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Citation:
Donald B., Editor King. Essays on Comparative Commercial and Consumer Law (1992).
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CHAPTER 4

State of Banking Regulation in Developing Countries

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The 1980s have been turbulent times for banking in many developing countries. Many countries have had to deal with troubled banks, banks with negative capital and a significant percentage of nonperforming assets. At the same time, there has been significant experimentation with deregulation and reform. This has taken many forms. Most significantly there has been liberalization of interest rates, often undertaken as a result of international, as well as domestic pressures. Countries have also reexamined policies toward specialized and segmented banking markets, thus confronting the question of equality of treatment as between different banks, as between banks and other depository institutions, as between depository institutions and other financial institutions, and as between financial institutions and commercial enterprises.

As part of the reform process, countries have wrestled with the problem of public versus private ownership of banks, some privatizing, some retaining public ownership and others nationalizing private banks. Throughout the process, the enduring conflict between the relative authority of the Ministry of Finance and the Central Bank has often become a central issue.

Reform has had to take place in an international context. Countries have been forced to adjust to the increasing internationalization of banking markets, realizing that external interest rate changes, foreign exchange pressures and growth rates in competing economies could have a profound effect on domestic banking systems. The proper sphere of foreign owned banks within domestic economies has been an important issue in the international context. This paper offers some modest observations and analysis of these issues.

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A few words of caution. Developing countries encompass a wide variety of countries at different stages of growth and from regions of the world with different problems. The points made herein are based largely on the experience of Pacific Rim countries, and to a limited extent Latin America.

Also, it is worth noting that developed countries have faced similar problems, although stronger regulatory frameworks, more robust economies and more developed capital markets, have made these issues somewhat less significant to the growth of their economies. Nonetheless, one should not overemphasize the differences. The United States thrift industry demonstrates that troubled institutions are not exclusive to developing countries. Many developed countries have deregulated interest rates in the 1980s. The issue of segmented or specialized financial markets has been a dominant issue of reform in the United States, Canada, and Japan, as well as other countries.

France has nationalized and then privatized banks within the relatively short time span of eight years. While the issue of Central Bank authority has been settled in most developed countries, Canada has faced this issue in the not too distant past. The developed countries have faced their own version of globalized financial markets, as demonstrated by the interdependence of securities markets during the days of October 1987. And the role of foreign-owned financial institutions has been center stage within the EEC.

I. TROUBLED BANKING INSTITUTIONS

Many developed countries have a significant number of banking institutions with low or negative capital, and a significant percentage of banking assets which are non-performing. The causes of this situation vary. In a few cases, such as Taiwan and Brunei, particular bank failures can be attributed to the forces that have plagued banks for centuries: fraud, waste and abuse.[1] But these problems tend to be experienced by particular banks rather than by banking systems as a whole.[2]

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[1] *See e.g.,* R. Pura, *National Bank Was Khoos' Money Machine,* Asian Wall St. J., Feb. 2, 1987.

[2] Many of these problems might be prevented or ameliorated by establishing limits on loans banks can make to individual borrowers. These limits prevent concentration of portfolio risk.

More systematic factors are at work. Primary among them are policies of credit allocation under which banks have been directed by the government, or been given subsidies by the Central Bank, to allocate credit to particular sectors of the economy. Few, if any, developing countries have been able to replicate the successful Japanese experience with these policies. Forced credit programs have been destructive to banks even in countries with high economic performance, such as South Korea. It is estimated that in South Korea bad loans are 6.2 percent of total loans, and 1.3 times total equity capital.[3] The banking system has been left with negative equity in the basket case industries, shipbuilding and Middle East construction loans, without getting a positive equity in strong performing industries that greatly benefited by low-interest-rate loans.

In other countries, such as Mexico and the Philippines, banks have been hard hit by significant downturns in the general economy and/or by political unrest. The untold story of Mexican nationalization of the banks in 1982, during the beginning of the foreign debt crisis, is that the banks were bankrupt and unable to repay their foreign lenders as a result of the Central Bank's inability to repay to the banks their foreign currency reserves.[4] The Philippines' banks, while saddled with significant bad assets as a result of forced lending, also experienced a liquidity crisis as a result of the political unrest surrounding the Marcos-Acquino succession.[5]

Developing countries are now faced with devising methods of putting their banks on sound footing. Above all this is a question of resources. Funds must be found to strip the banks of bad assets, and to recapitalize these institutions. Given the size of the problem, significant resources may be involved. While financial sector lending by the World Bank has made a contribution to addressing this

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[3] Joong-ang Economic Daily, Oct. 11, 1988.

