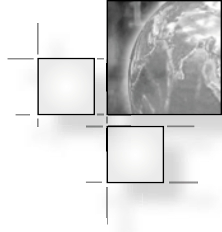


In cooperation with the United States Asia Pacific Council and the East-West Center

Benefits of Financial Market Liberalization:

Report to APEC Business Advisory Council Working Group on Financial Market Liberalization

Principal Investigator:
J. Kimball Dietrich, University of Southern California
With Mohamed Hisham bin Mohamad Noh
University of Southern California

This report concludes that there are important benefits to domestic economies and to domestic financial service competitors when liberalized markets allow foreign investment. These benefits include improvements in capitalization, management techniques, business practices, and product development.

These results are based on a statistical analysis of direct investment in financial services in APEC economies and an in-depth analysis of four case economies. Implications for policymakers as they deliberate financial market liberalization are that the expansion of the benefits outlined in this report depends on (1) further liberalization and openness and (2) specifically to extending the current level of unbalanced and confined liberalization to all financial market sectors. Limits on foreign investment or product competition in some markets, like insurance and securities services, have inhibited the efficient restructuring of those markets. Only by opening all financial markets equally can the benefits of increased efficiencies in the evolving financial services system be extended to all economies. Only with integrated and liberalized markets can domestic financial institutions be stimulated to develop long-term viable business strategies.

Benefits of Financial Market Liberalization: Report to ABAC Working Group on Financial Market Liberalization

J. Kimball Dietrich
University of Southern California

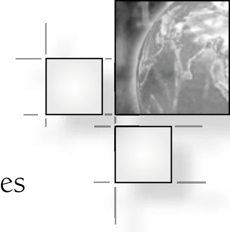
EXECUTIVE SUMMARY

The goal of this study is to analyze the experience of financial market liberalization in the Asia Pacific Economic Cooperation (APEC) region (or could define in a footnote). The methodology included a an examination of the impact of financial market liberalization on foreign direct investment in financial institutions and measures of selected financial institution aggregate capitalization, employment, and overall growth of the financial sector in the region. Background statistics on regional trends in investment provide a context for examination of specific cross-border investments in financial service firms on a firm (micro-economic) level in four case studies. Analysis of data is supplemented by interviews and surveys in the case studies to provide qualitative information and specific examples of the effects of foreign investment. The case studies are provided in the appendix to the report.

Analysis of mergers and acquisitions in the financial services sectors of APEC economies makes clear that financial market liberalization has accelerated since the Asian Financial Crisis of 1997. The Crisis revealed weaknesses in the financial systems of several economies, demonstrating the vulnerability of these systems to large shocks and the importance of flexibility gained by liberalization. It also resulted in the opening of financial systems to foreign investment more than in the past in order to finance the restructuring and recapitalization of weakened financial institutions in the region. However, this financial market opening was not evenly balanced between financial market sectors: banking markets achieved greater liberalization than did insurance and securities markets.

Foreign direct investment in the form of mergers and acquisitions more than doubled in the post-Crisis period from 1999 to 2003 relative to the period 1990 to 1996 (Table 1). Surprisingly, the restructuring of regional financial systems that has occurred was accomplished largely by domestically funded merger and acquisition activity within economies (Table 2, Panels A and B). Strikingly, in many of the economies, substantial investment came from neighboring economies: in China, Hong Kong, Indonesia, and Thailand, more than twenty percent of the investment came from economies within the Asian region (Table 2, Panel C).

More than half of the investment in financial services measured by merger and acquisition activity is concentrated in



commercial banking in most economies, but the concentration in banking varies. In China, for example, roughly equal amounts have been invested in insurance and banking. Banking investments may be overstated in terms of cross-border activity since in many economies the banking data reflect acquisitions of non-performing loan portfolios. In general in the region, some large investments have been made in securities firms (about a third of the total) and insurance (over 10%) but restructuring in these sectors lags banking in some of these markets.

These observations serve to emphasize that foreign investment in banking services is only part of the required restructuring of financial services sectors in the APEC region, and that future restructuring must go beyond commercial banking to achieve overall financial system efficiency. Foreign investment can be an important marginal investment only if more open policies allow foreign investors flexibility in investments they make.

To gain a concrete perspective on the effects of liberalized cross-border investments on economic growth, efficiency, and competitiveness of the financial sector in different economies, this study focuses on four APEC economies: Chile, Chinese Taipei, South Korea, and Thailand. The cases are used to develop a list of benefits and costs (summarized in a table) that have occurred in economies that have opened their domestic markets to foreign investment and competition. The cases also demonstrate the role foreign investment can play in financial system restructuring. These benefits are many. Large amounts of risk capital were made available in times of crisis to assist in the restructuring of domestic financial systems. Foreign firms introduce changes in procedures and methods that assist domestic firms in becoming more efficient and in following best international practices. Domestic market participants benefit from new services and expanded financial market offerings at lower prices. Domestic financial firms refine their strategies in their markets and use the advantages of foreign firms in dealing with regulators to expand their ability to compete in new product markets.

The report concludes that? Or/ The study shows that despite significant progress in these economies, the? realization of the benefits from foreign investment has been unbalanced and limited, mainly confined to banking. Further liberalization of financial markets could broaden benefits as the efficiencies are extended to securities and insurance markets.

Financial Market Liberalization: Report to ABAC Working Group on Financial Market Liberalization

J. Kimball Dietrich With Mohamed Hisham bin Mohamad Noh
University of Southern California

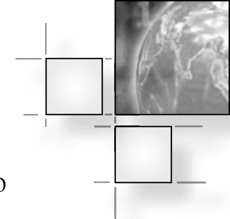
1. Introduction

Foreign direct investment amounting to over $100 billion in the years 1990 to 2003 played an essential role in the restructuring of financial markets in response to changes in global competitive conditions and to weaknesses identified in recent financial crises in the Asia Pacific Economic Cooperation (APEC) region. Equity capital, and especially capital provided by investors tolerant of high risk, made available by foreign investors like financial firms or investment funds, played a critical role in helping developing economies make required changes in financial market structure due to secular changes taking place in the global financial system and/or replacing capital losses stemming from failures in financial markets that had been insulated by government policy from making required adjustments in their structure and regulation.

The benefits from foreign investment is unevenly distributed among financial market segments. For a variety of reasons discussed below, liberalization of financial services has not been even across sectors. For example, in Thailand, liberalization of equity investments through relaxation of maximum foreign ownership in banking and securities business did not extend to insurance. In many economies, the insurance sector has lagged banking in terms of making required adjustments to achieve soundness and efficiency. Uneven liberalization does not allow for the benefits of synergies in providing financial services in different market segments to be realized. A goal in the evolving financial system of the future should be the most efficient integration of all financial services into all financial institutions and markets in the APEC region.

While critical and essential, the exact role of foreign direct investment in financial markets is not precisely understood by many policy-makers and market participants. This report is directed at making our understanding of the impact of foreign investors on developing domestic financial markets clearer. While total foreign investment played a key role in the restructuring going on in the global financial system, this investment has not turned even smaller economy financial markets upside down. Domestic financial firms and market participants in small and large economies have benefited from the presence of foreign investors, as this investment acts more as a catalyst of change rather than changing the fundamental nature of domestic financial institutions and markets.

