinas, provided emergency liquidity assistance, it was not on the scale of Indonesia or Thailand.[47] The Bangko Sentral ng Pilipinas's most controversial intervention was the temporary (eight month) closure of Orient Commercial Bank in 1998, before it eventually went into receivership. The Bangko Sentral ng Pilipinas decision subsequently led to tighter regulation of capital deficient banks.

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42 Using another measure of financial depth, in 1997, the ratio of loans to GDP for the Philippines was 60 to 70 per cent, less than half that of Malaysia (140 to 160 per cent) and Thailand (130 to 150 per cent). Only Indonesia (50 to 60 per cent) had a lower ratio (Delhaise, 1999).

43 Philippine non-bank institutions include insurance companies, securities companies, financing companies, investment companies, securities dealers and brokers, fund managers, pawnshops, lending investors, non-stock savings and loan associations, building and loans associations, venture capital corporations, cooperatives, and credit unions.

44 From 1990 to 1998, non-bank financial institution assets grew at an average of 17 per cent while bank assets grew at an average of 21 per cent per year.

45 The exchange rate bottomed at P 42.66:US$1 in January 1998, down from P 26.38:US$1 in June 1997. The benchmark 91 day Treasury bill peaked at 19.1 per cent in January 1998 up from 10.5 per cent in June 1997.

46 Since the crisis began, only one small commercial bank, Orient Commercial Bank, seven thrift banks and 18 rural banks have failed. Their combined assets represent less than 1 per cent of the banking system.

47 From July 1997 to November 1998, 11 banks, excluding rural banks, received emergency liquidity assistance worth P 14.8 billion (US$383 million) or 0.6 per cent of GDP and less than 1 per cent of bank deposits (Beltran and Guingundo, 1999).

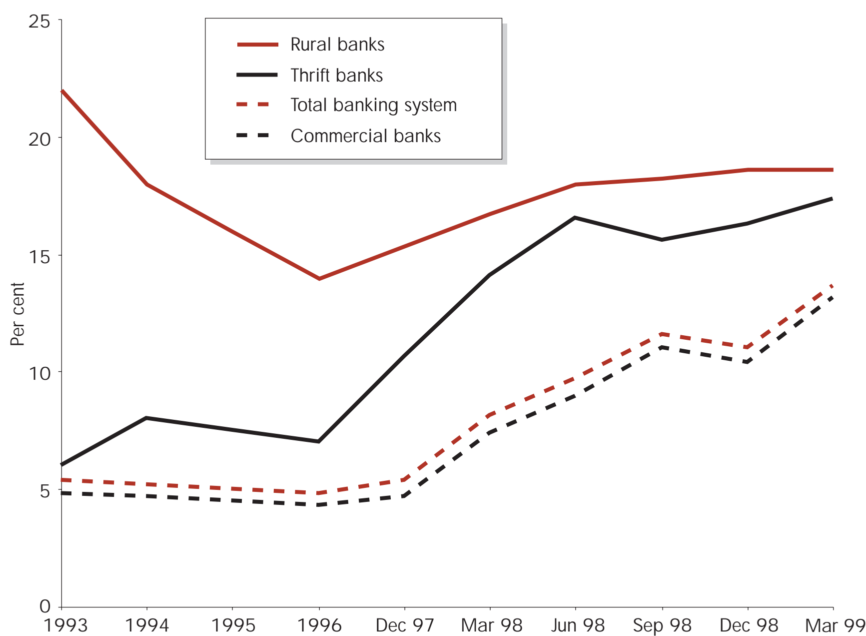
Despite generally good prudential controls, the slowing economy, peso depreciation and high interest rates reduced banks' asset quality and profitability in 1997 and 1998. The NPL ratio grew from 4 per cent in June 1997 to 14.4 per cent in May 1999, before falling to 14.3 per cent in July 1999. NPLs are much higher in thrift and rural banks than in commercial banks (Figure 8.6). The worsening ratio of NPLs to total loans also partly reflects tighter prudential standards for loan classification and loss provisioning, making asset quality problems more transparent.[48]

Bank lending decelerated as a result of growing NPLs and weak macroeconomic conditions. Net domestic credit growth slowed to close to zero in late 1998. Depositor confidence in the banking system remained strong, with no major run on deposits. However, thrift and rural banks' share of total deposits fell from 11.9 per cent to 10.3 per cent, suggesting a flight to quality. The deposit share of foreign banks also rose from 4.0 per cent to 7.1 per cent between 1996 and 1998, although this was partly because many foreign-owned banks were newly opened and just starting to mobilise deposits.