[4] Alan Robinson, *Portillo Pockets the Banks,* Euromoney, Oct. 1982, at 47.

[5] *See generally* M. Fry, *Financial Structure, Financial Regulation, and Financial Reform in the Philippines and Thailand, 1960–84, in* Financial Policy and Reform in Pacific Basin Countries 171–72 (H. Cheng ed., 1986); S. Lee & Y. Jao, Financial Structures and Monetary Policies in Southeast Asia 172–188 (1982).

problem in a few countries, most notably Turkey,[6] external funds for this purpose have been limited. A particular problem for developing countries in this regard is that there are no deposit insurance funds, financed by premiums collected during good times. Countries have begun to realize that the principal value of a deposit insurance system is not to insure deposits—this is done *de facto* through central bank extensions of credit—but to create a fund of resources to deal with troubled banks. Central bank credit delays do not solve the problem, and can be highly inflationary.

Most countries have dealt with the problem by the "hope and prayer" approach. Rather than committing resources to recapitalizing troubled banks, they hope and pray troubled borrowers will grow out of their difficulties. The problem, however, is that it is more likely that things will get worse, that troubled banks' negative capital position will deteriorate. This has certainly been the American experience throughout the prolonged thrift crisis.

The problem has been further compounded in certain developing countries—Brunei is a case in point—by the inability of regulators to spot the problem in time to take corrective action. Poorly capitalized banks can be rescued at far less cost than banks with negative capital. But the ability to act while it is relatively cheaper to do so often depends on monitoring capability beyond the capacity of supervisors. Competent, trained personnel are in short supply in supervising agencies, and outside accounting firms often do their employers' bidding.

Many countries suffer from cumbersome procedures for foreclosing on bad loans; banks are unable to force their debtors into bankruptcy or liquidate their assets. Even where such procedures are available, countries may direct their banks not to foreclose to avoid labor unrest or adverse political reactions. This has been a significant impediment in South Korea.

Systemic restoration of the banking system is possible. Spain did it in the 1978–83 period, but it had the advantage of having several strong large banks which could absorb the sick ones.[7] This option is

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[6] *See* G. Kopits, Structural Reform, Stabilization and Growth in Turkey 6–8, 12–14 (International Monetary Fund Occasional Paper 52, May 1987).

[7] M. Larrain and F. Montes, The Spanish Deposit Guarantee Fund 1–17 (draft, Feb. 1986).

unavailable in many countries. There are no simple recipes for success.

II. DEREGULATION AND REFORM

Interest-Rate Liberalization

Several developing countries have deregulated interest rates. Indonesia did so dramatically in 1983.[8] Three major reasons have led to interest rate liberalization. First, removal of controls on interest rates can relieve pressure on foreign exchange rates. For relatively open economies such as Indonesia, which permit free movement of funds in and out of the country, but do not have floating exchange rates, fixed interest rates on domestic deposits encourage movement from domestic currencies into foreign currencies. This in turn can cause a liquidity crisis for the domestic banking system, particularly where the central bank lacks monetary policy instruments, such as open market operations in government debt instruments, to counteract the shrinking of the domestic money supply. Allowing domestic interest rates to rise in response to expected depreciations brings more stability to the domestic monetary system.

A second major reason for interest rate deregulation is to encourage the growth of domestic savings. Interest rates set below the rate of inflation provide negative returns for savers. Thailand long suffered from a low *M1/GNP* ratio because no interest could be paid on demand deposits. Many Latin American countries have been forced by high rates of inflation to free up interest rates.[9] While some countries have tried to close their doors to foreign alternatives by imposing stringent foreign exchange controls, these controls have

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[8] Binhadi and P. Meek, Implementing Monetary Policy in Indonesia 1 (unpublished paper, Oct. 1988); S. Naya, *Economic Performance and Growth Factors of ASEAN Countries, in* The ASEAN Success Story 82 (L. Martin ed., 1987).

