Banking, Financial, and Regulatory Reform

Liu Mingkang
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Group of Thirty, Washington, DC

Occasional Paper 75

30

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Introduction

The three speeches presented here were delivered at the 57th plenary session of the Group of Thirty, held April 26th through April 28th, 2007, in Hangzhou, China.

The Group of Thirty is grateful to the authors, Liu Mingkang, Chairman of the China Banking Regulatory Commission; Roger Ferguson, Chairman of Swiss Re America Holding Corporation; and Guillermo Ortiz Martinez, Governor of the Banco de México, for allowing their presentations to be published as a Group of Thirty occasional paper. We are sure that their remarks on banking, financial, and regulatory reform will be of interest to the central banking community, in particular, and to the financial community, more generally.

Banking and Regulatory Reform: The Chinese Experience

Liu Mingkang[1]

In my remarks today, I will discuss two key themes: the progress being made by China's banking industry through reform, and how we got there.

Progress Made

Generally speaking, China's banking industry has been greatly strengthened during the past three years. From 2003 to 2006, the number of banks in compliance with the capital adequacy ratio (CAR) increased substantially, from a mere eight at the end of 2003 to the current 100. Further, the assets of those adequately capitalized banks accounted for only 0.6 percent of the total banking assets in 2003, and now cover 77.4 percent of the total. The shortfall of loan loss reserves narrowed from US$200 billion to only US$58 billion, the stock of Non-Performing Loans (NPLs) declined from US$254 billion to US$150 billion, and the NPL ratio declined from 17.9 percent to the current 7 percent.

In addition, we have witnessed an enhancement in corporate governance and commercial-oriented operations, improvements in the

1 Chairman, China Banking Regulatory Commission.

structure of bank portfolios and large exposure control, and a decline of criminal cases. Further, the Return on Equity (ROE) ratios for the reformed banks run from 14 percent to 17 percent in general, and Return on Assets (ROA) ratios run from 0.7 percent to 1 percent. The average cost-revenue ratio is well controlled below 35 percent, and most of the large and medium-size banks have been floating on capital markets both at home and abroad. In terms of capitalization, for the first time in China's banking history, three of our banks are among the top 10 worldwide, namely, the Industrial and Commercial Bank of China, which ranks No. 3 today, and sometimes No. 2; the Bank of China, which ranks No. 6; and the Construction Bank of China, which ranks No. 7, and sometimes No. 6.

That is the general picture of the progress made by China's banking industry. Now I will discuss how we got there.

The Five Essential Elements for China's Banking Reform

Our experience suggests that five essential elements must be in place to ensure the success of China's banking reform and restructuring.

First, it is imperative to establish goals and to formulate an overall plan. Simply put, the future does not improve by Chinese dreaming or hoping. It gets better by scientific plans. And to plan the future, we need goals. Keeping this in mind, beginning in 2003, we started to work very closely with the People's Bank of China (PBOC) in order to create a building-block approach to replace piecemeal reform, because the latter proved to be of no use to us during the last few years. After carefully studying all the existing problems and gaps between our old practices and international best practices, we set goals for banking reform and restructuring, starting with two types of financial institutions. One is the five large state-owned commercial banks, and the other is rural financial institutions, particularly credit unions. During this whole process, we are well aware that the goals must be challenging but realistic. We have repeatedly told the regulated bodies: it is a goal that you must achieve; it is not a hope.

Second, to implement the plans, what we need is a sequenced approach. This is even more important to a transitional economy like China. We must understand fully which one should go first, and which one should go next, by taking into account the social and economic costs, and the impact on the regulators, regulated bodies, and borrowers. Otherwise, it is just like the saying, "put the cart before the horse," which could be very costly.

Third, productive dialogue and proper incentives are very important, because, after all, the key to all motivation is desire. It lies in the regulated bodies' desire to change, instead of the desire of the regulators. To encourage people to make changes, we need cooperation and common effort. For instance, the government offers funds to help the large, significant banks lessen their historic burdens, resulting from the long-lasting planned economy. For the rest of the banks, however, we focus on providing incentives, mobilizing desires of the localities, and linking the changes with licensing. These prove to be very effective, because the banks can have their own incentives to make changes. Ultimately, all these incentives and motivations will be channeled by effective dialogue between the regulator and regulated bodies, and their shareholders.

Fourth, consistent assessment and prompt corrective actions are necessary, because the simple truth is: we need to find out whether there is something wrong, and whenever and wherever we go wrong, we should get back on the right track as soon as possible. For example, we encourage our banks to open their doors and usher in foreign institutional investors. To succeed in doing so, we must seek two things: synergy and long-term commitment. To achieve synergy, we need to make sure that both parties work very closely with each other; in particular, China is now in the most crucial stage of its opening up. Probably an analogy can best illustrate my point here: as we know, the middle years of marriage are the most crucial and sensitive, because in early days, people want each other, and in later years, they need each other. Because now we are marching into the third year (middle years) of opening up, it is our duty to have very consistent assessments to make sure that people are still pledged to work together to achieve the synergy.

