Overview of the Second International Conference on Financial Systems: Competitiveness of the Financial Sector

15 December 2006

Session 1: Competitiveness of the Financial Sector

In the first session, presentations were made on the "Competitiveness of the Financial Sector." Ms Sarah Carlson (Financial Services Authority, UK) explained that the strength of London as a financial centre is its human capital, legal infrastructure and market infrastructure. Mr Robert Feldman (Morgan Stanley, Tokyo) investigated the regulatory shortcomings that are affecting the competitiveness of Japan's financial institutions and sector and emphasized the need to improve the means of communication between the regulator, the market and financial institutions. Mr Jesús Saurina (Banco de España) explored the effect of European integration on the competitiveness of the financial institutions of the EU and described how increased competition has resulted in the improved efficiency of the financial institutions. At the same time, the retail sector remains fragmented in the EU, and although efforts are being made for further integration it will probably continue to be fragmented to a certain extent due to local tastes and preferences. Mr Yi, Hong-Cheol (Bank of Korea) gave an overview of Korea's experience of financial crisis and how this prompted consolidation of the financial sector. The profitability and soundness of banks have improved in Korea, but as a result of the concentrated market, there are now concerns that the banks may have become "too big to fail" or "too big to rescue." Ms Panita Piyaoui (Bank of Thailand) discussed how the structure of the financial system in Thailand has affected the level of concentration; however, bank performance has increased markedly since restructuring in the aftermath of the financial crisis. Mr R Gurumurthy (Waseda University) discussed the Indian financial system and its competitiveness since the reform of the market in 1991. In India, financial inclusion remains an important policy goal and thus competitiveness will need to be achieved within this framework.

The first point discussed was the entry and exit of financial institutions from the financial market. Mr Naoyuki Yoshino (Financial Services Agency [FSA], Japan, and Keio University) explained that competitiveness needs to be achieved within a stable financial environment. Although advanced markets, like the UK, do not consider exit policy to be as important because there are clear procedures and proposals of mergers for banks that are deemed to exit the market, in Spain, there is no prompt corrective action to support the exit of banks, and this is keenly needed. It was also mentioned that exit policy mainly refers to the "replacement of executives" and not to the exit of a bank or its investors. Korea has introduced a "sequenced approach" in which the action required by the bank differs according to the capital ratio. It was also pointed out that the entry and exit of public financial institutions in Japan are problematic. In the process of privatization, it is not always clear how to determine that there is a "level playing field" for both private and former public institutions.

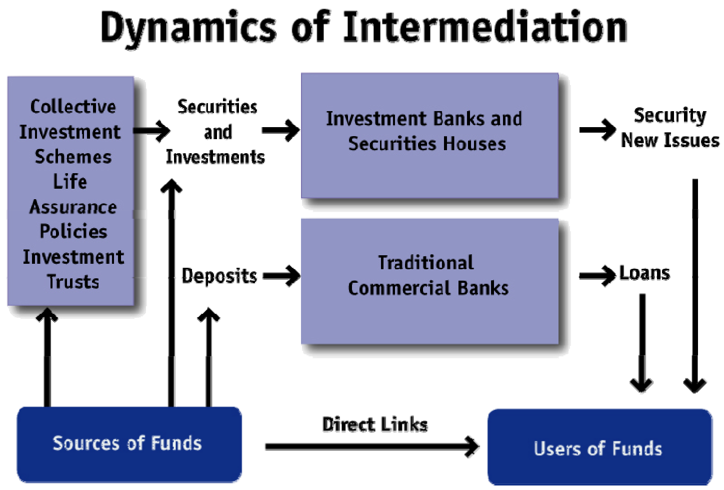
The next topic considered was human capital, including its importance for a financial sector to thrive and why some markets have an abundance of it and other markets have not as much. Speakers mainly discussed the differences between European and Asian labour markets. Some said that there was less talented human capital in Asia compared to Europe and the United States. Some said that labour markets in Asia lack mability and skill transferability.

