CHAPTER 2 : BANKING SYSTEMS IN EAST ASIA AND LATIN AMERICA

This chapter provides an insight into the banking systems in East Asia (Malaysia, Thailand, Indonesia and Korea) and Latin America (Argentina, Brazil, Colombia, Mexico, Peru and Colombia). It begins with background information, followed by key characteristics of banking in the two regions and finally banking systems of selected countries.

2.1 BACKGROUND

The banking sector in both East Asia and Latin America has traditionally been a highly protected industry. Efforts to liberalize the Latin America financial system took place in late 1980s or early 1990s. Financial liberalization include the liberalization of interest rates, directed lending and even the overhaul of regulatory and supervision of financial system. In the mid-1990s, global competitive forces and the banking crisis that hit several Latin American countries (Bolivia, Brazil, Mexico, Venezuela, Argentina and Paraguay), forced market participants and the authorities to deregulate the industry and to open it to domestic non-banks and foreign intermediaries (Jeanneau, 2007). During this period, the process of bank restructuring/recapitalisation increased foreign ownership of Latin American banks and concentration. Foreign banks gained market shares by taking control of domestic banks in need of fresh capital and new management rather than opening new institutions as during this period, the process, legal and regulatory limitations on activities of foreign banks were relaxed or eliminated (Singh et al., 2005).

Similarly, East Asia during the early 1990s, implemented financial liberalization programmes with the intention to increase the competitiveness of national banking sectors. However, with the onset of the East Asian financial crisis, financial liberalisation programmes ended and bank restructuring started in 1997 until the early 2000s. Policies on financial restructuring include bank privatisaton, facilitating wider foreign ownership and banking sector consolidation, either voluntary or compulsory basis (Williams and Nguyen, 2005).

2.2 KEY CHARACTERISTICS OF BANKING SYSTEM

We now look at three key characteristics of banking systems in East Asia (Malaysia, Thailand, Indonesia and Korea) and Latin America (Argentina, Brazil, Colombia, Mexico, Peru and Venezuela), namely, banking systems as percentage of GDP (Table 1), the ratio of bank credit to private sector as a percentage of GDP (Figures 1 and 2) and the cost of financial intermediation (ex-ante bank spreads, Figure 3). Table 1 is credited to Singh et al. (2005), while Figures 1 – 3 are compiled from International Financial Statistics August 2009, International Monetary Fund and the World Development Indicators 2009, World Bank. The formulae for ratio of bank credit to private sector as a percentage of GDP is based on the formulae in Backe and Egert (2007).

Table 1 show that assets of banking systems to GDP ratio in 2003 for Malaysia, Thailand and Korea is high, above 100%, compared with countries in Latin America. Within the Latin America countries, Brazil has the highest assets to GDP ratio of 74.6%., while Peru has the lowest ratio of 19.2%. Deposit to GDP ratio of countries in these Latin America countries is less than 40%, compared with above 90% for countries in East Asia. Similarly, credit to economic activity for East Asia is above 90%, while, for countries in Latin America, the ratio is less than 30%.

Table 1 : International Comparison - Banking System, 2003 (% of GDP)