The analysis in the following report leads us to the following observations concerning the



impact of foreign direct investment on financial service markets in developing economies in the APEC region. First, the largest domestic financial firms in these markets, whether banks or insurance companies, remain dominant in their respective markets after the entry of foreign capital in nearly all the cases analyzed. Second, the amount of foreign direct investment is often relatively small in terms overall investment activity in these markets, but these investments play a positive role in stimulating productive changes in the structure and role of financial markets in the case economies. Cross-border merger and acquisition activity usually result in foreigners having minority positions in large firms or controlling positions in smaller financial firms, so foreigners generally play a marginal role in financial market restructuring, but their impact is much greater in terms of influencing domestic firm business practices and product development and distribution. Third, foreign investment is part of an expansion and restructuring of financial services globally. In representing these global forces in domestic markets, foreign investors in domestic financial markets challenge local firms to develop long-term strategies and competencies assuring survival in more efficient and productive internationally integrated financial markets of the future. Finally, foreign direct investment in emerging markets does not follow a systematic, coordinated plan having the goal of foreign dominance of global financial services. These developments are part of a larger economic process of evolving financial structure in global markets where both domestic and international firms will have productive and profitable roles to play in the long run. Foreign direct investment consists of many firms experimenting with alternative business strategies, often in competition with each other, or attempting to exploit perceived opportunities, often accompanied by substantial risks. Internationally active financial firms are learning by trial and error, often entering a market to leave later by selling to domestic firms.

This study documents the benefits of financial market liberalization using two approaches: first, a comprehensive review of cross-border trends of investing in the financial services sector in the APEC region since 1990, and second, detailed analyses of individual economies as case studies that focus on specific examples of cross-border investments at the level of specific financial institutions and markets. The objective is to identify short-run and long run benefits to opening of the financial services sector to foreign competition and investment in terms of financial firms' efficiency, employment, and the impact on the growth and expansion of the range of financial services and markets.

Previous Research

Many recent studies have examined the benefits of financial market opening, typically focusing on commercial banking (see for example Claessens *et al*, 2001, for a recent example of a study or the World Bank, 1997 and 1998 for a bibliography). Few of these studies have concentrated exclusively on the APEC region. Some studies have looked for macro-economic evidence of the benefits of financial services liberalization (see for example Adams, *et al, 2003*, and Eichengreen and Leblang, 2003). These studies are useful for structuring an analysis and providing a broad overview of the role of liberalization in financial services in economies, but they provide few specific examples of the types of benefits that individual economies may experience from generalized improvements in financial institution efficiency and development stimulated by foreign activity in domestic markets. That is the goal of this study: to make the benefits (and costs) of market opening understood with examples of specific outcomes in representative APEC economies.

Benefits of financial market opening are most convincingly demonstrated at the level of specific financial institutions and markets. Evidence is derived from financial performance data of individual firms or specific market segments. Demonstrable benefits of financial market opening are found in economies experiencing the availability of new financial products as a result of foreign institution investment or competition, for example widespread marketing of retail financing products. Benefits to an economy are associated with the growth or maintenance of employment or reduced losses in employment in firms with foreign investors when new investment in financial services and new management reduce costs but at the same time expand markets or product offerings; these benefits will have to be measured by comparisons between domestic firms and firms influenced by foreign investment or competition.

Aggregate data is useful in analyzing the relative importance of financial restructuring attributable to foreign investment and other activities. In reviewing these data, it must be kept in mind that financial sector restructuring is a global phenomenon. In developed economies, this restructuring results from greater reliance on market forces, rapid technological change, and integration of global financial services market. Greater efficiency of financial systems no doubt has a positive impact on the growth of all economies but the relation between restructuring and economic growth is difficult to demonstrate because of the relatively short time frame (two decades or so) over which these changes have occurred.

In several APEC economies, moreover, financial systems were protected and often weakened by structural conditions until very recently, factors that led to the Asian Financial Crisis. Foreign direct investment may play a relatively large part in these smaller economies than in the large, developed economies. The connection between foreign direct investment, financial market restructuring, and economic growth, however, will be difficult to demonstrate given the even shorter history of financial market liberalization in most APEC economies and the very recent expansion of cross-border investment in most of those economies. Such evidence as there is will be found in the growth of specific financial market size measures in financial markets like life or property and casualty insurance, securities trading activity, or the size of corporate debt or consumer credit markets. Insights will be identified by comparing experiences of economies with varying degrees of financial sector liberalization and opening to foreign investment and competition. This study, while developing some evidence of the benefits of financial market opening when possible using aggregate financial market and economic statistics, will emphasize more narrowly success stories and problems derived from an examination of specific institutions and markets.

2. Statistical Analysis And Assessment Of Cross-Border Activity

Aggregate Statistics on Financial Sector Activity and Economies

Case studies and cross-country comparisons that are the basis of this study must be imbedded in the context of general developments in APEC economies. Most of the detailed analysis of the impact of liberalization or opening of the domestic financial sector is based on the acquisition by foreign firms of domestic financial institutions or their assets. A database of mergers and acquisitions[1] was used to develop detailed statistics on total foreign investment in financial firms in each economy, the allocation of investments in different segments of the financial services

[1] *Thompson Financial Mergers and Acquisitions database.*

industry, and finally specific deals relating to financial service firm acquisitions. It is possible to obtain information on the specifics of each acquisition (nationality of acquirer, ultimate nationality of acquirer's parent, percent of ownership, etc.). Given this information, representative transactions can be developed as the focus for case analysis in the case studies.

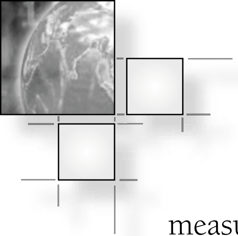
Tables 1 to 5 at the end of this report provide some information on investment in financial services in the APEC economies. Using Chinese Taipei as an example, Table 1 demonstrates that $3 billion was invested in financial services in the economy over the period 1990 to 2003, but that virtually all of this foreign investment took place after the Asian Financial Crisis of 1997 in the form of sixteen transactions, or deals.

The database on merger and acquisition activity does not include all foreign direct investment (e.g. a foreign firm investing in branches) but captures details of individual transactions we use below. Some of the transactions are not reported with dollar amounts so the totals are not complete. Given these limitations, the following table is extracted from Table 1 to provide some comparisons of the differing role of foreign activity in the APEC economies covered in the table. First, examining the allocation of foreign direct investment (FDI) activity to the countries in column (1) of the table, column (4) calculates each economy's FDI to the total for the economies represented in the table and demonstrates that Mexico alone accounts for over 22 percent of foreign merger and acquisitions activity in the economies shown, and Japan an additional 19 percent. Column (4) of the table shows that four economies, Mexico, Japan, Australia, and Hong Kong, account for over two-thirds of foreign investment activity in the economies of the APEC region represented in the table.

Table: Measures of Cross-Border Foreign Direct Investment*

	(1)	(2)	(1)/(3)	(4)	(5)	(4)/(5)
Economy	**FDI**	**GDP**	**FDI/GDP**	**FDI/Ttl**	**Total GDP**	**Ratio**
Australia	12,482.6	570.3	2.19%	10.1%	3.7%	2.75
Chile	7,085.7	154.6	4.58%	5.7%	1.0%	5.75
China	2,621.9	6,449.0	0.04%	2.1%	41.6%	0.05
Chinese Taipei	3,012.0	528.6	0.57%	2.4%	3.4%	0.72
Hong Kong	19,504.0	212.2	9.19%	15.8%	1.4%	11.54
Indonesia	1,448.5	758.1	0.19%	1.2%	4.9%	0.24
Japan	23,982.8	3,567.0	0.67%	19.4%	23.0%	0.84
Malaysia	2,335.3	207.2	1.13%	1.9%	1.3%	1.41
Mexico	28,351.9	942.2	3.01%	22.9%	6.1%	3.78
New Zealand	9,770.3	85.3	11.46%	7.9%	0.5%	14.38
Philippines	1,009.4	390.7	0.26%	0.8%	2.5%	0.32
South Korea	2,293.6	855.3	0.27%	1.9%	5.5%	0.34
Singapore	6,275.3	109.1	5.75%	5.1%	0.7%	7.22
Thailand	3,359.3	475.7	0.71%	2.7%	3.1%	0.89
Vietnam	21.3	203.9	0.01%	0.0%	1.3%	0.01
Totals	123,553.9	15,509.2				

** Source: Table 1, FDI is in $ millions, GDP in $ billions*



These economies vary vastly in size measured by GDP (2003 estimates), shown in column (2) of the table. To scale these differences, column (5) presents the percent of total GDP of the economies shown and the right-most column shows the ratio of the percent of total FDI measure to percent of total GDP. While limitations in the data and varying circumstances require caution in interpreting the last column, these calculations seem to capture at least to some extent the openness of an economy. By this standard, the economies most open to foreign investment stand out: Australia, Chile, Malaysia, Mexico, New Zealand, Hong Kong, and Singapore all have more FDI activity by this measure than the size of their economy measured by GDP would explain, that is, the ratio of their share of FDI is greater than their share of GDP. Hong Kong and Singapore are important financial centers of cross-border activity, so this result may not be so surprising. The other economies are simply the target of a great deal of foreign merger and acquisition activity and/or are open to greater levels of foreign investment activity.