The third issue discussed was the relationship between market concentration and competition in the financial industry. Mr Yi insisted that the profits of Korean banks grew because the large number of M&As strengthened financial institutions and increased efficiency. Ms Yuko Kawamoto (Waseda University) commented that interest margins remained small in Japan despite the consolidation of the banking industry. The difficulty of appropriately pricing and assessing the risk of loans was mentioned. Some were sceptical about the correlation between market concentration and the competitiveness of financial companies because if risk is well reflected even small financial institutions can be competitive.

Session 1 Presentations

The Road to a Competitive Financial Sector: Sarah Carlson, Manager, Global Risk and Risk Aggregation, Financial Services Authority, UK

London is a world-leading international financial centre. Are these advantages unique? What defines international competitive advantage? London's competitiveness lies in its scale, scope and internationalism. (1) Size of the London market creates genuine liquidity. (2) Clustering: London offers the full range of financial services. (3) We are the international centre for international bonds and share trading:



What makes a financial sector competitive?

People

- Skilled personnel: 'Our people are our greatest asset'
- Labour laws
- Culture and language
- Quality of life
- Time zone

Legal system

- Regulatory system
- Fair and just business environment
- Government responsiveness

Infrastructure

- Access to financial markets
- Availability of business infrastructure (IT, telecoms)
- Access to customers
- Liquidity

A Hint from Nietzsche: Imperatives in Japan's Redesign of the Financial Sector: Robert Feldman, Managing Director and Chief Economist, Morgan Stanley, Japan

"The most fundamental form of human stupidity is forgetting what we were trying to do in the first place." Nietzsche

Too many accidents: (1) Derivatives sales problem at a major bank; (2) non-payment by life insurers; (3) pension payment irregularities; (4) auditing irregularities; (5) market disruption from ill-timed sanctions; (6) postal savings system irregularities; (7) Horie/Murakami Fund problems; (8) stock manipulation by a railroad company; (9) Yubari Municipal problems; (10) TSE trading system problems; (11) consumer finance fiasco; (12) insider trading at a branch of a securities company; (13) insider trading by a member of the media;

Why so many? Because regulators are tougher and more aware? Because systemic flaws remain rampant? Because police/ regulator/ political incentives favor grandstanding?

Investors at home and abroad see Japanese financial regulation as uncoordinated "mogura-tataki" (mole hunt). Example: Dividend tax debate vs. consumer finance actions. Ad hoc nature of decisions destroys confidence in fairness and stability.

Japan needs a principles-based financial system. But ***what principles***?

All decisions about financial sector structure and regulatory design must foster efficient resource use. Otherwise, Japan's standard of living will fall. ***sub-principles*** are:

Principle 1: Resource Efficiency

1. Competition. Financial structure and regulation must enhance competition. Entry/exit barriers and vested interests must be destroyed.
2. Accurate information, disseminated fairly. Information supplied to markets by firms, regulators, and intermediaries (both analysts and media) must be accurate and balanced, and must be available on an equal basis. Leaks from both private and public sectors must stop.
3. Equal treatment. Distinctions among players and products should be made only on the basis of sophistication and potential contagion, not on such distinctions as region/center, private/public, regulator/intermediary, foreign/domestic.
4. Minimum cost. Technology and organizations, both private and regulatory, should minimize costs. Artificial barriers and overlap should be eliminated.
5. Self-Responsibility. Distinguish between amateur and professional investors, and enforce appropriate self-responsibility for both. Excess protection destroys efficiency.

Principle 2: Recognize Market and Regulatory Failure

- Market failures must be recognized. Such failures arise from asymmetric information (insider information), public goods (accounting systems), economies of scale (IT applications), and externalities (e.g. contagion).

