Competition Policy in the Banking Sector of Asia[1]

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Abstract

While the banking sector has not traditionally applied the competition policy strictly, the recent international trend is turning towards greater competition policy application. The uniqueness of banking has often inhibited countries from freely implementing the competition policy, but it is necessary to understand the backdrop of such considerations, and the context in which this has been changing.

This paper looks at the manner in which competition policy has been limited in the banking sector, and how this was carried out. Relevant policy issues are discussed, before turning to the main topic of the paper, the Asian financial systems. In the research project of the FSA, the financial systems of several Asian countries were examined to comprehend the extent of competition policy being applied to banks. This paper abridges the findings of this project and hopes to convey the issues that arise from the full or partial application of the competition policy to the banking sector.

概要

競争政策は銀行に対しては限定された形で適用されてきたというのがこれまでの実態である。しかし、近年は銀行に対する競争政策の適用が国際的に活発化しており、この変化のもたらす影響を分析する必要がある。このためには、これまで銀行に対し特別の配慮が行われてきた理由と、それが変わりつつある原因について検討する必要がある。

このDPは、著者が参加し、報告書をまとめた研究会「アジア金融セクターの規制緩和に関する法制度研究」(金融庁開催)の成果を踏まえ、内容を改善・改良しつつ新たな視点でまとめたものである。アジアの金融制度改革と変遷を参考にしながら、銀行への競争政策の適用について調査し、アジアにおける銀行への競争政策の適用について検討した。

[1] This paper is based on a study by the Financial Services Agency of Japan, *Competition Policy in the Financial Sector of Asia* (July 2007). The study covers theoretical issues and eight countries' financial systems in detail. This paper has been abridged to convey the gist of the study but not a comprehensive overview of country studies.

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Introduction

The support and proliferation towards liberalisation and the market economy has brought about the need for the financial sector to consider its competition policy.

Traditionally, the financial sector was segregated from the competition policy regime maintaining a special status as a heavily regulated industry. However, as market economies began to embrace competition, competition policy has become one of the main pillars of banking regulation and supervision.[2] Markets are increasingly required to assume a proactive role in the enforcement of the competition policy.

Asia is no exception. Following the financial crises in 1997/8, the region's need for better regulatory regimes and systems that are fair to all market participants has been a hallmark of the structural reform programmes required by the International Monetary Fund (IMF).[3] Furthermore, with the world economy becoming more global and international, and financial sector standards continually evolving, the negative impact of non-conformity with international standards could be significant. Markets would not only face risks to their reputations, but operation of domestic financial institutions in international financial markets may become threatened. Possible regulatory arbitrage makes it important to regulate the financial system within a certain range within international standards.

This paper draws on the experience of developed economies with competition policy in the financial sector, mainly of regard to banks. The first section considers the significance that competition policy has played in the financial sector. The second section briefly introduces the role competition policy has played in developed markets. The third section examines the various policy areas that affect competition policy. The fourth section investigates the state of play in Asian countries.

This paper asserts the hypothesis that certain traits of the banking sector did not allow a competition policy to be rigorously applied to the banking sector in the past. Sections I to III are used to develop the background to this. Section IV applies these to the cases of Asia to investigate the robustness of the hypothesis. The analyses in this paper are limited to a number of East Asian and South Asian countries and while Japan is used as the foundation, it is not the main subject of investigation.

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[2] The IMF's Financial Sector Assessment Program includes competition policy as one of the key components of its evaluation. Chapter 2 of IMF and World Bank, *Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward: A Handbook* (February 22, 2005), p. 24.

[3] Chapter 4 of Mamiko Yokoi-Arai, *Financial Stability Issues: The Case of East Asia* (Kluwer, 2002).

I. Application of Competition Policy to Banks

The enforcement of competition policy in the financial sector has become increasingly standard in major developed economies. However, this has not traditionally been the case. Therefore, we will begin by explaining the scope of competition policy in this paper, the traditional stance towards competition policy in the banking sector, and the changing attitudes towards this in recent years.

A. Scope of competition policy

Competition law is the first avenue to address the existence of a competition policy. It also indicates a country's attitude towards a competition policy, enactment implying the relative importance for the need of a fair and balanced competition environment. When considering the competitive environment of a country, merely analysing competition law is perhaps not sufficient. Competition law is not the only law that dictates competition in the marketplaces, or more narrowly regulates unfair transactions.

However, competition law is the hallmark of the economic constitution of an economy. Competition law that prohibits anti-competitive actions is meaningless in an environment in which there is little or no real competition. Thus, a caveat needs to be made that the fact that a competition law is legislated does not in itself ensure an effective competition policy. The wider system needs to be supportive to this philosophy, for example through civil law and intellectual property laws, or privatisation of state banks.

Another factor that needs to be taken into account is the uniqueness of the financial sector. Provision of public goods such as police and national security are often characterised by the exclusive provision of services by the states and competition is not a possibility.[4] While the financial sector *per se* is not considered to be a public good it has often been excluded from the strict application of the competition law regime.[5] Thus, when we consider this in the context of financial liberalisation, it is imperative to bear in mind that the nature of competition law will not necessarily be reflective of the wider competition law regime. The competition law regime may well present a more ambitious market-oriented perspective than reality or its non-existence may not preclude effective competition policy in the marketplace.

The rationale for competition law or policy is, ultimately and essentially, to improve the consumers' welfare. The objective of competition is to improve the efficiency in production and supply, and enable the provision of goods and services at lower prices and with wider choice.

In many countries, even in developed economies, competition laws are effectively not applied to the banking sector. Thus, when considering the ambit of competition policy, a broad scope needs to be applied. As well as laws and regulations, general policies that promote competition need to be taken into account.

Competition depends in part on the ability of new firms to enter an industry, to compete with

[4] Although public goods are not necessarily provided exclusively by the state, and moreover, services that have traditionally been associated with state provision have in recent years been outsourced to the private sector. For example, prison services are being run by the private sector in some countries.

[5] Financial stability is considered a public good. Mamiko Yokoi-Arai, *Financial Stability Issues: The Case of East Asia* (Kluwer, 2002), chapter 5.

incumbents and, by adding to supply, to force prices down. The objective of competition policy is to promote competition among firms which results in greater efficiency and cost reduction, which in turn leads to increases in consumer welfare in the form of lower costs and greater choice.[6]

The instinct of a firm is to try and avoid competition. Thus, it is necessary to monitor the market so as to limit firms' anti-competitive behaviour and to ensure that competition policies are functioning effectively.[7] Regulatory requirements that create *de facto* entry barriers need to be considered carefully. While some requirements may be due to legitimate security concerns, some may create barriers that exclude non-local firms.

In this context, this paper investigates competition policy from the standing point of entry and exit regulation, branching regulation, establishment of financial holding companies, and merger regulations. This paper does not examine disclosure systems or product approval systems that also have a strong impact on the competition policy of the banking sector, but only to items that Asian countries have had a relatively strong emphasis in recent years.

B. Traditional protection of the banking sector

Banks have a unique standing in the economy, and the structure of their balance sheets has lead them to be given greater protection than other industries. While the failure of an individual bank is not in itself particularly different from a corporate failure, the high possibility that it may precipitate a general systemic failure is often cited as the reason why banks are treated differently.[8]

The uniqueness of banks derives from the services that they perform. The difference in the quality of financial services that banks provide is opaque or indistinguishable for users. Banks with a higher risk profile will free ride on the reputation and trust of conservatively operating banks. Furthermore, the "indistinguishability" of banks will result in the failure of one bank leading to the withdrawal of deposits from other banks. As depositors seek to liquidate their deposits, a general run on bank reserves may be precipitated.[9]

Despite the widespread economic assumption that depositors will shift their deposits to other banks for safety and gain the highest return, in practice it is costly and time consuming to do so.[10] The credibility that depositors earn from dealing over a long period with one bank is also lost by shifting their current accounts, causing them disadvantages when taking out loans.[11]

Banks are also considered fragile because they are susceptible to contagion for three primary reasons: 1) low capital-to-assets ratio (high leverage with little capital to cover losses); 2) low cash-to-assets ratio (fractional reserve banking that requires sales of earning assets to meet deposit obligations); and 3) high demand debt and short-term debt-to-total debt ratio (maturity mismatch of assets

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[6] Richard Whish, *Competition Law,* 5th ed., (Oxford University Press, 2005), at p. 17.
[7] Dennis Swann, *Competition and Consumer Protection,* (Penguin, 1979), at p. 22.
[8] C.A.E. Goodhart, *The Evolution of Central Banks* (MIT Press, 1988), at p. 61 and George Kaufman, "Bank Failures, Systemic Risk, and Bank Regulation" 16(1) *Cato J.* (1996), at p. 39.
[9] See ***id.,*** Goodhart.
[10] ***Id.***, at p. 66.
[11] *Id*., at p. 97.

and liabilities, which is the cause of bank run).[12] The primary reason for special treatment of banks is their asset-liability mismatch.[13] Banks' assets are illiquid, as loans cannot be easily recalled since they are subject to contracts and difficult to resale due to their uncertain value.