[9] J. Hanson & C. Neal, Interest Rate Policies in Selected Developing Countries, 1970–82 (World Bank Staff Working Paper No. 753, 1985); *see also* S. Lee and Y. Jao, Financial Structures and Monetary Policies in Southeast Asia 164 (1982).

often been massively evaded and have ultimately led to capital flight.[10]

The third major reason for freeing up interest rates is to introduce a measure of competition in the banking system. This was an important consideration in Indonesia whose banking system in 1983 was dominated by state-owned banks which controlled approximately 70 percent of domestic deposits, and which rarely competed with each other.[11] Absent competition for deposits, there was little pressure on these banks to cut operating costs and improve efficiency. Following interest rate deregulation, recent studies have shown that bank margins were cut to the benefit of both savers and borrowers.[12] Of course, competition also has its downside. Certain players may lose out in the competition. Central banks have often resisted interest rate deregulation out of concern for the safety and soundness of banks. But efficiency gains through competition requires risking that some banks will experience difficulties.

While the Japanese maintained interest rate controls on most deposits until the 1970s,[13] and South Korea continues to do so,[14] these models have limited applicability elsewhere. Both countries had relatively few problems with depreciating currencies or high rates of inflation. Further, the work of some economists suggests that service

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[10] D. Lessard & J. Williamson, *Capital Flight: The Problem and Policy Responses,* Policy Analyses in Int'l Economics No. 23, at 17 (Institute for Int'l Economics, 1987).

[11] *See* H.W. Arndt, *The Financial System of Indonesia,* 11 Savings and Development 305–306, 314 (1987); R. Robison, Indonesia: The Rise of Capital 218 (1986).

[12] J. Chant & M. Pangestou, An Analysis of the Efficiency of Indonesian Banking (preliminary unpublished draft, Apr. 1987).

[13] R. Feldman, Japanese Financial Markets: Deficits, Dilemmas and Deregulation 29–35 (1986); The Japanese Financial System 40–50 (Y. Suzuki ed., 1987).

[14] A. Virmani, Government Policy and the Development of Financial Markets: The Case of Korea 1–19, 48–52 (World Bank staff working paper 747, 1985).

levels to depositors and compensating balance requirements for borrowers introduced an element of price competition in these countries.[15]

Specialization

Many developing country banking markets have been characterized by a high degree of legally mandated specialization. While some countries like Mexico and the Philippines have followed the West German universal banking model, this is more the exception than the rule.[16] The specialization issue has four dimensions: (1) as between commercial banks; (2) as between commercial banks and other depository institutions; (3) as between depository institutions and other financial institutions; and (4) as between financial institutions and commercial enterprises. Each is now briefly discussed.

Commercial Banks

Legally mandated specialization among commercial banks may take a variety of forms. For example, in Indonesia the state-owned banks in the 1970s were directed to specialize in the financing of certain sectors of the economy, *e.g.*, agriculture, housing, oil and industry. Also state-owned banks generally financed state-owned industry, while private owned banks financed private firms. A limited number of private banks were licensed to deal in foreign exchange. This had certain deleterious effects on the banks. Risks were concentrated in loans to particular sectors and little incentive was provided to increase efficiency. Banks had their own markets and could sit back and let the borrowers come to them. This, in turn, had a significant potential for kickbacks of various kinds. Borrowers were ill-served by the policy, being dependent on one or two banks for credit, and even then at monopolistic prices. In Indonesia, and many

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[15] *See* D. Cole et al., Financial Systems Reforms, Concepts and Cases 64 (paper presented at the Harvard Institute for International Development Conference, Marrakech, Morocco, Oct. 26–29, 1988).

[16] Institute of International Bankers, Global Survey of Permissible Activities for Banking Organizations in Major Financial Centers outside the United States 19–28 (1988).

other countries, policies underpinning this kind of specialization are on their way out.[17]

Perhaps the best recent example of specialization has been the creation of Development Banks, banks specifically devoted to economic development (as if normal banks are not!). The creation of these banks was promoted and financed by the World Bank. The experience with these institutions has not been good. Many of them are bankrupt because they made loans to "worthy" but unproductive borrowers. This suggests that "development" loans must be subject to some type of market test. The experience also calls into question why subsidized lending, if it is going to occur, should be channelled through one institution. One might be better off spreading the losses.