Fifth, with limited resources of the regulators, which I think is a common problem among regulators worldwide, we should be focused on the most important issues and make them very clear. In China, from day one of reform and restructuring, we made it very clear to the regulated bodies that there are six missions they have to bear in mind. To arm our banks with modern technology and managerial skills, the first thing is to match the benchmark of capital adequacy ratio. The second is provisioning coverage ratio, because this is the major risk for a transitional economy. The third is large exposure control; in China, we still have many SOE[2]-run companies, which are bank customers, and that is why we are very tough in controlling the large exposures, by stipulating that no single borrower can borrow more than 10 percent of a lender's equity. The fourth issue concerns impaired assets. That means all the banks must be focused on the reduction of NPL ratios and the reduction of NPL stock, and at the same time guard against the risk of NPL flows, because this is a real risk in the long run. The fifth issue is transparency and information disclosure, which had been very poor in the last few years but which has recently greatly improved. This improvement has been due to all the banks implementing the so-called "sunshine project" and moving toward greater transparency, especially listed companies, because these firms face the additional discipline of the public markets. Finally, the sixth issue is the accounting standards. Fortunately, at last, we have embraced the new accounting standards, which are 99 percent similar to the IFRS[3] standards.

Looking Forward

We have identified several key areas in order to do a better job.

One is that in doing supervision, we must focus on the head office. We all know the old saying well: a fish always stinks from the head. If the head office does not turn around in a correct way, the corporate governance will not make any sense.

Second, regarding supervision, we should attach more importance to the following areas: risk-based supervision, which should be the top priority as we go forward; and the need to be focused on consolidated supervision, because banks are becoming ever more complex and sophisticated in terms of their organizational structures and business. Therefore, instead of the bank-wide supervision, we must have consolidated group-wide and international-wide supervision.

To that end, the CBRC[4] has established functional supervision departments, which are composed mainly of holders of MBA and doctorate degrees, to balance the institutional supervision departments. In addition, we are also trying to strike a balance between off-site surveillance and on-site examination. For a transitional economy

2 State-owned enterprise.
3 International Financial Reporting Standards.
4 China Banking Regulatory Commission.

like China, we put more focus on the on-site examination, but since the quality of data is constantly improving, the feedback from off-site surveillance is becoming more and more important.

Finally, we are trying to appropriately combine rule-based supervision with principle-based supervision. For such above-mentioned areas like the CAR, provision coverage ratio, large exposure control, impaired assets, and accounting standards, we exercise rule-based supervision, while for innovation, IT security, corporate governance, transparency and information disclosure, and so forth, we conduct principle-based supervision. Of course we have clear-cut lines between principle-based and rule-based supervision to ensure that both regulators and regulated bodies have more room to maneuver in the future.

Conclusion

To conclude, I would like to quote two old English sayings. One is, "April showers bring May flowers," because the lessons drawn from the Russian-style outdated practices can provide good examples and ultimately result in best practices. The second is a saying from Mark Twain, who once said, "If we have any enemy, it is us." All along the way forward, we have to and we will fight against our own shortcomings, through efforts ranging from mindset change to the improvement of concrete infrastructure.

Thank you.

The Trinity of Regulatory Reform

Roger Ferguson[5]

I will start my talk by describing the trinity of regulatory reform confronting the G10 economies: (1) regulatory approach, (2) regulatory convergence, and (3) regulatory impact.

Regulatory Approach

First, on regulatory approach, I will pick up where Liu Mingkang left off, on the issue of rules versus principles. As often happens, complex and nuanced systems are sometimes described in simplistic terms and stark contrast, so that we can talk about them a bit more easily. The current debate going on in and among the G10 economies about rules versus principles is one such case of gross simplification for the sake of sharpening an argument. In fact, the dichotomy is false. Similar to what we just heard from Liu Mingkang—those of us who come from rules-based regulatory regimes base our rules on principles and consider ourselves to be principled individuals. Those from principles-based regulatory systems rely on rules to bring their principles to life.

The most obvious example of a principles-based system is the one used by the Financial Services Authority (FSA). The head of the organization, Sir Callum McCarthy, recently explained that the FSA has 11

5 Chairman, Swiss Re America Holding Corporation, and former Vice Chairman of Board of Governors of the Federal Reserve System.

core principles governing both it and the firms and individuals it supervises. Those 11 principles take about 194 words to explain, but then Callum is quick to go on and focus on the fact that the FSA is also an organization with a very large rule book of about 8,500 pages of rules and guidance. The reality is, always has been, and always will be, that principles-based regulation approaches have been a mixture of general principles and particular rules. Rules-based approaches have been a mixture of particular rules and general principles. Therefore, we in the West, similar to what we just heard from Liu Mingkang, seek a balance between the two—a greater reliance on general principles in the context of broader rules.

Thus goes the first great debate over rules versus principles: I would say that the issue is not "either-or," but rather "both-and."

The second issue that we are dealing with under the regulatory approach is prudential regulation versus enforcement. This is more important and goes to the differences that emerge in how to apply these rules. Banking regulators are clearly prudential regulators, driving the industry as we just heard from Liu Mingkang, with a combination of incentives and influences in order to get them to pursue sounder practices. At least in the United States, and in many other economies, our securities regulators are clearly an enforcement agency with a very strong sense of how powerful those rules are. In the United States we have 51 insurance regulators who all have a strong focus on micromanaging the industry, managing everything from approving products, to the introduction of new elements to products, to pricing, claims handling, and so on. So our bigger challenge, then, is how to balance prudential regulation versus enforcement. Here, again, I think that the dichotomy is too strong. When I look at what my former colleagues do at the Federal Reserve, they are prudential regulators but they do not hesitate to enforce our rules. When I look at what happens among securities regulators, we find that they clearly are moving toward a prudential approach. As an example, the concept of consolidated supervision is being used at the SEC,[6] taking a page from the Federal Reserve.