Figure 8.6

Commercial Bank NPLs Modest

NPLs by Major Bank Type, 1993-98 (Per cent of Total Loans)



Source: CEIC, 1999.

48 Bank profitability also fell, with returns on banking system assets falling to 0.37 per cent in June 1998, from 1.66 per cent in 1997, and an average of over 2.3 per cent during 1990-96.

Banks' strong and rising capital adequacy buffered them from rising NPLs. In 1996, Philippine banks were among the most highly capitalised and least leveraged in the region. In mid 1997, their capital adequacy ratios averaged 17.6 per cent, well above the regulatory minimum of 10 per cent and almost double those of Thailand and Korea (Bangko Sentral ng Pilipinas, 1999a). Over 1998, their capital adequacy ratios actually increased to 17.8 per cent; of the commercial banks, only Orient Commercial Bank had a capital adequacy ratio below 10 per cent. However, average capital adequacy levels disguised some significant problems, especially in smaller banks and the 46 per cent government-owned Philippine National Bank.

Fortunately, bank exposure to real estate lending was lower than in other ASEAN economies. Property demand was flat through much of the 1990s and an excess supply had not developed, except in prestige condominiums. Office vacancy rates were only 2 per cent before the crisis. Central bank restrictions on real estate lending encouraged real estate developers to pre-sell projects and tap foreign equity and stock market funds; this reduced bank exposure to this risk (East Asia Analytical Unit, 1998).

PRE-CRISIS FINANCIAL SECTOR REFORMS

After the 1992-93 financial crisis, the Bangko Sentral ng Pilipinas tightened prudential regulations, strengthened the banking system's capital base and reduced exposure to real estate and foreign currency risk. Between 1993 and 1998, the Ramos administration sought to reform further the inefficient and protected financial sector. It lifted restrictions on domestic bank branch networks in 1993, opened the banking and insurance sectors to new entrants in 1994, and expanded the business scope of universal commercial banks (East Asia Analytical Unit, 1998). However, despite these reforms, the banking sector remained small and inefficient, even by regional standards.

POST-CRISIS BANKING REFORMS

After the crisis began, the Bangko Sentral ng Pilipinas progressively increased bank minimum capital requirements to strengthen banks' equity bases and encourage mergers. Over 1999-2000, it will introduce further increases of between 20 and 60 per cent, depending on the type of bank.[49] In June 1997, Bangko Sentral ng Pilipinas lowered ceilings on real estate development lending from 30 per cent to 20 per cent of total loans and reduced the maximum ratio of real estate loans to collateral value from 70 per cent to 60 per cent, further limiting real estate lending exposure.[50] The Bangko Sentral ng Pilipinas also restricted borrowing from bank foreign currency deposit units to finance real estate and other speculative investments. With a few exceptions, like selected infrastructure projects, banks only can lend foreign currency to borrowers like exporters and others with a foreign currency revenue flow, who demonstrate a natural hedge.[51]

49 This requirement applies to existing banks; the central bank did not issue any new bank licences in 1998-99.

50 In March 1997, when the Government started regular monitoring of banks' real estate exposure, the average exposure was only 11 per cent. In September 1998, only ten commercial banks out of 53 exceeded the 20 per cent ceiling.

51 In addition, the Bangko Sentral ng Pilipinas requires 30 per cent of foreign currency deposit unit liabilities to be kept in highly liquid assets.