On the other hand, liabilities of banks are liquid and demandable. Depositors can withdraw their deposits on demand (for current accounts). However, if most depositors were to demand the withdrawal of most of their deposits at once, banks will not have sufficient cash or capital to repay them. This would cause bank runs, which can also occur upon the mere rumour of insolvency.[14] This self-fulfilling nature of bank business and the fact that banks operate on the basis of trust and confidence form the underlying rationales for banks being given special protection by regulators.

Banking is also characterised by information asymmetry that exists between the various parties. Information disclosure is the primary way in which to rectify information asymmetry. Better information also improves the competition environment by providing a better comprehension of the various products available.

C. Concept of prudential regulations

Generally, financial regulations can be classified into prudential and systemic regulations. The division is not clear-cut, with some regulatory methods overlapping the two and some objectives falling into either or both categories.

Systemic regulations pertain to the safety and soundness of the overall financial system. Prudential regulations aim to safeguard the safety and soundness of individual financial institutions for the purpose of protecting consumers.[15]

Prudential regulations result mainly from information asymmetry, which inhibits consumers from being able to make valid assessments of a bank's financial conditions. Financial institutions have a general fiduciary duty to consumers requiring them to act with due care.[16]

As the value of a contract can only be determined after the conclusion of the transaction, there is the possibility of receiving compensation from deposit insurance or investor protection funds. This would require care to be taken by the authorities so as to prevent any unnecessary depletion of the funds.

What constitutes prudential regulation is significant because these are the way in which consumer protection is ensured. Consumer protection policy seeks to ensure that the efficiencies and innovative

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[12] See Kaufman, *supra* n 8, at p. 39.

[13] For a detailed discussion on asset-liability mismatch, Jonathan R. Macey & Geoffrey P. Miller, "Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities" 12 *Yale J. on Reg.* (Winter 1995), at p. 1.

[14] Douglas W. Diamond & Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity" 91 *J. of Pol. Econ.* (June 1983), at p. 401-419.

[15] Charles Goodhart, Philip Hartmann, David Llewellyn, Liliana Rojas-Suarez & Steven Weisbrod, *Financial Regulation: Why, how and where now?* (Routledge, 1998), at p. 5.

[16] The general obligations of a fiduciary duty are: a duty of care, should not permit their private interests to conflict with their duty to a beneficiary of the duty, should not permit their duty to one beneficiary to conflict with their duties to another, should not make a secret profit, and have a duty of confidentiality. Banks are imposed additional duties of care "in circumstances of which give rise to a relationship of trust and confidence." However, banks by their core operation of deposit taking and lending do not give rise to fiduciary duty. Ross Cranston, *Principles of Banking Law* (Oxford University Press, 2nd ed., 2002), at pp 187-188, and EP Ellinger, E Lomnicka & RJA Hooley, *Ellinger's Modern Banking Law* (Oxford University Press, 4th ed., 2006), at pp. 127-135.

benefits brought about by competition are not retained by producers through misleading and deceptive conduct or unfair practices, but are instead shared with consumers. It provides an important safety net in market where vigorous competition might tempt some businesses to cut corners to gain an unfair competitive advantage.[17]

Thus, competition cannot be improved without establishing safeguards to ensure that competition does not result in the loss of consumer welfare. Consumer protection laws seek to protect the ability of consumers to make rational choices among competing options but do not necessarily strive to ensure that consumers have perfect information.[18] Prudential regulation needs to be carefully considered when competition policy is being strengthened.

D. Competition policy and financial stability

In the past, competition policy was not a primary objective of regulation of the financial sector. The influential 'charter value hypothesis'[19] asserts that an overly competitive banking sector will be prone to instability, convincing some countries to counterbalance the competition-oriented antitrust review with a stability-oriented supervisory review of bank mergers.[20]

However, as governments introduced deregulation and privatisation, and the presence of foreign financial institutions has become larger, there is now a growing need to address competition policy in relation to financial firms.

In practice, competition in the financial market has been limited by entrance and merger regulations. The number of banks operating within specific geographical areas has hitherto been limited or controlled in many countries through branching regulations. The rationale was to limit the number of banks competing in a relevant market,[21] and to maintain a margin of profitability.

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[17] UNCTAD, *Consumer Protection, Competition, Competitiveness and Development*, TD/B/COM.1/EM.17/3 (20 August 2001), at p. 6.

[18] Neil Averitt & Robert Lande, "Consumer Choice: The Practical Reason for Both Antitrust and Consumer Protection Law" 10 *Loy. Consumer L. Rev*. (1998) 46.

[19] Michael C. Keeley, "Deposit Insurance, Risk and Market Power in Banking" 80(5) *American Economic Review* (1990), at pp. 1183-1200.

[20] Carletti, Elena and Philipp Hartmann, "Competition and Stability: What's Special About Banking?" *LSE FMG Special Paper Series* No 140 (2002), at p. 7. Also, Franklin R. Edwards and Frederick Mishkin, "The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy" 1 *Federal Reserve Bank of New York Economic Policy Review* (July, 1995), at pp. 27-45. *Available at* <http://www.newyorkfed.org/research/epr/95v01n2/9507edwa.pdf> (visited on March 25, 2007).

[21] See *infra* Section III.A.

II. Cases of Developed Economies' Regulations Controlling Competition Policy

It is rare that the financial sector is designated as an industry exempt from the anti-trust code. However, the reality is that in most countries the anti-trust law has effectively not been applied to the financial sector.

On the other hand, enactment of a competition law is a relatively recent phenomenon in developing countries, and many countries are in the process of preparing such a law. If an anti-trust law has been legislated, it is unlikely that the financial sector will be excluded.

The US was the first country to enact an anti-trust law, the Sherman Act of 1890,[22] amended by the Clayton Act of 1914,[23] and further elaborated in 1963 through a Supreme Court decision stating that the financial sector was also to be subject to the anti-trust law regime.[24] Since then, more than 100 countries have enacted laws prohibiting anti-competitive behaviour.[25]

The issues that are directly related to financial regulation and competition policy are discussed in this section. Regulations that have been used to deter effective application of competition policy are examined.

A. Entrance and exit regulations

While countries do not legally or explicitly exclude new entrants from the market, acquiring a bank license is far more difficult than establishing other incorporations. There are financial requirements as well as senior management requirements inherent in the acquisition of such a licence. There are also ongoing quantitative and qualitative conditions for bank to continue their operations, which are strictly monitored.

Often, however, governments simply limit the number of banks by barring entry into the market for anti-competitive purposes. This would mean that an economic needs test is being applied in the licensing regime. This is applicable not only to greenfield entrants through the establishment of a newly licensed banks, but also through the acquisition of banks.

In Japan, no new banks were established from the post-war period until the late 1990s. The Banking Law does not prevent new entrants.[26] But as a result of the banking policy, existing banks were kept on equal footing in terms of branching and product approval, and competition was kept under control. This was the so-called "convoy system" of financial regulation, which maintained the even footing of all major banks.

[22] Sherman Act of 1890, 15 USC §§1-7.
[23] Clayton Act of 1914, §§ 12, 13, 14-19, 20, 21, 22-27 of Title 15.
[24] United States *v* Philadelphia National Bank, 374 US 321 (1963). Competition considerations were present in the Bank Holding Act of 1956 and the Bank Merger Act of 1960 even if the application of competition law to mergers was only clearly stated in the Philadelphia National Bank case of 1963 and subsequently in 1966 with the amendment of the Bank Merger Act. However, important checks and balances, including, for example, the attribution of the competence for merger reviews to the supervisory bodies and the general rule that anticompetitive mergers can be authorized if its anticompetitive effects are clearly outweighed by special benefits for the convenience and the needs of citizens and community in its whole. This particular exemption only seems to apply to mergers with failed institutions.
[25] See Whish, *supra* n. 6, at p. 17.
[26] Article 4 of Banking Law, Law No. 56 of 1981 (Japan).