On the first of the great trinities, I would say the regulatory approach really has been filled with false, or at best, overstated, dichotomies. This is certainly true for rules and principles—even prudential regulation and enforcement are drawing together.

6 Securities and Exchange Commission.

Regulatory Convergence

Let me turn to the second part of the trinity: regulatory convergence. The convergence question has two elements. One is structural choices and the other is the issue of mutual recognition and access for securities markets. Structural choices really do create a significant dichotomy between and among us. The debate here is well known to all. We have seen that there is clearly a trend toward the creation of financial services administrations of one sort or another, with the U.K., Japan, Germany, and Canada being most notable. On the other hand, there are a number of us that stick to industry-specific regulation. It is still alive and well in China, for example, and also in the U.S.

Also related to this issue of FSAs versus industry-specific regulation is the key question of central banks—should they be in regulation or out of regulation. The United States, the Netherlands, Spain, and Italy represent the traditional view. Obviously, those that have created FSAs have taken much of the authority away from the central banks. And, finally, there is an important dichotomy that exists between safety and soundness supervision versus market-conduct supervision. Here I will say we all follow both approaches.

It is difficult to say which of these various models is better, in part because the different models have not been tested by financial crises and because they each exist in a special cultural context. Therefore, those who are looking for guidance are forced to consider hypotheses, not experiences, in selecting among these various structural approaches.

The key questions for those favoring FSA structures, in particular, those who wish to move central banks out of regulations, fall into three categories.

First, can one entity effectively build and maintain the skills that are required to cover such a divergence of rapidly growing financial sectors?

Second, and particularly important in time of crisis: Will the information exchanges and coordination mechanisms that have been put in place on paper and tested from time to time work between and among the new FSAs, central banks, and treasuries?

And the final question for those who favor FSA structure and moving central banks out of regulation is: How does one avoid creating the imperial regulator—one that is a complete monopolist with no checks or balances?

Those who favor a more traditional industry-specific approach, in particular, those who favor central banks in regulation, also have questions to deal with.

The first is related to industry-specific regulation, namely: How do you deal with the obvious and very powerful forces of convergence across institutions and markets?

The second is: How do you have regulatory competition without having that become a race to the bottom? This is the question which was first raised by none other than Paul Volcker.

The third is: How do you avoid regulatory capture? This is particularly important for smaller, less-sophisticated regulators.

And finally, the obvious issue: Are there tensions and conflicts between central banks that oversee monetary policy and their role in supervision and regulation? Put another way, is there a risk of forbearance on the supervisory front in order to deal with macroeconomic shocks?

Certainly, I would say in this context of regulatory structure, in both Europe and in the U.S., there are fixes that are required. In Europe, the question of burden-sharing turns out to be a very hot, politically sensitive issue. This issue rises in importance as we finally see cross-border convergence in the banking sector.

In the U.S., while we are likely to stick with our industry-specific approach, there clearly is some low-hanging fruit of regulatory reform. How do we finally move forward to merge the SEC and the CFTC[7]? How do we merge two banking regulators, the OCC[8] and the OTS[9]? How do we create an optimal federal charter for insurance supervision?

The second element of regulatory convergence is the question of convergence versus national standards. This is of particular importance when it comes to dealing with exchanges and stock markets. Securities markets are traditionally national. They are identified by their country of origin and subject to domestic market regulations. However, in a fully electronic trading world, the challenges of maintaining national standards in a borderless environment have become palpable.

The question, of course, is: Why do national securities regulators care about maintaining their national standards for investor protection and also for orderly markets? Why do we continue to apply domestic market rules and find them so important when in fact we are in a world

7 Commodity Futures Trading Commission.
8 Office of the Comptroller of the Currency.
9 Office of Thrift Supervision.

of global capital movements? The very simple answer is that in each of our economies, in the U.S., in Continental Europe, and certainly in the U.K., we believe that our national regulatory regimes, even while changing over time, have fostered the development of the finest security markets in the world. And we certainly see, through the financial press, that there is a great deal of competition about which regulatory environment is stronger and better for the creation of capital and capital-building capabilities.

I think there has been a long-standing concern that it will be difficult to maintain a strong sense of domestic superiority if nations allow their securities regulations to converge too dramatically. A challenge, of course, is that our well-informed, technologically savvy investors have an ever-increasing appetite for investment products that are offered by foreign markets.

The reasons for their appetite for these products are many. One important reason is the desire to diversify their portfolios; another is their interest in accessing the growth opportunities of other economies, particularly in emerging markets; and clearly, issuers and markets have a strong interest in directly accessing a broader investment base. So, globally, we have relatively sophisticated and experienced investors with capital to spare and a high degree of confidence in a number of markets, but we continue to insist on local regulation.

