ISSN 1995-2864
Financial Market Trends

Pre-publication version for Vol. 2009/2
Preliminary version December 2009

Current and Structural Developments in the Financial Systems of OECD Enhanced Engagement Countries

John K. Thompson*

This paper discusses the financial systems of OECD Enhanced Engagement Countries (EE5: Brazil, China, India, Indonesia, and South Africa). Rather than providing a comprehensive survey of each financial system, it is designed to highlight some of the salient features of EE5 financial systems, emphasising those aspects of the system that these countries have in common and those that are different from those in OECD countries. While there are significant differences among EE5 countries, this group shares some distinctive characteristics. EE5 have relatively lower financial assets/GDP ratios and their financial intermediation remains relatively bank dominated and less international. Equity markets have reached proportions comparable to those of OECD countries, but fixed income markets (especially private debt markets) remain relatively backward. At the same time, the financial systems of EE5 countries have been developing rapidly supported by steady reforms. Going forward, many institutions outside OECD countries are likely to become bigger players in financial markets, and the emergence of large asset holdings, rising shares of world equity and bond markets and the emergence of powerful financial institutions in new regions of the world are likely to influence the contours of the world financial system in years to come.

* The main text of this paper was prepared by John K. Thompson, Consultant and former Counsellor in the OECD Directorate for Financial and Enterprise Affairs, with statistical assistance by Ting Yang, Consultant, and editorial input by Gert Wehinger, Economist, both in the Financial Affairs Division of the Directorate for Financial and Enterprise Affairs. The paper is a revised version of a background note prepared for a Policy Dialogue on Financial Markets that the OECD Committee on Financial Markets held with financial policymakers from Brazil, China, India, and Indonesia (Enhanced Engagement countries). This Policy Dialogue was sponsored by the Government of Japan whose grant for this project is gratefully acknowledged. The paper has benefitted from comments by participants of the Policy Dialogue and by OECD staff. All remaining errors are those of the author. This work is published on the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or of the governments of its member countries.

I. Background

Policy dialogue with OECD Enhanced Engagement (EE5) countries has taken on a new urgency due to the world financial crisis

Under a programme of Enhanced Engagement, the OECD has been pursuing policy dialogue on a broad range of issues with a group of five key non-Member countries, Brazil, China, India, Indonesia, and South Africa, hereafter the EE5. Interest in pursuing such policy dialogue has taken on a new urgency due to the world financial crisis of the past two years, which has vastly increased the importance of EE5 countries in world finance. With the loss of capital in major financial institutions since 2007, the weight of institutions from outside the OECD has grown as a share of world banking assets, while banks from non-OECD countries have become major participants in global financial markets. Moreover, the share of EE5 countries in capitalisation of equity markets has risen dramatically. As the crisis has continued, realisation has grown that the co-operation between OECD and non-OECD countries is essential not only for the management of the crisis but also for the design of a post-crisis financial architecture.

This note highlights some features of EE5 financial systems

In the context of Enhanced Engagement, the OECD Committee on Financial Markets (CMF) has held a Policy Dialogue with financial policy makers from the EE5 countries in October 2009. This article is based on a paper prepared for that meeting.

II. Current financial market developments and crisis-related issues

The most severe financial crisis in generations has led policymakers to provide unprecedented fiscal and monetary stimulus

As a result of the sharp drops in asset prices and the illiquidity in major components of the world financial system since 2007, a substantial part of the accumulated wealth of OECD countries has been lost during the financial and economic crisis. Many of the world's largest financial institutions became insolvent and/or required expensive official rescues. The authorities in OECD countries have provided an unprecedented fiscal and monetary stimulus to prevent further contraction of income. Indeed, the shocks of the past two years are so severe that some analysts and policy makers have begun to question many aspects of the model of finance that had gained currency among OECD countries over the past few decades.

EE5 countries have weathered the crisis better than most OECD countries

Thus far the EE5 countries have weathered the crisis far better than most OECD countries. Most EE5 countries experienced a slowing of growth, and Brazil and South Africa are expected to see GDP fall in 2009, but the real economy has proven more resilient than those of OECD countries and growth is expected to recover more rapidly than in the OECD as a whole (Figure 1). Equity markets have fared much better than those of OECD countries in the past three years (Figure 2). Moreover, credit expansion has been maintained much better in EE5 countries than in OECD countries (Figure 3). Bond prices in EE5 countries initially fell sharply in the wake of the crisis, but the subsequent narrowing of credit spreads underline an increased confidence by investors in the ,medium term prospects of these countries (Figure 4).

Common interests between OECD and EE5 countries

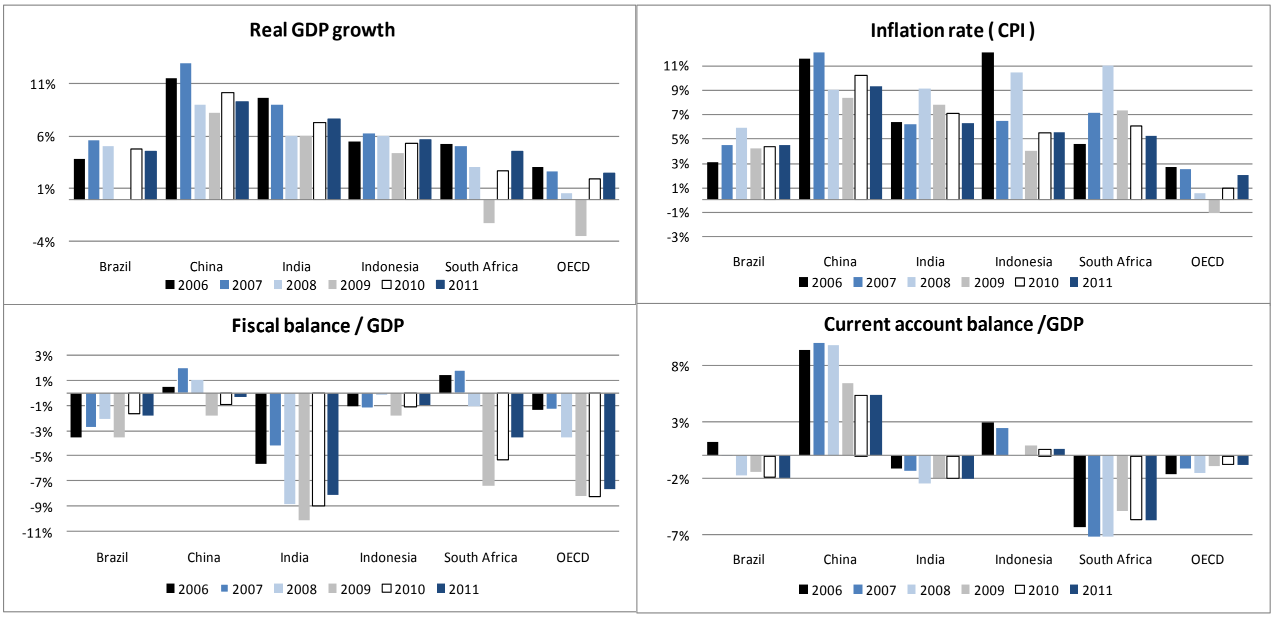
The crisis has highlighted the common interests between OECD and EE5 countries in preserving an open and fair environment for trade, investment and finance. Mechanisms for international co-operation have been tested during the past three years and the results have generally been positive. By agreeing on the need for concerted fiscal and monetary action and by resisting protectionist pressures, major countries have so far averted a retreat from an open trade and financial system that would have aggravated the downward spiral.

Need to co-ordinate policy responses among a broad group of countries

Recognition has grown of the need to co-ordinate policy responses among a broad group of countries and to engage a wide range of countries in the decision making process. Thus the G-20 that includes key OECD countries, the EE5, as well as other countries,[1] has assumed a leading role in making sure that adequate resources are available for countries experiencing external financing strains and in enunciating broad principles for reform of the financial architecture.

Figure 1. The macroeconomic situation in EE5 countries and the OECD

Selected variables, including forecasts

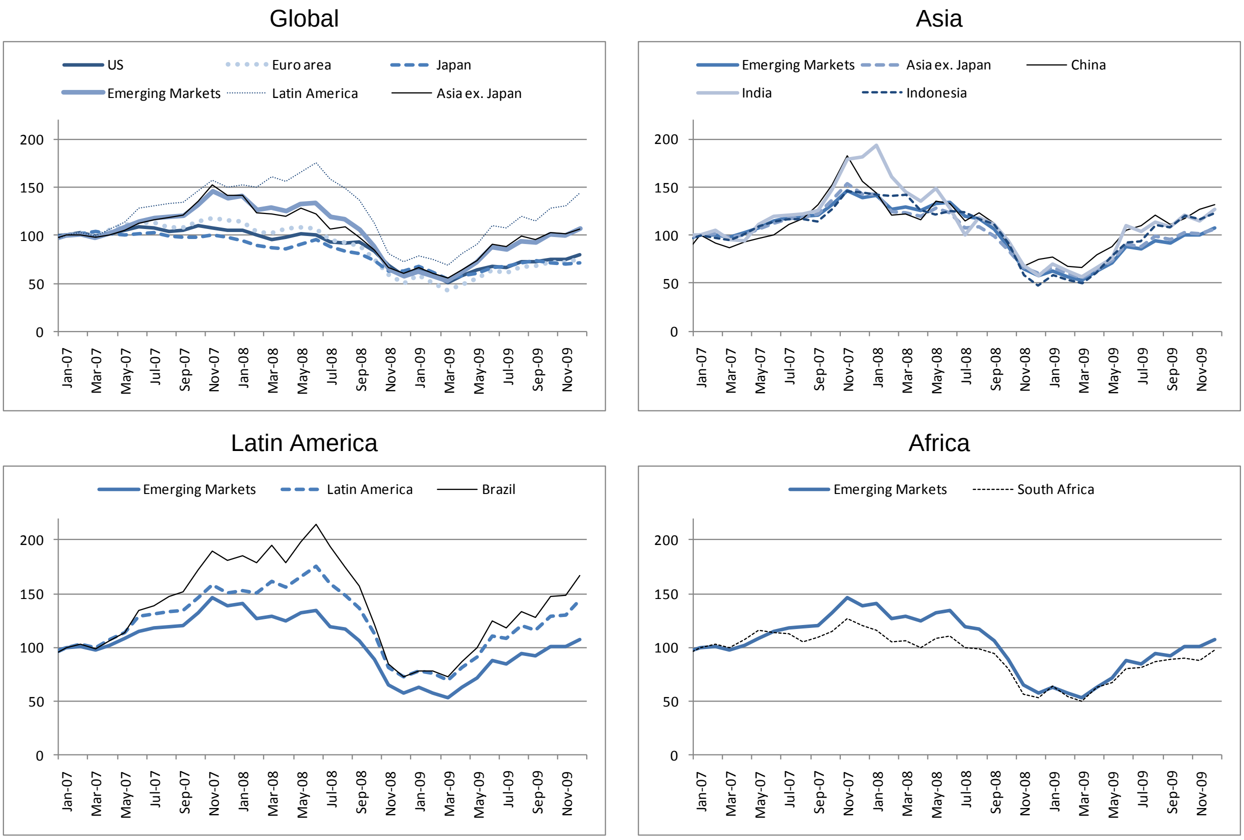


Source: OECD *Economic Outlook*, vol. 2009/2, no. 86, November 2009.

EE5 countries have a relatively lower financial intermediation and have taken a much more guarded approach to financial liberalisation and modernisation

To some degree, the relatively high resiliency of EE5 economies may reflect the fact that their financial intermediation is relatively lower as compared to the one of OECD countries, and that catch-up effects generate a relatively higher GDP growth. At the same time it appears true that the crisis erupted in the most sophisticated components of the financial system and the EE5 countries have taken a much more guarded approach to financial liberalisation and modernisation than the OECD countries. Banks in EE5 countries have continued to concentrate in traditional deposit taking and lending and became involved in capital markets to a much lesser extent than OECD countries. Domestic institutions in the EE5 had used fewer financial innovations such as structured products, derivatives and securitisation and engaged in less OTC activity. Moreover, the EE5 have had much lower levels of consumer and housing indebtedness than OECD countries.

Figure 2. Selected equity market developments

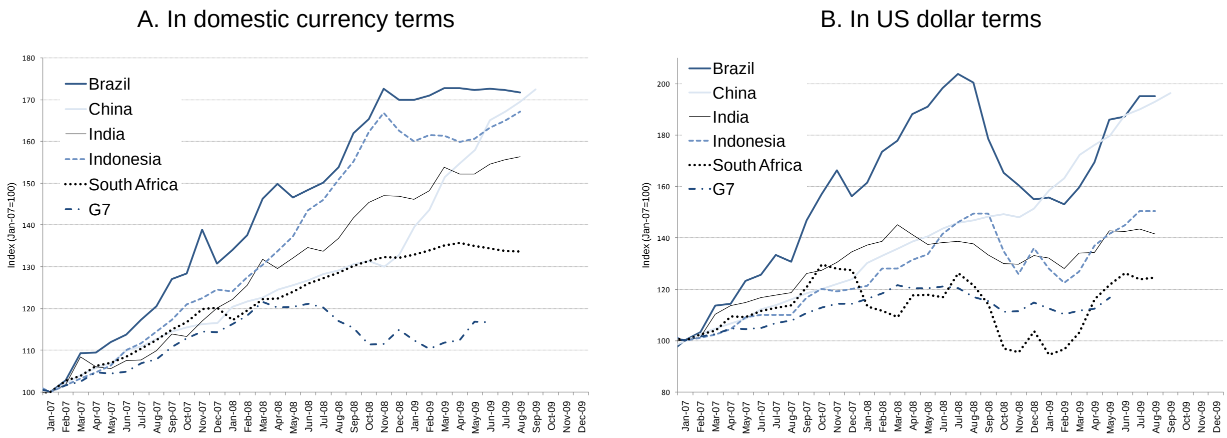


Note: Datastream total market indices (Jan 2007=100), all in US dollar terms,

Source: Thomson Financial Datastream.

Figure 3. Domestic Credit: Claims On Private Sector

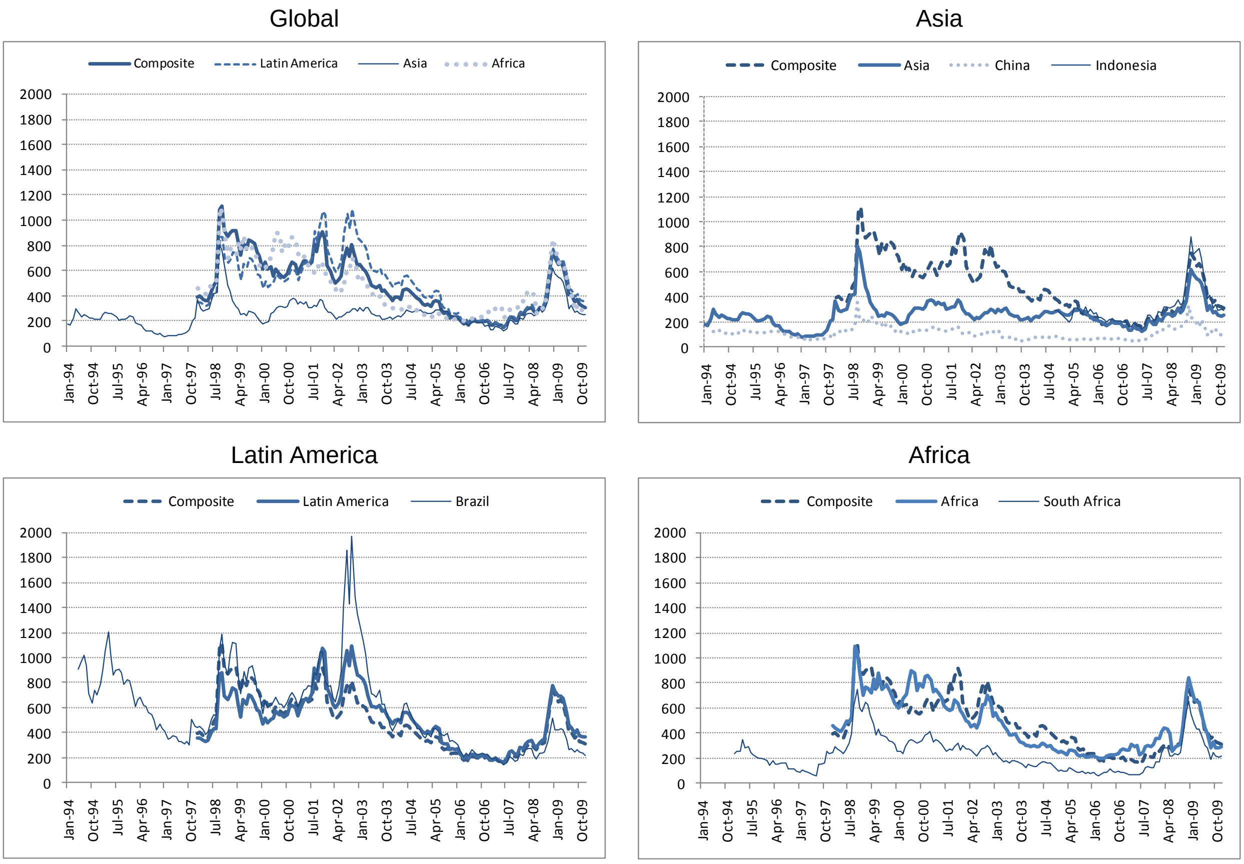
Indices (Jan-07=100), in US dollar terms



Note: G7 includes data from the United States, Japan, Germany, France, Italy, the United Kingdom and Canada, in USD terms.

Source: IMF International Financial Statistics; Thomson Financial Datastream; and OECD.

Figure 4. Selected emerging market bond spreads



Note: JPM EMBI Global - blended spreads.

Source: Thomson Financial Datastream.