Other post-crisis reforms include progressively introducing a risk based capital adequacy regime and a new loan classification and provisioning system, increasing the general loan to loss provision to 2 per cent from October 1999 and improving disclosure standards.[52] Banks now must publish their NPL ratios and loan loss provisions quarterly. By pressuring banks to increase their capital, these prudential reforms will encourage mergers and attract foreign capital.

FOREIGN CURRENCY DEPOSIT UNITS

Foreign currency deposit units allow Filipinos to deposit and borrow in foreign currencies (largely US dollars). They were first introduced in 1971 to encourage Filipinos to keep their money in the country and counter widespread capital flight. Overseas workers repatriate close to US$6 billion in savings every year; much of this is kept in US dollar savings deposits in Philippine banks (Delhaise, 1999). Throughout the 1970s and 1980s, the Government introduced incentives to increase the attractiveness of these accounts to compensate for lack of confidence in the Philippine economy.

Although foreign currency borrowing and lending poses great risks, as Thailand's and Indonesia's experiences demonstrate, two factors limited the Philippines' exposure to currency fluctuations. Firstly, Bangko Sentral ng Pilipinas regulations ensured most Philippine bank foreign currency lending was to exporters who have a natural hedge, as most of their revenue is in US dollars. In the March quarter in 1997, exporters or export oriented users accounted for 60 per cent of foreign currency deposit unit loans. Some utilities (like private power and water suppliers) which hold these loans also have a natural hedge because they can raise prices in line with currency fluctuations.

Secondly, most Philippine bank foreign currency liabilities are owed to domestic residents. In September 1997, residents held 63 per cent of the Philippine banking sector's total stock of foreign liabilities and 80 per cent of their foreign currency deposit unit liabilities. This contrasts with Thailand where residents held only 1 per cent of the financial sector's foreign exchange liabilities in the first quarter of 1996. Under these conditions, the peso's depreciation merely transferred wealth between domestic residents, with over 60 per cent of foreign exchange losses offset by gains to other residents. This significantly reduced the macroeconomic severity of the crisis. Domestic residents had little reason to withdraw funds from foreign currency deposit units, and domestic banks had no reason to call in loans from these units. Consequently, the Philippines suffered less capital flight than many other regional economies which had high exposure to short term foreign lending and portfolio investments.

Source: East Asia Analytical Unit, 1998.

52 The definition of overdue was amended from six to three months. By 15 March 1999, banks were required to provision for special mention loans (5 per cent), sub-standard loans (25 per cent), doubtful loans (50 per cent), and loss loans (100 per cent). In addition, general loan loss provisions of 2 per cent were required (Bangko Sentral ng Pilipinas, 1998a).

Reforms to Reduce Bank Margins

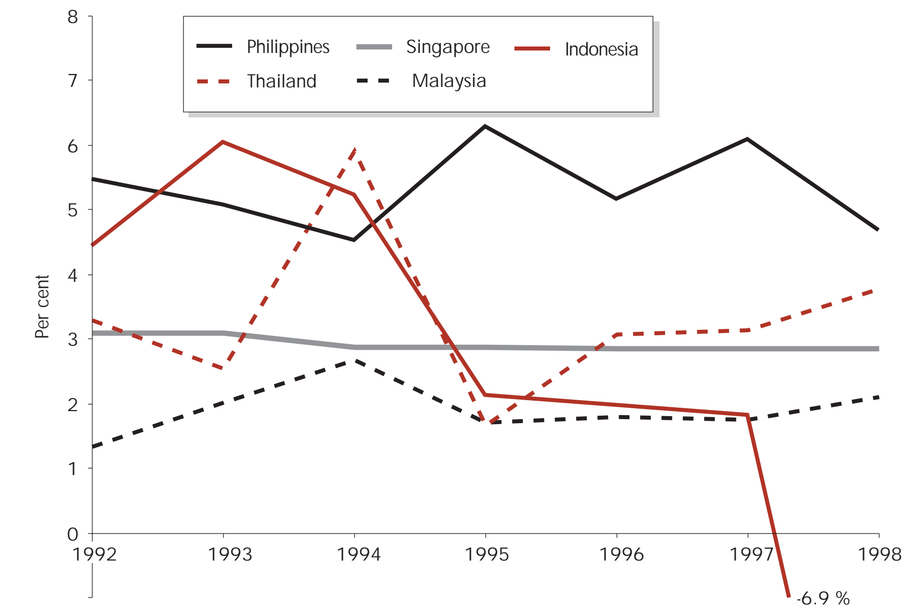
In the three to four years before the crisis, Philippine banks had the highest profit rates but also the highest cost margins in Asia, implying low competitiveness and inefficiency (Delhaise, 1999). In the 1990s, the spread between borrowing and lending rates ranged from 4.1 to 5.4 percentage points, well above the spreads in Malaysia, the United States and Singapore (Figure 8.7). Philippine banking is quite concentrated, and many analysts believe an interest rate cartel produces the high spreads between borrowing and lending rates, imposing high costs on the economy.[53]