So the question is: How have the securities regulators dealt with this important issue of convergence? They have gone to IOSCO[10] meetings to consult. This is clearly not sufficient, but it is certainly the first step. The good news is that securities regulators are looking for new cooperative approaches. They clearly are looking for a common set of standards having to do with investor protection, market behaviors, and importantly, information sharing. And the SEC has started to indicate a willingness to talk directly to the FSA about sharing some common views on markets.

Regulatory Impact

Let me turn to the third element of my regulatory trinity: regulatory impact. As you know, there is a cottage industry of studies on the impact of regulation on the competitiveness of U.S. markets. Reports by my former professor, Hal Scott, my former colleagues at McKinsey and

10 International Organization of Securities Commissions.

Company, and my friends at the U.S. Chamber of Commerce all suggest that the U.S. financial markets are losing competitiveness.

There is no question that Initial Public Offerings (IPOs) have recently moved to Asia. This is for the obvious reason that the institutions being IPO'd are Chinese. It is also true that the U.K. has managed to attract a large number of listings that would not meet U.S. standards. Much of the issue of loss of competitiveness by U.S. firms or U.S. markets is due primarily to a growing reflection of broader pools of capital emerging in Europe, Asia, and the Middle East. Having said that, it is also clear the U.S. should ease some of the burdens that have emerged. Fortunately, the U.S. is still considering ways to do just that.

One challenge is the very strong, litigious environment in the U.S. I will not take sides in this debate on litigation reform. I suspect fear of litigation will continue to be a part of why the U.S. capital markets may, on the margin, be somewhat less attractive than they have been in the past.

The second challenge that we are dealing with is certainty of regulation. I am referring to Basel II. The impact of Basel II, particularly on safety and soundness, has been well considered. The incentives to improve risk management are strong. I think the U.S. has a clear interest in moving on with Basel II now that it has been adopted in Europe.

So I conclude my discussion of the so-called regulatory trinity by saying that, unlike other trinities, this one is not totally impossible, it is just merely challenging.

Thank you very much.

Banking, Financial, and Regulatory Reforms: The Mexican Experience

Guillermo Ortiz Martinez[11]

After the banking crisis of the mid-1990s, Mexico implemented several regulatory reforms that allowed the banking industry to expand on a firm foundation. However, new challenges for the industry and for the financial authorities have emerged. Some are related to the fact that most of the banking sector in Mexico is foreign-owned as a consequence of the measures taken to overcome the crisis. Others arise from an insufficient degree of competition in the banking industry.

Financial Reforms in Mexico from 1995 to 2006

The 1995 Mexican crisis had a profound impact on the economy. Two figures help to illustrate the scale of the crisis: (1) the total cost of the banking-sector rescue reached about 18 percent of GDP; and (2) real wages in the manufacturing sector took almost 10 years to recover to pre-crisis levels.

The first actions addressing the crisis were aimed at recovering macroeconomic stability. Strict fiscal and monetary discipline, the adoption of a free-floating exchange rate, and an inflation-targeting framework

11 Governor, Banco de México.

has gradually brought a degree of macroeconomic stability to Mexico not seen in the last 30 years. Figures 1 and 2 show that both fiscal and monetary policies were geared toward lowering inflation and getting back to healthy public sector finances.

FIGURE 1. FISCAL DISCIPLINE
FISCAL DEFICIT AND PUBLIC SECTOR BORROWING

(As a % of GDP)

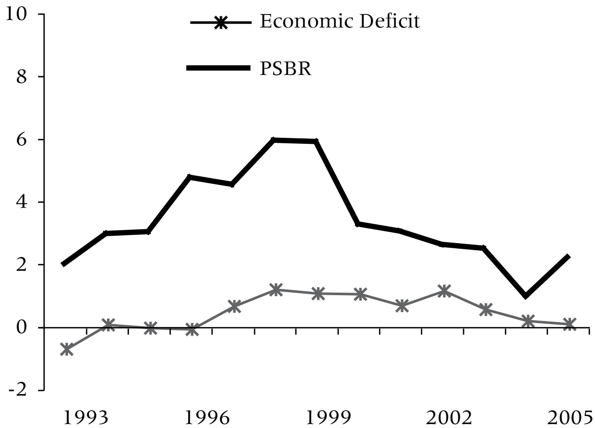
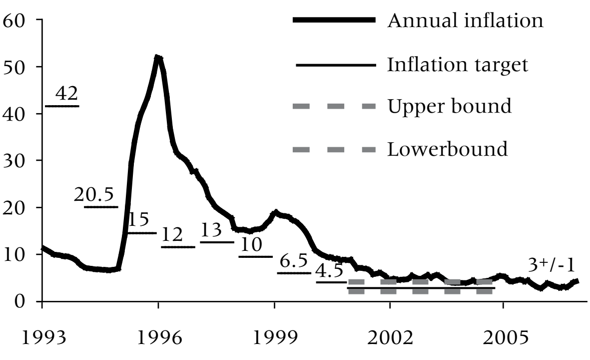


FIGURE 2. MONETARY POLICY: INFLATION TARGETING
ANNUAL INFLATION: TARGETED AND OBSERVED

(%)



Source: Banco de México.