Restrictions on the exit of banks from markets have been related to the use of the “too big to fail” concept applied to banks. “Too big to fail” is a situation wherein a certain bank is protected from insolvency due to the impact this would incur on the financial system as a result of its size. A relatively large bank would be spared insolvency through capital injection by the government.[27]

Many developed countries now have clear requirements regarding market entrants and usually do not implement tests that assess the economic need for an extra bank or the extra competition borne. Only the competence and financing of the new entrant in question is subject to evaluation.

The exit of a bank from the market usually occurs when financial difficulties are encountered. However, bank regulators are, in theory, able to detect deteriorating financial conditions and should be able to monitor the bank to rectify such situations. The US adopted the Federal Deposit Insurance Corporation Improvement Act of 1991, which established rules requiring bank regulators to implement sequenced actions in accordance with their bank’s capital adequacy ratio.[28] This has led many regulatory authorities of developed economies to implement early structural intervention plans or early warning systems,[29] and then to apply prompt corrective action[30] when serious financial breaches are detected.[31] Japan implemented an early warning system in 1998 as part of the financial restructuring plan.[32]

B. Branching regulation

Branching takes place throughout the lifecycle of a bank and affects the pace at which a bank expands. Regulators can restrict the number of branches established and in which areas, so as to control competition.

Branching was very strictly controlled in Japan until the 1990s. Permission from the Minister of Finance was necessary, making it very burdensome to open a branch. Bank branches would only be permitted if other banks of the same category were also permitted branches in the same area. From 1997 onwards, branching has more or less been freed, but due to the increase in ATM machines, the number of branches has fallen.

In the US, banks were only permitted to operate within the borders of their state of incorporation. However, ATMs and foreign banks were not subject to state border limits, eventually leading to the abolishment of branching restrictions.

The importance of branching has decreased as a result of internet banking and ATMs. However,

[27] In 1984, an interbank market run on Continental Illinois National Bank lead to its possible failure. However, failure was deemed too dangerous with systemic implications as Continental held deposits of other banks. Regulatory authorities saved Continental to prevent its failure from causing interbank runs. “Inquiry into Continental Illinois Corp. and Continental Illinois National Bank” Hearings Before the Sub-committee on Financial Institutions Supervision, Regulation and Insurance of House Committee on Banking, Finance and Urban Affairs, 98th Cong. 288, 460, 466 (1984).

[28] Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), 12 USCA 1823(c), Pub. L. 102-242.

[29] Measures are required to improve the safety and soundness of the bank. Management needs to address profitability, stability and liquidity.

[30] Rule-based regulatory action is taken when a certain capital adequacy ratio is reached.

[31] Advocated in George J. Benston & George G. Kaufman, “Risk and solvency regulation of depository institutions: Past policies and current options” *Monograph Series in Finance and Economics No. 1988-1* (New York University Press, 1988).

[32] The concept of prompt corrective action was first brought into Japanese financial regulation with the enactment of the Financial System Reform Law of 1997, which amended Article 26-1 of the Banking Law. This article states that financial institutions are required to take necessary measures to ensure the safety and soundness of their operations with consideration to their assets. Banking Law, *supra* n. 26, art 26-1 and Law Amending Related Laws for Financial System Reform, Law No. 107 of 1997 (Japan).

being able to establish a branch where demand exists, so long as the necessary conditions are fulfilled, remains an important aspect of a bank's strategy.

C. Separation of financial sector and financial holding companies

Segregation of financial sectors was first enacted in the US by the Glass-Steagall Act,[33] in response to the Great Depression of 1929. Continental Europe took a universal banking approach, and did not subject its financial sector to strict segregation rules. Financing holding companies exist out of managerial decisions and not legal restrictions.

Japan followed in the US' footsteps, segregating commercial and investment banking. The separation of commercial and investment banking, if done for all banks operating nationally, does not in itself limit competition. However, with financial services becoming increasingly globalised, financial institutions are increasingly demanding the ability to provide a variety of services to customers. Maintaining such segregation has become anachronistic in markets that cater to global institutions. Both the US[34] and Japan[35] now allow banks to form financial holding companies, thus allowing groups to provide both commercial and investment banking services.

The financial holding group structure allows for the emergence of mega-financial institutions through takeovers and mergers. This has lead to a certain degree of consolidation of financial institutions in developed markets.[36] If consolidation takes place to an extent that economic power is concentrated in the hands of a few financial institutions, this would have strong implications for competition policy.

D. Merger regulations

Since banking licenses are granted upon the fulfilment of certain requirements, when banks are to be merged the regulatory authority needs to review the licenses of the banks in question in order to authorise alterations in the banking license. This is the rationale behind the involvement of the banking regulator as well as the competition authority in bank merger cases.

This was confirmed by the US Supreme Court decision in 1963, which stated the same guidelines that apply to other industries would be applied to bank mergers.[37] US financial regulators currently hold veto power over bank mergers, while the competition authority conducts merger decisions.[38]

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[33] Glass-Steagall Banking Act of 1933, §§16, 20, 21 and 33, USC 48 Stat. 162.

[34] The US enacted the Gramm-Leach-Bliley Act of 1999 to dismantle the Glass-Steagall Act. Gramm-Leach-Bliley Act or Financial Modernization Act of 1999, Public Law 106-102, 113 Stat. 1338.

[35] Japan began to permit commercial and investment banking to intersect with the 1992 Financial System Reform Act which allowed entrance through subsidiaries. The Law Amending Laws Related to the Reform of the Financial and Securities Exchange System, Law No.87 of 1992 (Japan).

[36] Martin Schulz, "Banking Consolidation and Financial Innovation" 33(3) *Japanese Economy* (Fall 2005).

[37] United States *v* Philadelphia National Bank, n. 24.

[38] See *infra* Section III.B for detailed discussion on merger regulation.

III. Issues in Relation to Competition Policy in the Financial Sector

With the promotion of financial liberalisation and globalisation of financial activities, many countries are now opting or having to apply a strengthened competition policy regime in the banking sector. However, when doing so, numerous considerations need to be taken into account.

A. Relevant markets

When applying the competition policy to the financial sector, it is necessary to consider how one defines "relevant markets." A firm or firms may collectively have sufficient "power over the market" to enjoy benefits available to true monopolies.[39] The EU Commission's *Notice* serves as a useful guide to how competition authorities worldwide might define a relevant market: "…The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings involved that are capable of constraining those undertakings' behaviour and of preventing them from behaving independently of effective competitive pressure."[40] The issue of potential competition may also be taken into account. The matter then becomes a matter of "interchangeability"; where goods and services can be regarded to be in the same product market.[41]

When a competition authority assesses bank mergers, banking can be functionally segregated into deposit taking, lending, foreign exchange, securities business and trust business.[42] A bank's relevant market can be considered as either individual functional components or as an ensemble of various services.

The 1963 US Supreme Course case[43] defines "commercial banking" as a relevant market, while the UK has assessed a bank merger depending on the customer base.[44] A relevant market could also be geographical, which is relevant as financial restructuring laws often cite disruptions to local economies as a relevant consideration for assistance.[45]

Nevertheless, when we turn to the Asian markets, foreign banks may not be entering a market with interchangeability. Foreign banks do not enter the market to provide retail or SME banking services and compete with local financial institutions. They enter niche markets to provide lucrative private banking or investment banking services to large multi-national enterprises which is still an underdeveloped market in Asia. Thus the relevant market when considering competition with foreign banks would be relatively limited. This does not imply that the competition policy impact is negligible as the entrance by foreign banks is always a threatening affair to local banks.

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[39] See Whish, *supra* n 6, at p. 24.

[40] Commission, "Notice on the Definition of the Relevant Market for the Purposes of Community Competition Law" *OJ* C 372/5 (1997).

[41] Whish, *supra* n 6, at p. 28. The ECJ has ruled on the issues in cases Europemballage Corpn and Continental Can Co Inc. *v* Commission, Case 6/72 [1973] ECR 215, and United Brands *v* Commission, Case 27/76 [1978] ECR 215.