Table 2 at the end of the report demonstrates that foreign activity was only a small part of the restructuring of the financial services industry taking place in APEC economies. For example, in Chinese Taipei, over $16.6 billion in merger or acquisition activity is accounted for by domestic acquiring firms.[2] U.S. investment accounted for about a quarter of the foreign acquisitions but only 3.5 percent of total investment in the economy. Europe dominates as an investor in Chinese Taipei with most of the rest of the foreign activity. Panel C of Table 2 in conjunction with the table discussed above may demonstrate that Taipei is less open than other economies in the region, with only 15% of the funds from foreign investors. Panel C of that table shows that for other economies, like China, Indonesia, Mexico, and Thailand, over fifty percent of the investments in financial firms come from outside the domestic economy, although in the cases of China, Hong Kong, Indonesia, and Thailand, more than a third of the foreign investment comes from other Asian economies.

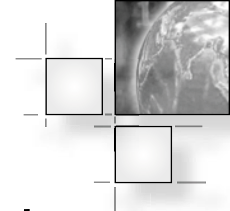
Table 3 places investments in commercial banking into context for APEC economies. While commercial banking is the focus of 50% of mergers and acquisitions, large amounts of activity are accounted for by insurance and securities firms. Furthermore, investments in banking in some economies do not reflect takeover of domestic banks by foreigners, but rather sales of non-performing loans.[3]

Finally, Table 4 isolates cross-border from domestic investments in financial services. The pattern of foreign investment across financial market segments roughly mirrors the totals reported in Table 3, with a slightly higher percent going into insurance than is the case with the total of domestic and foreign investments.

The data reported in the tables discussed above provide some insights concerning the role of foreign direct investment in financial services. Quantitatively, these investments are not large in terms of total domestic market merger and acquisition activity. They vary substantially across economies in terms of their industry segment and their percentage impact on domestic magnitudes like market capitalization of financial firms. However, the tables are most interesting for providing a background for our analysis of the details of the underlying

[2] Great care must be taken with interpretation of these results, however. Our final analysis examines deal-specific descriptions, for firms are classified into nationality by the legal domicile of the acquiring unit, for example the U.S. unit of Allianz acquired an insurance firms, and that was classified as a U.S. investment.

[3] See the discussion below for Chinese Taipei; a similar analysis is required for other economies to determine the amount of non-performing loans represented in the tables.



transactions for the four case economies.

Tables 5 and 6 provide data gathered to examine financial sector activity and development in different APEC economies. For example, Table 5 provides data on market capitalization of commercial banks in APEC economies and Table 6 the percentage of employment in the financial services sector (finance, insurance, real estate and business services). Data contained in Table 5 is valuable in assessing the relative impact of foreign capital inflows into financial services in an economy in terms of its quantitative importance to the capital available to provide financial services. For example, in Thailand, foreign investment in domestic firms over the period 1990 to 2002 accounts for about 6% of the total market capitalization of banks in Thailand in 1998. As can be seen in Table 6, developed economies in the region tend to have above 10 percent of their employment in financial and business services (an exception being Japan), while emerging economies have a much smaller percentage (e.g. Chile, Malaysia, Mexico, and the Philippines below 10 percent[4].) However, employment in financial services as a percent of the total is tending to increase in all economies, including the developed and emerging economies. Comparison of growth rates in financial services employment is one measure of the impact of opening on financial market development.

3. Comparison of the Case Economies and Financial Market Liberalization

Role of Foreign Direct Investment in Case Economies

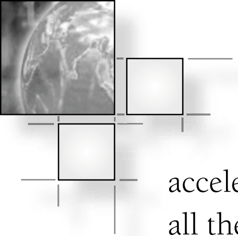
This report concludes that foreign direct investment has an overwhelmingly beneficial impact on domestic financial market restructuring with little apparent cost that would not be borne in any case with the natural evolution of the financial services industry. This conclusion is based on detailed analyses of the role and impact of foreign direct investment in the form of merger and acquisition activity for four case economies, Chile, Chinese Taipei, South Korea and Thailand. The case analyses are appended at the end of this report and a reading of them is essential for appreciating at a detailed level the basis for some of the following generalities. This section compares and contrasts the experience in these four economies and derives some general conclusions about the costs and benefits attributed to foreign investment in financial firms that we have summarized in the table, “Benefits and Costs of Foreign Direct Investment in Financial Services.”

Foreign Investment in Banking in the Case Economies

As discussed above, banking accounts for about half of foreign merger and acquisition activity in the APEC economies analyzed. For three of the case economies, Chile, South Korea, and Thailand, this foreign direct investment played a critical role in restructuring of their banking markets. In Chinese Taipei, the impact of foreign activity on banking markets has to date been minimal.

Chile represents a unique case among the four APEC economies studied in detail. Chile has had a policy of openness toward foreign direct investment since the 1980s, although foreign investment activity has

[4] Data on financial services alone are not readily available but the inclusion of business services, including accounting and data processing, has the advantage of including employment related to financial firms but outsourced recently as part of industrial restructuring. For example, a bank replacing its data processing division with an outside provider would reflect reduced employment even though it continues to require information technology employees.



accelerated in the last decade, as is true for all the case economies. Foreign firms have a long history of activity in the Chile with major international firms active but confined to a small market share in the sectors they operated in, primarily banking and insurance. Recently, however, two Spanish banks acquired the current largest and fifth-largest banks in Chile, Banco Santander and BBV Argentaria Chile, respectively. These banks have challenged domestic banks with new consumer-lending products and management methods, including performance goal setting and new risk-management techniques. They have concentrated in markets where their global and especially Latin American presence created efficiencies, focusing on retail lending markets and servicing large international corporations. These foreign banks have also exploited their international holding company structure to simultaneously compete in other financial markets, specifically the important and growing private pension fund management (AFP) market fostered by Chilean pension-fund reforms in 1981.

Other large banks in Chile have responded positively to the challenge posed by the Spanish banks operating in their domestic market: these banks have implemented more systematic management systems and focused on domestic markets where they have a competitive advantage; namely the professional individual and small and medium enterprise market. The large local banks are using the entry of the Spanish and other foreign banks into the pension management market as an argument in the current legislative and regulatory debate concerning further liberalization of banking activities in Chile. Domestic banks in general welcome the entrance of these larger foreign competitors and recognize that their competition has sharpened management's strategic focus and improved management goal-setting.

South Korea and Thailand both opened their banking markets as part of their negotiations with the IMF during the Asian Financial Crisis of 1997. In both cases, substantial sums of foreign capital, close to half of total foreign investment in each case, flowed into banking. The pattern of investment and the outcome on financial structure are very different from each other and, of course, from Chile.

South Korean banking markets remain dominated by large Korean controlled banks, although minority investors in those firms have provided substantial capital infusions and have connected these banks to foreign financial institutions and their methods and systems, improving risk management and risk-adjusted pricing. The foreign investors, while providing access to foreign practice through management visits and exchanges with foreign financial institutions investors, training programs, and consulting arrangements, have remained under Korean management.