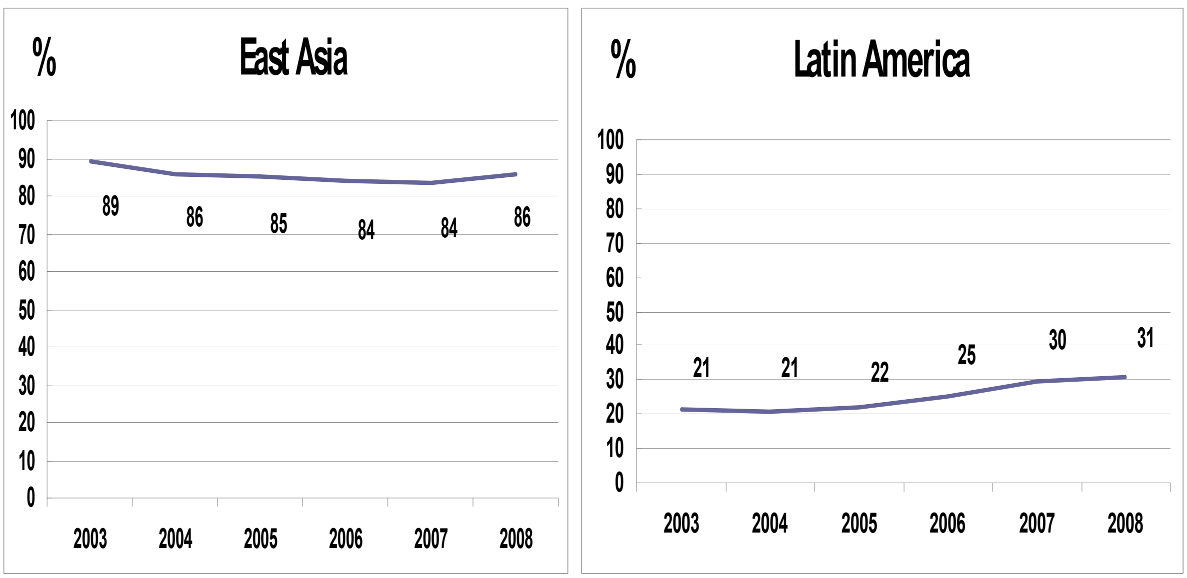
	Banking Systems (Deposit taking commercial banks)		
	Deposits	**Loans**	**Assets**
Argentina	25.3	14.2	44.8
Brazil	30.6	21.5	74.6
Colombia	19.7	19.7	37.9
Mexico	25.5	16.1	52.3
Peru	14.5	13.7	19.2
Venezuela	20.0	8.1	23.9
Malaysia	96.0	117.7	129.6
Thailand	90.5	90.9	106.2
Korea	76.6	98.9	114.0

GDP = Gross domestic product
Source:
Singh, A., Belaisch, A., Collyns, C., De Masi, P., Krieger, R., Meredith, G. and Rennhack, R., 2005. Stabilization and reform in Latin America: A macroeconomic perspective of the experience since the 1990s. International Monetary Fund Occasional Paper No. 238

Figure 1 and Figure 2 provide information on bank credit to the private sector as percentage of GDP by regions and countries, respectively, for the period 2003 - 2008. Bank lending relative to economic activity in Latin America (Argentina, Brazil, Colombia, Mexico, Peru and Venezuela) is low, compared with East Asia

(Malaysia, Thailand, Indonesia and Korea). From Figure 1, the ratio of bank credit to GDP for Latin America during the period 2003 – 2008 average about 25%, lower than the average 86% for East Asia. The depth of financial intermediation remained low, although lending to the private sector as a percent of GDP in Latin America has been steadily increasing, from 21% in 2003 to 31% in 2008.

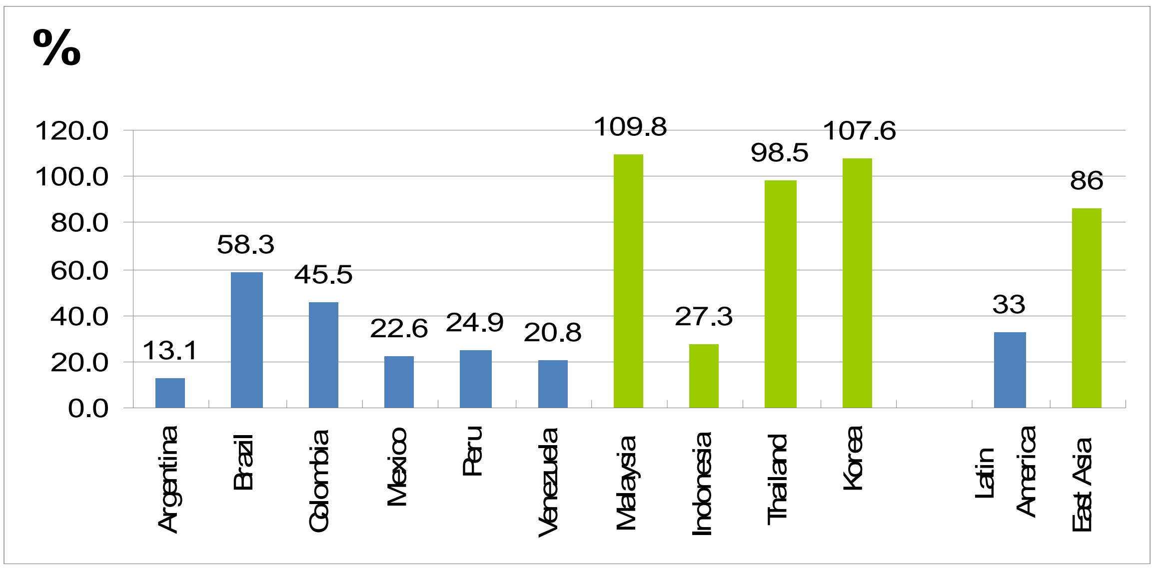
Figure 1 : Bank Credit to the Private Sector in East Asia and Latin America (% of GDP)