[42] Example taken from art 15.1.1 of The Anti-Monopoly Law of Japan. The Law Prohibiting Private Monopolies and to Ensure Fair Trade, Law No. 54 of 1947 (Japan).

[43] See *supra* n. 24.

[44] For example, in 2001, the Competition Commission of the UK halted a bank merger that sought to define retail, home loans, and small and medium size enterprises as its relevant markets. Competition Commission, "Lloyds TSB Group plc and Abbey National plc: A report on the proposed merger" (July 2001). *Available a*t <http://www.competition-commission.org.uk/rep_pub/reports/2001/458lloyds.htm>.

[45] For example, Japan's Law concerning Emergency Measures for the Revitalization of the Financial Functions states in art 36.1 that regional or industrial consideration will be given for public capital injection. Law concerning Emergency Measures for the Revitalization of the Financial Functions, Law No. 143 of 1998 (Japan).

B. Merger regulation and relevant authorities

As discussed earlier, bank mergers have been subject to a dual approval process, with both the bank and competition authority involved. The primary rationale is to review the bank license when conditions have altered, taking into consideration financial stability implications.

This is especially imperative when banks are subject to takeovers as a result of their weakening financial condition. In such cases, a healthy financial institution takes over an unhealthy one. Such a merger may not be sound in terms of competition policy, creating volatility in the markets. However, the banking regulator may overrule such concerns for the sake of financial stability.

However, this outlook has been changing in the EU area. The EU has been striving to overhaul its competition policy in order to strengthen the workings of the internal market. In this respect, the EU goes a step further, recommending the assessment of bank mergers by the competition authority alone.[46]

While many EU member states have transferred part of their bank merger regulations to the competition authority, decisions are often jointly reached with the bank authorities. France is the only state wherein bank merger authority remains under the auspices of the bank regulator. France has a distinct merger regime in which bank mergers do not undergo scrutiny by the competition authority, but only by the *Comité des éstablissements de crédit et des enterprises d'investissment* which issues banking licenses. The Comité is obliged to prioritise supervisory and public considerations over competition policy concerns.

C. Discretion of the banking regulator

A bank regulator with a wide-range of discretion is at odds with a more liberalised market structure. Banking regulation has always been based on the regulator having a certain degree of discretion. When discretion is strong, it prevents those regulated from predicting the outcome of the regulatory decisions.

The amount of discretion impacts the strength of the competition policy. If the regulator is able to exercise greater discretion, this would mean that the scope of the market determining resource distribution become limited. In turn, the range that competition policy can be implemented becomes restricted if discretion is strong. If discretion is limited the predictability of the market is high and market participants are able to make innovations based on the assumption of regulatory outcome.

Generally, discretion has been used to assist the growth of industries, with the regulators' decisions having a direct influence on the behaviour of suppliers of goods and service. Governments thus had a large stake in the determination of resource distribution, in contrast to Adam Smith's "invisible hand," or market forces determining resource distribution. The financial sectors of developing countries are especially prone to broad discretion, to supplement the lack of expertise in the market, volatile markets and underdeveloped regulatory systems.

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[46] EU Commission "Report on the Retail Banking Sector Inquiry: Commission Staff Working Document" (31 January 2007), SEC (2007) 106. *Available at* <http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/sec_2007_106.pdf> (visited on March 25, 2007).

In the past, Japan was notorious for its widespread use of discretion to counterbalance the lack of clear guidelines. The Anti-Monopoly Law of Japan[47] did not exempt government guidance from its application, and "Guidelines on the Application of Anti-Monopoly Law on Government Guidance" issued in 1994 further clarified that governmental guidance would not be excluded from anti-monopoly violations.[48]

Nevertheless, in practice, government ministries often used administrative guidance. This disadvantaged firms that were interested in entering the market but did not have knowledge of the system or people. Branching was an area that was affected by such policy, dependent as it was on regulatory discretion.

This situation has been changing over the past 20 years as a result of financial liberalisation and administrative reform in Japan. However, developing countries continue to depend on discretion to a certain extent in the pursuit of government policy, and this is often the source of authority for ministries.

The uniqueness of banking, as discussed in Section I, has been a major rationale for banking regulators in retaining discretion. With a view to ensuring financial stability, competition has been limited through the discretion of banking regulators.[49] In developing countries, the lack of expertise makes the sector dependant on banking regulators and their decisions.

However, as financial markets develop the demand for deregulation and liberalisation increases. As markets are liberalised, market forces assume an increasingly important role in determining the distribution of resources, leaving little room for discretion. The market is better at distributing resources fairly and timely, and encourages innovation.

This in turn leads to regulatory methods aimed at adjusting to such market developments, with increased emphasis being placed on risk management, fit and proper rules and internal controls. Competition policy takes centre-stage as market liberalisation is carried out, and opportunities to apply discretion decrease. Banking institutions are required to become financially sound and resilient in the face of external shocks.

[47] See *supra* n. 42.

[48] See Section I, Fair Trade Commission of Japan, "Guidelines on the Application of Anti-Monopoly Law on Government Guidance" (1994).

[49] See *supra* Section I.D. on the discussion on competition policy and financial stability.

Diagram 1: Changes in Bank and Merger Regulations and Financial Liberalisation

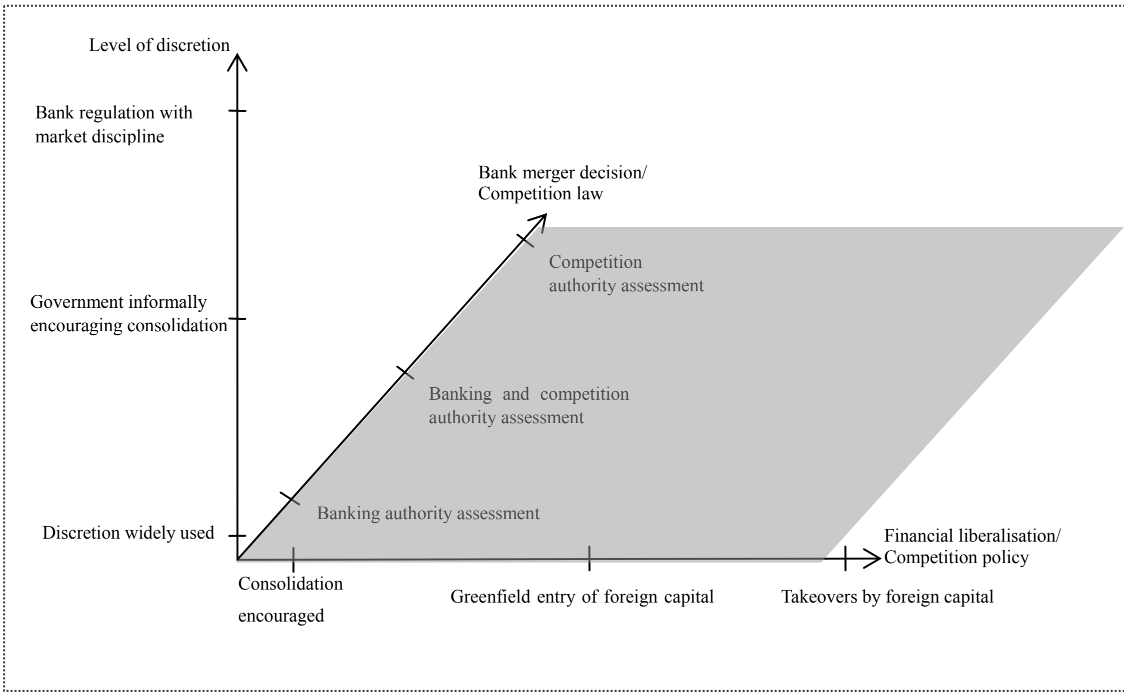


Diagram 1 presents a 3D conceptual framework of the evolution of competition policy based on observations of Asian countries. The further from the axis point, the better adjusted to liberalised markets. The level of discretion is represented by the vertical axis. Governments will initially maintain a wide-range of discretion in the area of financial regulation. These will become informal as the sector develops, and are eventually replaced by methods that employ market discipline.

The level of financial liberalisation and competition policy achieved corresponds to the horizontal axis. Governments in Asia have first tried to consolidate the financial sector so as to enable domestic financial institutions to gain competitiveness. Following this stage, foreign institutions are allowed greenfield entry, eventually permitting the takeover of domestic firms as a way to entrance.