III. Basic characteristics of the financial systems of EE5 countries

1. Overview

Large differences in financial structures of EE5 countries against OECD but also within their peer group

While striking differences are found among the EE5 Countries, this group of countries shares some distinctive characteristics. This section examines key indicators and compares the EE5 countries to OECD Members. It is recognised that comparison to the average of OECD countries may give a misleading impression of the relative position of EE5 countries. Thus in cases where other comparisons are relevant and where the data are available, the EE5 countries are measured against *(a)* the G-7 Countries *(b)* OECD Accession Countries and *(c)* low income OECD Countries (for definitions of these groups see footnote to Figure 5.) The financial systems of the EE5 countries will be analysed using indicators covering six sets of criteria: *(1)* financial system depth and patterns of intermediation, *(2)* patterns of asset holding, *(3)* access to financial services, *(4)* internationalisation of finance, *(5)* stability and prudential soundness, and *(6)* institutional and regulatory structure.[2]

Major features and trends in the financial systems

Some of the major features and trends in the financial systems of the EE5 countries are:

- The financial systems of EE5 countries have been developing rapidly but are, broadly speaking, at earlier stages of development as compared to OECD countries on average, reflected in lower financial asset/GDP ratios.
- Financial intermediation in EE5 countries tends to take the form of bank lending rather than issues of securities in capital markets.
- The institutional investor sector is far less developed in the EE5 countries, except in South Africa and to a lesser degree Brazil.
- The corporate bond market in EE5 countries is much less developed than in OECD countries, but the equity markets of most EE5 countries are proportionately as large as those of OECD countries.
- Except in South Africa, state-owned banks account for rather large shares of total bank assets
- Foreign presence in the banking market is small in China and India
- Following years in which banks often had poor balance sheet quality, banking has been transformed with improved supervision, higher rates of profitability, better asset quality and stronger capital ratios.
- While most EE5 countries have developed sophisticated instruments such as futures and options, they have been cautious about authorising new products such as OTC derivatives and structured products.

2. Market depth and patterns of intermediation

Financial systems of the EE5 countries tend to be not as deep as those of OECD Members

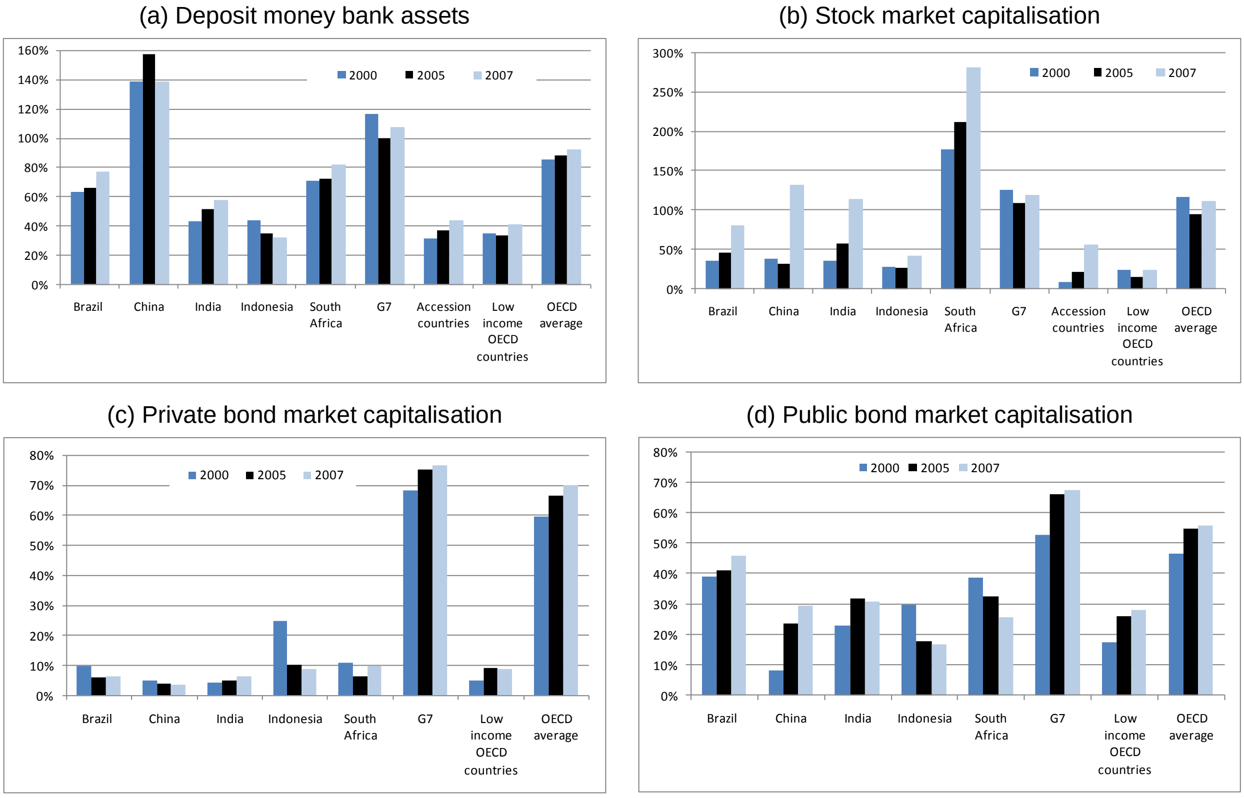
Figure 5 shows market depth and the relative size of major components of the financial system in the EE5 and OECD countries. Most indicators show that the financial systems of the EE5 tend to be not as deep as those of OECD Members. For example, total financial assets (bank assets + capital market assets) represent a smaller share of GDP in the EE5 than in the OECD countries, but the financial systems of the EE5 countries have been growing rapidly. The equity markets of most EE5 countries are already on a par with those of OECD countries (at least in terms of the size of markets). By most measures, South Africa's financial system is as deep as those of OECD countries.

EE5 countries can be characterised as more 'bank-dominated' than OECD countries

In general, the assets of the banking systems of the EE5 account for lower shares of GDP than those of the OECD countries. Nevertheless, financial intermediation in the EE5 countries can be characterised as more "bank-dominated" than OECD countries inasmuch as the predominant share of financial intermediation still occurs through on-balance sheet bank lending. Corporate debt markets are less developed and represent a smaller share of GDP than in OECD countries. OECD countries have been experiencing a process of disintermediation under which corporations have been relying less on bank borrowing and obtain external funding by issuing securities that are sold directly to investors. Similarly, markets in securitised assets, mortgage-backed securities (MBS) and asset-backed securities (ABS) in EE5 countries remain at an incipient stage.

Figure 5. Financial intermediation in OECD and EE5 countries

Selected variables, in per cent of GDP



Notes: Country groups show GDP-weighted averages of the respective variable. G7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. Accession countries (in accession to the OECD) are Chile, Estonia, Israel, Russia, and Slovenia. Low income OECD countries are those with a real GDP per capita of less than 15 000 USD in 2007 and comprise Mexico, Turkey, the Czech Republic, the Slovak Republic, Poland and Hungary. OECD averages are also GDP-weighted and are calculated over all 30 OECD member countries, except in Panel c where they do not include Luxembourg, New Zealand, Poland, the Slovak Republic, and Turkey (2001-2005); and Panel d where they do not include Luxembourg.

Sources: World Bank, *Financial Development and Structure Database*; People's Bank of China; and OECD.

Bond markets in EE5 countries are relatively smaller, as fiscal positions are stronger

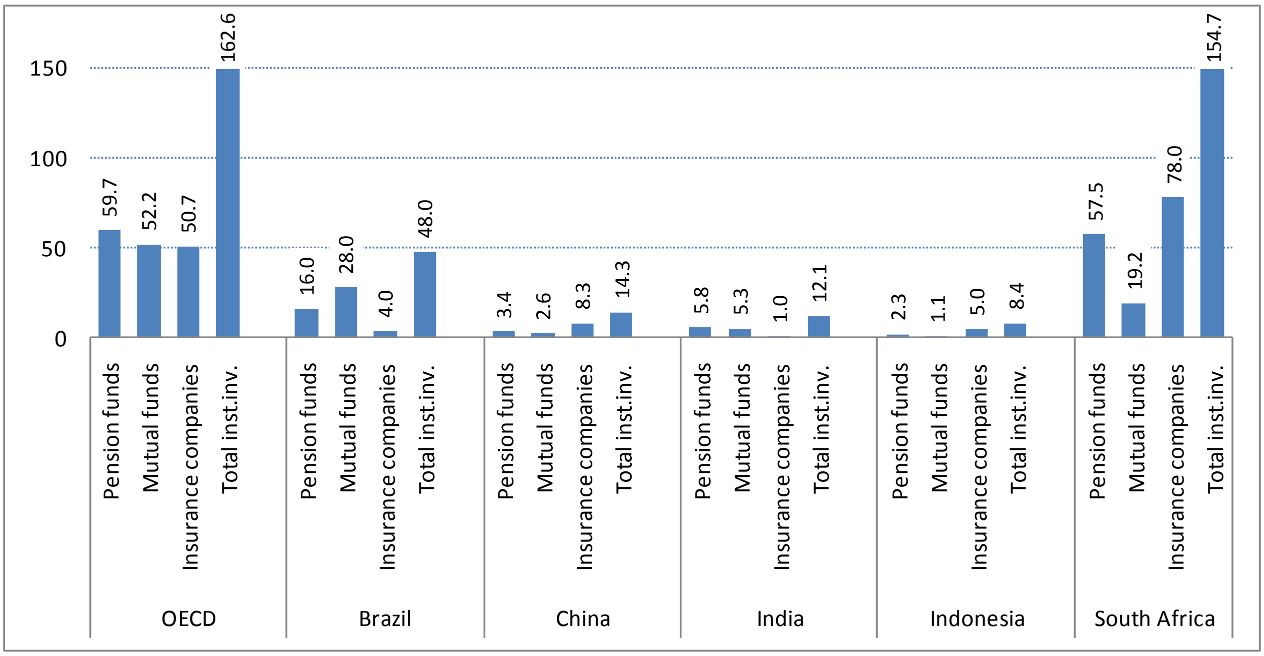
In addition to the continued strong dominance of banks in corporate finance in EE5, the relatively low level of fixed income market development also reflects the stronger fiscal positions of the EE5 countries and consequently lower levels of government borrowing. Thus, in all EE5 countries except South Africa, public debt-to-GDP ratios are lower than in the average of OECD countries.

Equity markets of EE5 compare favourably with those of OECD countries

The situation is rather different with respect to equity finance, where the markets of EE5 countries compare favourably with those of OECD countries. Despite a growing development of OECD equity markets over the past few decades, the capitalisation equity markets of EE5 countries had been growing more rapidly than those in OECD countries for several years. Moreover, in the current crisis the sharp correction of equity markets in OECD countries stands in contrast to the more resilient performance of in the EE5. In South Africa, where the equity market was already well developed, it has now advanced to the point that that market is comparatively larger than in any OECD country.[3] Brazil, China and India have all made significant strides in promoting the development of equity markets and their markets now rank among the largest in the world in absolute size. Indonesia has also made significant gains, but still lags behind other EE5 countries.

Figure 6. Patterns of holding of financial assets

Assets of institutional investors in 2005, in per cent of GDP



Notes: OECD averages are GDP-weighted and comprise data from Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Japan, Luxembourg, the Netherlands, Norway, Spain, Turkey, the United Kingdom and the United States; these data are comparable across countries and in aggregate represent more than 90% of institutional investors' activity within all OECD countries.

Sources: OECD Database on Institutional Investors assets; Inter-American Development Bank; Asian Development Bank; and World Bank (2006).

Institutional investment is far less developed in the EE5 countries, except in South Africa and, to a lesser degree, Brazil

One set of indicators that is closely related to the pattern on financial intermediation is the relatively simple pattern of holding of financial assets in EE5. As Figure 6 shows, although bank deposits represent a lower share of GDP in the EE5 than in OECD, bank deposits are still the primary means by which the public holds financial assets. By contrast, one of the most striking features of the financial systems of the OECD countries has been the emergence of institutional investors, *i.e.* pension funds, insurance and collective investment schemes or (CIS), as the main form of wealth holding in OECD countries and as the major investors in securities. Among EE5 countries, only South Africa has a pattern of asset holding that is similar to those of OECD countries. In some countries some categories of institutional investors are comparatively well developed. Thus in Brazil CIS are well developed while pension funds have accumulated a moderate amount of assets. On balance, however, institutional investment is not well advanced in the EE5 at this time.

With pension and other reforms, the pattern of asset holding in EE5 countries will change drastically

This situation is likely to change significantly as legal and regulatory frameworks are reformed and new funded pension schemes are introduced. In fact, major reforms are under consideration in several countries. Thus in 2007, India implemented a shift in the retirement scheme for civil servants to a new system of defined contribution accounts. An extension of this scheme to the general population is under active consideration. China and Indonesia are also considering major reforms. If these reforms are implemented on a substantial scale, the pattern of asset holding in EE5 countries will change drastically, a development with major implications for world financial markets.

Diversification of wealth holding away from bank deposits will foster competition and financial innovation

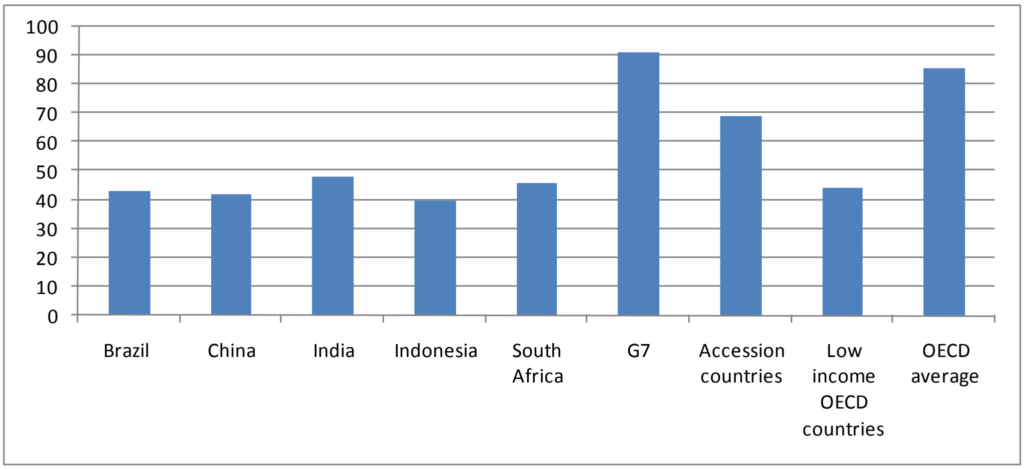
The present paucity of institutional investors in the EE5 is one of the explanations for the persistence of bank domination of finance, since there is a dearth of "natural buyers" for fixed income securities. The relative backwardness of institutional investment also means that one of the main pressures for financial innovation, *i.e.* competition among financial intermediaries to develop new products to satisfy the needs of investors, has been less pronounced in the EE5.

Less than half of the population of the EE5 countries has access to formal financial services

Another set of key indicators that helps to appreciate the situations of EE5 countries concerns the access of the population to finance. The World Bank has developed various indices of access to finance that's encompass both the access of small and medium enterprises (SMEs) to credit from formal institutions as well as the access of the general population to simple retail products such as accounts at depositary institutions, automatic teller machines, credit cards and consumer credit.[4] The composite indices of access for the EE5 are shown in Figure 7. Reflecting their earlier stage of development, somewhat less than half of the population of the EE5 countries has access to formal financial services.

Figure 7. Access to financial services

Index of access to Financial Services in 2007



Note: Country groups show GDP-weighted averages of the respective variable. OECD average: data are not available for Australia, Belgium, Iceland, Japan, and New Zealand. For definitions of country groups see footnote to Figure 5.

Sources: World Bank (2008b).

3. Financial policies: deregulation, innovation and liberalisation in EE5 countries

Since 1980, OECD countries followed a process of deregulation...

This section considers the policies of the EE5 countries with respect to the optimal pattern of official regulation of finance. While generalisations about the policies of heterogeneous groups of countries can always be contentious, one of the defining characteristics of the global financial system between 1980 and the onset of the present crisis is that OECD countries have been willing to leave a growing number of decisions to the market. This process of deregulation was reflected in removal of controls on interest rates, mandatory credit allocations and restrictions on activities of financial institutions. In an environment of rising confidence in markets, officials and regulators have been willing to allow financial institutions substantial leeway in developing new products, entering new market segments and assuming risk.

...and inter-nationalisation

In the past few decades, a rising share of financial operations has taken place against the background of a growing internationalisation of markets. It was accepted that foreign financial institutions should be allowed to become established in domestic financial markets and should be accorded national treatment. The capability of corporate entities and financial institutions to move operations into offshore markets persuaded regulators and legislators to look favourably on requests by private institutions to engage in new kinds of activities.

...contrasting the developments in EE5 countries

The evolution in the thinking of the EE5 countries presents interesting contrasts with that of OECD countries. If one were to look back a few decades, most EE5 countries rejected many of the basic presumptions that underlay the liberalisation, deregulation and internationalisation that was occurring in OECD countries. The initial motivations for rejecting the free market model included ideological scepticism about the operations of the capitalist system and suspicions that the international market operated to the advantage of powerful high income countries. Furthermore, many of these countries wished to pursue active industrial policies inside closed economies. Finance was often seen as a sector in which the state should maintain control and where foreign participation should be carefully circumscribed, if not excluded altogether.

Some deregulation and market opening took place in EE5 countries

While the EE5 countries have not embraced the free market model to the same extent as the OECD countries, there has been an unmistakable movement toward greater reliance on market mechanisms. Virtually every EE5 has experienced at least one financial crisis in the past two decades that has necessitated large public outlays and set back economic and social progress. The EE5 countries concluded that these crises can be attributed in part to excessive government intervention that left financial markets rigid, vulnerable and unable to contribute to efficient allocation of real resources. Moreover the EE5 countries are aware that financial modernisation has brought considerable benefits, such as increased access by SMEs to financing, increased access by the general public to affordable housing finance and improved possibilities for the general public to invest.

As incomes rise and the burden of providing retirement income shifts from families and governments to individuals, more sophisticated forms of institutional investment and more flexible capital markets will be needed. Thus, virtually all EE5 countries have deregulated their financial systems to a significant degree and permitted the introduction of some innovative financial instruments. All have opened their markets to a higher degree of foreign participation.

On balance, the EE5 countries are likely persevere in their cautious and gradual pattern of modernisation and liberalisation.

Crises led EE5 countries to take a more cautious approach to deregulation and liberalisation

At the same time, one of the lessons that EE5 countries have drawn from the crises of the past few decades is that international financial markets can be unpredictable and destabilising and that individual countries are well advised to take measures to insulate themselves from their potential adverse impact. For example, many observers concluded that among the major causes of the Asian crisis of 1997 were weaknesses, distortions and structural rigidities in the banking and corporate sectors of Asian countries and that part of the solution was to align practices in Asian countries with global standards. Asian countries essentially accepted this proposition but most also concluded that the crisis had exposed the risks of excess vulnerabilities to destabilising trends in the global financial system. As a result, most Asian counties have made it a point to build up their international reserves to the point that their vulnerability to instability in the world financial system is lessened significantly. They are also more likely to consider seriously the risks of easing controls on international capital flows or in allowing financial institutions to experiment with new instruments or techniques.