- Regulatory failures must also be recognized. These include lack of transparency, lack of accountability, lack of expertise, narrow incentive structures, information manipulation, short tenure of key officials.
- The financial system is highly vulnerable to both kinds of failures. All participants must approach these issues with humility

Implementing the Principles

- With financial markets subject to both market failure and regulatory failure, the only solution is open, trusting **communication** between markets and regulators. Japan is short on both trust and communication.
- There are **success cases** of communication between regulators and markets in recent Japanese financial sector history. Such cases include creation of the IRCJ, creation of the new Corporate Law, the Takenaka Plan, and the Advisory Council on Government Debt Management.
- In the financial sector two elements are lacking, **trust** and **policy competition**.

Communication Improvement Proposals

1. Create cross-industry (banks, securities, insurance, asset managers) industry associations, in order to identify common interests, to create common reform plans, and to give feedback to the FSA/government on financial regulatory matters. These associations could follow the models of Keidanren and Doyukai.
2. Ease the rules on entertainment (*settai*) between financial system regulators and the private sector. Current rules are unduly restrictive, hamper communication, and ignore progress toward a transparent regulatory system.
3. Enhance policy debate by mandating competing financial reform plans from different groups, both public and private.
4. Create a media equivalent of the *Gaimu-in* (US Series 7) and supervisory analyst (*shinsa tanto*, US Series 16) qualifications. Require by-lines by qualified reporters for coverage of financial news.

Financial Integration and Competitiveness: Jesus Saurina, Director, Financial Stability Department, Banco de España

Single market in Europe: larger markets offer higher economic benefits and increase in competitiveness. Spurs the development of a large, diversified and competitive financial market.

Increase in competitiveness*: Improved market efficiency, Impact on investment, growth and employment and Increase in welfare*

Increased competition results in a lower cost of capital for borrowers

- Competition widens the scope for product innovation and diversification
- A more complete financial market
- Improvement in risk management
- Greater liquidity and depth of financial markets
- Economies of scale and scope reduce the cost of providing financial services
- More effective transmission of monetary policy

Financial integration and risks

- On the one hand, intensified cross-border financial links might increase potential contagion
- On the other hand, more integrated financial markets increase risk diversification opportunities, thereby boosting the economy's shock-absorbing capacity
- Overall, enhanced financial integration has a long term positive impact on the stability of financial systems and of the economy
- Moreover, it increases resilience to shocks (as a result of enhanced risk-diversification)
- Shocks usually have a negative and significant impact on competitiveness, at least in the short term

Concentration and competitiveness

- More concentrated banking markets slightly more profitable but not more efficient
- More competition brings about more competitiveness…but the banking sector, given its systemic role, might be different
- Perfect competition might not be the ultimate target for banking regulators
- Look for a reasonable balance between the level of banking competition and a sound and safe banking sector
- Prudential regulation has a role to play

M&As and Competitiveness in the Korean Banking Industry since the 1997 Financial Crisis:

Yi Hong-Cheol, Deputy Director, Financial System Stability Department, Bank of Korea

As a result of IMF programs, financial sector restructuring took place leading to a wave of M&As.

- Shaking out non-viable financial institutions
- Clearing-off bad loans
- Tightening prudential regulations
- Heightening transparency of financial institutions
- Reorganizing the governance of financial institutions

5 insolvent banks were forced to exit the market through P&A.

11 unsound banks merged to form 5 successor banks.

8 banks voluntarily merged to form 4 successor banks.

3 financial holding companies were established to facilitate M&As and help banks realize

economies of scale

Changes in No of Banks (January 1998 ~ November 2006)

	End 1997	Exit (A)	Merger (B)	Exit and merger (A+B)	No of Banks operating
Banks	33	5	10	15	18
Commercial Banks	26	5	8	13	13
(Nation-wide Banks)	16	3	6	9	7
(Local Banks)	10	2	2	4	6
Specialized Banks	7	2	—	2	5

Through the injection of the public funds, 8 banks have been nationalized
Four of those state-owned banks have been privatized so far
3 banks have subsequently been sold to foreign investors (end January 2006)

Changes in the number of non-bank financial institutions (As of the end of June 2006)