Several smaller banks, ranking at the bottom of the eight nationwide commercial banks, were taken over by U.S. investment funds that appointed foreign managers who installed modern risk measurement and risk management systems, undertook substantial middle management training, and implemented management goal-setting and controls. One of these investment-fund operated banks was subsequently sold to a global financial services bank, the other is still under the investing fund's management. Korean government officials are said to be disappointed that bank industry investors were not available to take over these smaller banks and were concerned about the perceived short-term commitment of investment funds. However, these funds appear to have created value in their investments by selling a bank at a profit in one case. In the other case, the investor seems determined to sell the bank investments to a long-term financial

institution investor seeking strategic access to Korean banking markets.

In Thailand, majority ownership obtained by foreign investments in banking were possible because of a relaxation of maximum foreign-ownership limits after the crisis. These controlling investors came from neighboring Singapore and the Netherlands and the United Kingdom. As in Korea, these investments were in smaller Thai banks, ranked below ninth in terms of market share (out of thirteen commercial banks). Foreign investors also provided capital (about $5 billion over the two years 1997-1998) in the form of minority positions in larger banks. As in Korea, foreign investors have stimulated changes in management practices, particularly in risk management and product innovation. Further, smaller banks are gaining access to foreign markets and extending new services to domestic customers through their affiliation with foreign bank investors.

Foreign Investment in Insurance in the Case Economies

Insurance investments by foreigners has been less significant in the case economies than foreign investments in domestic banking and securities institutions, with the exception of Chinese Taipei. In that economy, foreign investment in insurance was a large part of the relatively small foreign activity in that economy. The total investment in the Chinese Taipei market, about a half a billion dollars over the period, was made in smaller firms. However, these investments have stimulated product innovation, improved risk management, and expanded management training among both foreign minority owned firms and larger domestically owned firms in Chinese Taipei. One important effect of the foreign activity in Chinese Taipei has been to influence insurance regulators to greater openness to sale of products available in foreign insurance markets.

The insurance market in Chile, like banking, has long a long history of foreign activity, but unlike banking, foreign players continue to play a relatively minor role. They have introduced new methods of risk management and some new products, but their recent investments are seen as useful in consolidating some smaller firms but not as a threat to the larger firms. The recently negotiated free trade agreement with the United States, which contains financial services provisions, is not seen as altering greatly the role of foreign insurers, including U.S. firms, in that market because cross-border sales of insurance products continues to be prohibited and required investments in the domestic affiliates of foreign insurance firms have not been relaxed.

Investments by foreign firms in the insurance business in South Korea and Thailand have been relatively small. Thailand did not relax the maximum investments in insurance companies during the financial crisis. While foreign investments were made, largely in smaller firms, and one foreign firm in Thailand has had a dominant position for many years, the impact of foreign investment in insurance has been as a minority investor, in one case as a joint venture with a domestic banks. In both South Korea and Thailand, foreign firms investments have nonetheless have had the effect of stimulating innovation in products and product distribution systems (particularly insurance sales through bank networks) and implementation of better risk-management methods. Foreign firms have expanded training programs, upgrading the skills of Thai managers and executives and bringing insurance company management into line with global best practices.

Foreign Direct Investment in Securities in the Case Economies

The experience associated with foreign investment in the securities sector differs a great deal in the four case economies. In Chile, securities markets appear not to be attractive to foreign investors because of low market liquidity and tight control of the securities market by a small number of domestic firms trading securities (pension fund managers) and firms providing trading services (brokers). Government taxes and fees and commissions on securities transactions are high. Many large Chilean firms list on foreign exchanges. For these reasons, foreign securities firms do not appear to view Chile as an attractive expansion market. Securities trading remains relatively inefficient and undeveloped in Chile.

Chinese Taipei did allow a major foreign securities firm to enter the domestic market as a minority investor, but that firm withdrew from the market after a few years, selling its stake to a domestic firm. Foreign investment has not played a major role in that economy's securities market development.

South Korea and Thailand, on the other hand, have benefited from foreign investment in their securities market sector. Foreign investors have provided substantial capital investments in South Korea. In Thailand, some foreign firms have formed long-term alliances with a minority position and other international firms invested and then divested by selling to local managers, but retained strategic allegiances in product development and securities research . Thai securities firms have improved their efficiency and range of services, but foreign investors have relied on domestic managers to implement changes.

Foreign Direct Investment in Other Financial Firms in the Case Economies

Foreign investors have provided needed capital in a variety of other financial industry segments as discussed in detail in the case studies. In Chile, foreign investors have been active in acquiring pension fund management firms (AFPs), stimulating competition and efficiency in that business, to some extent by integrating Chilean pension-fund management systems into a larger market base, for example, Latin America. Cross-selling of pension fund services by banks and insurance companies has put pressure on regulators to relax restrictions on domestic banks and insurance firms. These developments are movements towards greater efficiency in that market.

In South Korea, foreign investors were active in supplying capital to the distressed banking system by acquiring non-performing loan portfolios. They also made substantial investments in the troubled investment trust company and merchant banking sectors. Some consumer lenders were the recipients of foreign capital injections. All of these provided capital to the crisis damaged Korean financial system.

In Thailand, foreign investors were active in acquiring the assets of finance companies, non-performing loans, and investment companies. In some cases, these investments were large. Over $1.5 billion was invested in finance companies by foreign investors, and these firms formed the basis for financial strategies broadening domestic consumer credit markets. In other investment, foreign firms were a source of capital for distressed financial firms.

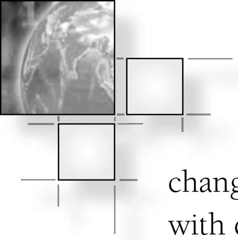
The following table summarizes the benefits and costs to developing case economies from foreign direct investment:

Benefits and Costs of Foreign Investment in APEC Case Economies
Benefits
Provided capital for recapitalization needs and required for stability in financial sector
Financial product innovations
Improved management techniques and performance measures
Training and improved risk management
Implemented technological advances
Consolidation of existing firms into larger, more efficient units
Increased competition leading to cost and price reductions
Demonstration to regulators of advantages of changing restrictive regulations
Implementation of controls fostering better risk measurement and management and risk-based pricing
Private investors willing to take risks in implementing long-term business strategies not acceptable to government officials
Exposure to foreign financial institutions' and their consultants' recommended management practices
Emphasis on employee training
Development of new sales channels and marketing techniques
Costs
Employment reduction in pursuit of efficiencies and profits for investors
Issue of fair, level playing field in the banking sector
Acquisition by investment groups who are not strategic financial institution partners
Possible reduction in financial service providers' focus on small business market financial needs

4. Foreign Investment in the Context of the Global Financial Services Industry

The preceding discussion of the role of foreign direct investment in financial services as a result of financial market liberalization should be interpreted in the context of global developments in the financial services industry. In the most advanced economies like the United States, domestic financial market liberalization, for example the elimination of interest-rate controls, balance sheet restrictions, and prohibitions preventing cross-selling of related financial services like lending and investment banking, is a relatively recent phenomenon, beginning less than two or three decades ago. Opening of financial markets like banking to foreign investors was implemented within the same time frame.

Liberalization of financial services in developed economies was inevitable because of unsustainable inefficiencies in the financial system of developed economies resulting from the inability of participants in the market to made adjustment to changing conditions due to legislative and regulatory rigidities. Consumers and corporate customers alike were demanding



changes to align costs with prices and to deal with dangerously weakened financial firms.

At the same time, technological innovations in information services and communications technology having direct relevance to the provision of financial services were providing opportunities for vast cost reductions and expansion in product offerings. Data mining, telephone call centers, on-line balance inquiries, computer order entry, and so forth, were unknown concepts as short a time ago as twenty years even in the most advanced economies.