Nevertheless, to prevent growth stagnating, reducing the high intermediation costs of the local banking sector deserves high government priority. Options include encouraging new bank entry, including foreign banks, lowering statutory reserve requirements, abolishing inefficient banking taxes, particularly the documentary stamp tax, removing branching restrictions on foreign banks, abolishing sectoral lending requirements and encouraging bank mergers. In March 1998, the Bangko Sentral ng Pilipinas reduced the banks' statutory reserve requirement by 3 percentage

Figure 8.7

Philippine Interest Rate Spread One of Region's Highest

Regional Lending and Deposit Rate Differentials, 1990-98



Source: CEIC, 1999.

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53 However, during the crisis, these high spreads proved an advantage as most Philippine banks could write off NPLs from retained earnings and still maintain high capital adequacy ratios. Bankers claim that inefficient taxes like the documentary stamp tax and high statutory reserve requirements are mainly responsible for high spreads.

points to 10 per cent while raising liquidity reserves by an equal amount to 7 per cent. The move aimed to reduce domestic interest rates by lowering bank intermediation costs.[54] In May 1998, the Bangko Sentral ng Pilipinas increased the proportion of statutory reserve deposits which can earn interest from 25 per cent to 40 per cent.[55] In February 1999, it began to ease banks' compulsory lending to agriculture by allowing development loans and lending to farmer associations and some types of housing in the mandated 25 per cent.

PRUDENTIAL SUPERVISION REFORMS

The Bangko Sentral ng Pilipinas supervises nearly all deposit taking and lending organisations.[56] The Office of the Insurance Commission supervises insurance companies and the Securities Exchange Commission supervises securities firms. The Philippines does not yet have sufficient human resources to set up an independent financial sector regulator outside the Bangko Sentral ng Pilipinas, but the Bangko Sentral ng Pilipinas is consolidating supervision; already, it supervises insurance and securities companies affiliated with banks.[57] Once new banking legislation currently before Congress is passed, the Bangko Sentral ng Pilipinas will introduce consolidated supervision (Government of the Philippines, 1999).

Improving financial supervision was a government priority well before the financial crisis, but since 1997 efforts have increased. In 1993, a new law strengthened the Bangko Sentral ng Pilipinas's capital base and increased its independence, and a new charter shielded it from political interference. Since 1998, Bangko Sentral ng Pilipinas accredited external auditors have had to report any matters adversely affecting the condition or soundness of banks to the Bangko Sentral ng Pilipinas. If they fail to inform the Bangko Sentral ng Pilipinas about bank problems, these auditors will be blacklisted (Bangko Sentral ng Pilipinas, 1999).

Most importantly, the Bangko Sentral ng Pilipinas now has tighter procedures for closing insolvent banks.[58] Supervisors have adequate immunity for their actions, and commercial banks cannot hide behind secrecy provisions. However, the Philippines Insurance Deposit Corporation still is hampered in its role as receiver, insurer and liquidator of troubled banks.

54 Liquid reserves can be kept in short term market yielding government securities, while statutory reserve deposits are held at the Bangko Sentral ng Pilipinas, and 75 per cent receive no return.