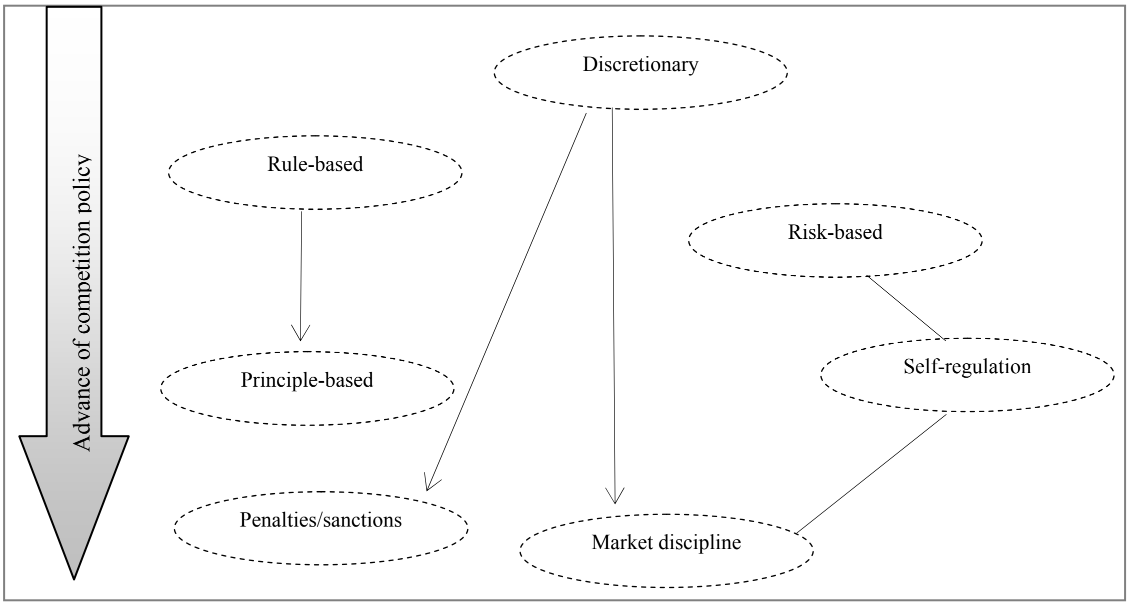
As discussed above,[50] the remaining axis depicts bank merger reviews and competition law. They are relayed from bank regulators to the joint decision of bank and competition regulators, and then eventually to the competition authority. This often demonstrates the determination of regulators to apply the competition policy on banks in full.

D. Evolution of regulatory methods

The evolution of regulatory methods is worth noting. There are a number of regulatory methods used in financial regulation that change depending on a financial system's stage of development. The method also corresponds to the level of discretion being applied to the financial sector. With the evolution of the financial sector, it is hoped that the regulatory method will also evolve.

[50] See *supra* Section III.B.

Diagram 2: Evolutionary image of regulatory methods



- Discretionary: the public authority uses its discretion to determine a wide range of issues.
- Rule-based: increasing dependence on rules, which may be prescriptive in nature, to clarify the contents of laws and regulations.
- Self-regulation: industry groups or self-regulation organisations establish rules for business conduct and marketing.
- Risk-based: the regulator distributes its resources depending on the risk-factor of each activity and institution.
- Principle-based: the principles of regulation are used to adapt to a more varying range of products and services. Financial institutions use their principles and judgement to determine if a product or service is suitable for sale.
- Market discipline: stakeholders of financial institutions monitor the institutions' risk and sanction bad management by moving investments or selling shares to induce financial institutions to operate more efficiently and profitably.
- Penalties/sanctions: strong sanctions, such as financial penalties or management censure, are required when a financial institution carries out illegal or rule breaking operations.

In the early stages of financial sector development, discretion is a major tool used for effective regulation, especially when a market is underdeveloped. As the market develops and liberalises, the use of rule-based regulation strengthens. Clarity of rules becomes increasingly important as the market begins to allow new entrants.

The timing of self-regulation emerging is not uniform, as countries, such as the UK, have had self-regulation for many decades. However, some countries initiate self-regulation only after the market has become well developed.

This eventually turns to risk-based regulation, which in turn evolves into principle-based regulation. The order of the two may not be necessarily as such, as there is no clear logical order to the two.

Increased use of market discipline in financial regulation becomes inevitable as financial markets develop and the need for regulation to be adaptable to rapid innovations becomes significant.

Strengthened penalties are becoming a popular enforcement mechanism in developed markets. Despite the large sums incurred in penalties, these amounts are not of significance to large financial institutions. However, the damage to establishments' reputations that these penalties represent is indeed significant.

Basel II,[51] the final agreement of the Basel Committee on Banking Supervision (Basel Committee) on the capital adequacy of banks has had an enormous effect on the evolution of regulatory methods. Basel II has standardised many regulatory methods whose effectiveness has been touted in recent years. Basel II includes market discipline as a core element. It also includes methods for disclosure of greater qualitative and quantitative information in order to increase awareness among, and information provision for stakeholders.[52] This enables the market and investors to make qualified evaluations of the financial institutions.

E. The effect of GATS

The manner in which foreign financial institutions enter new financial markets is largely affected by the host country's schedule of commitments in relation to the General Agreement on Trade in Services (GATS). The entrance of foreign financial institutions into a market hastens the speed of market development and innovation, but can also cause consternation to local financial institutions because of the possible loss of business, and takeovers by foreign firms. Such factors have prompted developing countries to be sceptical of market liberalisation and GATS (and the World Trade Organization, WTO for that matter).

Nevertheless, foreign financial institutions provide expertise, know-how and improved services to local markets, stimulating competition.[53] In terms of competition policy, permitting a greater number of financial institutions in the market, and foreign ones in particular, promotes a better competition environment.

GATS has played a key role in promoting the liberalisation of financial markets. The Uruguay Round was the first trade round to include service sectors, eventually leading to the agreement of GATS.[54] The schedule of commitments of member states, whether agreed upon during the Uruguay Round negotiations or in subsequent accession negotiations,[55] have all brought greater financial sector

[51] Basel Committee, "A New Capital Adequacy Framework" (June 1999) and Basel Committee, "International Convergence of Capital Measurements and Capital Standards: A Revised Framework" (June 2004).

[52] For details of the developments of Basel II, see Mamiko Yokoi-Arai, "Basel II in the national sphere" *EBRD Law in Transition* (Fall 2005) <http://www.ebrd.com/pubs/legal/lit052d.pdf > (Last visited 7 June 2007).

[53] Masamichi Kono, Patrick Low, Mukela Luanga, Aaditya Mattoo, Maika Oshikawa, & Ludger Schuknecht, "Opening Markets in Financial Services and the Role of the GATS" *WTO Special Studies* No. 1 (1998), section IV.

[54] The agreement itself is contained in the 1994 "Agreement Establishing the World Trade Organization" (the Marrakesh Agreement).

[55] Such as China and Vietnam.

liberalisation. They have also clarified the conditions for market entry.[56] Better guidelines are being produced for foreign institutions, as well as being better publicised to ensure the transparency of the financial system.[57]

Paragraph 2(a) of the Annex on Financial Services, in effect, allows members to apply regulatory measures that do not comply with their specific commitments. Whether or not this measure is in fact prudential in nature becomes irrelevant in the current legal context. The WTO can use the dispute settlement mechanism to interpret the prudential requirement, but there is no indication that this will take place. This paragraph theoretically permits members to take measures that are applied in the name of prudential concern. Although most members will act in good faith and not apply measures that would clearly and grossly exceed prudential concerns, the central issue of what constitutes "prudential" has hitherto not been defined or agreed upon by members.

The lack of discussion and hence agreement on the substance of prudential regulation causes confusion in the implementation of GATS in financial services and can result in the derailing of meaningful dialogue on scheduling. It also leaves the impression that financial liberalisation may be subject to the discretion of members.

[56] GATS, art XVI.
[57] GATS, art III.

IV. Competition Policy and the Banking Sector in Asian Countries

A. Recent reforms of the financial sector in Asia

As Table 1 shows, bank deposits remain the dominant form of financing in Asia, although capital markets have been growing at a rapid pace since the 1990s. There are three stages to the development of the financial markets in the region. In the early 1990s, most Asian countries adopted liberalisation and deregulation measures. Financial globalisation, standardisation of regulations, economic developments, pressure for financial reform by international financial institutions such as the IMF and the World Bank provided the backdrop for financial liberalisation.