East Asia refer to Malaysia, Thailand, Indonesia and Korea, while Latin America comprises of Argentina, Brazil, Colombia, Mexico, Peru and Venezuela
Source: Compiled from International Financial Statistics August 2009, International Monetary Fund.
IFS codes: Bank credit to the private sector: lines 22d (claims on private sector) and 22g (claims on nonbank financial institutions) (Backe and Egert, 2007)

In terms of country, Brazil has the highest bank lending relative to economic activity (58.3%), while Argentina the lowest at 13.1%. The low levels of private credit to GDP in these countries suggest unstable macroeconomic activity which held back financial sector development. Interestingly, within the East Asia region, the ratio of bank lending to GDP credit in Indonesia appeared to be much lower (below 30%) than Malaysia, Thailand and Korea (above 90%), which suggest a lower depth of financial intermediation by the banking systems in Indonesia.

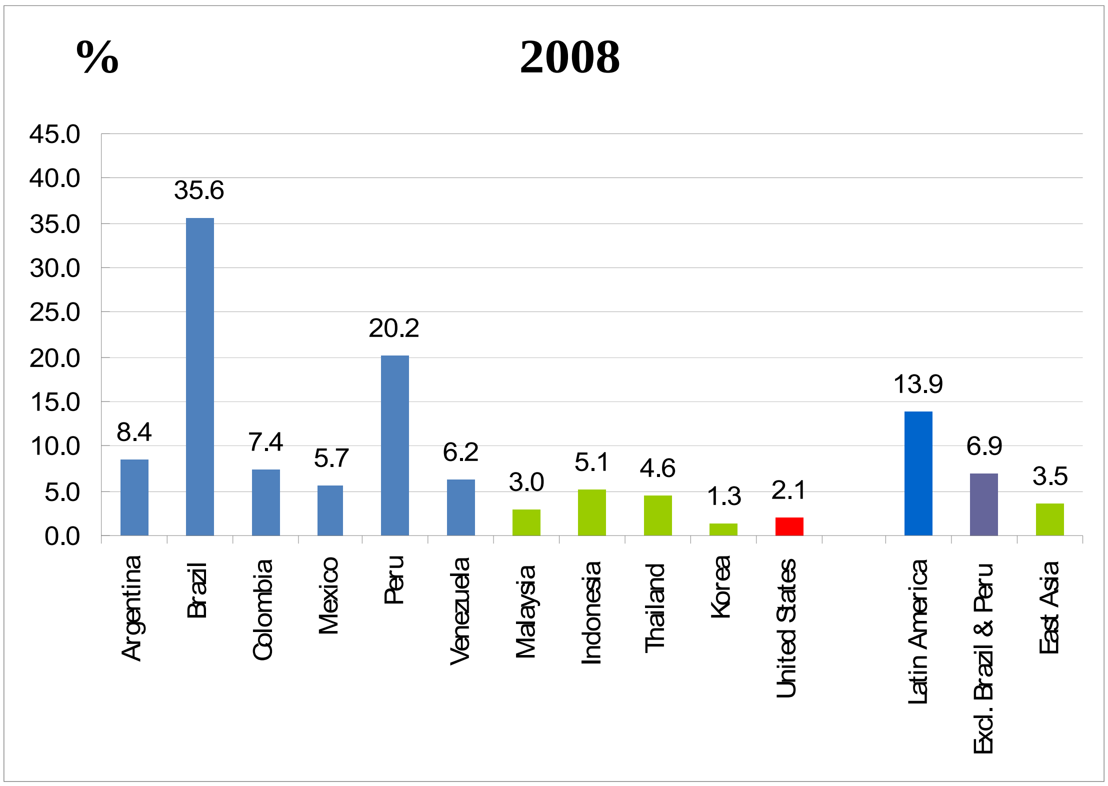
Figure 2 : Bank Credit to the Private Sector by Countries, 2008 (% of GDP)