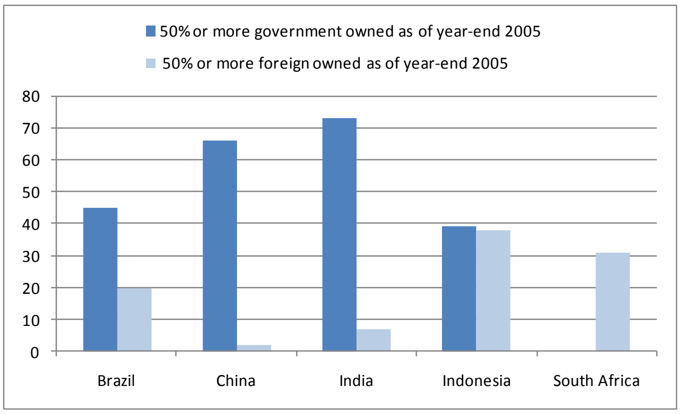
4. Institutional structures

The degree of government ownership of financial institutions remains considerably higher in EE5 than in OECD countries

Financial structures in almost all EE5 countries differ noticeably from those of OECD countries; the exception would be South Africa where structures are closer to those in OECD than to other EE5 countries. As can be seen in Figure 8, the degree of government ownership of financial institutions remains considerably higher than in OECD countries. In most EE5 countries the state retains a strong hand in setting interest rates, allocating credit and otherwise guiding economic activity. Many EE5 countries believe that the presence of a large state owned banking sector with some official guidance over credit allocation helps the authorities in reaching industrial policy goals and in reaching underserved regions and communities. Some EE5 countries believe that the presence of state owned-banks attenuated the impact of the crisis on the domestic financial system during the present crisis. Foreign controlled institutions are also less prominent than in OECD countries. Furthermore, financial intermediation is considerably less international as can be seen from the relatively low share of foreign-affiliated banks in the domestic banking system and the low volume of cross border bank lending and bond issues in EE5 countries (see Figure 9). At the same time EE5 countries have been reasonably flexible and have been trying to introduce elements of market competition even when banks remain under government ownership. In most EE5 countries, many public banks have been "corporatised" and often now accept private investors, including foreign investors, as minority shareholders.

Figure 8. Bank ownership

The fraction of the banking systems loans are in banks that are:

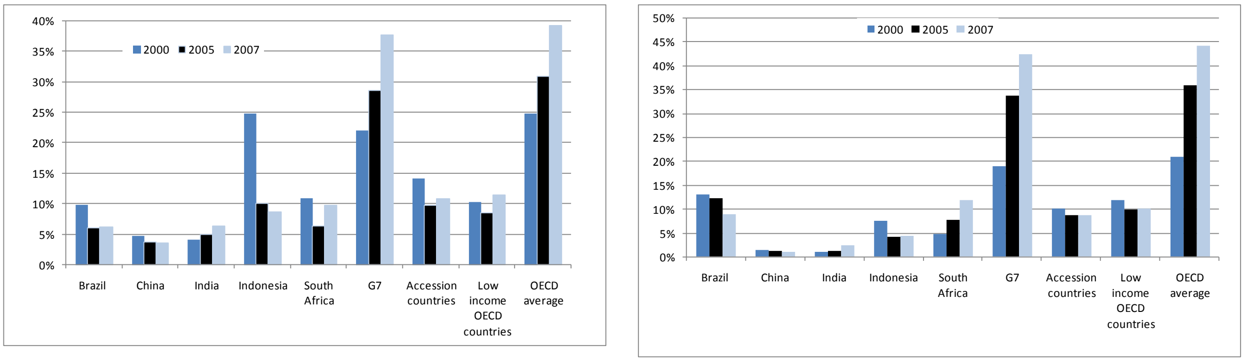


Sources: World Bank, *Financial Development and Structure Database*.

Figure 9. Internationalisation of EE5 financial markets

(a) Loans from non resident banks outstanding / GDP

(b) International debt issues /GDP



Note: Country groups show GDP-weighted averages of the respective variable. For definitions of country groups see footnote to Figure 5.

Source: World Bank, *Financial Development and Structure Database*; People's Bank of China; and OECD.

The diverse institutional frameworks in OECD countries are converging

The institutional framework in which financial activity should be undertaken has often been an issue among OECD counties as well as non- members. In the past, some OECD countries such as Canada, Japan and the United States imposed strict prohibitions on banks' capital markets activities, while most European countries, such as Germany, operated under a "universal banking" system. At present significant convergence is occurring within OECD countries where the dominant model is to allow banks to engage in a wide range of securities business but to operate through separate subsidiaries for each line of activity, and to build "firewalls" to minimise conflicts of interest and the risks of contagion. In more recent years, some OECD countries have experienced the growth of "financial conglomerates" which in addition to banking and capital markets activity engage in insurance and other financial services.

EE5 are more cautious than OECD countries regarding the formation of complex financial groups

The EE5 countries are generally more cautious than OECD countries regarding the formation of complex financial groups (see Table 1). China and Indonesia have restrictions on banks' securities and insurance business. The other EE5 countries have a system that is similar to that to that of OECD countries, with banks allowed engaging in securities and insurance, but with requirements for such business to be conducted through separate subsidiaries, with requirements for additional prudential safeguards. China and South Africa do not have formal deposit insurance schemes, but the introduction of deposit insurance is under consideration in both countries.

Table 1. Deposit Insurance in EE5 Countries

Is there an explicit deposit insurance protection system?	Brazil	Yes
	China	No
	India	Yes
	Indonesia	Yes
	South Africa	No

Source: World Bank, *Bank Regulation and Supervision Database*.

5. Improved balance sheet quality and risk management

EE5 countries have made their financial systems more resilient

One area in which the EE5 countries have made considerable strides is in their determination to make their financial systems more prudentially sound. In the past, many EE5 countries had effectively reduced the role of banks to that of supporting national industrial policies (in the extreme case of pre-1980 China the banking system was merely a passive appendage of the central planning mechanism). As a result, the prudential soundness of domestic financial institutions often was not an especially large consideration for policy makers and several EE5 countries experienced systemic crises in their financial systems. Usually, these crises have forced governments to expend large sums on bank rehabilitation. Furthermore, the turbulence in international markets has persuaded most EE5 countries that the improvement of domestic supervisory practices should be a high priority. Once again, the supervisory practices of South Africa were closer to those of OECD countries than to other EE5 countries.

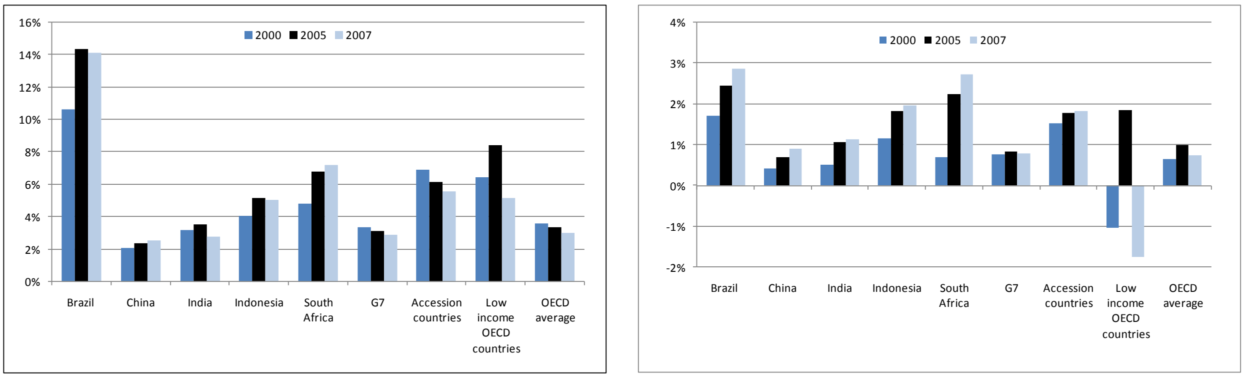
EE5 banks are now to observe more stringent standards of risk management than in the past

Awareness has grown of the need to require financial institutions, particularly banks, to observe more stringent standards of risk management and to improve prudential ratios. The capability of bank supervision has improved markedly and the political authorities now give much greater weight to considerations of systemic stability. Bank governance paradigms have been shifted so that bank management are expected to produce adequate earnings and to enforce credit discipline. These efforts are now reflected in higher profitability and significantly improved balance sheet quality in the EE5 counties, such as declining ratios of nonperforming loans (NPLs) to total loans and higher capital adequacy ratios (see Figures 10 and 11).

Figure 10. Profitability of banks

(a) Net Interest Margin

(b) Bank ROA

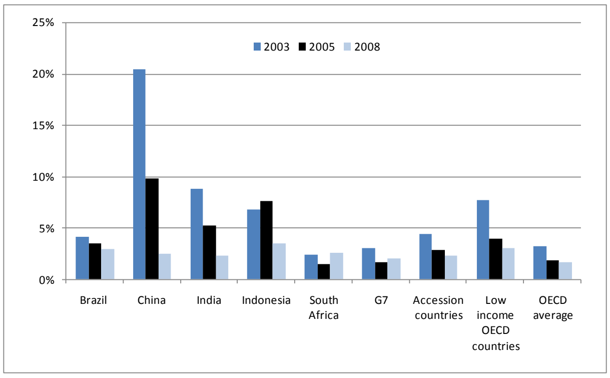


Note: Country groups show GDP-weighted averages of the respective variable. For definitions of country groups see footnote to Figure 5.

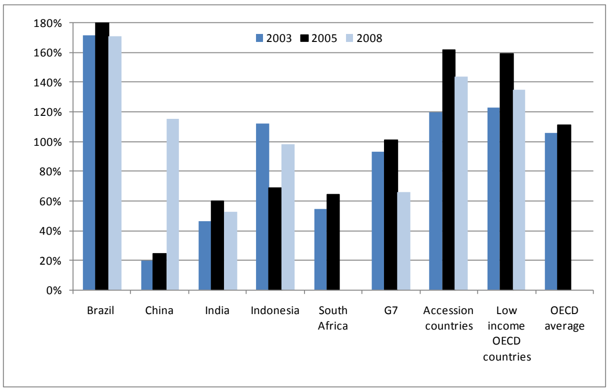
Sources: World Bank, *Financial Development and Structure Database*; People's Bank of China; and OECD.

Figure 11. Key prudential ratios

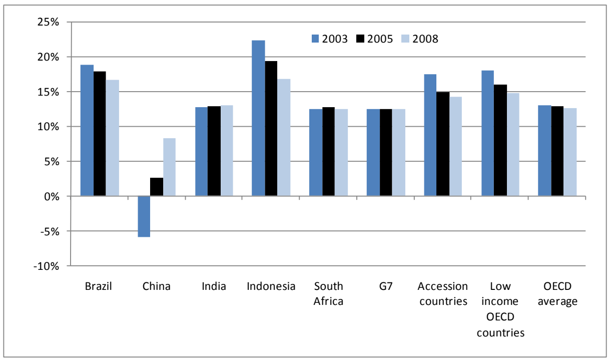
(a) Bank non-performing loans / total loans



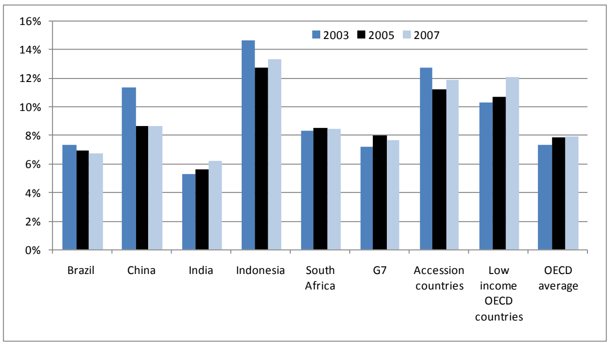
(b) Bank provisions / non-performing loans



(c) Capital adequacy
(bank regulatory capital / risk-weighted assets)



(d) Bank capital / total assets



Note: Country groups show GDP-weighted averages of the respective variable. For definitions of country groups see footnote to Figure 5.

Sources: IMF (2008).

6. Financial supervision and systemic stability

In OECD countries, there has been a trend toward supervision by a single entity

There is still a substantial divergence of opinion among OECD countries concerning the optimal institutional structure for financial supervision and on the role of the central bank in financial supervision. Most OECD countries that have engaged in systemic reassessments of their institutional structures have opted to consolidate responsibility for supervision of financial activity (banking, securities and insurance) inside a single entity. The trend toward consolidation reflects two basic considerations: *(i)* private institutions now offer all of these activities within complex groups; and *(ii)* due to financial innovation, many products have been developed that do not fit into the traditional categories of financial activity. In order to prevent contagion, ensure a level playing field and discourage regulatory arbitrage there has been a trend toward supervision by a single entity.

...but despite this trend most OECD countries still have separate supervisors

Despite this trend, most OECD countries still have separate supervisors for each of these activities. The main argument for separation of these activities is that banking, securities and insurance business are fundamentally different and therefore require different supervisors. In most such cases the central bank retains the responsibility for the supervision of banks as well as a general responsibility for systemic stability. In these cases, communication and co-operation among supervisors rather than a unified supervisory institution is seen as the best response to changes in institutions and products. Finally, it should be mentioned that the Netherlands and Australia have settled on a "twin peaks" model where there are two supervisors with a mandate for the oversight of all institutions, one with responsibility for prudential issues and the other for "conduct of business" oversight. Most countries, both OECD Members and non-Members, are likely to consider further their institutional structure for financial supervision in the light of their experiences during the post 2007 financial crisis.

No EE5 country has adopted the unified financial supervisor model

As Table 2 shows, the situation is somewhat simpler among EE5 countries. No country has adopted the unified financial supervisor model, each having separate supervisors for banking, securities and insurance. Indonesia, however, is seriously considering adoption of the unified supervisor. In all EE5 countries except China, the central bank is responsible for banking supervision. In China, there is a specialised China Banking Regulatory Commission that is separate from the central bank.

Table 2. Institutional structure of financial supervision

Body/agency that supervises banks

Brazil	Central Bank
China	China Banking Regulatory Commission
India	Central Bank
Indonesia	Central Bank
South Africa	Central Bank

Source: World Bank, *Bank Regulation and Supervision Database*.

7. A New Financial Landscape Emerging?

EE5 countries are gaining importance in world financial markets

As already visible in the leading role of the G-20, the events of the past three years will in all probability enhance the role of EE5 countries in the global allocation of capital and in global decision-making. Non-traditional financial players, with the EE5 countries in the lead, were already gaining importance in world financial markets as a result of their high rates of growth and their rising shares of world trade and investment. Meanwhile, global payments imbalances have been leading to the accumulation of investible assets in certain non-OECD countries. The events of the past three years should accelerate this trend.

Financial powers are shifting to new "power brokers"

Some recent analyses have predicted the emergence of "new power brokers" consisting of central banks and sovereign wealth funds from Asian countries and oil exporters as well as hedge funds and private equity funds.[5] Since the report was published in 2007, the 2009 update shows the prospects for the latter two categories of investors have dimmed on balance but the position of sovereign wealth funds and central banks from non-OECD countries has become larger. In addition, the relative weight of financial institutions has shifted dramatically among geographic regions in the last three years. At this time the three largest banks in the world measured by capitalisation are domiciled in the Peoples' Republic of China. More generally, institutions outside OECD countries are likely to become bigger players in financial markets. The emergence of large asset holdings, rising shares of world equity and bond markets and the emergence of powerful financial institutions in new regions of the world are likely to influence the contours of the world financial system in years to come.

IV. Brazil

Overview

Development of the Brazilian financial system has been heavily influenced by the period of inflation, indexation and directed credit that began in the 1960s. The Real plan of 1994 included disinflation as well as reform and partial deregulation of the financial system. A major transformation occurred in patterns of bank ownership with private and foreign banks gaining market share. However, official banks still account for about 45% of bank assets. Banking supervisors have been very cautious in authorising new financial instruments, especially for banks, and enforce rigorous prudential standards. Due to resolute restructuring programs and tightened supervision banks are profitable and well capitalised. The country has a thriving equity market, and the bond market is deeper than in any other EE5 country.

1. Banking

A long period of high inflation, indexing and directed credit had expanded and distorted the banking system…

From the late 1950s through the mid-1990s the economy experienced high inflation, indexing and directed credit. In this environment the banking system expanded considerably but also became rather distorted. Inflation enabled Brazilian banks to collect easy revenues by paying a negative or low real interest rate on the excess of demand deposits over reserve requirements. Real interest rates were often negative, meaning that for those borrowers able to obtain loans, the risk of default was low. Some analysts estimate that about half of Brazilian bank revenues were attributable to the ability to exploit the distortions of inflation.

…with public sector banks becoming more important…

Brazil has evolved a distinctive blend of public and private bank ownership. Public sector banks, which had existed for many decades, expanded more rapidly than private banks during the period of high inflation. On the eve of the "Real" economic stabilisation programme in December 1993, government banks were responsible for over 55% of lending and private institutions for about 45%. Almost all longer term lending came from government banks.

…also in financing government projects…

In spite of their importance in the financial system, government banks had been in constant conflict between maintaining their financial viability and their social and political goals. In many cases, states were able to use the state banks as a means of supporting employment in state entities and/or financing state-favoured infrastructure projects.

…but surviving, however, on public support

Despite recurrent crises from the 1970s through the 1990s, official banks survived due to substantial volume of low-cost financing from the public sector, inflation-driven earnings on float, periodic central bank restructuring efforts, and regulatory forbearance regarding their loans and investment portfolios.

Disinflation led to a sharp decline in

The Real Plan of July 1994 was a clear success in reducing inflation, which fell from four digits in 1988-93 to low single digits by the late 1990s. With the *banks' prudential strength…*

removal of their ability to profit from the inflationary environment, Brazilian banks experienced a sharp decline in prudential strength.