	Institutions as of the end of 1997 (A)	Type of resolution			Institutions newly established (C)	Institutions in operation (A-B+C)
		Exit	Merger	Total (B)		
Merchant banking corporations	30	22	7	29	1	2
Mutual savings banks	231	108	28	136	15	110
Securities companies	36	8	7	15	19	40
Insurance companies	45	11	6	17	9	37
Total	342	149	48	197	44	189

Banking System Performance in Thailand: Panita Piyaoui, Team Executive, Financial Institutions Strategy Department, Bank of Thailand

Structure of Thailand's Financial System: Deposit-Taking FIs

1. Deposit-Taking FIs	Supervisory Authorities
Thai Banks (16) Commercial banks (14) Retail banks(2) **Foreign Banks** (18) Full branches (17) Subsidiaries (1)	Minister of Finance and Bank of Thailand
Finance Companies (7)	
Credit Foncier Companies (4)	
Specialized Financial Institutions (SFIs)	Ministry of Finance and Bank of Thailand *
Cooperatives Savings Cooperatives (1,700 **) Agricultural Cooperatives (4,438)	Ministry of Agriculture and Cooperatives

Number of FIs Before and After Crisis

	Before crisis	Before FSMP (2004)	After FSMP
Locally incorporated banks	15	13	17
Thai Banks	15	13	14
Subsidiaries	-	-	1
Retail Banks	-	-	2
Foreign Branches	16	18	17
Finance Companies	91	18	4
Credit Foncier Companies	12	5	2
Stand-alone IBFs	17	5	0
IBFs attached to commercial Banks	25	24	0
Total	176	83	40

Commercial Bank Market Structure

	Assets	
	Million Baht	**% share**
Thai Banks- Large (5)	5,208,666	61.63
Thai Banks- Medium (3)	1,339,756	15.85
Thai Banks- Small (8)	857,924	10.15
Foreign Banks (17)	1,033,989	12.23
Subsidiaries (1)	10,771	0.13
Total (34)	**8,451,106**	**100.00**

Competition in Financial Sector & Competitiveness of Indian Financial Markets: R Gugumurthy, Senior Research Fellow, Institute for Indian Economic Studies, Waseda University

What drives competition?

- Competition as a pillar of competition
- Pros and cons of competition
- Urge to excel or *kiasuism ?*
- Levels of competition viz., *brand, substitute* and *budget*
- Desirability of competition in financial sector industry
- Intra industry and industry level competition
- Subtleties in international competition
- Country specifics and the level of compatibility between *financial inclusion* and *efficiency*

Growth of commercial banking in India

	1969	1980	1991	2005
Commercial banks	74	154	272	282
Bank branches	8,262	34,594	60,570	68,339
Population per office (‘000)	64	16	14	16

Session 2: SME Financing and Competitiveness

The second session considered the competitiveness of SME financing. The second session was kicked off by Mr Stijn Claessens (The World Bank) who gave a presentation on competition policy in the financial sector and then examined the constraints to SME financing and the means to improving the market infrastructure to support SME financing. Mr Osamu Tsukahara (Japan Finance Corporation for Small and Medium Enterprise [JASME]) explained the structure and infrastructure of SME financing in Japan. Mr Marzunisham bin Omar (Bank Negara Malaysia) described the Malaysian system to support SME financing and the various efforts that are taking place.