Depository Institutions

A more enduring form of specialization is represented by systems in which various kinds of depository institutions have different powers and are subject to different regulatory regimes. Quasi-banks or non-bank financial institutions have been a significant phenomenon in many developing countries in the 1980s. Typically these institutions do not take demand deposits, but do issue time deposit substitutes in the form of promissory notes of various maturities and denominations. Payment system access for note holders can be achieved through movement of matured note proceeds to demand deposits at commercial banks.

Non-bank financial institutions (NBFIs) are usually subject to much lower levels of regulation than commercial banks. They are less regulated as to capital, they are often free from interest rate controls or forced lending policies, and they are subject to less stringent ownership controls, *e.g.,* shareholding ceilings. This has been the pattern in South Korea. As a result, NBFIs have grown at a much

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[17] *See* H.W. Arndt, *The Financial System of Indonesia,* 11 Savings and Development 305, 306–308 (1987); T. Balino and V. Sundararajan, *Financial Reform in Indonesia: Causes, Consequences and Prospects, in* Financial Policy and Reform in Pacific Basin Countries 191–219 (H. Cheng ed., 1986).

faster rate than their commercial bank cousins.[18] This has raised two principal issues.

First, the more highly regulated commercial banks have sought competitive equality. This has in turn spurred some deregulation in that sector. Second, there is the problem of the solvency of the NBFIs. While not regulated as banks, they still take public money. As a result, they are likely to be rescued if they become insolvent. While lower levels of regulations of NBFIs than banks may be justified on the ground that NBFIs do not take demand deposits, and thus their failure is less likely to trigger failures of other banks (since such banks do not hold clearing balances with them), the level of prudential regulation of these institutions is currently too low in many countries.

The legal manifestation of the specialization problem inheres in the definition of a "bank," since this definition determines which institutions will be subject to prudential regulation. If a bank is defined as an institution which takes demand deposits and makes commercial loans, a variety of depository institutions may escape prudential regulation. For example, even an institution which takes demand deposits may not be a bank if it restricts its business to consumer lending. And a company which takes deposits only in the form of promissory notes will also escape.[19] Yet, if either of these

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[18] S. Kwack and U. Chung, *The Role of Financial Policies and Institutions in Korea's Economic Development Process, in* Financial Policy and Reform in Pacific Basin Countries 177 (H. Cheng ed., 1986); Y.C. Park, *Financial Liberalization and Prospects for Resource Mobilization in Korea, in* Korea, the Year 2000 (1987).

[19] Banking Act § 2, Statutes of the Republic of Singapore, ch. 19 (1985 ed.); *see* Vernes Asia Ltd. v. Trendale Investment Pte. Ltd. & Anor., 1 M.L.J. 357, 362 (1988) and Indonesia (art. 1A of Act No. 14 of 1967 on Banking Principles, as translated by Bank Indonesia) (a bank is defined as an institution which takes deposits and makes loans. This leaves open the question of what is a deposit. Further, however a deposit is defined, it permits an institution to escape regulation if it only invests in securities (risky or non-risky), or if it uses the deposits to fund its own business. The latter problem was highlighted by the 10th Credit case in Taiwan where an industrial company, funded in part by employee deposits, escaped regulation as a bank but was rescued when it failed). *See* C. Goldstein, *Running to the Bank,* Far

institutions fail there will be significant political pressure from savers, noteholders and depositors, to make good on their contracts. If the state envisions rescuing these institutions, it must protect its commitment by making sure these institutions are run in a safe and sound manner.

In this writer's view, the proper definition of a "bank," for determining which institutions are subject to prudential regulation, is any institution which takes funds from the general public. The focus is exclusively on the liability side of the balance sheet. This definition raises certain problems. For example, is a commercial company which issues short-term commercial paper on the capital market to be considered a bank? It the company issues its paper in large denominations, this should not be considered to be taking funds from the "general public." But if the denominations were small enough, there is little reason to distinguish commercial paper from time deposits. Of course, if the government of a country were clear that investors in small denomination commercial paper obligations would not be protected against the insolvency of their debtor, and was prepared to announce this policy in advance, and stick to it in the event it was tested, the line could be drawn differently. It is doubtful that this would occur, however, in most developing countries.