While competitive conditions were being altered in advanced economies by deregulation

and technological advances, globalization of financial services exploded with the expansion of trade and the interlinking of economies around the world. Firms were following customers around the globe and servicing an expanding array of foreign firms operating in domestic markets. Markets for financial instruments and services were increasingly developing without regard for national boundaries.

Long-run adjustment to the economically efficient structure of the financial services industry is nowhere near completion even in the most advanced economies. Nonetheless, dramatic changes in financial market structure are already evident. For example, in the United States, changes in the mass retail markets and large-corporate wholesale markets have meant that economies of scale can be realized from spreading fixed costs over larger markets. In retail markets, risk-pooling and use of asset-backed securities to finance retail credits have been a force in consolidating lending in some segments to giant consumer lenders. In the large business market, enormous risk exposures mandate large pools of risk capital and access to global securities markets to either fund advances to risky clients or lay off this financing and the associated risks to third-party investors in the securities markets. Reputation and technical expertise demanded in approaching financial markets are associated with large size. These developments have relevance to all economies in a globally integrated financial system as these markets evolve.

The movement of large international financial firms into foreign markets can be seen as a way for these firms to further reduce risks through diversification and to exploit their investments in data intensive consumer lending and skills required for risk-intensive large corporate lending. Economic forces compel the realization when possible of these efficiencies and drive much of the activity we observe in global financial markets. These developments have the desirable effects of reducing the costs of funds to consumers and large corporations while spreading risks more broadly than is possible with closed markets. These efficiencies are the result of the forces of global competition in expanding markets. Realization of the benefits of these efficiencies are not possible without continuing financial market liberalization within and between global economies.

The inevitable movement of financial institutions and markets towards economic efficiency has produced some remarkable outcomes in developed economies that could not have been imagined two decades ago. To illustrate with the situation in the United States again, note the following selection of facts: five of the ten largest banks in California are owned by Japanese banks. There is no bank headquartered in the State of Texas. Credit card operations and telephone service centers are located in places like North Dakota and India. Banks were underwriting corporate securities legally even before the repeal of the prohibition of the combination of commercial and investment banking in the United States.

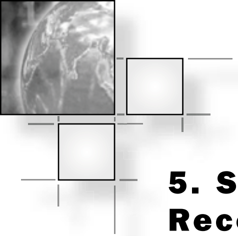
The implication of a movement toward the efficient allocation of capital in financial services to developing economies is that there will be large changes around the world and in open economies in the future. These changes benefit economic growth and development because they reduce the cost of funds for investment in productive activities and distribute risk more broadly. The cost of funds will be reduced in all economies around the world if these developments are allowed to occur through further liberalization of financial markets.

Survival of domestic financial firms, however, in the face of some large multinational financial firms operating across markets to realize economies of scale from risk capital and capital investment, will require adjustments. In economies that are more liberalized and open, like Chile, domestic financial firms have started to make necessary adjustments. Financial firms in all economies, including developing economies, will have to identify strategies for markets where they have a comparative advantage. Economies delaying their opening to international competition will likely be unable to protect these firms from the realities of the evolving financial system forever. Ultimately, these firms will have to make more painful adjustments or may not survive.

Domestic firms will no doubt find their greatest advantage in dealing with those aspects of their economies that are most resistant to standardization and where cross-cultural differences stemming from language barriers, institutional variation, and local market conditions, are hardest for remote firms to understand and service. The most likely markets where domestic firms will have competitive advantages are markets serving heterogeneous customers like small and medium businesses and professional and wealthy individuals. Here, personal service and understanding of local customs and conditions are essential to provide what customers need and want.

Financial institutions developing profitable strategies by serving heterogeneous customers in somewhat segmented financial markets does not mean that they will want to reduce the movement towards global financial market integration, however. They can exploit international markets to reduce the cost of their funding by tapping into investors seeking diversification and higher returns. They can utilize these markets by using financial contracts that reallocate and reduce the costs of bearing risks. They can expand their range of services by collaborative strategies with foreign firms operating in their markets who can help them provide services involving international markets at reduced costs.

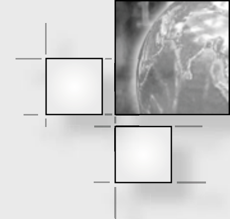
The exact nature of these developments cannot be predicted. The implication is invariant, however. In order to realize the maximum efficiencies and exploit profitable opportunities in domestic markets, financial market liberalization must proceed.



5. Summary, Conclusions, and Recommendations

This report has demonstrated a wide range of benefits, and few costs, associated with developing economies opening their financial markets to foreign investment. It stresses that developments in those markets in the last ten years are only the beginning of a process that will expand the benefits of an efficient financial system to a widening range of economies. The changes that have taken place so far, however, have not revolutionized or traumatized financial market participants in economies that have opened. In fact, the most regrettable fact is that some economies have missed the opportunity to improve their financial systems even more by limiting the extent of financial market liberalization to narrow segments of their economies.

APEC policy makers should pursue continued liberalization of their financial systems. The benefits identified in this study should allow them to present convincing arguments in the debate concerning the threat to domestic financial firms from foreign competition. In the face of the benefits identified from liberalization in the case economies and the APEC region discussed above, it is hoped that officials will structure their policy deliberations more along the lines of how to expand the benefits of foreign investment more broadly in their financial systems by reducing barriers that continue to exist in certain market segments. This discussion emphasizes that more liberal policies would have expanded the progress that has been made in restructuring financial institutions and markets in line with long-term movement towards efficiency in the global financial system.



Benefits of Financial Market Liberalization: Report to ABAC Working Group on Financial Market Liberalization

CASE STUDY

J. Kimball Dietrich
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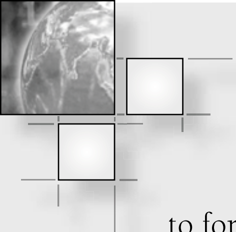
CHILE

Chile's economic and financial market experience differs dramatically from the other case economies in this study. A recent International Monetary Fund (IMF) country report on Chile discusses the last two decades of economic development as follows:

> *Chile has long stood out among developing countries for its pioneering economic reforms and for its success in raising real per capita income. Among emerging markets, Chile has also distinguished itself in avoiding a financial crisis for nearly 20 years, and more generally, for the stability of its growth and inflation rates.*[1]

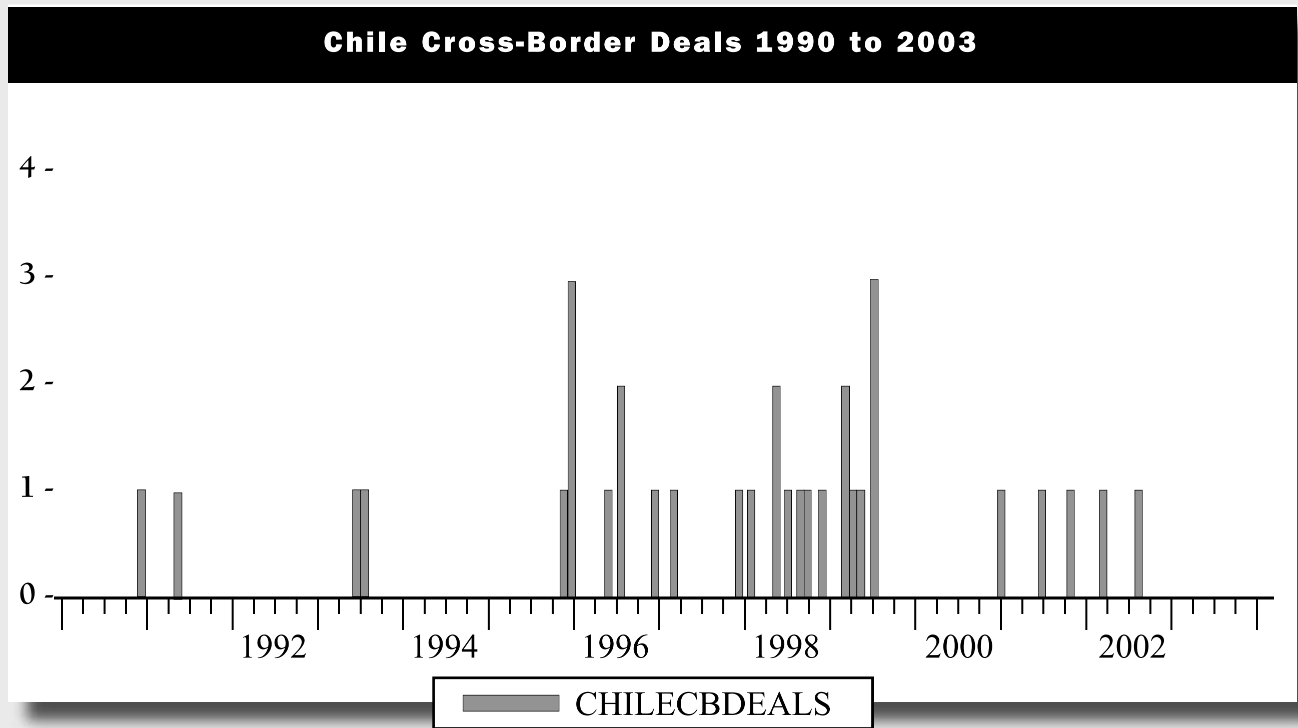
The report and its related publications are uniformly positive on "Chile's sound policy framework and strong fundamentals."[2] As is well known, Chilean economic policy makers have long advocated liberal trade and foreign investment policies as part of a strong market-orientation strongly influenced by the "Chicago School" of economics.