55 The Bangko Sentral ng Pilipinas reduced the statutory reserve deposits requirement by a further 2 percentage points to 8 per cent on 29 May 1998. In an effort to siphon off excess liquidity, the Bangko Sentral ng Pilipinas then increased statutory reserve deposits to 10 per cent from 2 October 1998. Concurrently, it increased the interest rate on the 40 per cent of the banks' balances with the Bangko Sentral ng Pilipinas from 4 per cent to 4.5 per cent.

56 These include non-bank financial institutions with quasi-banking functions, trust or investment management authority, building and loan associations, non-stock savings and loan associations, trust companies, and non-bank subsidiaries of banks. The Philippine Deposit Insurance Corporation also has some supervisory responsibilities, and is empowered to examine insured institutions, although it extensively uses Bangko Sentral ng Pilipinas supervisory findings.

57 In June 1995, expanded commercial banks could become majority stockholders of insurance companies.

58 Steps now enhance exit procedures, including earlier identification of troubled banks, intensified monitoring and inspection of troubled banks, harsher penalties for capital shortfalls, time-bound liquidation procedures, and more restrictive guidelines for the granting emergency loans to banks.

Disclosure Based Supervision

In line with developed economy trends, the Bangko Sentral ng Pilipinas is changing the focus and method of bank supervision, so it can detect early bank distress symptoms and better assess the health of the banking system. A forward looking, risk based framework will replace the current compliance based and checklist driven approach. The Bangko Sentral ng Pilipinas has reoriented examination processes and bank rating methods to assess and manage risks (International Monetary Fund, 1999).

Draft Legislation before Congress

In 2000, Congress should pass important changes to the general banking law and the central bank law, further strengthening Bangko Sentral ng Pilipinas regulatory powers. The changes will enable the Bangko Sentral ng Pilipinas's controlling board, the Monetary Board, to adopt internationally accepted standards for setting risk based capital requirements and defining unsound practices; allow 100 per cent foreign ownership of distressed banks (although foreign owners must reduce their stake to 70 per cent over ten years); tighten bank licensing criteria; strengthen disclosure requirements and restrictions on lending to directors, officers, stockholders and their related interests; and penalise erring directors (Economist Intelligence Unit, 1999). This legislation will raise Philippine prudential standards closer to international best practice.

MERGERS

The Bangko Sentral ng Pilipinas is encouraging mergers among local banks by raising minimum capital requirements. In the largest merger announced to date, Far East Bank and Trust Corporation will merge with Bank of the Philippine Islands, creating the largest bank in the country with assets of P 352 billion (US$8.7 billion). Equitable Banking Corporation and two state run funds bought a controlling stake in the PCI Bank for P 31.9 billion. Several other mergers are being negotiated and many others are expected; for example, Bank of the Philippine Islands and Metropolitan Bank are expected to take over smaller banks (Asian Banker Interactive, 1999). The future banking sector will be significantly more consolidated, and foreign banks will increase their market share.

FOREIGN FINANCIAL INSTITUTION ENTRY

In 1995, for the first time since 1949, the Government issued ten new foreign bank licences, adding to the four foreign banks already operating. It also issued licences to ten foreign insurance companies to compete with the 12 new domestic insurance companies. The new entrants encouraged existing financial institutions to boost their capital base, diversify their products and adopt new technologies.

However, new foreign banks can open only six branches, limiting them to wholesale banking. Further, they can only borrow US$4 dollars of head office capital for every US$1 of domestically held capital, limiting their capacity to expand local lending (La Brooy, 1997). As a result, foreign banks' share of domestic banking has grown only slowly. By 1997, foreign banks had around 20 per cent of the equity of universal commercial banks and 12 per cent of ordinary commercial banks. However, their share of total deposits jumped from 4 per cent to 7 per cent during the financial crisis.

Foreigners now can hold up to 60 per cent equity in an existing local bank. In 1999, the Bangko Sentral ng Pilipinas approved 100 per cent foreign ownership of distressed local banks, although this provision will not be legislated until 2000.[59] Under this provision, Singapore banks acquired two medium sized commercial banks; and foreign banks also acquired smaller thrift banks.[60] However, new foreign owners must reduce their stake to 85 per cent within five years and to 70 per cent within ten years. The new general banking law also will increase foreign participation on bank boards by removing the requirement for two thirds of directors to be Filipino citizens.