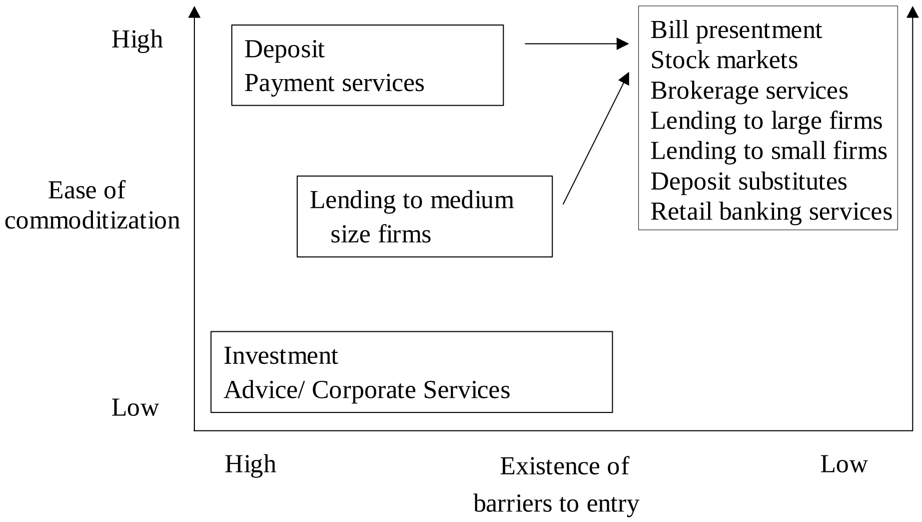
The discussion opened with each speaker being asked whether government intervention is necessary for SME financing. Mr Claessens insisted that government intervention can have validity if it is targeted and sequenced. However, he also pointed out that government intervention often fails and can cause the crowding-out of the private sector. Mr Omar commented that the government has a role in stepping in where the market has failed or for SMEs that do not have a loan record. Mr Yoshino agreed that in markets that lack information, like Japan and Malaysia, and do not have a culture of venture capitals or financing start-ups, the government remains a relied-upon player in financing. Mr Tsukahara mentioned that Japan decided after careful consideration that JASME will retain its function as a government-owned entity. As a case of successful small-scale financing without government intervention, the case of Grameen Bank was mentioned, but some commented that Grameen Bank had received government funding at one point.

Basic lack of information on SMEs was the main reason why SMEs had difficulty in obtaining financing. In order to encourage financing of SMEs, alternative financing methods, such as relationship banking and credit scoring, have been extremely useful tools. The need and lack of collateral was discussed as an obstacle to SME financing. Mechanisms of securitisation are also important to support SMEs. Large banks do not participate actively in SME financing even though they have the financial capacity and network to provide such financing.

The link between competitiveness and SME financing: Stijn Claessens, Senior Adviser, Financial Sector Vice-Presidency (FSE), The World Bank

Results suggest concentration and number of banks wrong measure for competition. Confirm IO that contestability rather than structure most important

- Concentrated banking system can be competitive
- Greater foreign bank presence, lack of activity restrictions ◊ more competitive banking systems
- Open to foreign entry & less restrictions important
- Some role of non-bank financial institutions in increasing competition policy
- However, large, unexplained variations. Country circumstances matter evidently a great deal



New competition policy to combine three approaches

- Institutional: assure contestable markets by entry/exit of institutions, domestic and cross-border (all GATS modes)
- Functional: assure contestable markets by leveling playing field across similar financial products (in all dimensions)
- Requires competition policy to be more harmonized: Horizontal/vertical and service-specific & Globally, WTO, FTA
- Production: assure efficiently provided, equally accessible, affordable network services (information, distribution, settlement, clearing, payment, etc.)

SMEs: Sign, not Cause of a Successful Economy, but Need Finance

While large SME sector characteristic of successful economies, SMEs do not “cause” growth, nor do SMEs alleviate poverty or decrease income inequality. Rather overall business environment–ease of firm entry and exit, sound property rights, and proper contract enforcement–influences economic growth. Finance, however, accelerates growth by removing constraints on small firms, more so than for large firms

- Finance allows firms to operate on a larger scale and encourages more efficient asset allocation. Financial and institutional development helps leveling the playing field
- SME not served as it is a too high-risk, high-cost proposition for most banks

What constrains SMEs' access?