One specific policy innovation has had a strong impact on the Chilean financial system, namely the privatization of pensions in May, 1981. The Chilean pension system relies on government rules and tax incentives to foster retirement savings and has induced over 95 percent of all workers to save in pension plans that are managed by private pension fund managers, called *Administratrdoras de Fondos de Pensiones* (or AFPs). By 1999, total savings in the form of pension funds was over 42% of Chile's gross domestic product.[3]



The openness of the Chilean economy to foreign investment in financial services is evident by comparison with our other case economies: cross-border investment in Chile was more than two times that in Chinese Taipei and more than the total for South Korea even though its economy (measured by gross domestic product) is less than a third the size of Chinese Taipei and a fifth that of South Korea. Despite the stable growth and evolution of the financial system in Chile, however, the pattern of cross-border investments in the financial sector in Chilean financial firms displays some similarity to the other case economies in this report in showing an acceleration of activity after 1998, although there were a number of investments throughout the early 1990's.

Foreign direct investment in the Chilean financial sector was a much larger fraction of total mergers and acquisitions activity than in most the other case economies. Well over a half of all merger and acquisition activity in banking and insurance as can be seen in Table 4 of the main report is accounted for by foreign investors in Chile, whereas foreign investments were well under a half in the other case economies and well under a third for Chinese Taipei (except for banking in Thailand). This provides further evidence of the openness of Chile to foreign investment in financial services and demonstrates the importance of foreign investment to the financial market restructuring in that economy.



Foreign Direct Investment in Banking in Chile

Foreign bank branches have long been active in the Chilean banking sector but they have not been dominant: capitalization of foreign bank branches is well under 10 percent of total bank capital in Chile, and the largest foreign operation, Citibank, ranked 11th in terms of total loans with only a 2.63 percent share of total bank loans[4]. Many Chilean financial market observers view these foreign bank branches as "niche" players (serving their home market customers, providing specific financial products like hedging instruments, representing the headquarters operations to large local customers, and so forth). While important in the Chilean banking competitive environment, we will not focus on the operations of long-established banks similar to Citibank operating in Chile, for example Bank Boston, JP Morgan Chase, Deutsche Bank, Bank of Tokyo-Mitsubishi, and so forth, all of whom (in terms of assets) are smaller that Citibank.

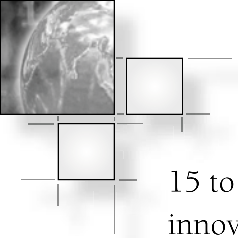
Starting in the 1990s, foreign direct investments in the banking sector played a major role in the restructuring of the banking sector in Chile. The largest investments were by two Spanish banking firms in the period 1993 to 1999, Banco Santander and Banco Bilboa y Viscaya (BBV). Banco Santander, in a sequence of transactions involving multiple firms, acquired Banco Santiago and O'Higgins Central Hispano to form the Chilean Banco Santander, now the largest bank in Chile. BBV acquired Banco Hipotecano de Fomento to form BBV Argentaria Chile, the fifth largest bank in Chile. The two Spanish banks invested over $ 2 billion in Chilean banking assets and saw their Chilean acquisitions as part of a Latin American strategy that is changing the face of banking in that region. They accounted for a major part of the cross-border investment in banking during the period we study, 1990 to 2003.

Other foreign investors were also active in the Chilean banking industry but at a much smaller scale. Bank of Nova Scotia paid around $130 million to acquire what became Scotiabank Sud Americano and Deutsche Bank acquired Credit Lyonnais' operations in Chile. As of the end of 2003, the top four private banks in Chile, Banco Santander, Banco de Chile, Banco de Credito e Inversiones (BCI), and BBV have over 50 percent of banking assets in Chile, and when the state-owned Banco del Estado de Chile (number three in size) is added, the five banks account for over 63% of banking assets.

Benefits and Costs of Cross-Border Investments in Banking in Chile

Regulators and banking executives interviewed in Chile seemed very comfortable with the level of foreign activity in the banking industry in Chile[5]. The entry of Banco Santander into the Chilean banking market was considered by a majority of observers to have been an important catalyst in the rationalization of banking practices in Chile. Banco Santander brought a strong focus on operational efficiency (as represented by the efficiency ratio or non-interest expense over net interest margin plus non-interest revenues) and a commitment to improve other performance ratios measuring shareholder returns, like return on equity and share appreciation. This concentrated concern with efficiency and performance has greatly influenced bank practice by all major players in banking in Chile, and reduced Chilean bankers' previous obsession with market share.

Banco Santander is also viewed as bringing advanced technology to the Chilean banking market and using that expertise to provide innovative products. Banco Santander has developed a strong presence in the mortgage market, bringing new products, like



15 to 20 year mortgages. BBV is also seen as an innovator in home financing, having introduced variable rate mortgages in the Chilean market. The net effect of the increased competition in mortgage lending provided by these foreign-owned banks has been to lower mortgage borrowing spreads, benefiting homebuyers considerably.

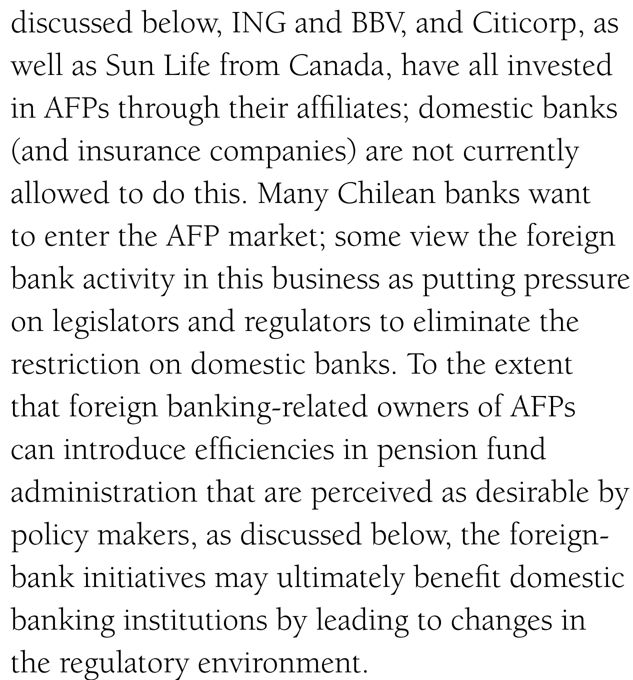
Banco Santander and BBV have led to improved risk management practices in domestic banks. Starting with credit risk, Banco Santander credit risk analysts at the bank's headquarters in Madrid review all important credit decisions by the Chilean unit. Foreign banks, with access to capital and advanced risk assessment and management techniques, have provided a model of improved risk measurement and management to larger domestic banks. Risk management strategies involving derivatives, used by Banco Santander and BBV and other foreign banks in Chile, are viewed as promoting better risk management among domestic banks.