Financial Institutions

Another aspect of the specialization issue is whether banks should be allowed to engage in non-banking type financial activities, such as insurance or securities (brokering, dealing and underwriting), or whether the markets for these services should be separated from banking. Separation deprives banks of serving customers needing such services, *e.g.,* the large corporation which wants to issue commercial paper rather than getting a bank loan or the consumer who wants to save through whole life insurance rather than through a time deposit. The customer, in turn, is deprived of one-stop shopping for financial services. Economies of scale, which can be realized through computer systems and distribution outlets such as branches, are sacrificed. And firms which cannot diversify their product portfolios are subject to more risk. There is empirical evidence, for example, that profitability

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Eastern Economic Review 50–51 (Mar. 7, 1985); A. Rowley, *Problems of Overexposure,* Far Eastern Econ. Rev., May 15, 1986, at 87.

of banking and securities businesses are counter-cyclical, *i.e.,* banking profits are down when securities profits are up, and vice-versa.[20] The principal argument against allowing banks to engage in these businesses is that they are too risky. But experience with the core banking business in developing countries— and some developed countries—shows that the banking business is itself risky. Otherwise we would not have the troubled institution problem previously discussed. Furthermore, if risk is a concern, one could require the activity to the organized in an affiliate where losses would only impact the holding company and not bank capital, or in a subsidiary of the bank up to a certain percentage of bank capital. The latter policy is followed in some European countries, *e.g.,* the United Kingdom, while others allow securities activities directly in the bank, *e.g.,* Germany.[21]

Many banks in Latin American countries can engage in a wide range of financial services, and have followed the German universal banking model. Mexico is the leading example.[22] In Asia, the picture is more mixed. While Hong Kong has universal banks,[23] Indonesia and South Korea have followed the Japanese-U.S. model and enforced separation between banking and the securities and insurance businesses.[24] What explains this choice? Some countries, such as

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[20] Note, *Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation,* 97 Harv. L. Rev. 720, 728–29 (1984).

[21] Institute of International Bankers, Global Survey of Permissible Activities for Banking Organizations in Major Financial Centers outside the United States 20, 59 (1988).

[22] Jorge Graf, Nueva Legislacion Bancaria 15–17 (Porrua ed., 1985); Miguel Romero, Derecho Bancaria 362 (Porrua ed., 1978).

[23] Institute of International Bankers, Global Survey of Permissible Activities for Banking Organizations in Major Financial Centers outside the United States 29–34 (1988).

[24] Far Eastern Economic Review 68–70 (Nov. 10, 1988) (Korean restrictions are reflected in arts. 18, 22 and 25 of Korea's Banking Law. The Indonesia restrictions on bank securities activities may be changed with adoption of financial reforms adopted on Oct. 27, 1988).

Indonesia, have been concerned about their capacity to supervise universal banking institutions. Bankers and other financial service providers, particularly insurance firms, have sought to avoid head-to-head competition. Most importantly, perhaps, different bureaucracies often regulate insurance and banking. Merger of the two services would cause bureaucratic realignment and loss of power for some.

FINANCIAL AND COMMERCIAL FIRMS

This aspect of separation has two aspects. First, the question of whether commercial firms may own banks, and second, whether banks may invest in commercial firms.

In most developing countries, the line between commerce and banking is maintained at the ownership level. Several countries, like South Korea, are concerned with the issue of concentration of power. South Korea requires that no shareholder hold more than 8 percent of a nationwide commercial bank.[25] This limit was adopted in order to prevent the conglomerates from owning the nationwide commercial banks (they can and do own regional commercial banks and NBFIs, however, where such limitations do not apply). This issue is irrelevant where banks are publicly owned, as in the case of the Indonesia state-owned banks, but there is a distinct concern over concentration in the case of privately owned banks in Indonesia and Thailand. Most European countries, as well as the United States and Japan, also limit commercial firm ownership of banks.