Following this stage, the aftermath of the Asian Financial Crises in 1997/8 resulted in greater financial reforms. The countries that suffered from the crises, namely Indonesia, South Korea and Thailand, followed a restructuring program of the financial sector as a result of the conditionality for IMF emergency financial assistance. These countries were required to remove non-performing loans from banks' balance sheets and establish regulatory measures to prevent nepotism. Other countries that were not as seriously affected as the above-mentioned three also took additional reforms with a view to improving the safety and soundness of their financial systems.

Table 1: Financial Market Structure in Asian Countries (Market size to GDP)

	Bank Deposit		Stock Market		Bond Market		Insurance	
	1990	2005	1990	2005	1990	2005	1990	2005
China	75.6	177.8	2.4*[1]	32.0	8.5	25.6	0.8	2.7
South Korea	32.6	688.8	48.2	72.9	34.1	78.1	11.0	10.5
Indonesia	29.8	36.2	4.4	27.1	0.4	19.0	0.9	1.5
Malaysia	52.1	93.5	100.7	143.6	69.8	90.4	3.0	3.7
The Philippines	24.1	45.8	20.6	35.3	22.1	38.8	2.0	1.5
Singapore	74.3	102.3	95.8	163.4	27.8	58.0	3.0	8.8
Thailand	56.8	78.8	29.2	68.0	09.7	41.1	1.7	3.6
Vietnam	10.9*[2]	38.7	n.a.	n.a.	n.a.	n.a.	0.5*[3]	1.6
India	31.4	52.2	10.4	60.1	19.9	33.8	1.5	3.2

Note: *[1]:1992, *[2]: 1996, *[3]:1995.
Source: Sheng, Andrew and Kwek Kian Teng "East Asian Capital Market Integration: Steps beyond ABMI", Paper given at Advancing East Asian Economic Integration Conference, 22-23 February, Bangkok, Thailand, 2007. Updates and revision made by the author.

By the early 2000s, most countries had completed the IMF programs and were looking towards mid/long-term financial sector reforms. This is highlighted by the financial sector "masterplans" implemented by many countries (Table 2 and 3). These masterplans generally constitute financial sector blueprints with a timetable for certain benchmarks. In many cases, they have constituted plans for improving financial systems not only with a view to ensuring greater resilience in the face of instability but also to ensure attractiveness of their financial centres to foreign investment.

Table 2: Examples of Masterplans for Financial Sector Reform

Indonesia	Aristektur Perbanken Indonesia (2004)
	Capital Market Master Plan (2005)
Malaysia	Financial Sector Masterplan (2001)
Thailand	Financial Sector Master Plan (2004)
	Capital Market Master Plan (2006)
	Insurance Master Plan (2006)
India	Narasimham Committee Report (1998)
	Road Map for Presence of Foreign Banks in India (2005)
Vietnam	Financial Reform Vision (2006)

Source: Described by the authors of the country studies.

One common feature of these masterplans is an emphasis on the opening of financial markets and the strengthening of the competitiveness of financial sectors. Specifically, these masterplans often entail the implementation of international standards, the strengthening of market infrastructures, and the adoption of prudential policies aimed at bolstering the financial robustness of individual banks and the financial system.

Table 3: Major Items in the Master Plan by Country

		Indonesia	Malaysia	Thailand	India	Vietnam
Bank supervision	Bank licensing			√	√	
	Branch authorisation		√	√		
	Bank M&As	√			√	√
	Financial product authorisation		√	√		
	Information disclosure		√	√		√
	Financial conglomerate supervision	√	√	√	√	
Market infrastructure	Risk management	√	√	√	√	√
	Basel II	√			√	√
	Prompt corrective action	√	√	√	√	
	One-presence policy	√		√	√	
	Settlement system		√		√	
	ATM network connection		√		√	
Competition	Consumer protection		√	√		
	Tax		√			
	Competition policy		√		√	

Source: Authors of case studies in original study.

For countries with a strong presence of national banks that were originally established to promote economic development, their partial or full privatisation has been part of these masterplans. Therefore, some masterplans have included social policies that emphasise financing aimed at rural areas and the economically disadvantaged sections of the population to ensure access to finance to all. For example, India requires banks to engage in "primary sector lending," which obliges them to lend a proportion of their total loan to specified sectors such as the agricultural sector, SMEs and the educational sector. In Indonesia, banks must maintain lending programs geared towards SMEs, although there are no mandatory lending requirements.

B. Financial regulation and supervision

The institution of financial regulation will impact the approach to regulation and subsequently the approach to competition. If the structure of regulation is adhering to certain principles of changes within the financial sector, it is likely that regulation would respond positively towards a competition policy. It is not the actual structure itself that would affect this outlook, but the philosophy behind the formation of the structure.

1. Financial regulatory structure: institutional or integrated model

There are currently two types of regulatory structures for financial regulation being applied worldwide: the institutional model, which has a regulator for each sector, and the integrated model, which has a single regulator for the entire financial sector.

Traditionally, banks were supervised by the central bank or the ministry of finance; securities business by the securities exchange commission; and insurance firms by the central bank, the ministry of finance, other economic ministries such as the ministry of commerce, or by a special insurance agency. This structure forms the basis for the institutional model that regulates the sector by way of licenses granted to functionally named institutions. Currently, China, India, the Philippines and Thailand maintain this institutional model.

On the other hand, the integrated model has a single authority which regulates all financial activities like the Financial Service Authority in the UK. This model has been adopted in response to the migration of business across institutional boundaries and the growth of financial conglomerates. Singapore follows this model, albeit within the central bank, and Indonesia has concrete plans to adopt the integrated model. Korea also has an integrated system, although the planning and supervisory functions are performed by separate agencies. Malaysia's central bank regulates banks and insurance companies, while securities are regulated by a separate agency.

2. Relationship between the central and local governments

In federal states like China and India, local governments often have a major stake in financial regulation. If local credit societies conduct business in a specific local area, they operate under the supervision of local authorities. Tax may be levied by the local government influencing the finances of such local banks. Though local banks are too small to affect the financial market, their performance has an effect on local economies. In China, local securities firms are often capitalized by local governments, resulting in local governments functioning as both supervisors and owners of securities firms. Local banks in India are small on an individual basis, but together they provide financial services for a majority of the population, making their well being essential to a majority of the population.

3. Regulatory methods

Basel II has been accelerating the review of regulatory methods in Asian countries. Although these countries are not members of the Basel Committee and are thus not obliged to follow its agreements, some countries have adopted elements of the capital adequacy regulations of the Basel Accord.[58]

Most countries are also in the process of applying the basic methods of Basel II with a view to raising the status of their financial systems. The form of Basel II being introduced differs from country to country. Albeit with certain exemptions, Malaysia, Thailand, Indonesia and India have established mandatory implementation deadlines and are more positive towards the introduction of global standards. The Philippines will require banks to provide auditing reports in accordance with Basel II in order to enhance disclosure. China and Vietnam are planning a selective application of Basel II due to their underdeveloped markets.

C. Competition Laws

1. Enactment of competition acts

Most countries, with the exception of Korea and Japan, have only recently legislated their competition laws, or are still in the process of legislating such laws, and lack experience in the implementation. China adopted the Anti-Monopoly Act in July 2007 with enforcement from August 2008.[59] Malaysia and the Philippines have draft competition statutes but their legislation timetables are unclear. Thailand and India have relatively new competition acts, but they lack guidelines and cases of effective implementation. While a competition act is not necessarily required for a country to apply competition policy principles to the financial sector, the presence of a competition act generally bodes well for the effective implementation of such a policy.

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[58] Financial Service Agency of Japan, *Competition Policy in the Financial Sector of Asia* (March 2007), at pp. 167, 175, 183, & 327 (in Japanese).

[59] The Standing Committee of National People's Congress adopted the Anti-Monopoly Act in July 2007 and will be enforced in August 2008.