Foreign-owned banks rely heavily on Chilean managers below the top levels and those managers benefit from exposure to foreign management procedures and techniques. Overall total employment in banking in Chile is down over 21% from 1997 to 2003, but employment at Banco Santander is down slightly less than that (minus 19%) and the domestic Banco de Chile's total employment is also down substantially (minus 12%)[6]. Total employment at BBV and the other large domestic bank, BCI, has increased.

Several banking market commentators observe that the large foreign bank investments in the Chilean banking market are part of a broad regional strategy by large foreign banks to concentrate resources on serving large corporate customers and large retail markets and not to concentrate on middle-market lending. While some argue that middle-market firm lending has been disadvantaged by the entry of the large Spanish banks, other market observers believe that Chilean owned and managed banks are essential to understand and develop middle-market lending strategies and that domestic banks can survive and prosper in this market where foreign-owned banks are not as competitive. In particular Banco de Chile and BCI, in addition to the state-owned Banco del Estado de Chile and smaller banks, are said to be well positioned to serve this critical business financing market. Domestic banks do not feel threatened about their ability to compete in these local financial markets against larger foreign firms.

There is a view that serving large corporate customers and big, homogeneous consumer credit markets are both subject to greater economies of scale than the information-intensive and heterogeneous demand for credit by small and medium enterprises and middle-market firms. This analysis suggests that the bank restructuring in Chile accompanying the entry of active foreign banks is a move towards economic efficiency. The reduction in mortgage lending costs and proliferation of retail lending products stimulated by both foreign competition and non-bank entry into the credit-card market (by retail stores and even the insurance industry) are evidence of benefits to consumers of allowing foreign investors to compete in domestic markets. Local bankers feel that the foreign firms will be disadvantaged in dealing with credit markets where local information and customs require local knowledge and experience, providing local banks with ample opportunities to compete effectively and grow.

An important issue to domestic Chilean bankers concerning foreign-bank competition has to do with the limited authority of domestic banks to operate in the insurance and pension-fund management (AFP) businesses. As



discussed below, ING and BBV, and Citicorp, as well as Sun Life from Canada, have all invested in AFPs through their affiliates; domestic banks (and insurance companies) are not currently allowed to do this. Many Chilean banks want to enter the AFP market; some view the foreign bank activity in this business as putting pressure on legislators and regulators to eliminate the restriction on domestic banks. To the extent that foreign banking-related owners of AFPs can introduce efficiencies in pension fund administration that are perceived as desirable by policy makers, as discussed below, the foreign-bank initiatives may ultimately benefit domestic banking institutions by leading to changes in the regulatory environment.

Foreign Direct Investment in Insurance in Chile

The insurance market in Chile remains fragmented compared to the banking market following the restructuring of the last decade. In 2002, there are 23 casualty and 32 life for a total of 55 insurance companies in Chile[7]. Many small companies have tiny market shares and regulators are concerned about the small, undercapitalized companies in the business. Foreign direct investment in insurance since 1990 has played a role in consolidating the industry and increasing its capital base.

Patterns of foreign investment in the insurance industry are very different than in the banking industry. Major insurance company acquirors come from the United States, the United Kingdom, following investments earlier in the 1990s by companies from Luxembourg and Switzerland. Spain has not been a source of foreign direct investment in the Chilean insurance industry.

The insurance business has been growing rapidly in Chile. Premiums in the casualty insurance business have grown at an annual pace of 8.2% from 1990 to 2002, and at annual rate of 10.8% for life insurance. Market observers also expect increasing growth rates due to the retirements of workers who have been using the private pension funds since 1981 and who usually convert their pension accumulations to annuities offered by life insurance companies.

Benefits and Costs of Cross-Border Investments in Insurance in Chile

Foreign insurance companies have been active but not major players in the Chilean insurance market for decades. Zurich Insurance bought 97% of La Chilena Consolidada in 1991; Citicorp bought 50% of Cruz Blanca Seguros de Vida in 1993, but sold its interest to ING Groep from the Netherlands in 1997. ING bought the rest of Cruz Blanca, becoming the largest life insurer (measured in premiums) for 2002. However, most observers believe that Chilean insurance companies will continue to dominate the insurance market as they have in the past. Recent rapid growth of the largest domestic firm, Consorcio, stemming from annuity sales and insurance savings products, confirms domestic firms' ability to compete effectively.

There is a widespread belief that foreign firms can accelerate the restructuring of a fragmented industry[8]. As examples of this role for foreign investment, Agence Generale de France (AGF) had earlier in 1990 acquired two Chilean firms, Consorcio Casualty and Prevision. More recent examples of foreign investors assisting in industry consolidation by acquiring multiple insurance companies, Principal Financial Group, a U.S. insurance group, bought Cia de Seguros de Vide El Robi, Banrenta, and a third company[9] in the period 1996 to 1998, and Metlife acquired Cia Seguro de Vida Santander and Soince, both in 2001.

Foreign insurance company investors have brought innovations to the Chilean

insurance market. For example, Zurich introduced universal life insurance policies. ING has been using its insurance sales force to cross-sell pension management services (something domestic insurance companies are not allowed to do.) Foreign insurance companies have set a standard for training. One example cited was AIG training of agents to assist them in developing a career focus.

Insurance industry observers interviewed in Chile do not seem to be concerned about the presence of foreign owned insurance firms in their market. They are convinced that there are unique attributes to Chilean market participants, requiring local area knowledge and understanding of local habits and traditions, that will assure that Chilean firms will ultimately play a major role in the insurance industry in their country. As evidence of this, Royal Sun exited the Chilean market in 2002 (due to losses from the September 11, 2001, events) by selling its Chilean operations to a domestic group.

Foreign Direct Investment in Pension Administration (AFP) in Chile

Foreign firms have been active recently investing in pension fund management firms (AFPs) in Chile[10]. BBV bought Provida AFP, the largest in Chile, and Banco Santander bought a smaller firm, the fifth largest. Citicorp bought 22.5% of Habitat AFP in 1996 and Sun Life of Canada bought 31.2% of Cuprum AFP in 1998. ING acquired Santa Maria AFP. Given that there are only eight active AFPs in Chile, the extent of foreign activity is obviously large.

As mentioned above, Chilean banks and insurance companies are not allowed to operate AFPs. There appear to be many synergies between the two businesses: pension contributions must be made monthly and customer account services (corrections and inquiries) must be provided; and of course, marketing must be conducted to compete for business. Bank branches could handle these functions very effectively. Insurance companies also have similar potential synergies with AFPs: processing premiums and customer service for pension plans are similar to insurance policies, and furthermore, retirees usually convert their funds balances to annuities, sold by insurance companies, upon retirement. Stand alone AFPs have had to establish branch offices and have formed a cooperative to deal with the many small transactions involved with monthly contributions.

Foreign investors have two strategic advantages over domestic AFPs: first, they can circumvent the restriction requiring separation of banking, insurance, and pension fund administration through their foreign holding companies. Exploiting this loophole and challenging the intention of the regulations, ING and BBV both use their branch systems to serve their customers and cross-sell related products. Second, as international financial institutions, they can broaden their marketing and spread the costs of offering pension fund management services. For example, BBV has plans to offer pension fund management services in Mexico, Argentina, Columbia, Dominican Republic, Ecuador, El Salvador , and Peru, all Latin American economies that have adopted private pension plans similar to Chile's. Mexico's system is already second in size only to Chile after five years. BBV is developing one computer system that can handle all of these pension programs and is consolidating its back office operations in Mexico.