In developing countries, where there are extended family relationships, typified by the Chinese community, enforcement of commercial-financial separation for closely held firms is difficult. One brother owns the bank and another brother owns the commercial firm. This is often the pattern in Taiwan, and within overseas Chinese communities. The *10th Credit* case is an example. Cross-ownership in small percentage amounts within a corporate group, *e.g.*, each of twenty

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[25] Art. 17, cl. 3 of the Korean Banking Law.

group firms owns 5 percent of the group's bank, may also evade or avoid ownership restrictions. This may be the case in Japan.[26]

As for investment by banks in commercial firms, such investments are tightly controlled in many developing countries, reflecting concentration concerns, as well as additional considerations of risk and supervisory capacity. In principal, the risk issue should be no different for securities activities than for automobile manufacturing as the bank's risk is limited. Again, this can be done through requiring the activity to be placed in an affiliate, or in a bank subsidiary in which the capital investment is limited.

Ownership: Private or Public?

This paper has already touched on one aspect of ownership, whether commercial firms can own banks. The focus here is on public versus private ownership.

There are many developing countries in which banks are state-owned, *e.g.,* India, Mexico, Philippines and Indonesia. While one cannot ignore the socialist ideology underlying such ownership, often other considerations are predominant. In Mexico and the Philippines, banks became publicly owned in the 1980s largely because the banks were insolvent. State ownership went with state rescue. In principle, the phenomenon was no different than the case of Continental Illinois in the United States. One might expect banks nationalized for solvency reasons to be privatized as soon as they can be restored to health. The timing is a matter of the resource issue already discussed with respect to troubled institutions.

In Indonesia different forces are at work. State ownership of banks may be maintained to avoid the Chinese dominance of the banking system that might result if banks were privately owned. Privatization of banking could stir ethnic fears. At the same time, however, it is interesting to note that the market share of privately owned banks (largely Chinese controlled) has been growing at the expense of the public sector since interest deregulation in 1983. This form of privatization (by market share rather than institutions) is less visible but, nonetheless, significant. It may be the only politically acceptable way to realize the benefits of private ownership. Despite

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[26] 5 Doing Business in Japan §1.03[6] (Z. Kitagawa ed., 1988); Kaisha Shikiho, Toyo Keizai Shinpo-sha 810–17 (Spring 1989).

heroic efforts by the state banks, it is still questionable whether Indonesian banking can be modernized and made more efficient without more of a role for private enterprise.

South Korea privatized its major commercial banks in 1982.[27] Yet, these banks were and are troubled institutions, highly dependent on central bank credit. Their management and direction is dominated by the government. The control position of the government is further enhanced by the 8 percent share ownership limitation that prevents any strong economic firm, such as one of the conglomerates, from controlling one of these banks. The case of South Korea illustrates that private ownership in and of itself may not cause a firm to act much differently than if it were publicly owned. It also raises the troubling question of whether the government could reasonably oust current shareholders, as part of a plan to restructure the commercial banks, given that it was the government which sold the banks to investors without fully disclosing the nature of the bad loan problem.

III. REGULATORY AUTHORITY: CENTRAL BANK (CB) VERSUS MINISTRY OF FINANCE (MOF)

Japan and the United States offer two polar models of the relationship between the CB and MOF. In Japan, the Bank of Japan is largely subservient to MOF;[28] in the United States the Federal Reserve Board is independent from the Treasury. Other countries take some intermediate position. In Canada, for example, the Finance Minister must publicly order the Governor of the Central Bank to follow his direction in cases where the Governor disagrees. While this reposes ultimate authority in MOF, the Minister may be restrained from issuing such an order because of the accompanying publicity.

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[27] C. Lee, *Financial Reform Experiences in Korea, in* Financial Policy and Reform in Pacific Basin Countries 138 (H. Cheng ed., 1986).

[28] The Japanese Financial System 314–315 (Y. Suzuki ed., 1987).

This, in turn, may force the two institutions to reach a compromise.[29] Developing countries, such as South Korea and Indonesia, have special considerations when choosing among these approaches.