Compiled from International Financial Statistics August 2009, International Monetary Fund. IFS codes: Bank credit to the private sector: lines 22d (claims on private sector) and 22g (claims on nonbank financial institutions). (Formulae from Backe and Egert, 2007)

Financial intermediation cost is high in Latin America (Brock and Suarez, 2000; Jeanneau, 2007 and Gelos, 2008). As can be seen from Figure 3, the ex-ante bank spreads (lending rate minus deposit rate) of Latin America in 2008 is higher at 13.9% compared to East Asia (3.5%) and US (2.1%). Brazil has the highest interest rate spreads of 35.6%, followed by Peru (20.2%). On a positive note, Tarsila et al. (2001) reported that interest spreads in Brazil has been on a downward trend, from a rate of 135% in 1995 to 35% in 2001 due in part to a stable macroeconomic environment and official measures aimed at reducing loan interest rates. Excluding Brazil (35.6%) and Peru (20.2%), bank spreads in Latin America remained higher than East Asia and US, at 6.9%. In Latin America banking literature, high operating cost is identified as one of the reasons for the high interest spreads.

Figure 3 : Ex-Ante Banking Spreads of Latin America, East Asia, United States (in percentage points, 11 countries), 2008



Bank Spread: Lending rate minus deposit rate (%). For East Asia and Latin America regions: Simple average of interest margin. Source: World Development Indicators 2009, World Bank and International Financial Statistics August 2009, International Monetary Fund.

2.3 SELECTED BANKING SYSTEMS

In this session, we provide a brief description of the banking system in Brazil, Korea, Malaysia and Thailand. Brazil has the highest number of banks, 159 banks, followed by Korea, 56 banks, Thailand, 32 banks and Malaysia 22 banks (excluding Islamic banks).

2.3.1 BRAZIL

Tables 2 and 3 provide information on the number of banks in Brazil and the capital origin. The number of banks in Brazil has declined from 164 banks at end-2004 to 159 at end-2008. There are 140 multiple (or universal) banks, 18 commercial banks and 1 savings banks by end-2008. This group of banks is either public (7.5%) or private owned banks (92.5%). Overall, domestic banking institutions dominate the Brazilian banking system (49.1%), followed by domestic banking institutions with foreign control (35.2%). (Central Bank of Brazil website).

Table 2 : Brazil Banking System - Type of Institutions and Number of Banks, as at end

	2004	2005	2006	2007	2008	2008 %
Multiple Banks	139	138	137	135	140	88.1
Commercial Banks	24	22	21	20	18	11.3
Savings Bank	1	1	1	1	1	0.6
Total	**164**	**161**	**159**	**156**	**159**	**100.0**

Source: Central Bank of Brazil website

Table 3 : Brazil Banking System - Distribution of Banking System by Capital Origin (Number)

	2004	2005	2006	2007	2008	2008 %
Public/Government owned	**14**	**14**	**13**	**13**	**12**	**7.5**
Private	150	147	146	143	147	92.5
National/Domestic	**82**	**82**	**81**	**77**	**78**	**49.1**
Domestic with Foreign Participations	**10**	**8**	**9**	**10**	**7**	**4.4**
Domestic under Foreign Control 1/	**49**	**49**	**48**	**49**	**56**	**35.2**
Foreign Full Branches	**9**	**8**	**8**	**7**	**6**	**3.8**
Total	**164**	**161**	**159**	**156**	**159**	**100.0**

1/ Foreign participation equal to or greater than 10% and lower than 50%
Source: Central Bank of Brazil website

2.3.2 KOREA

Banking institution in Korea can be classified into commercial banks and specialized banks. As of the end of June 2009, commercial banks consisted of 7 nationwide commercial banks, 6 local banks, and 38 foreign bank branches, while there are 5 specialised banks.