…and soaring NPLs…

When the central bank tightened money and credit conditions in the second half of 1994, NPLs began to soar. Past due loans rose from 6% of total loans in 1994 to 16% in 1996. With the imminent insolvency of some big private banks, a bailout mechanism was put in place in November 1995.

…but a major bank restructuring and privatisations transformed the banking sector…

At that point the authorities launched a major bank restructuring that would eventually lead to a transformation of ownership structures and a realignment of banking practice. A large number of public banks were privatised with foreign interests eligible to participate in the equity of the privatised entity. With the reform, private domestic banks managed to keep their share of total banking assets while foreign controlled banks increased their share from 5% at the time of the Real Plan to 25% at present. The share of banks owned by Brazilian states declined sharply but the share of federally owned banks declined only marginally.

..and enhanced competition

The reforms in ownership introduced in the late 1990s led to heightened competition between various categories of banks. Due to exits and consolidation, the number of commercial banks has been declining since the Real plan. By most measures the degree of concentration in banking remained rather low in this period, but concentration increased significantly in 2008 as a result of major mergers. At the end of the year, the top five banks in total accounted for 75% of assets.

Credit to the private sector contracted and its growth remained sluggish

After the introduction of the Real Plan, credit to the private sector contracted and credit growth remained sluggish for several years after 2000. In fact, the loan/deposit ratio and the ratio of domestic credit (and especially credit to the private sector) to GDP are still very low compared to other countries. Securities and credit to state entities constitute a comparatively large share of bank portfolios. Moreover, the central bank has maintained high reserve requirements on bank deposits, often receiving criticism for stalling credit expansion and growth.

Lending rates and net interest margins are very high by international comparison

One of the striking features of banking in Brazil is that rates charged to borrowers and net interest margin are much higher than in other EE5 countries and in other Latin American countries. Official and academic analysts have been seeking to explain the persistence of high credit spreads in the face of partial deregulation and increased competition, but no definitive explanation has been given. For example, it was suggested that poor information flows and difficulties of clients switching banks may be part of the explanation.[6] Costs and expense ratios appear to be in line with those in other countries. By other measures of profitability (*e.g.* ROA and ROE), Brazilian banks appear to be only slightly more profitable than other EE5 countries.

A distinctive mix of financial policies has enabled the country to weather the post-2007 financial crisis reasonably well

The Brazilian authorities believe that their distinctive mix of financial policies has enabled the country to weather the post-2007 financial crisis reasonably well. State-owned banks maintained a strong pace of credit growth, offsetting the slowdown in private-sector bank loans. Given high reserve requirements, the Central Bank was able to provide a stimulus by cutting its reserve requirements. The Central Bank also slashed local interest rates by 500 basis points to their lowest level in several decades and made credit lines directly available to the corporate sector.

Brazil has been making a determined effort to enforce sound supervisory practices

Due to earlier banking and balance of payments crises, Brazil has been making a determined effort to enforce sound supervisory practices. The central bank, which is responsible for banking supervision, has been very proactive in assuring that banks observe cautious risk management practices. The Minimum Capital Ratio has been set at 11%, rather than the 8% suggested in the Basel Accord. In fact, Brazilian banks maintain risk-weighted CARs of about 17%. Brazil also has tough regulation limiting the inclusion of hybrid securities and subordinated debt in capital.

Limits and requirements are comprehensive…

All limits and requirements are applied in consolidated terms and are meant to capture off-balance sheet exposures. Banks face strict transparency requirements with respect to their operations involving OTC derivatives and other exotic instruments. Over-the-counter derivatives that have a supervised entity as counterparty have to be registered and monitored. Banks must perform sensitivity analyses of these instruments and must satisfy the central bank that risk is accurately assessed and provisioning is adequate.

…and forward looking, with careful evaluation of financial innovations and risk monitoring

Banks' loan classification practices must be forward looking, measuring not only delinquency but the risk of eventual delay in payment. Reserves must cover all debt payments past due 60 days. The central bank does not use credit rating agencies' evaluation of assets but adheres to its own rules regarding asset classification. The central bank conducts stress tests on each bank and issues ratings for the banks. The central bank also has the authority to monitor operations of investment firms that could have an impact on systemic liquidity.

NPLs have been reduced steadily

Due to strict supervisory norms NPLs have been reduced steadily since the banking crises of the 1990s, even though these ratios are still somewhat above the level of other EE5 countries. At the same time, banks' provisions against NPLs are almost twice the levels of NPLs.

2. Institutional investors

Institutional investors' assets represent a fairly large share of GDP

One of the underpinnings of the capital markets is a broad community of institutional investors. Institutional investors' assets represent a larger share of GDP in Brazil than in any other EE5 country except South Africa. As a result of pension reform, pension funds assets have been rising since the early 1990s and were equivalent to 16% of GDP at the end of 2005. Brazilian pension funds hold lower shares of their portfolios in government bonds than in most emerging markets and are major investors in equity. The CIS sector is very well developed, with assets equal to some 28% of GDP. By contrast, the assets of insurance companies represent only some 4% of GDP (2005 figures for all).

3. Capital markets

Brazil has the largest bond market as a share of GDP among EE5 countries

Although the Brazilian bond market is smaller than that of most OECD countries, Brazil has the largest bond market as a share of GDP among EE5 countries and also the largest in Latin America. The market is dominated by government bonds. The Brazilian federal public debt market is one of the most liquid and sophisticated among emerging markets, with a wide range of debt instruments (fixed-rate, floating-rate and inflation-indexed bonds).

The indexed market is well developed, and the securities settlement system well advanced

During the period of prolonged high inflation, a market in indexed instruments developed. The market experienced periods of expansion and contraction, often related to changes in the government's policy on indexation. In 1979 the central bank initiated the SELIC settlement and custody system leading to a completely paperless treasury securities market that, with continued upgrading, is still in operation today.[7]

The Treasury market is modern and liquid

By the early 1990's, all the main treasury debt instruments currently available had been introduced and it began to take on many of the characteristics of a modern liquid market.[8] All Treasury instruments can be used as collateral in repo transactions with the Central Bank. The Treasury has established a regular auction calendar. Currently, there are 12 primary dealers and 10 secondary (specialist) dealers. Federal bonds can be traded over the counter by telephone or electronically through screens. All transactions are registered with SELIC. Most bonds are linked to the overnight SELIC interest rate but the central government started to increase the issues of non-indexed fixed interest rate bonds in 2005. Issues of state government debt have contracted after some local government bonds defaulted.

Dollar-linked and floating-rate securities have declined, with fixed rate securities rising and maturity lengthening

As the market has matured, issuance of dollar-linked bonds has declined drastically. At the same time, the National Treasury initiated a process of gradual replacement of floating-rate for fixed rate securities, and their volume has been rising significantly since 2003. There also has been a gradual extension of the maturity structure of government debt in local currency. This has been achieved in part through a shift from short-term to fixed rate bonds and through a lengthening of the maturity of fixed rate bonds. Average maturities of debt have also been rising, as reflected by its 20-year global bond issues. The average maturity of new central government debt in Brazil stood at 56 months at the end of 2006.

Global bonds in local currency have been issued increasingly during the past few years

During the last few years, Brazilian public and corporate entities have been issuing global bonds (*i.e.* bonds simultaneously issued to domestic and international investors) denominated in local currency, an innovation pioneered by the Inter-American Development Bank. In September 2005, the Brazilian government issued BRL 3.4 billion (USD1.5 billion) of global bonds with a maturity of 10 years and a 12.5% coupon. The issue was oversubscribed several times and the distribution was purchased by investors from Europe and the United States. The issue contributed to extend the maturity of the yield curve for real-denominated fixed rate government debt, which had hitherto been limited to seven years in the domestic market. In May 2007, Brazil issued 20-year real-denominated global bonds, securing the lowest-ever yield for real-denominated debt securities. These securities have long maturities, they are not indexed to inflation and offer a fixed interest rate. Both inflation and exchange rate risk are thus transferred to investors. While denominated in Brazilian currency, both interest and principal are settled in US dollars, freeing investors from any risks associated with exchange controls. Brazilian global bonds fall under the laws of the state of New York, enhancing their attractiveness to international investors.

Private bond market activity remains at a lower level

The development of the private bond markets paralleled that of the public bond market, but activity remains at a much lower level. A law passed in 1965 enabled the indexing of private bonds to inflation. In 1976 several structural reforms were implemented. The Securities Commission (CVM) was created as the agency responsible for capital markets regulation and several types of bonds were authorised including bonds with or without collateral, subordinated bonds, bonds with warrants and those in foreign currency etc. Although much of the infrastructure of a corporate bond market was put in place, due to the attractiveness and availability of subsidised financing as well as taxation issues, bond market finance was not an attractive source of finance for the corporate sector. After the Real plan in 1994, the Brazilian corporate bond market entered its current phase. In 2003 the CVM issued new rules that further facilitated corporate bond issuance while a simplified standard bond indenture and tax law changes to improve liquidity in the secondary market are being discussed.

More private global bonds are being issued in local currency

Initially, most private sector bonds were issued in foreign currency. However, at the end of 2004, a few Brazilian private financial institutions began issuing external debt denominated in the local currency. In 2005, more major financial institutions issued global bonds in local currency. Besides private financial institutions, a few corporations, such as an electricity company (Eletropaulo) and a telecommunications company (Telemar) have also issued foreign bond in local currency.

Securitisation, activity began to take off after 2002, mainly in ABS, much less in MBS

Securitisation has made substantial progress in. Two special kinds of investments instrument are used for MBS and ABS.[9] Following reforms in the legal and regulatory framework for securitisation, activity began to take off after 2002. The volume of issuance rose from less than USD 1 billion equivalent in 2001 to more than USD 6 billion equivalent in 2006. Activity has centred mainly on the ABS sector, where securitisation has included a wide variety of collateral, such as leases and corporate receivables as well as more traditional assets such as credit cards and auto loans. The MBS sector has not been very dynamic, with securitisation of residential mortgages accounting for only about 2% of the total.

The Brazilian equities market is well developed

Brazil has an equities market that is huge by most measures, although smaller proportionally than those of China, India and South Africa. On 8 May 2008, the São Paulo Stock Exchange (Bovespa) and the Brazilian Mercantile and Futures Exchange (BM&F) merged, creating the new BM&F Bovespa, the main platform for equities trading[10]. Bovespa operates under the supervision of the CVM.[11] Since the 1960s, it has constantly evolved with the help of technology such as the introduction of computer-based systems, mobile phones and the internet. As a result of a 2008 stock swap, Chicago's CME Group owns an approximately 5% stake in BM&F Bovespa, and in turn, BM&F Bovespa owns a 1.7% stake in CME Group. Among its broad range of trading products, the new exchange offers equities, bonds, indices, interest rates and commodities as well as foreign exchange futures and spot contracts. The BM&F Bovespa is linked to all Brazilian stock exchanges, including Rio de Janeiro's BVRJ which trades in government bonds and currencies. Individual investors and institutions (pension funds and CIS) each account for about 20% of trading and foreign investors account for some 35%. A special board for smaller and newer companies was recently formed.

Macroeconomic stabilisation brought a wave of IPOs

The amount of listed equity stagnated for a prolonged period as the IPO's market was not attractive or available during the volatile macroeconomic situation and unstable interest rate environment of the inflationary period. Few companies chose the stock market to raise new capital. With the improvement of the macroeconomic scenario, increased global liquidity and reduction of interest rates as well as structural reforms in the market itself, a wave of IPOs has been occurring. Between 2004 and June 2008 there were 110 IPOs which raised USD 88.5 billion, compared to market capitalisation of USD 592 billion equivalents in 2008.

V. China

Overview

With a very high savings rate, China has one of the largest pools of assets in the world. The banking system is undergoing a profound change as a result of reforms that have transformed ownership of the four large state-owned banks through corporatisation, ownership diversification and public listing. Competition between state-owned banks and other banks has helped improve efficiency. Activities that hardly existed a decade ago, notably housing finance and consumer credit, are growing very rapidly. Banks have made considerable progress increasing profitability and improving balance sheet quality. Bank's risk management and prudential ratios have improved substantially over the past five years and banks are offering a much wider variety products and services than they have in the past

Chinese equity markets are among the largest and most heavily traded in the world. The lack of strong institutional investors, dominance of listings by state-owned enterprises and small presence of foreign investors make the Chinese market unique. With very large banks and capital markets, China will be one of the world's largest financial markets in coming years.

1. Banking

Authorities have put in place a strategy to improve the banking system, but unresolved issues remain

Since the 1990s, the banks have been undergoing a rapid evolution from their traditional role of allocating credit in accordance with government directives. Competition within the banking sector has increased. The authorities have put in place a coherent and comprehensive strategy for further improvement of the banking system. However, further efforts will be needed before banks can adequately serve the needs of the increasingly important private businesses and the rural economy. A number of unresolved issues, notably the status of the state-owned commercial banks and the scope for private ownership in the banking system will also need to be addressed.

State-owned Commercial Banks (SOCBs) largely dominate the three other segments of the commercial banking system

The commercial banking system consists of the four segments (1) four large State-owned Commercial Banks (SOCBs), (2) the twelve nationwide Joint-Stock Banks (JSBs), (3) city commercial banks (CCBs) and (4) credit co-operatives. The share of the four SOCBs in total assets has been declining in recent years and now amounts to slightly more than half of total bank assets, with the share of all three other categories of banks rising. One distinguishing feature of China's banking landscape is pervasive state ownership and control. The SOCBs are majority-owned by the central government and, with some very few exceptions, JSBs and CCBs are majority-owned or controlled by local governments and/or SOEs. There are an extremely small number of purely private banks, and the market share of foreign banks is still quite small.

On balance the Chinese authorities believe that a continuing large government presence in the banking system has enhanced stability.

Nearly all bank credit went to state-owned enterprises

Reflecting the country's history as a centrally planned economy, banks traditionally had little autonomy in credit decisions and nearly all bank credit went to state-owned enterprises (SOEs). In addition to the central government, local governments have traditionally exercised considerable influence over the lending policies of banks in their areas.

The banking system has changed considerably and lending standards have improved

As the country had progressively sought to introduce elements of the market economy, China's banking system has changed considerably since the 1990s, with the pace of change accelerating after 2004. Since 1996, with the creation of the three policy banks and subsequent abolition of the credit plan, commercial banks have in principle been free to make loans purely on the basis of commercial criteria and it is generally agreed that lending standards have improved considerably. The authorities have taken a number of steps to reduce interference by local governments in operations of bank branches.[12]

Changing banks to become more businesslike has proven difficult

Despite the government's announced policy of requiring banks to act in more businesslike ways, it has proven difficult to change bank behaviour. Resolving the problems has been made all the more difficult by the weak condition of the banks' main borrowers, the state-owned enterprises (SOEs) which often depended upon bank credit for survival and which the authorities hesitated to close for fear of social unrest.

In 1998-99, a significant effort to strengthen weakened banks' balance sheets was undertaken…

By the late 1990s, much of China's banking sector was effectively insolvent. A very large share of the loans of the SOCBs had become non-performing (although they were not yet fully recognised as such at that time) and most city commercial banks, RCCs and joint-stock banks had high NPL ratios. Banks were inadequately capitalised and had low profitability ratios. In 1998-99, a significant effort to strengthen SOCB balance sheets was undertaken with the subsidised sale of a large portion of NPLs to government-owned asset management companies (AMCs). Bank management was made, at least theoretically, responsible for any new NPLs.

…however with mixed results

Despite expenditure on restructuring amounting to about 16% of GDP, the results were mixed. On the positive side, the financial conditions of the JSBs improved markedly, and the SOCBs and JSBs implemented a more rigorous loan classification system. Practices regarding transparency and disclosure, likewise, showed a marked improvement. However, NPLs remaining in the SOCBs turned out to exceed those that were carved out in 1999 and by official estimates were still 18% of total loans at the end of 2003. SOCBs could make very little headway in reducing the level of NPLs or in preventing new NPLs from emerging, due to the low level of their own profits and persistent problems in autonomy in credit allocation. A certain reduction in the ratio of NPLs to total loans at SOCBs was achieved between 1999 and 2004 but this was mainly due to increases in loans.[13]

Reforms in 2004 were based on upgrading supervision, ownership diversification, public listing and expanded foreign presence

In 2004, the authorities accelerated their effort to align practices in the banking system with best international practices. In addition to the expenditure of additional funds to strengthen bank balance sheets, this reform was based upon an upgrading of supervision, ownership diversification, public listing and expanded foreign presence. These measures were designed to subject all banks to higher standards of transparency and disclosure, with more intense scrutiny by banking counterparties, investment analysts, institutional investors and rating agencies. The change in ownership and governance practices was aimed at focusing bank management on profitability and prudential soundness.

Responsibility for bank supervision was transferred to CBRC

Measures to improve bank supervision were accelerated. Responsibility for bank supervision was transferred from the central bank to a newly formed agency, the China Banking Regulatory Commission (CBRC) and a series of laws and regulations to improve supervision, based on international practices and global standards, was enacted. In ensuing years, the CSRC imposed a stringent supervisory regime. Capital requirements were set above the international norm, with strict rules discouraging the use of tier 2 capital. At present more than 80% of bank capital is tier 1. The CSRC has also insisted that banks demonstrate an in-depth knowledge of any new instruments that are introduced.

Special entity (Huijin) to assume state's ownership interest in SOCBs

In December 2003 a special entity (Huijin) was set up to assume the state's ownership interest in the SOCBs. The SOCBs were first transformed into joint stock companies with the state as the sole owner and received cash injections to increase capital to adequate levels and build reserves against NPLs.

SOCBs were converted into corporations and ownership was diversified

The first step was to convert SOCBs into corporations. (The JSBs and CCBs had been legally incorporated since the 1990s.) In 2004, the Bank of China and China Construction Bank became the first of the SOCB to be transformed into corporate form, the other two SOCBs were subsequently transformed. The second step was to diversify the ownership of the banks, with new owners to include private interests, to be followed at least in the case of the larger banks, by listing on the stock markets. This second element is regarded as critical to ensuring that financial institutions remain focused on commercial objectives. The JSBs and many of the CCBs already have multiple investors, although they are for the most part still state controlled entities. The SOCBs have become much less specialised and more competitive with one another and with the JSBs.

Banks have expanded operations in housing finance, consumer finance and asset management. The CSRC generally requires banks to set up separate subsidiaries when engaging in activities not strictly related to commercial banking. Banks may also offer insurance through specialised subsidiaries.