South Korea has in recent times followed the Japanese model. This has been justified by the belief that the government needed to have a coherent monetary and regulatory policy. The Bank of Korea was to execute the policies set by the government. Recently this approach has been under attack by opposition parties and the Bank of Korea. A bill has been proposed[30] to limit the power of MOF to control the Central Bank. The bill proposes to make the Bank of Korea independent from MOF in matters of monetary policy and to give the CB more regulatory authority over banks and NBFIs.[31] MOF would only have regulatory authority over securities and insurance companies.

The independence of the Bank of Korea is part of the democratization agenda of the opposition. In fact, the call for independence can be seen as an attack against the government. One would question how serious the opposition would be about independence if they were in power—they have not called for extending the terms of the Board members beyond four years, which corresponds to the term of the government.

Nonetheless, the MOF must take some responsibility for the current troubled state of Korean banks, and there is some merit in the Bank of Korea position that forced lending, and the resulting bad

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[29] B. Crawford, 2 Banking and Bills of Exchange 1076–77 (1986).

[30] Bill No. 273 (submitted by Congressman Chunwon Lin, to amend Bank of Korea Act, Nov. 30, 1988).

[31] Under the proposal, the Monetary Board would be given more power. The Bank of Korea Governor would chair the Board, rather than the Minister of Finance, as under present law. In addition, the domain of the Monetary Board would be expanded to cover monetary policy and the supervision of NBFIs, as well as commercial and specialized banks. Also, the Prime Minister, rather than the Minister of Finance, would make the recommendation to the President of a new Bank of Korea Governor. *See generally Bank of Korea Fights for Autonomy,* Financial Times, Dec. 1, 1988.

loans, might have been prevented or retarded if MOF had been unable to use Bank of Korea to encourage and subsidize this process. However, the fragmenting of authority between MOF and the CB, with MOF having insurance and securities and the CB banking, may create a serious obstacle to breaking down the walls between these financial service sectors.

The Bank of Indonesia is relatively independent, in practice, from MOF. Although major monetary policy decisions are made through a Monetary Board, which is chaired by MOF, Bank of Indonesia exerts considerable influence in the process through its expertise. On the other hand, ultimate monetary policy decisions may rest beyond either institution with the "wise man" group of economists who have traditionally had a major role in economic decision-making.

It is relatively more clear that the CB dominates regulatory policy in the banking field. MOF is not required to assent to regulatory initiatives of the CB. On the other hand, MOF retains sole authority over NBFIs, even those taking deposit substitutes, *e.g.,* promissory notes, as well as insurance firms and securities companies. This split authority has caused problems. In recent years, MOF has favored deregulation and increased competition between banks, while CB, out of concern with safety and soundness, has often resisted that approach. Thus, while MOF was instrumental in deregulating interest rates in 1983, CB continued to pursue policies which had the effect of limiting competition among banks. The tug between safety and soundness, championed by the Bank of Indonesia, and competition and efficiency, championed by MOF, may have to be resolved before a comprehensive reform in the banking sector can take place.

IV. INTERNATIONALIZATION OF MARKETS

Prices

Banks in many less developed countries are significantly affected by developments in external markets. This is particularly true when there is free movement of funds into foreign currencies, and into and out of the country. The paper has already suggested that interest rate deregulation in Indonesia is partly explained by this reality.

Perhaps the best indication of the effect of external markets on the banking systems of developing countries in Asia comes in the form of determining how deposits and loans are priced. Pricing in most

countries is usually done on the basis of a "reference rate" for short-term money, *e.g.,* the Fed Funds rate in the United States or LIBOR in the United Kingdom. These are rates at which banks will buy or sell short-term funds from or to each other. Transactions with customers are then priced with regard to these reference rates, *e.g.,* LIBOR plus 2 percent.

At a recent conference of experts from several Asian countries, the issue of the reference rates was discussed.[32] For Indonesia, the reference rate for funds bought and sold by banks in Rupiah was said to be SIBOR (the Singapore inter-bank U.S. dollar rate) plus a premium for expected changes in exchange rates between the Rupiah and the U.S. dollar (in practice, the foreign currency swap premium), while for Thailand it was LIBOR plus a premium. This indicates that domestic transactors in these countries feel constrained by external rates. If Indonesian banks pay SIBOR plus a swap premium for funds, they are recognizing that banks selling funds will sell to Singapore banks at lower rates. Thus, the Indonesian rates are highly conditioned by competition for funds in external markets.