To minimize the vulnerability of public finances to adverse interest- and exchange-rate movements, the government has actively managed its debt, improving the amortization schedule and relying more on debt denominated in local currency. The debt-to-GDP ratio has been cut by more than half since 1996 to its current level at around 25 percent of GDP. Even when taking into account the remaining contingencies left over from the banking sector crisis and other public sector liabilities, public debt stands at a manageable level at 34 to 35 percent of GDP.

Macroeconomic stability has allowed the rapid development of the domestic debt markets. The longest maturity of a government domestic bond in 1999 was one year; in 2001, it extended to five years and continued increasing through last year, when the federal government successfully issued a 30-year bond. It is not surprising that deepening of the domestic market occurs in an environment of economic stability. What is quite striking, however, is the pace at which this has happened in Mexico and other countries in Latin America.

Following the collapse of the exchange rate, one policy decision was for Mexico to move to a free-floating exchange regime. The last intervention in the foreign exchange market occurred in 1998 during the Russian crisis. A number of necessary conditions were developed to support the new regime. For instance, all regulations that prevented the Mexican peso from being traded abroad were eliminated, thus allowing the peso to be traded on the Chicago Mercantile Exchange. Regulations were formulated by the Central Bank to develop the internal OTC[12] markets and to establish the organized derivatives market in Mexico (MEXDER). Participation by foreign institutions has contributed to the depth of the peso–dollar market, which has jumped from an average of about US$6 billion of daily trading in 2000 to about US$28 billion to US$29 billion recently.

Markets for derivatives provide commercial banks and investors with a wide range of alternatives to manage their market risks. By taking an important share of credit risk in these markets, foreign financial institutions also promote domestic financial stability. Figures 3 and 4 show the rapid increase in the volume traded on the derivatives markets.

12 Over-the-counter.

FIGURE 3. VOLUME TRADED ON OTC MARKET PESO / US DOLLAR DAILY AVERAGE

(US$, in billions)

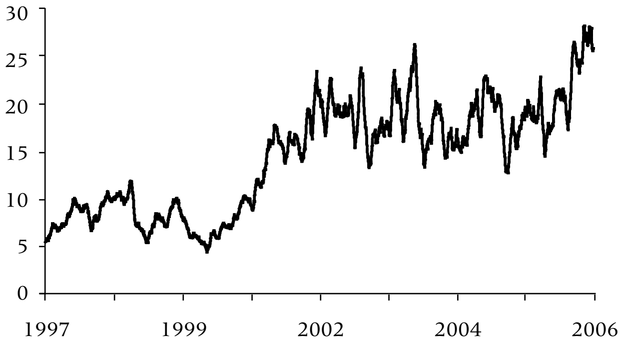
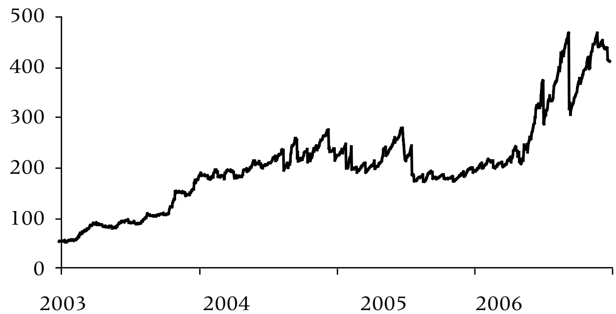


FIGURE 4. INTEREST RATE FUTURES PESO / US DOLLAR OPEN INTEREST

(US$, in billions)



Source: Banco de México.

To develop the domestic securities markets, several measures have been gradually adopted. The pensions system underwent major changes from 1996 to 1997, leading to the formation of private pension funds in Mexico. As a result, today these funds represent close to 10 percent of GDP, up from about 2 percent around six years ago (Figure 5). The development of institutional investors has been key on the supply side to increasing the breadth and depth of the domestic debt markets.

Figure 6 shows that the creation of the Certificados Bursátiles (also known as CEBURES, a new and more flexible type of security) made an important contribution to deepening the domestic debt markets. At the same time, a number of formal requirements that had hindered the issuance of private securities were also removed. These new securities can be issued by financial and non-financial entities, and by trusts. This has facilitated the securitization of mortgages.

FIGURE 5. PRIVATE PENSION FUND ASSETS UNDER MANAGEMENT

(As a % of GDP)

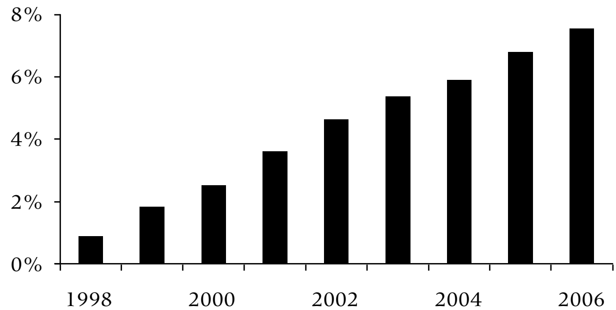
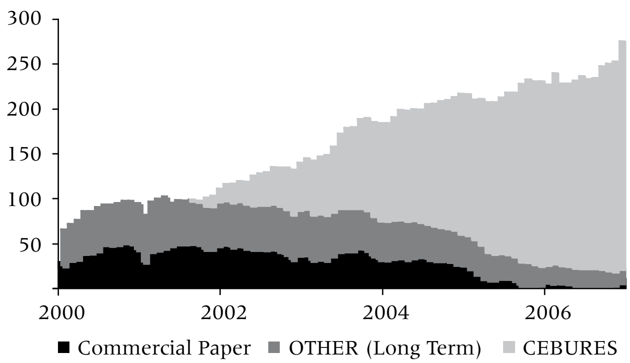


FIGURE 6. PRIVATE DEBT SECURITIES IN MEXICO

(In billions of pesos)



Source: Banco de México.