Table 4: Enactment of Competition Acts

State	Name of the Act	Authority
China	Anti-Unfair Competition Act 1993 Anti-Monopoly Act 2007	National Industrial and Commercial Administrative Bureau
Korea	Monopoly Regulation and Fair Trade Act 1980	Fair Trade Commission
Indonesia	Anti-Monopoly and Fair Competition Act 1999	Business Competition Observation Commission
Malaysia	Under discussion	Ministry of Domestic Trade and Consumer Affairs
Philippines	Under discussion	Ministry of Trade and Industry
Singapore	Competition Act 2004	Competition Commission
Thailand	Trade Competition Act 1999 (Price Control and Monopoly Prevention Act 1979)	Trade Competition Commission (Domestic Trade Bureau, Ministry of Commerce)
Vietnam	Competition Act 2004	Competition Administration Agency, Competition Council (Ministry of Commerce)
India	Competition Act 2002 (Monopolies and Restrictive Trade Practice Act 1969)	Competition Commission of India

Source: M. Kurita, "Establishment of International Competition Rules and Its Influence to enactment of Competition Law in Developing Countries" in S. Imaizumi (ed.), *Establishment of International Rules and Developing Countries – Globalised Economic Statutory Reforms* (Institute of Developing Economies, JETRO, 2007), (in Japanese). Updates and revisions made by the author.

2. Defining relevant markets

The concept of relevant market needs to be developed and cases accumulated for the competition authority to be able to determine whether appropriate competition exists in a certain market. For competition policy to be actively applied in the financial sector, consideration needs to be given to relevant markets in the financial sector.

For example, in the past, foreign banks in Singapore were not allowed connection to the ATM networks of local banks. This was justified on the basis that ATM networks are a discrete market, since there are no prohibitions against banks developing their own ATM networks. However, this does not take into consideration the structure of ATM networks, which are affected by the network effect, namely that the connectability of a network has a critical effect on its viability.

3. Abuse of dominant market positions

In Japan, the issue of dominant market position is discussed mainly in terms of financial institutions' control of firms. In other Asian countries, for example South Korea, the main issue arises from financial institutions' lending to firms that maintain a controlling stake of the financial institution in question. Industrial firms have a more dominant role in the economy than financial institutions, which often leads to banks making loans to firms that are overly concentrated.

While the close relationship between banks and firms has been addressed in the aftermath of the financial crises, there is still a lack of awareness of the dangers of concentrated, large-scale exposure. This is closely related to the lack of knowledge on dominant market positions.

D. Development of prudential regulations and the financial sector

1. Restructuring banks and their prudential implication

The Asian Financial Crises have influenced the manner in which governments deal with the financial sector. Countries affected by the crises had previously shown good macro-economic performance. However, this did not prevent them from being subjected to large capital flows. One of the main reasons for this was the structure of their financial systems.[60]

In the aftermath of the crisis, the countries most severely affected by the crisis had to undergo special programs to strengthen the soundness of their banks and introduce prudential regulation. The process followed the procedure outlined below[61]:

i) Classification of banks into viable and unviable banks;
ii) Injection of capital provided by the government and foreign investors into viable banks;
iii) Clarification of the roles and responsibilities of regulatory authorities, and their independence;
iv) Establishment of asset management companies to purchase non-performing loans;
v) Amendment of banking statutes to enable authorities to intervene in the affairs of unsound banks; and
vi) Announcement of the governments' intention not to bail out insolvent banks.

Viable banks are required to change management, and shareholders are asked to accept capital reduction. Unviable banks are nationalised, taken over by bridge banks and made subject to purchase and assumption (P&A) by other banks or a compulsory sale of its assets and business.

The conditions for each procedure often serve as the foundation for prudential regulation. Capital adequacy ratios become the determining factor of a bank's viability and loan classifications are tightened so as to enable the disposal of non-performing loans.

2. Post-restructuring prudential regulations

Following the restructuring of the financial sector in response to the crises, Asian countries are addressing the manner in which they must develop their financial markets in the face of globalising markets. Strengthened prudential regulations have been an important characteristic of this process, as they form a vital element in global financial standards.

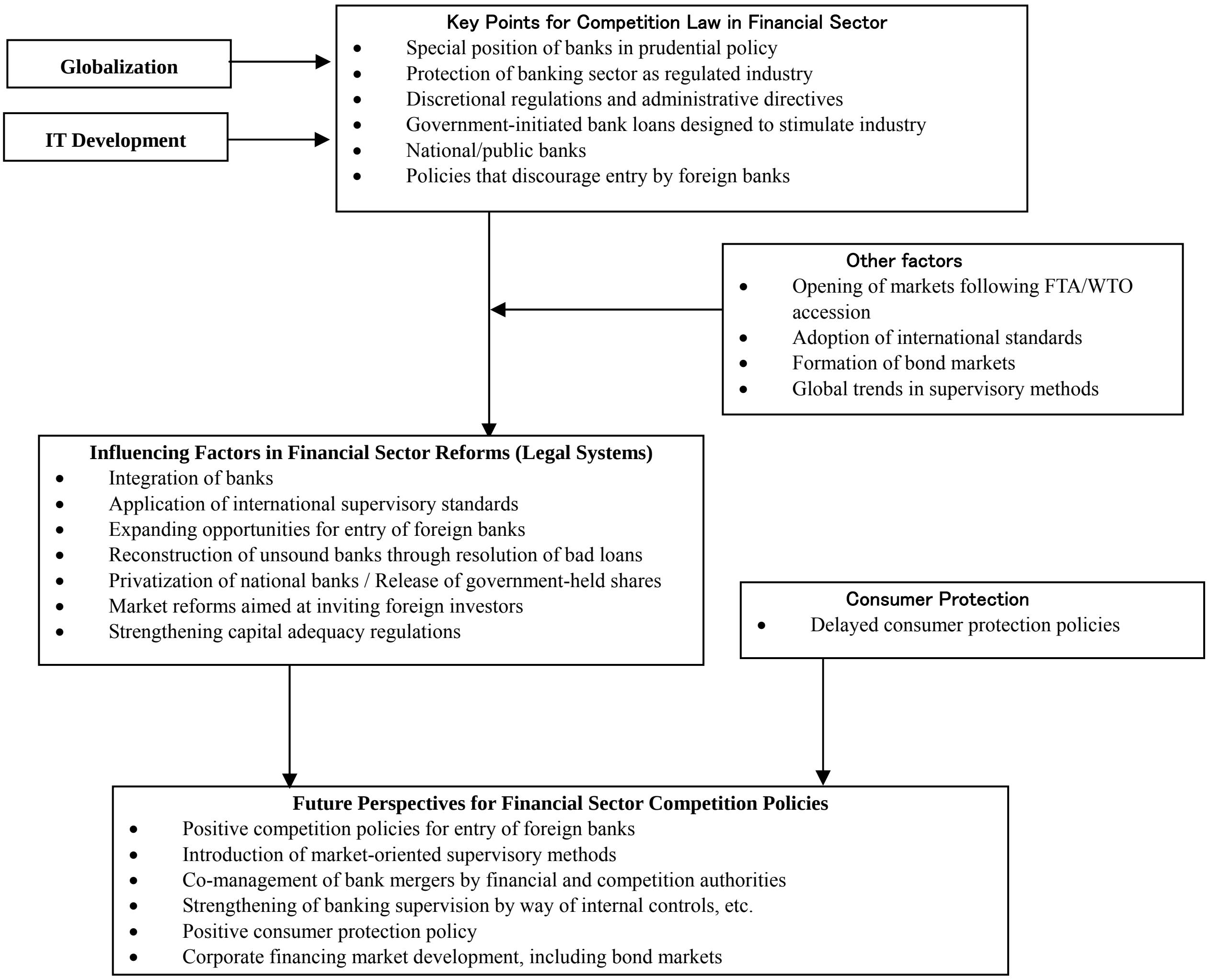
Basel II constitutes a core element of prudential regulation and many Asian countries have stated their intention of applying components of Basel II or sequence the implementation thereof to suit their financial markets[62]. GATS has also provided a strong impetus for Asian countries to improve their financial regulations. China and Vietnam have promised extensive financial liberalisation as a result of their accession to WTO.

Diagram 3 maps the process of financial regulatory changes and competition policy implications.

[60] Lindgren, Carl-Johan, Tomás J. T. Baliño, Charles Enoch, Anne-Marie Gulde, Marc Quintyn, and Leslie Teo "Financial Sector Crisis and Restructuring: Lessons from Asia" I*MF Occasional Paper No 188* (1999).
[61] See Tobias M. C.Asser, *Legal Aspects of Regulatory Treatment of Banks in Distress* (IMF, 2001), at pp. 52-71.
[62] See *supra* Section IV. B. 3.