Bank performance was to be improved by better governance structures and subjecting companies to market discipline

The strategy to improve the performance of banks was to change the ownership and endow them with governance structures (notably boards of directors and/or supervisory boards and the shareholder's general assembly) that align management incentives with owner's interest; and subject the companies to market discipline over their performance via a combination of stock market listing, bond issuance, and monitoring by lenders and shareholders. The authorities placed great hopes on the introduction of strategic investors, particularly foreign strategic investors, as a means of further strengthening the commercial orientation of the institutions as well as bringing in new business techniques and other expertise.

Many major international banks have become strategic investors in corporatised SOCBs

Although the problems of these banks were widely recognised, major international banks believe that China is likely to be a major player in international finance and thus it is important to have a presence in the market. Consequently many major banks have become strategic investors in the corporatised SOCBs. The SOCBs will select their own management, which will be accountable for meeting the most commonly used benchmarks for earnings and balance sheet quality as well as targets for improvement in internal governance. Public listing and a broad investor base will lead to improved monitoring to protect shareholder value. The SOCBs as well as JSBs have listed on both Chinese markets and international markets. These have been among the largest IPOs ever launched anywhere. This has enabled them to raise large volumes of capital and to include institutional investors from around the world into their capital structures.

Heightened competition was permitted between SOCBs and other domestic banks, with JSBs gaining market share

Heightened competition was permitted between the SOCBs and other kinds of domestic banks. The JSBs have already been gaining market share in recent years. To make further gains, the JSBs were able to raise capital by *(i)* domestic or international equity; *(ii)* issues of subordinated debt; and/or *(iii)* strategic investments by foreign banks. The CCBs were also opened to strategic investments by foreign banks. Finally, an expanded foreign presence would be encouraged partly linked to Chinese WTO membership and partly linked to a desire to benefit from foreign competition.

Substantial progress was made in risk monitoring and management…

Substantial progress was made in modernising internal systems for credit assessment, loan monitoring, and risk management within the SOCBs, JSBs, and some CCBs. These include the separation of loan origination and assessment; the introduction of objective criteria and procedures for assessing creditworthiness; and the adoption of a new loan classification system in line with international practices. At least in principle, new loans as well as loan extensions are granted only to borrowers with a good credit record and based on standard creditworthiness criteria such as cash flow and business prospects. The new system incorporates forward looking indicators relating to a borrower's ability to repay and requires reassessment in the event of a significant change in those conditions.

…but political considerations continue to play a role in lending decisions

Efforts have been made to reduce interference by local governments in lending decisions by moving the authority to grant large loans to higher levels. However, the extent to which lending decisions by the banks are driven by commercial criteria is uncertain. Improvements in lending decision frameworks have been made but there is evidence indicating that political considerations continue to play a significant role.

The prudential quality of banks has improved, and reforms help prepare the banking system for its next phase of modernisation

Overall, efforts to improve the prudential quality of banks have been reflected in improving ratios. Profitability has improved. Banks' ROA are still somewhat low in comparison to other EE5 countries, but net interest margin and ROE are in line with other EE5 countries. NPL ratios have declined substantially while provisions now exceed NPLs. CARs, which had been as low as 4% in 2004, are now approaching international norms. There is virtually no one who believes that the measures to date are sufficient to cure the problems of the Chinese banking system. At the same time the measures taken are bold and leave the country positioned to move on to the next phase in the modernisation of its banking system.

2. Institutional investors

The institutional investor sector is still rather small in China…

The institutional investor sector is still rather small in China. The assets of all institutional investors were equal to only 14% of GDP in 2005, the second lowest ratio among EE5 after Indonesia. CIS and pension funds accounted for only about 3% (each) of GDP in 2005. Nevertheless, institutional investors are becoming significant holders of certain categories of securities. Thus, the China Securities Regulatory Commission (CSRC) estimates that institutions now own half of all tradable "A shares." The assets of insurance companies were slightly larger, representing over 8% of GDP in 2005.

…but government has been seeking to better promote it

The government has been seeking to promote institutional investors, recognising that these investors tend to be able to engage in more disciplined and professional analysis of issuers thereby encouraging a rise in standards of disclosure and performance while reducing volatility.

The introduction of a comprehensive pension reform…

The development of institutional investors is also closely related to another major policy goal, the introduction of funded pension schemes. At the end of 2007, only a small proportion of the total Chinese labour force (25.6%) participates in any government pension scheme, fundamentally a pay as you go (PAYG) system. Moves toward pension reform have been hesitant. Rural workers have barely any coverage, but urban workers currently participate in a PAYG public pension scheme. This system is partially backed by a reserve fund (the National Social Security Fund), with some foreign investments outsourced and managed by professional asset managers. The government has introduced a pilot scheme for rural pensions and migrant workers that will eventually raise coverage, but it has only just started.

…would open immense investment possibilities for domestic and foreign asset managers

In addition, a layer of individual DC accounts has been added to the public pension system, but these accounts are yet to be properly funded. The assets so far accumulated are still run by the government, but there is debate as to whether they should be managed by professional investors in future. The government is also encouraging the development of private, occupational pensions, known as Enterprise Annuities, which are still mainly confined to large companies, with the assets required to be managed by specially licensed institutional investors. If China actually launches a comprehensive pension reform, it would in the long run open an immense amount for domestic and foreign asset managers to invest.

3. Capital markets

China has made impressive strides in building a dynamic equity market in the past two decades

China has made impressive strides in building a dynamic equity market in the past two decades. As of today the ratio of market capitalisation to GDP is comparable to that of OECD countries, even though the market is still backward in many ways. Chinese residents have very high aggregate savings rates, but still do not have a wide array of investment options. Small investors hold large amounts in bank accounts and modest amounts in government bonds, but other capital market instruments and institutional savings products are not well developed. As a result stock market investment has captured the interest of the public. Retail investors have tended to trade on technical factors, rumours and real or supposed insider information, with the emphasis on short-term trading profits. Chinese investors trade very frequently by comparison to those in other markets

Retail investors have been dominating the market, but investment funds are gaining share

Retail investors have been dominating the market, but the institutional investor share of the A-share market's tradable shares is now just over 50 per cent. There has also been a history of investment fund operations operating in a "grey market". These funds range from small community-based funds in which funds are invested by informal networks of friends, work colleagues and relatives to much larger and more professional operations involving solicitation from the public.

State-owned securities

Given the regulations separating banking and securities business in China, the main intermediaries in the capital market (other than the government debt market

companies are the main intermediaries in the capital market…

where banks predominate) are the securities companies. Chinese securities companies differ considerably from securities companies and investment banks in the major world markets. All of China's securities companies are state-owned, either directly or through SOEs. Chinese securities companies still depend heavily on trading commissions as well as income from IPOs for revenue. Given the pace of technological advance, there is likely to be consolidation in the Chinese industry as there has been in most countries.

…with little pressures to produce high quality, independent research

Given the lack of depth in the investor community, pressures to produce high quality research have not been strong. The securities companies are widely suspected of collaborating with investment funds and other market participants to manipulate stock prices. In-house systems for risk management and compliance are not well developed. Until recently enforcement of market conduct rules had been sporadic.

The vast majority of listed companies are state-owned enterprises (SOEs)

The vast majority of listed companies are state-owned enterprises (SOEs). Listed companies usually belong to SOE groups that select some of their stronger members for public listing. In practice, the separation between the listed company and its unlisted affiliates remains incomplete. Given that SOEs have been able to obtain large sums on capital markets and while requiring only very limited behavioural changes on the part of listed companies, public listing has been a very attractive proposition. Chinese companies had extremely high valuation ratios by global comparison.

Many shares are non-tradable

Through the middle of 2001, a listed company typically offered only about 25-30 per cent of its total equity to public investors of all kinds (*i.e.* employees of the company or retail or institutional investors).[14] The remainder was held by the state or "legal persons" and were not traded. As a result of these non-tradable shares, the assertion that equity market capitalisation represents a high share of GDP must be interpreted with some caution.

Reform in 2005 aimed at eliminating the difference between tradable and non-tradable shares

In April 2005 the authorities launched a reform aimed at eliminating the difference between tradable and non-tradable shares while, at the same time minimising market disturbance due to the huge amount of "new" supply coming to the market. Appropriate compensation was therefore a core element of the reform and usually holders of non-tradable shares compensated those of tradable shares by giving out a portion of their shares at mutually agreed prices. By the end of 2007, listed companies accounting for 98% of total market capitalisation had at least started the reform process. During the transition mechanisms were introduced to compensate owners of non-tradable shares for expected price declines while formerly non-tradable shares were subject to a "lock-up period" when they could not be traded. In addition, the authorities imposed a ban on new IPOs to cushion the expected downward pressure on equity prices that would result from the expansion of tradable equity.

Stellar rise of Shanghai and Shenzhen stock exchanges, their combined 2007 market cap being Asia's second-largest

China operates two stock exchanges, in Shanghai and in Shenzhen. Instruments traded on both exchanges include shares (A shares and B shares[15]), convertible bonds, warrants, mutual funds, ETFs, corporate and government bonds, and repos. Aside from B shares, all instruments are only denominated in local currency. China's stock market experienced a first period of strong growth between the mid- and late 1990s with the Shanghai Composite Index almost quadrupling within five years. However, over the following five years, the index lost half of its value. Starting in 2006, China's stock markets witnessed a stellar rise and the Shanghai Composite Index doubled in both 2006 and 2007. In 2007, the combined market capitalisation of both exchanges in Shanghai and Shenzhen became the second-largest in Asia after Japan's. Average daily trading volume reached USD 26 billion, making it one of the most actively traded markets worldwide. The stock market started to correct in October 2007, market capitalisation declined from 140% of GDP to around 50% as of end-2008.

Chinese stock markets rebounded at record pace in 2009, and IPO activity has been strong

In 2009, Chinese stock markets have rebounded strongly, rising over 100% since the beginning of the year – the strongest performance in the world. The sharp rises and falls of the stock market have been reflected in IPO activity. Domestic IPOs were suspended for after the non-tradable shares were phased out in 2005. Both the amounts raised as well as the number of IPOs rose sharply between 2005 and 2007. By November 2008, they had fallen below their 2005 levels. At the same time Chinese companies (led by banks) have been making huge overseas IPOs. In 2009, Chinese IPOs were among the highest in the world and the combined IPOs of China and Hong Kong, China (most of which are China related) were almost twice as high as in the United States.

The bond market is still relatively small although total annual issuance has risen eightfold since 2000

The bond market is still relatively small although total annual issuance has risen eightfold since 2000, reaching RMB 8 trillion at end-2007. Bonds issued in 2008 amounted to RMB 6.9 trillion, a decline of 12.7% from the level in 2007, mainly attributable to a lower issuance of national debt.[16] People's Bank of China (PBC) and treasury bonds accounted for about 65% of outstanding at the end of 2008 while financial bonds (*i.e.* those issued by financial institutions account for about 25%. Policy bank bonds constitute more than 90% of total outstanding financial bonds while commercial bank bonds make up only roughly 10%. Corporate bonds (of which those from state-owned enterprises account for more than 70% of the total) represent only 5% of outstanding bonds. All other categories of bonds accounted for 3-4% of the total.

The OTC market accounts for more than 97% of total transaction value

The secondary bond market can be divided into two main sections: the OTC section – which can be further sub-divided into an interbank and the commercial banks' OTC market – and so-called exchange-based trading. The OTC market accounts for more than 97% of total transaction value, with the overwhelming majority in interbank activity. In addition, the "bank counter market," which targets individual investors, is very small. The varieties of bond instruments available are very limited, mainly government bonds in the form of certificate bonds and electronic savings bonds.

Domestic commercial banks are the major bond holders

Domestic commercial banks now hold close to 60% of the total amount outstanding, but their share has been declining from around 65% in 2006, while the share of insurance companies, CIS and other institutional investors has risen. This trend reflects the explicit policy of broadening the investor base and making the bond market an alternative for institutional investors. Ongoing reform of the social security system coupled with growing sophistication and awareness on the part of market participants will help to increase the share of institutional investors.

4. Internationalisation of the Chinese market

Capital inflows have increased, but integration with

As China has liberalised rules for foreign portfolio investment, it has benefited from rising capital inflows. On average, foreign portfolio investments have increased by 50% annually over the past 5 years, reflected in the strong desire of *international securities markets is only at an early stage*

foreign investors for exposure in this dynamic market. Despite growth in recent years, China's integration with international securities markets is only in an embryonic stage. Price differentials of Chinese bonds compared to other debt securities traded on international markets are one indicator of the relatively low level of integration.

The international integration of the Chinese stock markets has been hampered by its segmentation into categories of shares

The international integration of the Chinese stock markets has been hampered by its segmentation into categories of shares, with different degrees of restrictions of access for foreign investors.[17] Thus, the vast majority of companies are listed in so-called-A shares, which are listed on the Shanghai and Shenzhen exchanges and could traditionally only be purchased by domestic investors. Foreign institutional investors authorised under the Qualified Foreign Institutional Investor (QFII) scheme are now allowed to buy and sell A-shares. An aggregate ceiling of US$10 billion that all QFIIs may purchase was imposed in 2002 when the scheme was introduced. This ceiling was raised to $30 billion at the end of 2007. Each QFII has a limit on the amount of Chinese securities that may be purchased. At end-2008, 76 foreign financial services providers were licensed as QFIIs. B-shares – which are denominated in USD or HKD – were originally designed for foreign investors only, but since March 2001 domestic retail investors are also allowed to trade them as well. A-shares are by far the most important instrument in China's stock market and, since the early 2000s, the amount raised via B-shares has been very meagre indeed. Liquidity has been scarce over the past few years, and rumours of a possible merger of A- and B-shares also add to lacklustre performance of the latter.

Possibilities for foreigners to invest have grown

With the listing of Chinese equities on foreign stock exchanges, possibilities for foreigners to invest in the markets have grown. On balance, foreign participation remains narrow but it is likely to expand substantially.

5. China as a global financial player

China is likely to further increase its weight in global financial markets…

The combination of large and growing markets that are now highly restricted but are expected to open gradually implies that China is likely to further increase its weight in global financial markets dramatically. The country has already created banking giants that are the five largest banks in the world in terms of capitalisation. China has the world's largest pool of savings. At present, the funds tend to be held in bank deposits or in government bonds of OECD countries, but as Chinese patterns of holding financial assets and Chinese investment patterns change, the impact on world finance promises to be enormous.

…but potential growth scenarios differ widely

Potential growth scenarios differ widely depending on the assumptions the pattern of development. According to sensitivity analysis performed by Deutsche Bank Research, a continuation of growth rates as observed in the years 2003 through 2008 – even taking account of corrections in the wake of the financial crisis – suggests a further vigorous expansion that should make China one of the dominant financial markets in the world by 2018, after the US and the EU.[18] The exact position of China in the global financial system will vary upon growth rates of income of financial markets and of policies related to opening markets. However, even in a scenario of modest expansion by the year 2018, China to would attain market shares of 5%, 16% and 13% in the global bond, equity stock and banking markets, respectively.

VI. India

Overview

Between independence in the late 1940s and 1990, Indian economic policy operated under the assumption that the state should maintain a strong hand in making economic decisions. This policy implied high levels of government ownership and official direction of activity as well as limitation of foreign presence in the domestic markets. In the financial sphere, this policy was reflected in high government ownership of banks, widespread controls on interest rates, mandatory credit allocations and limits on foreign bank presence. By 1990, state-owned banks controlled 90% of bank deposits. All banks, public or private, were required to channel an extremely high proportion of funds to the government or government targeted sectors. Interest rates were determined administratively; credit was allocated on the basis of government policy and approval of the Reserve Bank was required for individual loans above a certain threshold.

In 1991, partly in response to a balance of payments crisis as well as a systemic problem of bank solvency, a major reform of the financial system was launched. Since the early 1990s, the financial sector has become much more diversified. Competition has increased within the banking sector and also between different financial sectors. However, even with the reform India has a much higher degree of government ownership and control than OECD countries and rules restrict foreign participation.

The Indian equity market ranks among the world's largest. The government bond market is well developed, but the corporate bond market has not yet shown much dynamism.

1. Banking

Post-1991 deregulation reform

The post-1991 reform included recapitalisation of public sector banks and measures to spur greater competition. Fundamental changes included the elimination of interest rate controls, reductions in reserve and liquidity requirements and a reduced priority sector lending.

The Reserve Bank functions include banking supervision, but go well beyond those of central banks of other countries

Banking supervision was considerably strengthened in 1994 with the introduction of a Board of Financial Supervision within the Reserve Bank of India (RBI). In addition to being the central bank and the banking supervisor, the RBI's functions go well beyond those of central banks of other countries. For example, the Reserve Bank has lent directly to the government. It is the owner of several financial institutions, including State Bank of India (the largest commercial bank in the country) as well as the National Agricultural Bank and the National Housing Bank. (A proposal has been made that would transfer the RBI's majority holding in the State Bank of India to the Ministry of Finance.) The Reserve Bank is responsible for management of government debt. Another proposal has been made to create a new debt management agency that would be located in the Ministry of Finance. The RBI continues to be responsible for foreign exchange controls, for approving independent directors for both public and private banks, and it is the manager and regulator of the government securities market. The RBI is the government's investment banker, arranging sales of government debt and the banker for state governments.

Entry of new and foreign banks fostered competition in the banking sector, as did deregulation of interest rates

Competition was injected into the banking system through two channels. First, new banks were allowed to enter the market. A dozen private Indian banks were created, some by the transformation of existing institutions, others started from scratch. Foreign establishment was also allowed in the market. Second, once prudential reforms were undertaken, bank interest rates were deregulated. By 2009, controls remained in only four areas – saving deposit accounts, small loans in priority areas, export credits and non-resident transferable rupee deposits. Government control over credit allocation was relaxed somewhat.

The system is still dominated by state-owned banks…

Commercial banks traditionally provided short-term credit. Since deregulation, however, many of the larger nationalised commercial banks have begun to target the medium- to long-term requirements of the corporate sector and the growing infrastructure debt market. Recently, banks have been targeting the retail sector as well. The system is still dominated by state-owned banks, which account for nearly 74 % of deposits and assets, but state banks have accepted private and foreign investors as minority shareholders. Proposals have been made to further enhance the efficiency of the banking system by including one to reducing government ownership of public banks below its current minimum of 51%, but reduction in that share is currently not contemplated.