Measures were also taken to increase liquidity in the secondary markets, such as introducing price vendors and market makers; standardizing repo rules for banks, brokerage houses, and mutual and pension funds; and issuing regulations to allow the "boot strapping" of certain government securities (fixed-rate bonds and inflation-indexed bonds).

Reforms to the legal framework have also been made to align the incentives of debtors, bank creditors, and shareholders. These include:

- Major changes to the Bankruptcy Law. Among these was the creation of IFECOM,[13] an independent institution in charge of managing bankruptcy claims. IFECOM has adequate technical knowledge and enforces strict timelines throughout the different stages of an insolvency process.

- Credit Bureaus. Two private credit registries have emerged since 1995. One began operations in 1996 and compiles information on individuals and firms; the other started operations last year and provides information on individuals only.

- Accounting standards, brought into accordance with international criteria.

- Stricter capital adequacy regulation.

- Financial information disclosure requirements, increased to enhance market discipline.

- Introduction of explicit and limited deposit coverage for bank deposits (US$130,000).

- A system of prompt corrective action incorporated into the Banking Law. The system sets out immediate actions to be undertaken by banks and supervisors in the case that a bank's capital falls short of the legal minimum. Mandatory and discretionary measures are prescribed to supervisors according to different capital levels.

- Improved corporate governance. Defining the characteristics and number of independent board members became a critical issue as the largest banks became subsidiaries of foreign banks and other banks

13 Instituto Federal de Especialistas de Concursos Mercantiles.

owned by commercial firms received operating licenses. Creating audit committees composed of independent board members also became paramount.

- Creation of risk management units. In order to be given authorization to operate derivative instruments and thus to improve risk management, banks must comply with regulations that adhere to international standards, such as having in place risk units operating under approved board guidelines and using modern systems allowing operators to constantly check risk exposure limits in real time. In addition, internal and external audits are set to periodically verify bank compliance with these requirements.

- A new Securities Market Law. This law protects minority shareholders' rights and improves corporate governance by establishing responsibilities and membership criteria for audit committees and attorneys. The law creates the figure of "Investment Promotion Company" as an intermediate step, for a maximum of three years, between private and publicly listed companies. This legal entity allows medium-size companies to issue debt and equity on a private or public basis, provided they comply with minimum governance standards.

- Enactment of a new Payment System Law in line with the "Core Principles for Systemically Important Payment Systems" issued by the BIS.[14] The main objectives of the new law are the promotion of efficient payment system operations and the minimization of systemic risk. This law ensures finality in all systemically important payment systems and assures that the collateral pledged to the payment systems cannot be confiscated. It also grants more power to Banco de México to regulate, supervise, and implement adjustment programs to financial entities that are managing a systemically important payment system.

As a result of these reforms, today Mexico has a stronger financial system. Figures 7 and 8 show that macroeconomic stability and financial sector reforms have made possible not only the recapitalization of the banking system, but also the recovery of profitability. The Return on Equity (ROE) of the banking system has been rising over the past few

14 Bank for International Settlements.

years as a result of considerable gains in efficiency, among other reasons (Figure 8). The relation between operating expenses and total income has been declining sharply and is now close to international standards.

FIGURE 7. REGULATORY CAPITAL

(Billions of pesos in real terms and %)

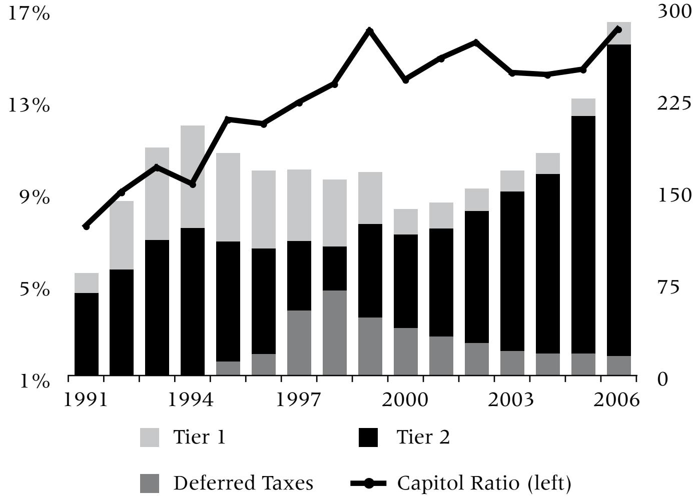
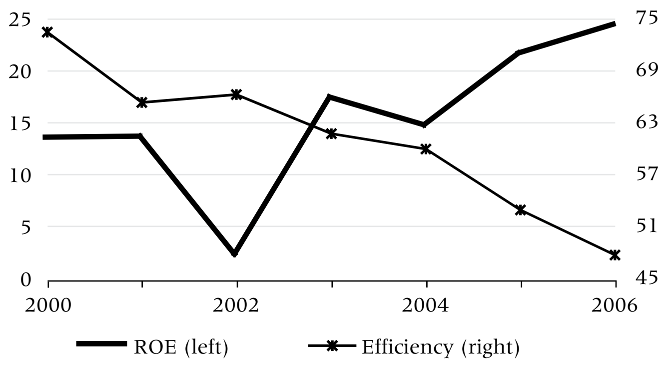