In February 1998, the amended financing company law expanded the maximum foreign ownership of finance companies from 40 per cent to 60 per cent. Now finance companies can issue bonds and other capital instruments, as well as provide money market, trust and quasi-banking services (Institute of International Bankers, 1999).

Opportunities for Foreign Financial Institutions

Opportunities will increase once the legislation supports central bank policy to allow greater foreign ownership of local banks. Privatising the Philippines National Bank, which is on the Government's reform agenda, may allow a foreign bank to take a significant shareholding. As competition increases, merger activity should accelerate, and foreign banks may increase their share of the local market by acquiring smaller domestic banks or finance companies. Already, ANZ and CMG Asia have built a significant presence in the Philippines (East Asia Analytical Unit, 1998).

CAPITAL MARKET DEVELOPMENTS

Before the crisis, the Government undertook several reforms to develop capital markets and reduce reliance on bank finance. Most importantly, in 1994, it unified the Manila and Makati stock exchanges, boosting total liquidity. The new Philippine Stock Exchange has stock market trading monitors in regional cities to enhance investor participation outside Metro Manila. The long standing difficulties in settling and clearing government securities soon may be resolved, providing a workable delivery-versus-payment system (*Asiamoney*, April 1999, p. 26). The Government also recently established a central clearing and settlement agency for equity securities, and issued new rules to curb price manipulation and insider trading.[61]

[59] Despite the lack of legislative backing, Bangko Sentral ng Pilipinas Governor Rafael Buenaventura has urged Congress to allow 100 per cent foreign ownership of local banks, subject to the proviso that foreign banks own only 30 per cent of total banking system assets (Asian Banker Interactive, 1999).

[60] Development Bank of Singapore acquired a medium sized commercial bank, Bank of Southeast Asia in August 1998 for P 1.2 billion to P 1.5 billion, and United Overseas Bank acquired Westmont Bank of Philippines in July 1999 for P 3 billion. Among the thrift banks, ABN Amro acquired Great Pacific Savings Bank in April 1999, and Royal Canadian Financial Group invested in Prime Savings Bank in February 1999.

[61] For instance, licensed traders cannot directly or indirectly trade their personal account in the exchange. The securities regulator also issued new rules on the dissemination of news tips or rumours by listed companies.

The Philippine bond market is embryonic. The corporate bond market remains much smaller than the government bond market, with around P 50 billion outstanding as against P 750 billion in the government bond market. The 0.75 per cent documentary stamp tax applicable to private debt security trades inhibits the growth of private debt markets and secondary market trading. It also inhibits the emergence of an effective settlement and clearing system for private debt securities.[62] A 20 per cent withholding tax applies to private investors' income from private and government debt securities, further inhibiting secondary market trading.

Securities Regulation

Since 1996, securities regulation reforms have promoted full disclosure and self-regulation, a trend evident in more developed regional markets (See Chapter 5 - *Capital Markets*.) In 1998, the Government granted the Philippines Stock Exchange self-regulatory organisation status. Corporate return processing changed from a merit based to a full disclosure system. Further reforms to the regulatory framework promise a full shift to disclosure based regulation, upgraded prudential standards and improved enforcement.[63]

FUTURE CHALLENGES

One of the Philippines' most important medium term challenges is to reduce the wide gap between bank lending and deposit rates. Increasing international bank competition in domestic banking, including allowing 100 per cent takeovers of non-distressed banks, should help reduce these spreads. Further liberalising and preferably abolishing restrictions on the number of branches foreign banks can operate, removing restrictions on their access to head office capital to underwrite lending, and encouraging further rationalising and merging of small and medium sized banks should increase competition. Similarly, abolishing the documentary stamp tax, reducing the statutory reserve requirement and increasing the proportion of statutory reserves receiving a market rate of return also will reduce spreads.