… characterised by their large branch networks and broad geographic coverage

The public-sector banks are characterised by their large branch networks and broad geographic coverage. At end-March 2008, about 45% of commercial bank branches were located in rural regions, a further 20% in semi urban areas, and the rest were mainly in metropolitan areas. Although they are significant in terms of deposit gathering, rural branches tend to be unprofitable, while urban and metropolitan branches are profitable. The Indian authorities note that the state owned banks have fared better than private banks during the post-2007crisis. Among public-sector banks, the State Bank of India (SBI) group, with over 13,600 branches and 54 overseas offices, is the largest bank in the country.

Competition has increased with the opening of the market

Despite continued domination of public sector banks, the years since liberalisation have seen the emergence of new private sector banks as well as the entry of several new foreign banks. Within a decade of its formation a private bank, the ICICI Bank, has become the second largest bank in India. Competition has clearly increased with the opening of the market. Concentration is lower in India than in other emerging economies with the Herfindahl index (a frequently-used measure of concentration) for advances and assets dropping by over 28% and about 20% respectively between 1991-1992 and 2000-2001.

Foreign participation has risen

The reform has expanded the range of opportunities for foreign banks. A foreign acquisition of domestic banks is now allowed up to 74% under the ‘Automatic Route’.[19] In fact India has been rather liberal in allowing entry of foreign banks. While India accepted a WTO commitment to permit twelve foreign bank branches per year, it has actually permitted up to 18. In mid-200932 foreign banks with 393 branches were operating.

Banks must lend 40% of their total to priority sectors…

All banks, whether public or private, are subject to government control over their lending portfolios. The objective of India’s priority lending programmes is to ensure adequate lending to sectors in society or the economy that have a major impact on large or weaker sections of the population and which are employment intensive. A large portion of bank lending is targeted to agriculture, which the authorities believe, fosters financial inclusion and supports rural demand. In fact, financial inclusion is one of the main goals against which most policy measures are measured. The scope of mandatory credit allocation has been reduced somewhat with the reform, but it is still very large in comparison with other countries. Banks must lend 40% of their total to priority sectors such as agriculture, certain small businesses and clients from scheduled castes and tribes. With reform, banks have been allowed greater leeway in branch rationalisation, credit delivery recruitment and the creation of posts.

…and keep 25% of their liabilities in specific public sector securities

In addition to priority lending requirements, banks are subject both to a cash reserve ratio (6.5% of assets since May 2007) and a statutory liquidity ratio (SLR) that requires 25% of their liabilities to be kept in specified public sector securities. SLRs were as high as 50% in the early 1990s.

Mandated allocation of bank assets are constraining

Overall, the state mandates the sectoral allocation of 59% of bank assets. In earlier periods, the statutory liquidity ratio was not a serious burden on banks inasmuch as public sector banks actually held a higher-than-required proportion of their assets in targeted assets. As patterns of expansion change this ratio will be a medium-term constraint on bank portfolios. In January 2007, a new law empowered the Reserve Bank to lower the SLR below its current level. Some analysts believe that despite the government's role in the credit allocation process Indian banks have learned to work effectively with these allocation guidelines and make credit decisions, including those for directed credit segments, on commercial grounds.

Rules for corporate governance of banks are distinctive

Indian rules concerning the corporate governance of banks are distinctive. The Bank Regulation Act overrides any provisions made for stock market listing or by the Companies Act. Specifically, shareholders owning more than 10% of the equity of a bank have their voting rights capped at 10%. Foreign shareholders are still limited to 20% ownership of public banks. They can own up to 74% of private banks but their voting rights remain capped at 10%. Even in the case of private banks, there is still a limit on the shareholding of any one entity. The Reserve Bank no longer appoints directors to the boards of public banks but is responsible for undertaking due diligence process prior to their nomination by the government. There have been recent amendments to the Banking Companies (Acquisition and Transfer of Undertakings) Act to improve corporate governance by increasing the number of full-time directors and shareholder directors, and a tightening of criteria for the selection of directors.

Deposit insurance exists since 1962

Deposit insurance has been operational in India since 1962. The Deposit Insurance and Credit Guarantee Corp. (DICGC), a government-owned corporate entity, administers deposit insurance in India. DICGC insures deposits of up to Indian rupees (INR) 100,000 (USD 2,350) per depositor per branch.

Reforms introduced in 2002 strengthened credit discipline, regulatory standards and supervision

Before the reform, the lack of credit discipline and credit information as well as poor protection of credit rights were serious problems. Since 2002, the authorities have implemented several measures to strengthen the processes for the resolution of nonperforming assets, for improving flows of information regarding credit and for streamlining the corporate debt restructuring process. Measures include (1) the setting up of Debt Recovery Tribunals across the country, (2) the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002, and (3) registration of asset reconstruction companies (which engage in the business of resolution of non-performing loans acquired from banks and financial institutions).

Regulatory standards have moved towards international best practices

Regulatory standards have been progressively moved towards international best practices. Rules governing the recognition of bad loans were substantially tightened. A forward-looking system of supervision, similar to Prompt Corrective Action systems in other countries, was introduced under which banks are required to promptly undertake specified changes to their portfolios and management when specified trigger points are breached. Banks are also required to maintain high quality asset and liability and risk management systems to be used in conjunction with Basel II banking supervisory systems.

Indian banks are profitable, adequately capitalised and are demonstrating good capability to manage risk

Indian banks are profitable, adequately capitalised and are demonstrating good capability to manage risk. Despite considerable deregulation, net interest income margin for Indian banks has remained high and stable. The contribution of treasury income has been falling, pushing banks to focus more on fee income. The growth in fee income should be helped by the distribution of third-party products such as CIS, insurance, securities, and commodities. Indian banks have reasonably high earnings although somewhat lower than the average for EE5 countries. The ROA averages about 100 basis points for domestic banks and about 200 basis points for foreign banks. ROE for most banks is in the range of 15%. Improvement in credit quality has been evident in the past few years. The NPL ratio declined from 11.4% in 2001 to 2.3% in 2008.

Capitalisation remains adequate as Basel II is being introduced

The Indian banking system's capitalisation remains adequate. Increases in capital ratios have been supported by Indian banks' healthy retained earnings as well as new equity and hybrid capital issuance. From 2003 onwards, a pilot project was launched to operate a risk-based supervision approach in preparation for the introduction of the new Basel II risk-based capital framework. Internationally active banks were required to be compliant with Basel II as of March 2008, while banks having only domestic operations may delay implementation until 2009 in order to raise the necessary capital.

Coordination of financial supervision

In order to deal with issues of systemic risk that transcend the concerns of individual regulatory bodies, a high level coordination committee on financial markets has been established. The members of this committee include the RBI, the Securities and investment Board of India which supervises capital markets and the Pension Fund Regulatory and Development Authority (PFRDA.)

Need for capital infusions to support balance sheet growth

Indian banks are expected to need capital infusions to support their projected balance sheet growth and to implement RBI's new capital adequacy framework. Hybrid capital instruments (Tier I and Upper Tier II) are expected to comprise a significant proportion of the new capital.

2. *Institutional investors*

While investment controls for institutional investors inhibit the development of dynamic financial markets, pension reform could foster a transformation

Although institutional investors represent a slightly larger share of national income than in China and Indonesia, controls on the investment of institutional investors inhibit development of dynamic financial markets. Prior to the reform institutional investors were mainly government controlled. In fact, the insurance sector is still dominated by the state-owned Life Insurance Company of India, which invests most of its assets in public sector liabilities. The largest pension scheme in the country is part of the government, private pension schemes are allowed to invest only 5 per cent of their new inflows in shares and 10 per cent in equity-linked mutual funds. There is a possibility for major changes in this situation. Thus in 2007, India implemented a shift in the retirement scheme for civil servants to a new system of defined contribution accounts. An extension of this scheme to the general population is under active consideration. If this pension reform is properly implemented it could pave the way for the accumulation of assets in private retirement accounts over time with the potential to transform the country's financial system.

Domestic private CIS have played a key role in resource mobilisation…

Domestic private CIS have played a key role in resource mobilisation. Previously, only publicly owned CIS were authorised and a public sector fund manager (Unit Trust of India) held a commanding position. The Unit Trust of India had to be completely restructured in 2002, for the second time, due to failure of its investment portfolio to meet the returns that it had promised to investors. With the deregulation of the capital market, privately owned mutual fund management companies were allowed into the market. These funds have been preferred by investors and now have a market share in excess of 90%.

… but mutual funds' penetration remains limited

Despite a significant growth in the number of schemes and assets under management of mutual funds in recent years, their level of penetration remains limited in comparison with other countries. Assets of CIS in amount to less than 5 % of GDP as against 70 per cent in the US and 28 % in Brazil. The share of equity CIS has increased significantly in recent years, but still account for less than 25 % of assets. Most of the growth has occurred in money market schemes, which are used by corporates and large institutional investors for short term liquidity management. There is considerable potential to develop household investments in CIS.

3. Capital markets

Equity and government bond markets are large and dynamic, but private debt markets are much less advanced

Before the reform, overregulation discouraged the modernisation of Indian capital markets. In 1992 a breakthrough was achieved when a new regulatory authority for capital markets – the Securities and Exchange Board of India (SEBI) – was established and a substantial degree of deregulation was undertaken. In the intervening period capital markets have grown considerably but unevenly. While the equity and government bond components are large and dynamic, the private debt markets are much less advanced.

The number of India's stock exchanges has grown to 23, and BSE was by far the largest

The number of India's stock exchanges has grown from four at Independence (1947) to 23 at present. Of these "traditional exchanges" the largest by far was the Mumbai-based Bombay Stock Exchange (BSE). At one point the BSE boasted the largest number of listed companies in the world – well over 10,000 – but a high proportion was illiquid. At present about 4900 companies are listed. As recently as the early 1980s the ratio of market capitalisation to GDP was only 3%. Until that time, Indian capital markets were a closed club of brokers, with few primary market offerings and little trade and marginal participation of the general public. This partly reflected the lack of transparency in Indian businesses and limited protection afforded to minority shareholders.

The creation of NSE, competitor to BSE, in 1994 was a major turning point in the development of the equity market

One major turning point in the development of the equity market came with the establishment of the National Stock Exchange (NSE) in 1994, a fully automated competitor to the Bombay Stock Exchange (BSE.) The NSE was created in response to the stagnant performance of the existing stock exchanges. Its founding shareholders were a number of public development banks (including one that founded the largest new private bank), government financial institutions and a private bank. The computerised trading system made it easier for investors from across the country to trade in a transparent market. The NSE was one of the first stock exchanges in the world to have a corporate structure, as opposed to a mutual ownership dominated by intermediaries. It rapidly became the third largest exchange in the world, measured by the number of transactions. It now has foreign shareholders (New York Stock Exchange and various banks) up to the maximum (26%) allowed by foreign direct investment regulations. Since its inception in 1994, the NSE has challenged the BSE in terms of capitalisation and surpassed it in turnover. The Bombay Stock Exchange was 10th largest in the world in terms of capitalisation in 2008. The NSE has a much higher turnover in equities and derivates than the BSE.

Equity market infrastructure has been upgraded

Reforms have also been implemented in equity market infrastructure. In 1995/96 mandatory electronic trading was introduced. The Depositories Act of 1996 gave a legal basis to electronic reports and paved the way for paperless trading. Exchange-based derivatives trading began in 2000. The establishment of the Clearing Corporation of India Ltd. (CCIL) in April 2001 provided for real-time risk management and the removal of counterparty risk.

Competition between trading platforms proved beneficial to all participants

Competition between trading platforms proved beneficial to all participants. The BSE has automated its trading systems considerably. Both exchanges have attracted a considerable amount of new listings as well as enlarged trading volume. There has been a strong growth in equity issuance with IPOs averaging slightly about 1% of GDP annually in recent years.

The ratio of India’s market capitalisation to GDP (comprising both BSE and NSE) rose from 30% at the time of the reform in 1992 to over 200% in the year ending March 2008, before falling to about 100% a year later. These ratios are high, even compared to the OECD countries.

An integral part of the new architecture was the creation of a centralised counterparty for transactions, which greatly reduced the incidence of settlement risk. At the same time, a law passed in 1996 allowed the creation of a new depository institution for holding all stocks in dematerialised form.

4. Fixed income market

India’s debt markets are divided into two segments: *(a)* the government bond segment is the larger and more active of the two, with issuers comprising the central government (90% of the total) and state governments. *(b)* The corporate bond market with Public Sector Undertakings (PSU), corporates, financial institutions and banks being the primary players.

a) Government bond market

The government bond segment is the dominant component of the debt market

The government bond segment is the oldest and largest component of the debt market. Its size has taken off exponentially over the past decades, with the total stock of debt outstanding at roughly 35% of GDP, comparable to other large emerging Asian economies but significantly lower than the OECD average. With growing demand from institutional investors such as insurance companies and pension funds, bonds with maturity extending to 30 years are now available.

While various reforms have helped, its driving growth factor was the high public sector borrowing requirement

The broad outlines of the government bond market began taking form around 1992 as a result of the government's broad-based attempts to move away from reliance on overseas borrowing toward market based systems of domestic debt management. Reforms included a move toward an auction-based sale of government securities, appointment of Primary Dealers, and the implementation of delivery-versus-payment (DVP), mitigating the risks associated with trading and settlement. In 1997, foreign institutions were permitted to invest in government securities. Subsequent innovations, such as zero-coupon bonds and index bonds, have so far received only tepid response from investors. One factor driving growth of the government debt market has been high fiscal deficits and the resulting high public sector borrowing requirement. Although the total public deficit has been declining since 2003, government debt outstanding has averaged 85% of GDP over the past 5 years.

Restrictions on issuers and investors have created a semi-captive market

Restrictions on issuers and investors have created a semi-captive market for government paper. Banks are required to invest 25% of their net demand and time deposits in government bonds or other approved government securities, the so-called statutory liquidity reserve (SLR). In fact banks and insurance companies tend to hold an even greater share percentage of government bonds in their portfolios than prescribed by regulations.

Control of institutional investments is significant

Official regulations governing investment by institutional investors are significant. Life insurance companies must lend 50% of their assets to the government and place a further 15% in infrastructure lending. Traditional pension funds must place 90% of their assets in government securities and postal savings deposits are invested totally in government securities. Presumably, the newly created investment accounts will have more flexibility in asset allocation.

b) Corporate bond market

The corporate bond market remains at less than 2% of GDP

In contrast to the government bond market, the corporate bond market remains very shallow amounting less than 2% of GDP. State-owned Public Sector Undertakings (PSUs) have persistently exceeded private corporate issuances. PSUs and private companies can raise debt capital either by private placement or public issue, with the private placement by far the preferred method. Companies continue to borrow from banks to meet financing needs. Bank credit accounts for 90% of corporate funding, with state-owned banks supplying 70% of the total.

Documentation requirements have resulted in the almost complete absence of traded corporate bonds

Public issues are subject to documentation requirements that have resulted in the almost complete absence of traded corporate bonds and the domination of the market by private placements. Private placements, which can be made to a maximum of 50 "Qualified Institutional Buyers", require much less documentation. Given the small number of investors, private debt placements can more easily be customised in accordance with issuers' and investors needs. For example, a change in market interest rates will lead to a renegotiation of the coupon rate.

Private placements mostly at three to five years maturity

There is a preference to raise funds with maturities between three to five years, which suggests that companies remain cautious of borrowing over the medium-term segment, and also reflects investors' limited demand for longer tenors.

Credit rating agencies CRAs) are regulated

India was also one of the first countries (in 1999) to register and regulate credit rating agencies (CRAs) as proposed by IOSCO. CRAs have to comply with IOSCO's code of conduct essentially regarding conflicts of interest.[20]

Trades are usually done over the counter

Trades are usually done over the counter. When brokers intermediate, they are required to report the transaction to the exchanges. Corporate debt can also be traded via an electronic order book system, but this has largely been unpopular in the absence of wide retail interest in such securities. At the same time, the pension fund system is moving toward a defined contribution mechanism which should provide impetus to the demand for corporate bonds.

Rules restrict foreign purchases of Indian bonds

There are restrictions on foreign purchases of domestic bonds. Foreign investors are required to register with the SEBI, and that there are quantitative limits on foreign purchases of private as well as government bonds.

Rules governing issues by private companies have been eased

The SEBI has been working to facilitate the development of the publicly traded private debt market. In 2008, SEBI substantially rationalised disclosure requirements for bond issuers, especially for companies already listed in the equity segment of exchanges which now face minimal additional disclosure rules. There is no pre-vetting of prospectuses for corporate debt, and only ratings and terms sheets are required. Such reforms have resulted in a large number of public bond issues.

In part, tight regulations in the domestic markets spurred Indian corporates' overseas borrowing

Partly due to tight regulations in the domestic markets, Indian corporates have been stepping up overseas borrowing, spurred by easier and fewer listing requirements, lower cost of funding and better liquidity in the secondary markets. The rise in overseas investment in Indian corporate debt coincided with the improving perception by foreign investors of the quality of Indian companies. Several Indian companies have issued Rupee-denominated bonds in Singapore and Hong Kong.

Securitisation is still in its nascent stages, but demand for infrastructure financing and future flow securitisations could lead to rapid expansion

The market in asset-backed securities (ABS) and mortgage backed is still in its nascent stages. India began securitisation in the early1990s. Growth accelerated after 2000, reaching INR 580 billion (USD 12.5 billion) in fiscal year 2007/08, but has apparently levelled off. Volumes still tend to be low and asset types limited. The market is also subject to regulatory, legal, and tax uncertainties. Auto loans were the first component of the market to show expansion in the 1990s. Since 2000, residential mortgage backed securities (RMBS) have also contributed to market growth, but still account for less than 1% of total securitised debt. Growth in credit card securitisation has been limited, partly because of stamp duty costs, but also because the credit card market in India remains small. There have also been limited future flow securitisations, such as toll receipts, and some infrastructure financing. Demand for infrastructure financing in India is now projected to grow rapidly and securitisation of receivables from those projects has the potential to expand rapidly.

MBS is a segment with the potential to rise quickly

The growth of commercial bank credit for housing, averaging approximately 90% since 2002, suggests that MBS is a segment that has the potential to rise quickly as soon as the necessary market infrastructure and regulatory adjustments are enacted.