Nationwide commercial banks have branch banking system throughout the country, while local banks branch banking system are within a province, and serve the small and medium enterprises. Foreign banks are mostly into wholesale banking, and can now carry on business almost identical to Korean banks as preferential treatment has been reduced and discriminatory business regulations lightened.

Specialized banks were first established to provide funds to particular sectors (example, agriculture and fisheries) due to insufficient supply of funds through commercial banks. Subsequently, as the financial environment changed, these specialized banks expanded their business into commercial banking areas. They now have about the same pattern of business as commercial banks, although their allocation of funds to their relevant sector is still high. (Bank of Korea website).

2.3.3 MALAYSIA

Malaysia has a dual banking system, conventional and Islamic banking. Prior to 2005, there are only 2 Islamic banks. From 2005 onwards, the number of Islamic banks increased. From only 2 Islamic banks in 2004, the number increased to 6 in 2005, and by 2009, there are 17 Islamic banks in Malaysia. In contrast, the consolidation of the domestic banking system (announced in 1999), saw the number of commercial banks & finance companies reduced from 35 in 2002 to 27 in 2005. By 2006, with the completion of a merger between two domestic banking groups, the number of commercial banks stands at 22 (up to end-2009), comprising of 9 locally owned banks, and 13 locally incorporated foreign-owned banks. Another milestone in the Malaysian banking system is the emergence of investment banks framework in 2005, whereby a merchant bank can merge with a stock broking firm to form an investment bank. An investment bank holds both the merchant bank and dealers licenses, and is regulated by both Bank Negara

Malaysia and Securities Commissions of Malaysia. (Central Bank of Malaysia Annual Reports, 2005 - 2006).

Table 4 : Malaysia Banking Institutions

	2002	2003	2004	2005	2006	2007	2008	2009
Commercial Banks 1/	35	34	29	27	22	22	22	22
Merchant/Investment Banks	10	10	10	10	10	14	15	15
Islamic Banks	2	2	2	6	10	11	17	17

1/ Includes finance companies
Source : Financial Stability and Payment Systems Report, 2006 – 2009, Central Bank of Malaysia

2.3.4 THAILAND

Bank of Thailand Financial Sector Master Plan Phase I (2004 – 2008) (FSMP) implemented in 2004, sought to rationalize the structures and roles of the financial institutions. The aim was to enhance operational efficiency and minimize redundancy through consolidation of existing financial institutions, to result in a significant reduction of small financial institutions. Prior to the FSMP, Thai financial institutions comprises of commercial banks, foreign bank branches, finance companies, credit froncier companies and international banking facilities. Under the FSMP, there are only two types of Thai financial institutions: commercial bank and retail bank; and two types of foreign financial institutions: foreign bank branch and subsidiary. Finance and credit froncier companies are allowed to upgrade to become a retail bank, or merge and upgrade to a commercial bank; foreign branches upgrade to subsidiary or merge with finance companies and upgrade to subsidiary; stand-alone international banking facilities could upgrade to full branch, or merge with finance and credit froncier Company and upgrade to subsidiary. As a result, by end-2009, there are 38 financial institutions in Thailand compared with 84 at end-2003. Nevertheless, at end-2009, the number of commercial banks, retail banks, foreign bank branches and subsidiary total 32, an additional one bank, compared with 31 commercial banks and foreign bank branches at end-2003 (Bank of Thailand Supervision Report 2004).

Table 5 : Thailand Financial Institution

	Before FSMP End-2003	**After FSMP End-2009**
Thai Commercial Banks	**13**	**14**
Foreign Bank Branches	**18**	**15**
Finance Companies	18	3
Credit Froncier Companies	6	3
IBF attached to Commercial Banks	24	
Stand alone IBFs 1/	5	
Retail Bank		**2**
Subsidiary		**1**
Total	**84**	**38**

FSMP = Financial Sector Master Plan
IBF = International Banking Facilities
Source: Supervision Report, 2004, Bank of Thailand; Bank of Thailand website

2.4 CHAPTER SUMMARY

In summary, total assets of banking system to GDP and bank credit to the private sector as percentage of GDP in Latin America are lower than East Asia. On the other hand, ex-ante banking spreads in Latin America is higher than in East Asia. We shall now proceed to Chapter 3 on literature review.