Other useful measures include abolishing the mandatory credit allocations which force banks to lend 25 per cent of funds to agriculture and agriprocessing, and 10 per cent to small and medium enterprises.[64] These restrictions prevent banks from allocating capital to maximise returns. They also increase default risks by forcing banks to lend to sectors in which they have less experience.[65] The resulting inefficiency widens the spread between lending and deposit rates.

[62] To avoid stamp duty, the sale of private debt usually is not followed by a legal transfer of title. Instead a new paper certifies the security has been assigned to a new owner.

[63] The proposed *Securities Regulations and Enforcement Act (House Bill 8015)* will strengthen the regulatory powers of the Securities Exchange Commission, and enshrine disclosure based regulation and self-regulation in the securities industry. In January 1999, the Government transferred control of the Securities Exchange Commission from the Department of Finance to the Office of the President, potentially giving it more autonomy.

[64] These restrictions are circumvented somewhat as lending to large corporations, such as San Miguel which has some food processing activities, may count as lending for agriculture and agri-processing.

[65] To mitigate this problem, the Bankers Association of the Philippines encourages institutions like the Land Bank of the Philippines and the Small Business Guarantee Finance Corporation, which have relevant sectoral expertise, to issue market based securities for banks to buy in lieu of direct lending to these sectors.

The Bangko Sentral ng Pilipinas and Government remain committed to further rationalising the banking industry through mergers and acquisitions. They also appear willing to allow increased foreign presence, although the long term provisions for foreign takeovers remain uncertain. Similarly, the Government is committed to further reducing the Government's stake in the banking system by selling its remaining share in the Philippine National Bank. This bank was severely affected by the crisis, and is likely to be sold to a strategic partner by mid 2000 (Government of Philippines, 1999).

Although reforms to regulation and supervision are ongoing, some still need congressional approval. While adopting risk based and consolidated financial supervision represent major positive developments, the Bangko Sentral ng Pilipinas has yet to implement these new approaches. Enforcing capital adequacy requirements and bank exit policies present further challenges.

PROSPECTS FOR THAILAND, MALAYSIA AND THE PHILIPPINES

Due to structural reforms and stimulatory macroeconomic policies, the financial sectors of Thailand, Malaysia and the Philippines all are recovering from crisis.

Compared to Malaysia's approach, Thailand's less interventionist approach to financial sector restructuring and refinancing probably has lengthened its crisis. While its private sector led approach possibly limited the short term cost of the public bailout, by slowing economic recovery, the ultimate cost of this strategy may be higher than rapid intervention to clear NPLs. Continuing uncertainty, slow corporate and financial restructuring, and weak economic recovery have escalated Thailand's NPLs; as the Government has guaranteed all deposits, higher NPLs will raise the fiscal cost of resolving the financial system's problems.

Despite the large number of smaller financial institutions and their exposure to some highly leveraged corporates, Malaysia's pre-crisis banking system and prudential controls were stronger than many others in the region. Capital controls introduced in 1998 may have given Malaysia useful policy flexibility, but in other regional economies, which did not employ such controls, interest rates also fell and the currency also stablised in late 1998. More importantly, Malaysia continues to make good progress in restructuring and recapitalising its financial system and this is building market confidence.

In the Philippines, major pre-crisis improvements in financial regulation and supervision were central to modernising the financial sector and helping avoid systemic bank failure. The nature of foreign currency liabilities and the late start to the Philippine asset boom also helped the country avoid the worst of the crisis.

The Philippines' financial system has opened gradually to foreign participation. Competition from foreign banks and higher capital requirements are forcing mergers between domestic players. The banking system will emerge from the crisis better regulated with the major players bigger, better capitalised and more competitive than before. In the relatively open foreign investment environment, many opportunities are emerging for foreign financial institutions.

All three economies recognise the importance of improving prudential regulation and supervision, and increasing domestic competition, but the Philippines is the most advanced in recognising the benefits of foreign competition. All three are making progress on enhancing financial market infrastructure and further developing capital markets. In the medium to long term, as these initiatives are effectively implemented, they will enhance these three economies' ability to achieve high levels of sustainable growth.

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