VII. Indonesia

Overview

The Indonesian financial system is at a relatively early stage of development in comparison with other EE5 countries. While the banking sector is small as measured by most indicators such as the ratio bank deposits and bank credit to GDP, it is by far the dominant component of the financial system. Bank deposits account for some 80% of all financial assets. The banking system, which was devastated by the 1997 Asian crisis, is now emerging in a more dynamic and prudentially sound form that is capable of playing a more active role in economic development. The non-bank financial institution (NBFI) sector, including capital markets and institutional investors, is expected to gain in importance in the future as the public begins to channel savings into institutional investors and as the capital market gains a larger role in intermediation.

1. Banking sector

The central bank is also responsible for banking supervision

Bank Indonesia, which is both the central bank and the body responsible for banking supervision, also plays a leading role in addressing systemic stability and macro prudential issues. Bank Indonesia has been working intensively to build a financial safety net to prevent recurrences of the kind of problems that made the post 1997 crisis particularly severe in Indonesia.

The relatively open domestic banking system proved highly vulnerable during the 1997 Asian crisis

Prior to the 1997 Asian crisis, the banking system was comprised of state-owned banks as well as private domestic banks. The latter were often linked to family-owned industrial conglomerates. Policies toward foreign bank establishment were relatively open and foreign banks gained a significant foothold in the market. Due to practices such as related party lending and borrowing in dollars for lending in local currency, the domestic banking system proved highly vulnerable during the crisis when the evaporation of foreign credit and the sharp fall in the currency drove many corporate entities and banks into bankruptcy. The major banks became insolvent and outstanding credit contracted sharply, aggravating the decline in real income.

Post-crisis bank recapitalisations entailed expenditures of 50% of GDP

The recapitalisation of the banks entailed expenditures of USD 45 billion (about 50% of 1997 GDP) and incapacitated the financial system for much of the ensuing decade. The restructuring was led by the Indonesia Bank Restructuring Authority (IBRA) which removed impaired assets from bank balance sheets, recapitalised banks and attempted to recover value from impaired loans.

Restructuring was led by a special entity (IBRA), and the government became the majority owner of insolvent banks, sold on to foreign strategic investors

Working closely with international financial institutions, the authorities, led by IBRA and Bank Indonesia, engineered a recovery in the banking system. In the case of banks that had become insolvent, the government became the majority owner while acquiring large portfolios of non-performing loans (NPLs). In the phase of rehabilitation, the insolvent banks acquired by the government were sold, mainly to foreign strategic investors. While investors from Europe, North America and Australia made sizeable strategic investments, other Asian countries (*e.g.* China, Malaysia, Singapore, India and Korea) took even bigger stakes. The government also sold minority stakes in the major state-owned banks. With stronger ownership and governance structures, bank managements are under considerable pressure to adhere to strict norms of internal risk management and earnings.

State banks control some 39% of assets, and the system is moderately concentrated

There are over 130 national commercial banks in the country, a reduction from 220 at the time of the 1997 crisis. State banks control some 39% of assets. Although there are many small credit institutions, the system is moderately concentrated. The four largest banks, of which three are state-owned,[21] control nearly half of total bank assets. There are eight regional development banks which account for some 11% of loans. There are also thousands of small regional banks and credit co-operatives.

NPL ratios are relatively low and the major banks are very profitable; following the banking reform, loan growth has been accelerating rapidly

NPL ratios had approached 50% at the time of the crisis, but due to sales of impaired assets and stricter risk management procedures, NPL ratios are now only about 3.5% of total loans on average, and provisions for NPLs are almost 100% of NPLs. The major banks are very profitable as measured by net interest margin, ROA and ROE. Following the crisis, lending contracted sharply and banks portfolios contained heavy weightings of government bonds. The loan to deposit (LTD) ratio declined to as low as 25%. With the reform of the banking system loan growth has been accelerating rapidly in the past few years, despite the global crisis of 2007, and now stands at about 68%. Indonesian banks have comparatively high net interest margins and return on assets. ROE is somewhat lower than in other EE5 countries.

The 2004 Banking Architecture Plan aimed at developing a core of prudentially sound market-oriented banks

As the recovery from the 1997 banking crisis gained traction, Bank Indonesia in 2004 unveiled its Banking Architecture Plan, a sweeping strategy aimed at developing a core of prudentially sound market-oriented banks capable of providing a broader range of financial services with more competition and reduced systemic risk. The Plan aims to consolidate the industry into 58 national banks through mergers and acquisitions over a period of 10-15 years. Bank Indonesia envisages that banks will be stratified by size into categories such as international-class banks, national banks and specialised or rural banks.

More consumer and SME lending is expected from banks

As part of the transformation of the banking landscape, banks will be expected to move from their earlier business model which stressed lending to large corporate entities (often in affiliated groups) to lending to consumers and SMEs, while larger corporate entities are expected to rely more heavily on capital markets.

2. Capital markets

The Indonesian equity market has relatively advanced infrastructures...

The Indonesian equity market has relatively advanced physical and technological infrastructures with an automated stock trading platform as well as custody and clearing and settlement systems that are in line with international norms. In 2007, the exchanges in Jakarta and Surabaya were merged to form the Indonesian Stock Exchange. Several derivative products are traded on the exchange.

...but makes a relatively small contribution to raising capital for business

The equity market makes a relatively small contribution to raising capital for business. Total market capitalisation as a share of GDP (41% in 2007) is the lowest among EE5 countries. The exchange has not attracted a large number of new listings in recent years. There were 335 companies listed in 2005 compared to 288 ten years earlier and volumes of IPOs have not been high. The market has very high rates of concentration, with the ten largest firms accounting for more than half of market capitalisation. Most listed companies are family-owned conglomerates in which the inside group maintains control. The "free float" is generally about 35-40% of the total.

Trading has been dominated by foreigners, which increases volatility risk, but domestic investors become more active

Domestic institutional investors do not invest heavily in equity and retail investors have also been largely absent. This can be contrasted with some other Asian countries with strong equity cultures where the general population invests heavily in stock markets. As a result, trading has been dominated by foreign institutions. While the presence of foreign investors is basically positive, excessive reliance on foreign investors plainly increases the risk of volatility. In this context, it is a positive sign that domestic investors have been increasing their activity in recent years.

Bank recapitalisation bonds were issued after the 1997 crisis

Prior to the 1997 Asian crisis, the government had been legally prohibited from issuing domestic debt, but with the banking crisis a large volume of bank recapitalisation bonds were issued. The sharp rise in the outstanding stock of debt enabled the authorities to engage in large scale operations to restructure banks balance sheets.

Substantial strides have been made in modernising the government bond sector

Substantial strides have been made in modernising the government bond sector by issuing paper with longer maturities and by introducing regular issuance calendars. A system of primary dealers with access to special central bank facilities has helped add liquidity. Banks are the largest holders of government debt, but much of the trading is conducted by foreign institutions. Still, trading remains very thin. The market expansion is constrained by the scarcity of institutional investors who are normally the natural buyers of longer-term fixed income assets.

Outside of the government debt sector, the fixed income market is rather shallow

Outside of the government debt sector, the fixed income market is rather shallow. Outstanding corporate bonds amount to some 6% of GDP, which is comparable to other EE5 countries. Domestic institutional investors are the main holders of corporate bonds. An attempt was made to launch a market in local government debt in 2001, but few issues have actually taken place.

There is no market in housing-related debt, but there are efforts to build one

There is no market in housing-related debt. Outstanding housing loans amount to 2% of GDP (28% in Malaysia). One institution, Bank Tabungan Negara (BTN), is mandated to extend credit to middle and low income families. BTN depends upon deposits and government funds for its operation and its business remains limited. The government created a specialised institution (*Sarana Multigriya Finansial*) to purchase mortgages from banks in order to build a secondary market in housing related assets.

3. Institutional investors

92% of the labour force is not covered by any pension plan; and Jamsostek as a comprehensive social security scheme seems not to be very efficient...

It is estimated that 92% of the labour force is not covered by any pension plan and thus depend upon their personal savings or upon their families. At present there are unfunded pension plans for civilian government employees and for the armed forces. Both of these schemes represent a growing drain on the public finances. Private companies are required by law to provide coverage to their employees through Jamsostek, a scheme that provides pensions as well as health, accident and life insurance. The employer contributes to funds for all purposes but the worker contributes only to the retirement portion of Jamsostek. Jamsostek makes lump sum payments at retirement or upon earlier termination of employment. Jamsostek has very high administrative expenses, and more than 40% of its assets are in bank deposits.

...and coverage is very narrow

Despite the fact that the law mandates coverage for all private sector employees, only an estimated 21% of formal sector employees are actually covered. Since most workers are outside the formal sector, coverage is very narrow indeed.

Some employers voluntarily offer additional funded pension plans

In addition to the mandatory plans offered by employers through Jamsostek, some employers voluntarily offer funded pension plans to their employees through special plans, which can be defined benefit or defined contribution. One final category of pensions is Financial Institution Pension Funds (FIPFs) which are offered by banks and insurance companies. These plans can be purchased by employers or individuals can provide for their own retirement through voluntary subscription. Over half of all pension fund assets are in these two categories of private plans, although the number of individuals covered is much smaller than in Jamsostek. Private plans also have a better investment record.

The reform of the pension regime will take many years

The reform of the pension regime will take many years of concerted efforts, a task complicated by the wide number of interests involved. In 2005, BAPEPAM L&K (see below) produced a "Road Map" for the comprehensive reform of the pension sector. A number of objectives were set forth, but no rigorous timeframe was adopted.

The insurance coverage is very low...

The insurance coverage of the Indonesian population is very low by international comparison. In addition to the low level of participation, low net earnings on investment by insurance companies have meant that the insurance industry has not generated a pool of long-term savings suitable for purchasing long-term assets.

...and insurance companies are not very profitable

Despite the small market, there are 162 companies offering insurance, many of the companies being too small to be economically viable. There apparently are a number of companies that are insolvent, but no action has been taken to close or consolidate marginal companies.

The CIS industry is very small but expanding; however, valuation procedures and disclosure practices are still inadequate

The CIS industry is very small in Indonesia, although it has expanded since its inception in 1995. Even in its current embryonic form, however, the industry has already experienced substantial problems. With the resolution of the banking crisis after 2000, the government began to issue special bonds to recapitalise banks. CIS managers bought heavily for their portfolios. As a result, the assets of fixed income funds surged from 4.6 trillion RPH in 2001 to 37 trillion one year later. The domestic CIS industry was ill-equipped to absorb this sharp rise in inflows. Valuation procedures were inappropriate. Many of the funds were marketed without adequate explanation of the risks in fixed income investments. Disclosure practices were inadequate.

Large bond price corrections led to a major loss in confidence in the CIS industry

The highly publicised surge in investment in 2000-2005 was followed by a collapse which led to a major loss in confidence in the CIS industry. In 2003 and again in 2005, price corrections in the bond market induced a panic among investors which led to a wave of redemptions and widespread allegations that improper methods of valuations were used. Net liquidations were especially high during 2005, when assets in fixed income funds fell from 88 trillion RPH at the end of 2004 to only 14 trillion a year later. It is widely agreed that much improvement is needed if the industry is to expand its role in finance.

4. Multi-finance companies

Multi-finance companies that engage in a range of near banking activities are a significant category of NBFIs

One significant category of NBFIs is "multi-finance" companies that engage in a range of "near banking activities," such as credit cards, leasing, consumer finance and factoring. There are about 130 multi-finance companies. Originally multi-finance companies were engaged in leasing but in 2005 nearly 70% of their activity was in consumer finance, with leasing accounting for most of the remainder. Automobile and motorcycle credits and leases, often to low income segments of the population, are the most common operation. Multi-finance companies receive a considerable amount of their funds from commercial banks; the largest multi-finance companies are bank affiliated. It should be noted that finance companies of this kind have encountered serious problems in a number of Asian countries such as Thailand and Korea.

5. Islamic finance

The past decade has witnessed a sizeable expansion of Islamic financial products

The past decade has witnessed a sizeable expansion of Islamic financial products; *i.e.* instruments that are structured so as to conform to restrictions in the Koran, especially concerning the payment of interest. As of August 2007, only 1.3% of bank assets were in Shariah-compliant products but Bank Indonesia projected the proportion to grow to 5% by end-2008. In 2008, a special law on Islamic finance was enacted. There are three pure Shariah banks, while 24 conventional banks have opened Shariah units. The government recently issued its first Shariah-compliant bond-like product (sukok) in the domestic market and further issues are planned. Sukok have also been issued in foreign currency for placement with foreign investors. Islamic financial products are also found in the mutual fund and insurance sectors.

6. Institutional arrangements for financial supervision

Bank Indonesia is responsible for banking supervision, NBFIs are supervised by BAPEPAM & LK

As mentioned above, Bank Indonesia is responsible for banking supervision. NBFIs are supervised by BAPEPAM & LK. This agency was created by merging BAPEPAM, the existing regulatory authority for capital markets with bodies responsible for other NBFI. BAPEPAM (Capital Market and Financial Institution Supervisory Agency), which has a long history as the capital markets regulator, is undoubtedly the strongest official institution in the NBFI sector. BAPEPAM, which focuses on market conduct and investor protection issues, has the basic organisational structure that is common to all capital market supervisors with departments responsible for intermediary's market conduct and investment management.

In order to deal with issues that do not fall completely within the competence of one supervisory agency the Financial System Stability Forum (FSSF) was established on 30 December 2005[22]) with three levels of co-ordination: 1) at the ministerial level, 2) the management level, and 3) the operational level. The institutions represented on the FSSF are which all involve the ministry of finance, the central bank (Bank Indonesia – BI), the Deposit Insurance Corporation (DIC)[23] and BAPEPAM & LK.

There are plans to consolidate supervision in a

In 2003 it was agreed in theory that all financial supervision (*i.e.* supervision by Bank Indonesia and BAPEPAM & LK) would be merged into Otoritas Jasa Keuangan (OJK), a unified financial supervisor. Bank Indonesia would retain *unified financial supervisor by 2010*

responsibility for systemic stability and monetary policy. The proposed merger has been postponed several times.

VIII. South Africa

Overview

By many measures South Africa has the most sophisticated financial system of any EE5 country. Institutional investors are well developed, and for the most part on a par with OECD countries. The banking system is deep compared to those in other emerging economies. Both banks and capital markets have been functioning as competitive institutions for extended periods. Local capital markets, including derivatives markets, are well developed and securitisation is growing rapidly. Following the end of the Apartheid era in 1994, the financial system has become increasingly internationalised, with South Africa a major provider of financial services for other African countries. The country continues to have a solid record of financial stability and good supervision.

1. Banking system

Foreign banks have a relatively strong presence

Currently, there are 38 registered banks in South Africa, consisting of 15 domestically controlled banks, 6 non-resident bank subsidiaries, 15 branches of foreign banks, and two mutual banks. In addition, 44 foreign banks have representative offices in South Africa. The acquisition in 2005 of one of the country’s four largest banks by a U.K. bank increased foreign presence substantially. Foreign banks have traditionally been mostly active in corporate banking but the foreign acquisition of a large domestic bank will surely change that business model.

Banks are universal; the commercial banking sector has no government ownership

The banks are universal, offering a wide range of services to both individual and corporate customers. Conglomerates have been formed that combine banking, securities trading, and insurance within single organisations and also have extensive cross-border operations. Meanwhile, several banks, especially small local and foreign banks, service niche markets where they hold some competitive advantage. In contrast to other EE5 countries, the South African commercial banking sector has no government ownership.

The banking system is rather concentrated, as many small and medium banks disappeared as a consequence of a crisis in 1999

The banking system has become rather concentrated. The number of medium to small local banks increased steadily in the 1990s, but in 1999, the a crisis erupted when Saambou Bank, a medium-sized bank with a strong deposit base and wide branch network, experienced a liquidity crisis, emanating from declining balance sheet quality and negative market perceptions. A withdrawal from both larger and smaller banks ensued. The South African Reserve Bank entered into consultations with the National Treasury, which ultimately issued a guarantee to all depositors that the government would fund their withdrawals. Subsequently, however, many small and medium banks faced liquidity pressures and were forced to exit or were acquired by larger institutions. Overall, by the end of March 2003, some 22 banks had exited. At present five major groups continue to dominate the banking sector, controlling some 85-90% of total assets.[24] Small local banks constitute only 3% of the total banking sector assets, in comparison to 22% cent in 1994.

Micro-loans are equivalent to 1% of GDP

The banking system also includes development and postal banks (which do not fall under the Banks Act) as well as microfinance institutions, which have had some success in reaching low income segments of the population. Micro-loans are equivalent to 1% of GDP.

"Four-pillar" policy to maintain minimum levels of competition

Noting the rising level of concentration in the banking system in 2004 the Minister of Finance articulated a "four-pillar" policy that sets the objective under of having a minimum number of substantial domestically banks (so called "pillars") on which the domestic banking industry relies and to discourage the merger between any of those four banks. The objective of this policy was the maintenance of minimum levels of competition, in the interests of prudential and systemic stability. Additionally, any foreign bid to acquire one of the major banks would be examined in the light of the potential impact on competition and systemic stability.

Lending to the household sector has increased

Banks have increasingly been stressing lending to the household sector in recent years. A the end of 2008 mortgage loans and instalment debt accounted for about 33 % recent and 11 % of total loans and advances, respectively, while credit card debt accounted for another 3%. In contrast, loans and overdrafts amount to about 25 % as corporates are increasingly turning to capital markets.

The banks are profitable and prudentially sound

The banks are profitable and prudentially sound. As a result of problems in the smaller and medium-sized banks around the year 2000, profitability measures showed some decline. In the ensuing years there has been a trend toward improvement. The net interest margin of banks at over 700 basis points is second only to Brazil among the EE5. ROA has been improving and in 2008 was estimated at 270 basis points and ROE at 23%. Credit quality has tended to be good, with NPL ratios declining from 2.4% in 2003 to 1.1 per cent in 2008. There are some concentrations on the lending side in households and the property market as mortgages account for 45 per cent of total private sector credit. Also, the funding structure shows some concentration in short-term wholesale deposits.

Banks are well capitalised and have improved risk modelling following Basel II

In 2002 the official CAR was set at 10% (against the minimum global norm of 8 %). At the end of 2008 South African banks held capital equivalent to 12.5% of risk weighted assets with a tier 1 ratio of over 10%. The larger banks have implemented the advanced internal ratings based (IRB) approach under Basel II, which has led them to develop sophisticated risk monitoring and modelling capabilities.