- Underserved are new, not experienced in business
- Even when business is viable, uncertain repayment capacity given volatile income and expenditure
- High exposure to systemic risks (macro, other)
- Absence of credit information, lack of collateral, difficulties in contract design and enforcement
- High transactions costs for small volumes: Not conducive interest rates/credit subsidies policies and government interference distorts risk-return signals

What is constraining SME access across countries?

Analysis limited to date, but quality of legal, property rights, information, especially important for small firms: Small firms and in countries with poor institutions use less external finance, especially less bank finance and protection of property rights increases external financing of small firms significantly more than of large firms, mainly due to more bank + equity finance

Substitutes are imperfect, e.g., small firms do not use disproportionately more leasing or trade finance

Financial sector development, correlated with these good policies, helps alleviate constraints

Regulations can hinder access: Interest rate ceilings, usury laws, restrictions on lending, priority lending ,Rigidity in chartering, (high) minimum capital adequacy req., limited degrees in funding structures, Too heavy regulations and supervision, too strict accounting req., high compliance costs, Costumer identification ("Know Your Customer"), AML/CFT, other costly rules (e.g., see South Africa)

But tradeoffs arise

Regulations serve other public policy purposes, e.g., stability, integrity, consumer protection

Facilitating credit by public interventions risky: Generally distortive, often do not reach intended, e.g.: Subsidies for SME-lending captured by those with already access, middle class, well-connected, No additionality of general credit lines on growth, Institutional development undermined, banks do not develop credit skills, e.g., development banks' NPLs high, Setup subsidies can increase final costs as they lead to too small scale institutions that need to recover fixed costs, E.g., subsidies to setting up MFIs can lead to higher spreads.

Case for intervention in credit less clear than other: Need to keep the direct and indirect subsidies minimal: Costs and risks co-sharing with private sector key

<u>**Japanese SME Financing:** Osamu Tsukahara, Managing Director, Japan Finance Corporation for Small and Medium Enterprises</u>

Expected Roles of SMEs in Japan

(1) creating new industries

(2) increasing employment opportunities

(3) encouraging competition in the market

(4) vitalizing regional economies

Business Programs of JASME

Loans to SMEs

Purchase corporate: bonds (with subscription rights to newly-issued shares) issued by SMEs

Securitization of loan claims against and corporate bonds for SMEs (Synthetic CBO Program)

Support for private financial institutions in using securitization methods

① The business of securitizing loan claims, etc., taken over from private financial institutions.

② The business of guaranteeing part of the loan claims of private financial institutions, or partially purchasing/guaranteeing asset-backed securities. Provide insurance for the guaranteed liabilities of Credit Guarantee Corporations (CGCs)

- Coverage Ratio: 70%, 80% or 90%
- Comprehensive Insurance
- 52 CGCs throughout Japan

Loans to CGCs.

No-collateral provision

Eligible applicants	SMEs or individuals using Special-purpose loans as direct loans, which are recognized from their financial positions as posing relatively low credit risk
Maximum amount	¥ 80 million per company
Interest rate	A prescribed interest rate is added according to the loan period and credit risk.
Loan period	Maximum 5 years

Partially collateralized provision

Eligible applicants	SMEs or individuals using Special-purpose Loans
Maximum	Up to 75% of the loan amount (maximum ¥ 120 million) under

amount	each Special-purpose Loan scheme
Interest rate	A prescribed interest rate is added according to the loan period and credit risk for the portion of the loan subject to the insufficient collateral loan program.
Loan period	The loan period stipulated for each Special-purpose loan.

No-guarantor provision

Eligible applicants	SMEs or individuals using direct loans.
Guarantor exceptions	CEOs or senior managers are exempted from providing personal guarantees for loans.
Interest rate	An extra 0.3% is added for loans to which the no-guarantor loan program applies.