Singapore's reference rate for SIBOR is U.S. dollar LIBOR, suggesting that Singapore U.S. dollar rates are conditioned by rates in London. Thus, developments in developed country markets (London) are transmitted to Indonesia through Singapore.

Internationalization depends on open markets, but as the paper has earlier suggested open markets may be necessary in order to avoid capital flight and to encourage the development of domestic credit markets. Korea has resisted opening its markets; it still employs foreign exchange controls, as did Japan for many years. Perhaps this is a luxury for a country with a currency which is appreciating against the yen as well as the dollar. Capital flight is not a real concern in such circumstances.

Internationalization of banking markets means less control for developing countries over interest rates and foreign exchange rates, two major tools of economic policy. At the micro level it means less control for bankers over the rates on deposits and loans.

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[32] Program on International Financial Systems (unpublished minutes of conference in Singapore sponsored by Harvard and Columbia Universities, Aug. 20–21, 1988).

Participants—Foreign Banks

An issue facing many developing countries is the proper sphere of operation of foreign banks. In many countries, the number of foreign banks is limited. In addition, there are significant limitations on the products and geographic location of foreign banks. Often foreign banks cannot take local currency deposits from the public, and may only operate in the major cities.[33]

Countries are reexamining these policies. While originally adopted to protect local institutions from competition, and to protect the economy from foreign domination, the negative aspects of these policies are beginning to surface. In many countries foreign banks can facilitate foreign investment through financing foreign firms doing business in the country. In some countries with concentration of private ownership, or public ownership, foreign banks may offer needed competition to spur domestic banks to become more efficient.

If developing countries want to liberalize the treatment of foreign banks, they might consider the Canadian approach. Foreign banks could be given the same powers as domestic banks, and competition among foreign banks could be encouraged by licensing new entrants. On the other hand, the market share of foreign could be limited.

The Canadian Bank Act currently restricts the Schedule B foreign bank subsidiaries (the six major banks are Schedule A banks), as a group, to 16 percent of the total domestic assets of all banks in Canada.[34] Until the spring of 1988, this 16 percent market-share limitation was sub-apportioned between foreign banks based on what these banks did for Canada, *e.g.,* loans to preferred sectors such as the middle market.[35]

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[33] The U.S. Department of the Treasury's National Treatment Study (1986 update detailing the various restrictions on foreign banks in selected developing and developed countries).

[34] Bank Act, § 302(7) and Schedules A and B.

[35] Telephone conversation with Suzanne Labarge, Deputy Superintendent of Financial Institutions (Nov. 22, 1988). This was accomplished by requiring each foreign bank to apply for "deemed authorized capital" which when applied to a gearing ratio determined the total assets that could be held by each foreign bank. The United

In thinking about the role of foreign banks, a key issue is whether host countries should require them to operate in branch or subsidiary form. A number of considerations come into play. From a regulatory point of view, branch form may be preferable. The entire capital of the home country bank backs up its host country office, and its safety and soundness will be supervised by more sophisticated home country regulators. While there is no capital as such within the country, the assets of the branch, plus normal in lieu of capital requirements set with relationship to deposits, protect against the branch dishonoring obligations to depositors. On the other hand, branches by their very nature are wholly owned. If a country wanted to encourage joint-ventures with domestic investors it would opt for the subsidiary option.

V. CONCLUSION

The 1980s have left developing countries with a legacy of troubled banks. These troubles were mainly produced by the credit allocation demands of governments which led to bad loans—sometimes, as in the case of Latin America, from the banks to the government.

But as these problems are being digested, we seem to be entering into a new era of reform, characterized by liberalization of interest rates, elimination of specialization requirements, and privatization of ownership. These reforms reflect dissatisfaction with the controlled markets of the past, and a new willingness to allow freer markets to operate. They also reflect the reality of the dependence of domestic financial markets on international ones.

States, as part of its recent Free Trade Agreement with Canada, has succeeded in removing these restrictions for United States banks; art. 1703(2) of the Canada-United States Free-Trade Agreement, as reprinted in 27 International Legal Material 281, 381–82 (1988).

III. SALES AND PRODUCTS LIABILITY