FIGURE 8. ROE AND EFFICIENCY†/*

(Weighted average, %)



Source: Banco de México.
† Efficiency: Operating Expenses / Total Income
* Includes only the six largest banks.

Banks have focused on increasing credit to the private sector where margins are high (Figure 9), a phenomenon also witnessed in transition countries in Europe. The combination of the shift in lending toward consumers and the increase in efficiency has led banks to obtain and maintain extremely high interest rate margins (Figure 10).

Consumer credit practically disappeared after the banking crisis. Thus, there was pent-up demand for credit, which has been growing at extremely fast rates from a very low base and has resulted in extremely profitable conditions for domestic banks.

FIGURE 9. CREDIT TO THE PRIVATE SECTOR

(Percentage points)

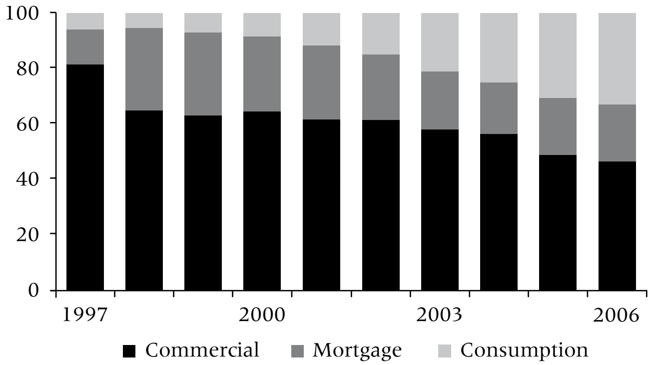
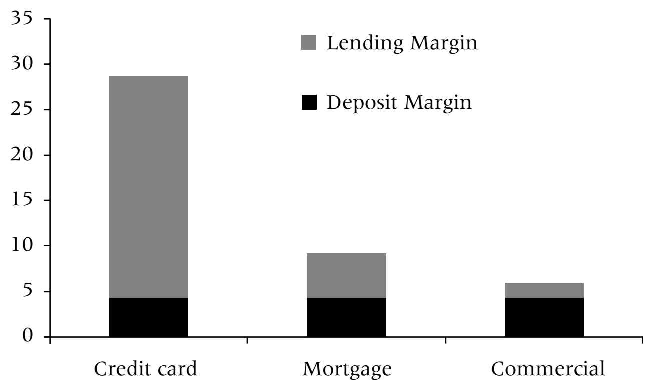


FIGURE 10. INTEREST RATE SPREAD

(Percentage points)



Source: Banco de México.

Lending to business has not expanded as fast. The growth of lending to large firms has been very low and even negative for some periods in recent years. To some extent, this is explained by the fact that large firms are financing themselves via the local bond market. Lending to small and medium-size firms has been expanding in the last few years, but clearly not as fast and broadly as needed.

Challenges from the Presence of Foreign Banks

The presence of foreign banks in Mexico has increased sharply in the last 10 years. From a foreign participation of 30 percent in the late 1990s, the banking system has become almost completely foreign owned. This has also taken place in transition countries in Europe. The penetration of foreign banks has brought important benefits such as better management techniques and risk evaluation procedures, as well as efficiency gains. However, a number of challenges associated with the internationalization of the banking system have emerged.

It is common knowledge that parent banks and subsidiaries are different legal entities. In practice, however, subsidiaries are managed as branches except that the legal responsibility of the parent bank is limited to the capital invested. This situation brings about an uneven division of decision-making powers between parent banks and subsidiaries, and of responsibilities between home- and host-country supervisors.

The uneven division of decision-making powers has had consequences with operational significance. For example, there is a growing tendency on the part of international banks to book transactions where funding and regulatory costs are lower. Although this makes sense from the global banks' perspective, it shifts revenues away from the local banks where the businesses originated, and this obviously has tax and fiscal implications.

Global banks usually establish individual country limits to credit exposure in each foreign country according to the sensitivity of the overall portfolio, which is not necessarily in the best interest of the locally operating subsidiary. Global banks have also increasingly adopted matrix reporting arrangements whereby local officials report directly to the head financial officer of the parent bank rather than to the local CEO. The result is that the manager of the subsidiary of the local bank does not really control the decision-making process within the bank. And in some cases, the manager is no more than an ambassador of the banking institution.

A second challenge concerns conflicts of interest that may arise should an international bank find itself in trouble. Even though such a potential situation is receiving increasing attention from policymakers and international institutions (such as the BIS and IMF[15]), there is not yet a common understanding on how to deal with or resolve the failure of an international bank. Neither is there a common jurisdiction nor a supranational legal court in place to resolve legal disputes.