Enhancing Access to Financing by Small & Medium Enterprises in Malaysia: Marzunisham bin Omar, Director, Development Finance and Enterprise Department, Bank Negara Malaysia

National SME Development Council: Driver of SME development

Broad Objective: Promoting development of competitive and resilient SMEs in all sectors towards increasing their contributions to the economy

Strategic Thrusts for SME Development:

1. Strengthening Enabling Infrastructure
2. Building Capacity and Capability
3. Enhancing Access to Financing

Venture Capital & MESDAQ: Complemented bank lending to finance innovative SMEs

Growth in VC Industry: Provides important source of financing for newly-established businesses, esp. ICT sector

In 2005, total size of VC Funds increased by 14% to US$0.7 b (2004: US$0.6 b) for investment in 380 companies. Mostly at bridge, mezzanine/pre-IPO, expansion and early stages.

MESDAQ: Launched Oct 1997, 128 companies listed, with market cap of US$3.4 b (at Nov 2006)

- Listing requirements
- Issued & Paid-Up Capital > RM2 m (US$541,000)
- Operating History:

  Tech-based − No min period of op, no profit record required; and

  Non-Tech based − Min. 12 months in operation, audited accounts, but no profit required.

Session 3: Roundtable on the Competitiveness of the Financial Sector and Its Regulatory Implications

Mr Yoshino gave a brief summary of the issues and topics discussed at the conference in the first two sessions and requested the panellists of the third session to comment on them.

Mr Thomas Cargill (University of Nevada) considered the competitiveness of regulatory systems and institutional design being an important part of this. Ms Kawamoto mentioned three points: (1) effective competition needs to be promoted by the government for greater innovation to take place, (2) the management of banks is not well diversified and rationalised within organisations lacking efficiency, and (3) the regulatory system needs to be able to adapt better to new technologies, such as e-money. Mr Renpei Nakamura (Shoko Chukin Bank) considered issues in SME financing and said that financing needs to be developed for each stage of an enterprise's development. This requires the training of experts who are able to assess the riskiness of newly established enterprises and the incorporation of such persons into the system of SME financing. As a Japanese analyst, Ms Naoko Nemoto (S&P) questioned the profitability of Japanese banks in the long run as their interest margin remains small and long-term sustainable growth is uncertain. Japanese banks have not been successful in pricing their services or differentiating the services provided dependent on the prices. Mr Tong Shiping (Matsuyama University) analysed that competitiveness in a country like China needs to be considered in a different framework. Competition in China is government-led and will increase with the opening of the markets to foreign banks. Mr Noriyuki Yanagawa (University of Tokyo) emphasized the importance of corporate governance in the Japanese financial market and the inappropriateness of having the FSA be the provider of corporate governance in Japan. He also mentioned that the definition of a bank is changing with the diversification of the operations of banks and the provision of traditional bank products by new financial institutions.

Mr Yoshino summarized the discussion, saying that competitiveness can be considered from two angles: individual financial institutions and the regulatory system. Financial institutions need to reconsider management, R&D, the risk-based pricing of loans and customer-based services to increase competitiveness. Regulatory systems are now being developed into single or multiple regulators, and regulation is increasingly becoming market-friendly or pro-competition. Regulatory systems need to evolve with the advancements made in the financial system. It is necessary to further investigate how SME financing can be directed to involve larger financial institutions which have the financial strength to expand relationship banking as a key method for SME financing.

The characteristics of the human capital of a country, namely, a culture of risk adversity, may influence whether there is an abundance of talented personnel. The education system was criticised for not producing people suited to the financial business. Language skills are also a prerequisite for working in an international financial environment.

The pros and cons of a single regulator were discussed in the context of adapting to the financial sector. While many single regulators have been established in past years, the US multiple, competitive regulatory system has also proved to be resilient to crises. At the same time, the diversity of the system can be confusing in some instances. From a developing country perspective, the credibility of the regulator is an essential factor to operate effectively, and it may be better to maintain regulation where such resources exist, usually with the central bank. For all systems, good coordination, accountability and governance structure are critical for a financial regulator to function well and effectively. Efficiency of regulatory systems was cited as crucial, and the single regulatory system may not always provide this even though this was one of the objectives for this system's establishment.