The circumstances and stages of development of the countries in question differ, but the influencing factors and problems are similar.

Diagram 3: Development Process of Financial Regulations and Competition Policy



E. Competition policy issues in the financial sector

1. State banks

Many Asian countries have state banks, which are banks which capital or shares are predominantly owned by the government. In some cases, the state banks hold a large market share. Countries such as China, Vietnam, Indonesia and India, promoted social policies to develop the rural areas, establishing state banks which monopolise banking or are the only services provider in some markets. State banks have the advantage of being government guaranteed, with often subsidised lending rates.

If state banks do not make loans on a commercial basis, while in the short term they may be have a competitive advantage, in the long-run they will become saddled with bad loans and require the government to bail out the state bank. If national banks are made to pursue good corporate governance practice and sound financial principles they will have a positive impact on competition policy. For example, ICICI Bank in India was established by ICICI, a privatised public financial corporation in India. It has become the country's second largest bank thanks to its adherence to strict commercial principles and sound marketing strategies.

2. Foreign banks

Foreign banks have been playing a significant role in Asia. Governments have tended to take a sequential approach to opening financial markets to foreign banks. However, the pace of this liberalisation has accelerated as a result of agreements of GATS and Free Trade Agreements and Economic Partnership Agreements.

Governments will initially permit only a select segment of the market to be opened to foreign banks. There are usually restrictions on the venues and number of branches permitted. The legal entities in which foreign banks are permitted to establish a commercial presence also have significance. If a foreign bank is allowed to open branches, the range of business opportunities available may be limited, but the capital cost is relatively limited.

If a foreign bank is required to open a local subsidiary, it is often granted similar status to local banks and regulators are able to regulate local subsidiaries more fully. Subsidiaries are required to maintain their own funds, which are kept separate from the parent institution, creating a significant capital cost for the organisation.

In many cases, shareholding of foreign subsidiaries by foreigners is limited. Thailand limits foreigners' shareholding of foreign subsidiaries to 25% in principle, but has been permitting local subsidiaries whose foreigner shareholdings are 95% to encourage entrance by foreign banks.

Some countries still maintain branching regulations on foreign banks. Nevertheless, the strategic importance of branching is decreasing with the use of IT. Foreign banks are using ATM networks and alliances with local banks to substitute for a lack of branches. Furthermore, the purchasing of regional banks can be carried out if permitted. Rabobank, a Dutch bank, controls two Indonesian banks, Haga and Hagakita, and utilizes them for business in Indonesia. In 2006, the Bank of Tokyo-Mitsubishi UFJ (Malaysia) made an alliance with the CIMB Group, the second largest bank in Malaysia. These alliances have facilitated the expansion of foreign banks in the host countries.

F. Consumer protection and deposit insurance

1. Consumer protection in Asian countries

With deregulation and competition in the market, consumer protection as a response to market failure must be considered. In the countries we have researched, consumer protection movements expanded in 1970s, following international trends, and after 1980s, most countries established general consumer protection statues, which have been applied to financial transactions (Table 5).

Table 5: Consumer Protection Legislation

	Year of enactment	Administrative authority
China	1993	Consumer Association
Korea	1980	Consumer Protection Board
Indonesia	1999	National Consumer Protection Organization
Malaysia	1999	Ministry of Domestic Trade and Consumer Affairs
The Philippines	1991	Ministry of Trade and Industry
Thailand	1979	Consumer Protection Board
Vietnam	1999	Ministry of Commerce
India	1986	Consumer Protection Commission

Source: T. Matsumoto, "Consumer Protection Law in Asian Developing Countries", N. Sakamoto (ed.), *Economic and Social Development and Law in Asia*, Institute of Developing Economies, (JETRO, 2002), (in Japanese). Updates and revisions made by the author.

As consumer protection issues have various aspects, most countries establish special agencies to deal with such issues, like the Ministry of Domestic Trade and Consumer Affairs of Malaysia and the Consumer Protection Board in Thailand. Consumer protection system provides special schemes to protect weak consumers through class action lawsuits (Thailand, Indonesia), punitive damages (China), and alternative dispute resolution (ADR)(Malaysia and India).

2. Consumer protection in financial services

Consumer protection in financial services is of special concern to regulators, due to the information asymmetry of the services. Consumers may suffer severe damages if their deposit or invests are lost as a result of a failure of a financial institution. The nature of financial institutions causes the contagion of instability to other institutions. Three of the major consumer protection measures, financial education, deposit insurance and dispute settlement system are discussed here.

(1) Financial education

Financial products have complex structures and consumers must be educated in order to understand the risks inherent of them. Thailand and Malaysia emphasise consumer education in their financial masterplans. Indonesia, Thailand, and Malaysia have pledged to improve information disclosure, and Vietnam and China consider this an important measure to be implemented.

For example, Malaysia introduced a special website for consumer education, which provides a variety of information concerning financial services.[63] It includes competitive tables for individual consumers' needs, consumer checklist in utilizing the services, and simple calculator for monthly loan payments.

(2) Deposit insurance

Most Asian countries have introduced deposit insurance schemes designed to protect deposits up to a prescribed limit after the Financial Crises (Table 6). Some, like the Philippines and India, have had

[63] *Available at* <http://www.bankinginfo.com.my/>.

deposit insurance systems from very early on.

The functions of deposit insurance systems can vary, and one of the major developments in Asia would be the inclusion of capital assistance to troubled banks. Malaysia and Indonesia have deposit insurance systems which provide capital assistance.

The independence of deposit insurance is essential to the sound functioning of deposit insurance. While most countries establish their deposit insurance corporations as public companies, the use of funds is often controlled by the government or the central bank. The large funds involved in insurance management make its independence and sound financial management important. Delineating its independence and methods for managing funds is essential for its well being.

It is now conventional knowledge that coverage of deposit insurance needs to be limited. The blanket guarantees imposed during the crises incurred a moral hazard in the financial system, creating distortions in the market. Nowadays, deposit insurance generally protects up to the equivalent of 100 thousand dollars. Some deposit insurance systems are now applying risk-weighted premiums. Malaysia is planning to introduce risk-weighted premiums.

Table 6: Deposit Insurance Legislation

	Year of enactment	Amount insured*
China	Under discussion	All amounts
Korea	1995	50 million won
Indonesia	2004	100 million rupiah
Malaysia	2005	60 thousand ringgit
Philippines	1962	250 thousand pesos
Thailand	Under discussion	All amounts
Vietnam	1999	30 million dong
India	1961	100 thousand rupees

* Amount insured per depositor at an institution
Source: Described by the authors of the country studies.

(3) Dispute settlement systems

As legal proceedings are lengthy and costly, simplified procedures aimed at resolving consumer complaints are being set up in most countries. It is becoming mandatory for financial institutions to establish in-house complaints departments. Malaysia, India Korea and Indonesia all have ADRs specialising in complaints and conflicts in financial transactions.

Many Asian countries are pushing their financial institutions to have adequate internal complaint handling systems, together with formal dispute resolution systems. India has such a system, with the Reserve Bank of India, the Indian central bank, requiring individual financial institutions to try and resolve complaints before handing over cases to the bank ombudsman in the RBI. National and local consumer redress systems are also being established.

V. Conclusion

The pace at which Asian financial markets have developed in the past decade is astonishing. The experience of the Financial Crises is present in most financial reforms, and they are still strongly committed to establishing financial systems that are resilient to financial shocks.

Prudential standards have improved with international standards being adopted in most countries. GATS and FTAs/EPAs have also had a strong impact on the liberalisation of financial markets. Competition acts are being enacted, pointing to a more liberalised economy in general. Financial systems are evolving towards a more market-oriented system with less regulatory discretion and more market forces being used to determine resource allocation.

While competition policy has been given greater emphasis in recent years, it has yet to be decisively applied to the financial sector. This may be due to the restructuring of the financial sector still underway. Governments may be focused on the initial establishment of robust and sound financial system prior to moving on to implementing improved competition policies.

Nevertheless, the importance of competition policy in the financial sector has been increasing in recent years. The IMF's Financial Sector Assessment Program highlights the importance of competition policy. The EU has been actively seeking better application of competition policy in the financial sector. Globalisation may bring the wave of competition policy to Asia's financial markets quicker than expected.