Important efforts have been made to identify the information that needs to be shared among supervisors if such a crisis arises. However, the failure of an international bank could easily lead to conflicts among the various parties involved, because their interests may diverge considerably. These conflicts could make the attainment of reasonable and fair solutions extremely difficult.

It is essential to encourage cooperation frameworks among supervisors, central banks, and finance ministries from countries involved in extensive cross-border banking. Such frameworks should not be limited to the exchange of financial information. They must include agreements over procedures and the establishment of standards for the sharing of responsibility.

To improve the effectiveness of crisis management plans, the European Union and Scandinavian countries have been conducting crisis simulation exercises. It is important that countries in other regions with large subsidiaries start to conduct simulation exercises with the authorities of countries where the parents are located.

A third consequence of penetration by foreign banks, in the case of Mexico, is that they have de-listed subsidiaries from local stock exchanges. Assets of banks listed on the stock exchange in 1998 represented 73 percent of total bank assets; as of 2005, they represented 13 percent.

15 International Monetary Fund.

The de-listing has had a number of consequences. For instance, the role of independent board members for local subsidiaries is limited today, to the extent that no minority shareholders participate in the ownership structure. Banks that have been de-listed face no obligation to publish relevant financial information. The most straightforward regulatory response to the loss of information is to require banks to publish the same amount of information as they did when they were listed. However, the publication of information is not the only condition for effective market discipline.

Market participants and financial authorities need price signals as well as the research carried out by independent bank analysts, both of which are lost when banks are de-listed.

Another possibility for dealing with this problem of aligning the interests of shareholders more closely with those of domestic stakeholders is to require the listing of the foreign subsidiaries on local exchanges. This topic is not exclusive to Mexico and is being discussed elsewhere as well.

The Importance of Competition

This final section will discuss the issue of competition. Figures 11 and 12 illustrate that the interest margin in Mexico is, as mentioned, extraordinarily high when compared to other countries with similar degrees of bank penetration and, of course, with respect to more developed financial systems.

Figure 11. Credit to Private Sector

(% of total assets)

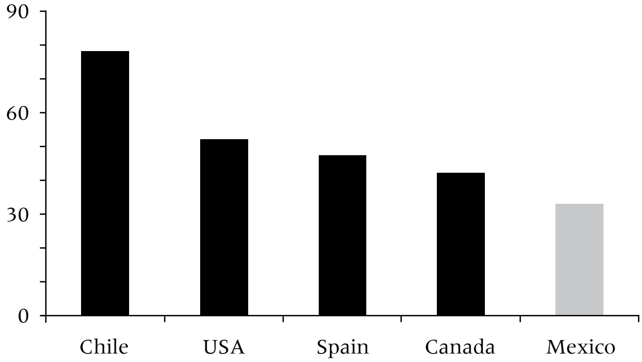
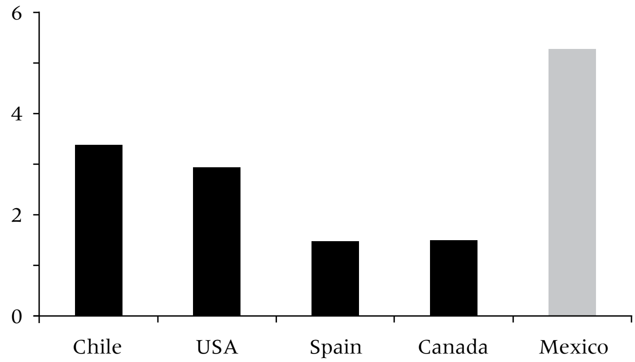


Figure 12. Interest Margin

(% of total assets)



Source: Banco de México.

Economic theory states that when markets do not operate under competitive conditions, social losses generated tend to be larger than income obtained by sectors protected from competition. This phenomenon reduces the efficiency of the allocation of resources and affects income distribution. Such considerations become even more relevant when lack of competition appears in the provision of goods in widespread use in the economy, such as financial services.

To increase competition, Banco de México has lowered barriers to entry and promoted the incorporation of new intermediaries, promoted the interconnectivity of the payment system, and strengthened the market discipline imposed by consumers themselves.

Regarding more numerous market participants, many new banks have been allowed to enter the market. Twelve new banks received authorization over the past year and a half. Of course, the current market structure is such that these new banks will probably need a long time before they represent real competition to the existing network of larger banks. It is important to mention the licensing of commercial firms to provide banking services. Wal-Mart, for example, has received a banking license. Along with other commercial entities with wide distributional facilities, it is likely to increase competition, particularly in the retail sector. The incursion of commercial firms in the banking sector implies new risks and challenges for financial authorities, which must be committed to avoiding conflicts of interest and the possible transfer of risks between these banks and the retail establishments that hold them.

Finally, with respect to strengthening disclosure and transparency, a regulation requiring banks to publish the total annual cost of credit was promulgated, thus enabling consumers to compare the real costs involved in different credit products. It is very striking that despite the fact that information is widely available on the different costs of the various products offered by the banks, consumers seem to be quite insensitive to price. Consumers are apparently willing to pay considerably different prices for similar products since dissemination of information has not been sufficient to alter consumer behavior. A much deeper development of the population's financial culture has to take place.

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