A substantial internationalisation of banking activity has occurred

A substantial internationalisation of banking activity has occurred. Due to the political isolation of South Africa in the mid-1980s, international banks had curtailed their operations in the country considerably. With the advent of the democratically elected government in 1994, however, amendments to the Banks Act allowed representative offices, subsidiaries and branches of international banks to be established in South Africa. At the same time most controls on non-residents' lending and investment in South Africa were lifted. At the same time some controls on residents operations remain. The authorities plan further liberalisation of rules for residents.

The arrival of foreign banks increased competition and made domestic banks more efficient

Following the opening of South Africa's financial system in 1994, international participation in the local market has expanded considerably. Besides adding further depth and sophistication to the South African market, these foreign banks could utilise the highs skill of South African labour force. Consequently, the arrival of these predominantly resourceful and experienced banks posed formidable challenges to local banks. Facing intensified competition, South African banks have become more efficient.

Domestic banking groups are rapidly expanding into the rest of the continent...

South Africa's large domestic banking groups are rapidly expanding their banking operations into the rest of the continent. The democratisation of South Africa coincided with the relaxation of controls in the foreign exchange and capital markets in neighbouring countries, thus permitting the increased regional and international participation in local financial systems. Within the broad framework of liberalisation, factors such as privatisation, the seeking of joint ventures and technical partnerships with larger firms and the need for assistance in recapitalisation have provided opportunities for outward investment by South African banks. These banks have attained dominant market shares in many of the host countries.

...mostly through deals with existing banks in the host countries

Rather than establishing a *de novo* presence, South African banks have chosen to enter other markets by acquisitions of existing banks, purchase of stakes in privatisation deals of state banks and buy-outs of other international banks. The trend has been to establish subsidiaries rather than branches. In most countries the corporate structures of the subsidiaries are simple with no additional subsidiaries and few affiliate companies. However, in countries with burgeoning capital markets(e.g. Botswana, Namibia, and Swaziland), corporate structures are showing signs of increasing complexity, with banks establishing separate additional subsidiaries for capital markets and money market operations.

Banks operate mostly in the wholesale side of the market

South African banks operate mostly in the wholesale side of the market while funding has been secured from increased deposit mobilisation in domestic markets. In addition, the high interest rates on government securities have provided profitable and low-risk investment opportunities. While there are signs of a shift towards large branch networks, retail lending is yet to develop and the credit card market remains largely untapped.

Expansions have occurred in major trading partners

These expansions have occurred in South Africa's major trading partners, many of which are in Southern Africa. Most lending is to support South African firms expanding into the region. While South African banks have rapidly expanded into the region, financial institutions from other parts of Africa have a very modest profile in South Africa. There are currently only three African financial institutions operating in South Africa, of which two are Nigerian banks.

Banking operations are sound and profitable

The banking operations in Africa are basically reported to be sound and profitable. The operations continue to trade profitably, driven by steady growth in low cost and stable retail deposits, commercial assets and improved operational efficiency. The banking subsidiaries are usually also well capitalised with capital adequacy ratios exceeding the statutory required levels.

2. Institutional investors

Institutional investors are well developed, with a comprehensive system of funded pensions

The institutional investor community is rather deep. Virtually all categories of institutional investors are well developed. According to SARB data, the assets of pension funds are equal to 57% of GDP and the assets of all institutional investors equal 155%, a figure exceeded only in a handful of OECD countries. The country has a well developed system of funded pensions for both public and private workers.

Insurance and CIS are also important

The insurance sector has one of the highest penetration ratios in the world. The CIS sector is fairly advanced, but less so than in Brazil in the OECD countries.

Regulation of institutional investors is relatively flexible

Regulation of institutional investors is more flexible than in many countries. Domestic institutions have reasonable freedom in their investment policy and are among the major investors in the domestic bonds and equity markets. Pension funds are major investors in equity and in all components of the fixed income market.

3. Capital market

JSE is not only the largest exchange in Africa, but also one of largest in the world

The Johannesburg Securities Exchange (JSE), previously the Johannesburg Stock Exchange was founded in 1887 to raise funds for the fledgling mining industry. While mining related stocks still are significant, the majority of the companies listed today are non-mining organisations. JSE Limited is by far the largest exchange in Africa and one of largest in the world in terms of market capitalisation.

A number of initiatives improved the exchange's efficient functioning

A number of initiatives were introduced beginning in the mid 1990s to improve the efficient functioning of the exchange. The first major change occurred in November 1995, when the Stock Exchanges Control Act changed the way in which stocks were traded in South Africa, opening the door to non-South Africans as intermediaries, and allowing brokers to buy and sell stock for their own account. The trading system was automated through an electronic clearing and settlement system in1999. The bond market was separated from the JSE to the Bond Exchange of South Africa (see next section). In 2001, the JSE merged with the South African Futures Exchange (SAFEX), thereby becoming the leader in both equities and futures and options trading in South Africa.

Decline in listings as companies moved their primary listings to London

Despite technical innovations the number of listed companies on the JSE declined from 732 in 1990 to 403 in 2004, as a large number of South Africa's biggest companies moved their primary listings to London to be more attractive to international investors. This loss caused concern in the South African securities industry market and resulted in a decline in trading volume on the JSE.

SETS, a London-based securities exchange trading system, allows JSE securities to be displayed globally

In 2005 the JSE replaced the existing Johannesburg Equities Trading system with the Securities Exchange Trading System (SETS), a London-based securities exchange trading system. SETS is an electronic limit order book trading service used to trade 'blue-chip' shares as well as other securities. In addition to improving accuracy of information, SETS enables the JSE's securities to be displayed on more than 100 000 trader screens worldwide, thus potentially attracting interest from fund managers and brokers around the globe.

South African companies can now issue shares on JSE and LSE

Through this alignment of the London Stock Exchange (LSE) and the JSE, South African companies can now issue shares on both exchanges, without changing residence. In addition to SETS, the Securities Exchange News Service (SENS) was introduced to issue price-sensitive information to all market-watchers simultaneously. The trading engine and information dissemination feed-handler is hosted in London and connected remotely to the JSE. More than 1,500 traders and information users access the system. The JSE also aligned their equities trading model with that of Europe, and reclassified their instruments in line with the FTSE Global Classification system. The exchange was demutualised in July 2005.

Equity prices fared well during this

The ratio of equity market capitalisation to GDP is one of the highest in the world. About 20% of total turnover is done by non-residents. Prices have been

crisis and appear reasonably valued

sustained comparatively well during the world financial crisis. Despite these rises, the market appears reasonably valued. According to IMF estimates, the dividend yield was 4.3%, the price to book value ratio was 3.75 and the P/E ratio was 17.

AltX for small and medium sized high growth companies

The exchange has been developing special products to service specific market segments. The Alternative Exchange (AltX) is a stock exchange that was founded as a division of the JSE in order to accommodate small and medium sized high growth companies.

JSE is planning to create a pan-African exchange

The JSE is taking steps to bring the stock exchanges of Africa closer together and to improve the tradability of stocks in African companies. JSE is planning to create a pan-African exchange by initially enabling investors to trade in shares from Ghana, Namibia, Zimbabwe and Zambia. Later it will expand this across the rest of Africa. In October 2008, the JSE launched the "FTSE/JSE All Africa 40 Index" and the "FTSE/JSE All Africa ex South Africa 30 Index". The first index shows the top 40 largest eligible companies listed on qualifying African stock exchanges (which include South Africa as well as Botswana, Egypt, Ivory Coast, Kenya, Mauritius, Morocco, Nigeria and Tunisia). The second index excludes South African companies. In February 2009, the JSE launched its JSE's Africa Board, a regulated trading platform that provides investors access to the African market. Non-South African companies on the Africa Board retain their local listing and take a secondary listing on JSE's Africa Board. The JSE shares its trading revenue with the local exchanges. South African stock brokers have been encouraged to enter into brokerage sharing agreements with brokers on the rest of the continent.

Bond Exchange of South Africa Limited (BESA) acts both as an exchange and as a self-regulatory organisation; OTC trades are reported through the BESA system, increasing transparency

The Bond Exchange of South Africa (BESA), which was originally part of the JSE, was established in 1996 as an independent, mutually owned exchange. In 2007 the BESA was demutualised. The BESA acts both as an exchange and as the self-regulatory organisation (SRO) for the bond market. Essentially, most of the trading takes place in the OTC market, but is reported through the BESA system, which provides increased transparency. BESA brings together: *(i)* a trade capture and matching service that is locally developed while using international best practices, and *(ii)* comprehensive market data and reports, which include mark-to-market prices, bond indices, yield curves and market-turnover statistics, and *(iii)* a price-discovery system displaying live-for-trading prices. In June 2009, BESA became a wholly-owned subsidiary of the Johannesburg Stock Exchange. With this acquisition there was some consolidation of the derivatives that were traded on the two systems.

The infrastructure is highly sophisticated, and the bond market is one of the largest in EMEs…

The market infrastructure is highly sophisticated, with T+3 settlement, a central clearing counterparty, and guarantee funds. The South African bond market is one of the largest in proportion to the economy in emerging-market economies. In December 2008 BESA had listed some 1,102 debt securities, issued by 100 sovereign and corporate borrowers, with a total market capitalisation of ZAR 935 billion. The market is very liquid with trading volume equal to 23 times capitalisation.

… including a full range of products

BESA lists over 375 bonds issued by central and local government, public sector corporations and major companies, and regulates their trading, clearing and settlement. About 1/3 of trading is by foreigners. Bonds include a full range of products such as strips, inflation indexed bonds, zero coupon as well as bond derivatives.

MBS and ABS issuance has been strong since 2001, also providing an alternative for government bonds

Issuance of mortgage backed securities (MBS) and asset-backed securities (ABS) has been strong since 2001 when changes in the legal infrastructure were implemented to facilitate development of this product. While changes in the regulatory environment are partly responsible, decreased supply of government bonds also left investors base looking for alternatives. As retail assets on bank balance sheets grew, banks turned to securitisation as another source of funding. Issuance has been equally divided between residential MBS and ABS collateralised mostly with vehicle loans and credit card receivables. Securitised notes found a good market among the country's asset managers and pension funds. At the same time, asset-backed commercial paper has become a funding vehicle for the corporate sector.

55% of listings are government bonds

About 55% of listed bonds are central and state government issues with state-owned companies accounting for another 10%. The shares of corporate bonds, MBS and ABS, have all been rising in recent years.

4. Financial supervision

The Reserve Bank supervises the banks, and consolidated supervision is applied to all banking groups

The Banking Supervision Department (BSD) in the Reserve Bank (SARB) supervises the banks. Consolidated supervision is applied to all banking groups, which must demonstrate that they are adequately capitalised in order to sustain both their banking and nonbanking operations. The entities subject to consolidated supervision are the bank controlling company, its subsidiaries, joint ventures, and companies in which the bank controlling company has subsidiaries or its subsidiaries has a participation. The BSD conducts both off-site and on-site supervision, although the latter relies heavily on external auditors. Supervision initially focused on off-site analysis of statistical information contained in the statutory returns. However, the approach has been broadened to include a larger component of on-site supervision. This includes, *inter alia*, ongoing interaction and regular prudential meetings with the executive management and risk managers of banks, annual presentations to banks' boards of directors and trilateral discussions with the management, including the audit committee, and the external auditors of banks.

FSB supervises non-banks

The Financial Services Board (FSB) supervises non-banks, including insurance companies, pension funds and exchanges.

After certain reforms in financial supervision, the 2008 FSAP drew positive conclusions

In 2000, South Africa agreed to have an FSAP in order to review its systems for financial supervision. The assessment was basically positive but some recommendations for improvements were made. On the basis of these recommendations, certain reforms were implemented Another FSAP was performed in 2008. One major conclusion was that a system of formal deposit insurance should be introduced. This recommendation is now under consideration. At that time it was concluded that the financial system was fundamentally sound, and that the regulatory framework for the financial sector is modern and efficient.

NOTES

[1] The G-20 was created as a response both to the financial crises of the late 1990s and to a growing recognition that key emerging-market countries were not adequately included in the core of global economic discussion and governance. The Group has regained importance in response to the current financial and economic crisis. The G-20 is made up of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States of America. See www.G-20.org.

[2] In order to have a comparable set of data, this paper uses data and information provided by the IMF (2008) and the World Bank (2008a, 2009).

[3] In fact, the share of listed equity is higher in Luxembourg than in South Africa, but this is due to the large number of foreign companies listed in Luxembourg.

[4] World Bank (2008b).

[5] McKinsey Global Institute (2007, 2009).

[6] Salviano (2008).

[7] The *Sistema Especial de Liquidação e de Custódia* - SELIC (Special System for Settlement and Custody) is the settlement system for most - around 96% - of central government's domestic securities. SELIC is the resulting of a joint effort of BCB and market participants represented by the National Association of Financial Market Institutions (Andima). Since then, all of the relevant government securities in Brazil were dematerialised and kept in custody in SELIC. With the restructuring of the Brazilian payments system in 2002, SELIC was reformed to follow international recommendations for securities settlement systems, providing from then on immediate, simultaneous and final transfer of securities and, through a direct link with STR (Central Bank Money Transfers System), bank reserves (genuine DVP-1).

[8] In 1987 the government introduced what is now the main instrument for Brazil's federal debt, the LFT (Letra *Financeira do Tesouro*).

[9] For mortgage backed securities (MBS): CRI (*certificado de recebíveis imobiliários*); and for asset-backed securities (ABS): FIDC (*fundos de investimentos em direitos creditórios* - receivables investment funds).

[10] *Bolsa de Valores, Mercadorias & Futuros de São Paulo*.

[11] *Comissão de Valores Mobiliários*.

[12] These steps include the reorganisation of the People's Bank of China into regional branches in the late 1990s, which was partly intended to strengthen its control over local branches and the shift of lending authority to higher level branches by the SOCBs at about the same time.

[13] The steps also created some adverse incentives. Banks responded to the tighter individual accountability for bad loan outcomes by virtually shutting out smaller and medium sized state and non-state SME who were no longer officially backed by central and local governments. At the same time, the targets for reduction in the NPL ratio encouraged banks to continue to expand loans rapidly, but toward outlets that were perceived to be state backed (lending to larger SOEs and state infrastructure projects) or to housing and consumer credit, where delinquencies were expected to be lower than in business lending.

[14] The remaining about 2/3 of their equity was held as *(i)* state shares representing the state's investment in the company and theoretically owned by the State Council; the state shares are not tradable. *(ii)* "Legal person" shares are held by SOE, institutions, authorised social groups or other entities that have been granted "legal person" status.

[15] Companies incorporated in mainland China can be traded in the mainland A-share markets, quoted in Renminbi, and currently open only to mainlanders and selected foreign institutional investors, or in the mainland B-share markets (Shanghai and Shenzhen), quoted in foreign currencies (USD or HKD). In the past, only foreigners were allowed to trade B shares. Starting from March 2001, mainlanders can trade B shares as well. However, they must trade with legal foreign currency accounts.

[16] Issuance in 2008 has been reported as follows: national debt: RBM 708.5 billion; financial bonds: RMB1.2 trillion; corporate bonds: RMB 249.3 billion; central bank bills: RMB 4.3 trillion.

[17] See also endnote 15.

[18] Deutsche Bank Research (2009).

[19] Foreign direct investment does not require approval, *i.e.* it is under the "Automatic Route" of the Reserve Bank of India, if the investment is in a company engaged in a given sector is less than a specified percentage (74 % in the case of banking) – and meets specified prudential conditions.

[20] The debate of whether and how the rating methodologies of CRAs should be subjected to regulation is still ongoing at the IOSCO level, but once decided there, India is ready to adopt such policies.

[21] Mandiri, Negara and BRI.

[22] According to official information, the FSSF "is a venue for coordination, cooperation and information exchange among the authorities responsible for safeguarding financial system stability in Indonesia. This forum has a crucial role, particularly in addressing systemic risk that can only be resolved through joint policies and decisions followed by coordinated, effective actions. […] The key functions of the FSSF are: [i] To discuss the various issues confronting government stakeholders in the financial system with potential systemic impact, as informed by the financial institution supervisory authority; [ii] To coordinate and exchange information for synchronization of laws and regulations concerning the banking system, non-bank financial institutions and the capital market; [iii] To coordinate the implementation or preparation of specific initiatives in the financial sector."
See http://www.bi.go.id/web/en/Perbankan/Stabilitas+Sistem+Keuangan/Forum+SSK/.

[23] According to official information, the "the FSSF is divided into three levels: [1] The Steering Forum, which is responsible for providing general guidance to the Executive Forum on the key FSSF functions. This forum has 7 members, 3 at the level of Director-General in the Ministry of Finance, 3 members of the BI [Bank Indonesia] Board of Governors and the Chief Executive Officer of LPS [=DIC - Indonesia Deposit Insurance Corporation]. [2] The Executive Forum, which carries out the key functions of the FSSF according to the instructions of the Steering Forum. This forum has 14 members: 6 second-level officials from the Ministry of Finance, 6 BI Directors and 2 LPS Directors. [3] The Working Team, which supports the work of the Steering Forum and Executive Forum. Team members are officials appointed from the Ministry of Finance, BI and LPS by decision of the Steering Forum after nomination by the respective institutions." See http://www.bi.go.id/web/en/Perbankan/Stabilitas+Sistem+Keuangan/Forum+SSK/.

[24] The Absa group, the Standard Bank group, the FirstRand Bank group, Investec and Nedcor.

REFERENCES

Deutsche Bank Research (2009), *China's Financial Markets: A Future Global Force?*, March 16.

McKinsey Global Institute (2007), *The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Shaping Global Capital Markets*, October.

McKinsey Global Institute (2009), *The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Faring in the Financial Crisis*, July.

IMF (2008), *Global Financial Stability Report.* Washington, D.C.

Salviano, Cleofas, jr. (2008), *Fostering Competition in the Brazilian Financial Sector* (April), presentation at the Cemla-Banco de México Seminar "Financial Inclusion and Modernization in Latin America".

World Bank (2006), *Unlocking Indonesia's Domestic Financial Resources: The Role of Non Bank Financial Institutions*, December.

World Bank (2008a), *Bank Regulation and Supervision Database* (updated June 2008), available at http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20345037~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html.

World Bank (2008b), *Finance for All*, World Bank Policy Research Report.

World Bank (2009), *A New Database on Financial Development and Structure*, updated May 2009, available at http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20696167~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html.