The foreign investment in AFPs seem to have different strategic significance for different investors: BBV's Provida is the largest in Chile, even though BBV is substantially smaller than Banco Santander, whose AFP is very small. Citigroup's minority position may be a strategic investment to gain experience relevant to private pension plans expected to grow in

Eastern Europe and may not be an effort to dominate the Chilean market.

In any case, sellers of Chile's AFPs are widely described as benefiting from the high prices paid for these financial institutions. Selling assets at high prices is always a benefit for owners of domestic firms. The proceeds of these sales can be redeployed at higher returns elsewhere in the restructuring financial markets of Chile.

Foreign Direct Investment in Securities in Chile

Securities operations have not been an important target of foreign investment in Chile in the last decade[11]. This reflects the concentration of ownership of Chile's few securities trading firms and the high costs of transactions due to taxes and commissions, estimated at over 3% of transaction amounts. A common complaint concerning Chile's exchanges is the lack of liquidity, with most explanations exploring the small number of AFPs firms (eight) and the ease of off-shore trading in securities of major Chilean firms that are listed in New York using ADRs.

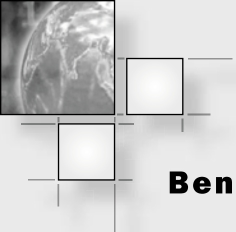
Regulators believe that foreign competition in the domestic Chilean securities market is essential to break up the concentration in trading activity, to bring innovation to the markets, and to impose discipline on market participants in terms of best practices. Lack of competition and innovation has resulted in a stultification of trading of derivatives, useful for hedging risk by financial institutions and investors. In other words, the securities markets low level of development in Chile is ascribed in part to lack of foreign investment. The lack of interest by foreign firms in investment in the securities business in Chile is no doubt in part the result of the domestic business and regulatory climate.

Summary

Foreign direct investment in the form of mergers and acquisitions has had an important impact on the banking, insurance, and pension-fund management segments of financial services in Chile in the last decade. However, the impact has been different in these sectors: in banking, major investments by two Spanish banks as part of a broader Latin American strategy has influenced both product innovation, use of technology, and risk management strategies, and has also served to focus domestic bank approaches on more refined marketing strategies, for example, focusing on middle market lending. These effects, combined with the new entrants clearer management discipline, has both made domestic banking markets more efficient and more reasonably priced and has produced a general improvement in bank performance.

The insurance business in Chile is not as far along in terms of restructuring as banking, but foreign investment is aiding in this process. Foreign firms do not dominate this market, though, and individual investors have shown a range of business strategies, including some who have invested and then divested. Major Chilean insurance firms do not feel threatened by the presence of foreign competitors.

Finally, pension fund management market is clearly changing in response to foreign investors who have an advantage in terms of flexibility relative to domestic providers. Most believe that in the long run the efficiency of the AFPs will be increased as competition and more efficient organization of marketing and production activity reduce fees and costs.



Benefits

Foreign direct investment has contributed to the efficiency of the Chilean banking system: capital investments have contributed to the restructuring of the banking system and focused management practices on efficiency and high returns, introduced new products, emphasized employee training and improved risk management, and implemented high technology methods, all of which have stimulated increased competition, lowered prices, and provoked more focused management strategies by domestic banks. This has had the effect of reducing costs and refining marketing plans for the major banks in Chile. Foreign direct investment in insurance has begun to play a role in restructuring the insurance sector in Chile and has also brought new products and management focus to that sector. Foreign firms have combined smaller firms into larger and more efficient units and have introduced cross selling of products to realize reduced marketing expenses. Pension fund management has been the target of substantial foreign direct investment that has had the effect of increasing the values of AFPs, benefiting domestic owners of those firms, but also putting pressure on policy-makers to open that business to operating and marketing efficiencies possible when pension-management products are sold and delivered with banking and insurance products.

Costs

Financial market observers did not emphasize the costs to the Chilean economy. There were some concerns about transitional unemployment and reduced employment in some sectors, for example banking. Some observers were concerned about the level of service available to smaller firms in the face of banking consolidation.

Table: Benefits and Costs of Foreign Investment in Chile
Benefits
Financial product innovations
Improved management techniques and performance measures
Training and improved risk management
Technological advances
Consolidation of existing firms into larger, more efficient units
Increased competition leading to cost and price reductions
Demonstration to regulators of advantages of changing restrictive regulations
Costs
Possible transitory employment adjustments
Possible reduction in providers focus on small business market financial needs

(Endnotes)

[1] International Monetary Fund. 2003. "Chile: 2003 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Chile", September, IMF Country Report No. 03/303.

[2] International Monetary Fund. 2003. "IMF Concludes 2003 Article IV Consultation with Chile", August 20, Public Information Notice (PIN) No. 03/103.

[3] L. Jacobo Rodriguez. 1999. "Chile's Private Pension System at 18: Its Current State and Future Challenges," July 30, The Cato Project on Social Security Privatization, SSP No. 17, Cato Institute, Washington, D.C. and Armando Barrientos and Aziz Boussofiane. 2001. "The Efficiency of Pension Fund Managers in Latin America," October, Centre on Regulation and Competition, Working Paper Series no. 11, Institute for Development Policy and Management, University of Manchester, Manchester.

[4] All banking data and rankings discussed here and below are fromSuperintendencia de Bancos e Instituciones Financieras Chile *Informacion Financierea (December, 2003),* primarily from the table "Ranking de las Instituciones Financieras Segun Colocaciones Totales" (p. 88).

[5] This analysis is based on our discussions with the following representatives of the banking industry in Chile: Alejandro Alarcon Perez of the Asociacion de Bancos e Instituciones Financieras de Chile; Enreique Marshall Rivera and Ignacio Errazuriz Rozas of the Superintendencia de Bancos e Instituciones Financieras Chile; Francisco Garces, C., Alex Ladrix O., and Ricardo Morales A. of the Banco de Chile; Sergio Lehman, Luis Antonio Ahumanda and Alejandro F. Jara R. of the Banco Central de Chile; and finally Marian-Robert Lingsch W., Banco Credito Inversiones. All interviews were conducted in their respective offices in Santiago, Chile, in June, 2004.

[6] Employment data are from Superintendencia de Bancos e Instituciones Financieras Chile *Informacion Financierea (December, 2003),* primarily from the table "Numero de Empleados de las Instituciones Financieras" (p. 105) adjusted to reflect the combination of Banco Santander Chile with Banco Santiago in 2002 and Banco de Chile's acquisition of Banco de A. Edwards the same year.

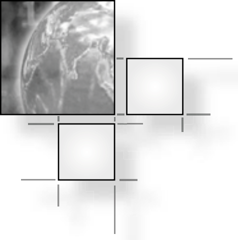
[7] Data are derived from the Asociacion de Aseguradores de Chile, "Sintesis Estadistica del Seguro en Chile", 2002, various tables.

[8] This analysis is based on our discussions with the following representatives of the insurance industry in Chile: Alejandro Alarcon Perez of the Asociacion de Bancos e Instituciones Financieras de Chile; Jorge Claude B., Asociacion de Aseguradores de Chile; Marcos Muechi Buc, Consorcio Seguros Vida

[9] Transaction not reported in the Thompson Financial Data Base.

[10] This analysis is based on discussions with Joaquin Cortez Huerta of BBVA Provida; Salvador Seda and Edward J Waitzer, both with the Supintencia of Securities de Chile.

[11] This analysis is based on discussions with Joaquin Cortez Huerta of BBVA Provida; Salvador Seda and Edward J Waitzer, both with the Supintencia of Securities de Chile.



Benefits of Financial Market Liberalization: Report to ABAC Working Group on Financial Market Liberalization

CASE STUDY

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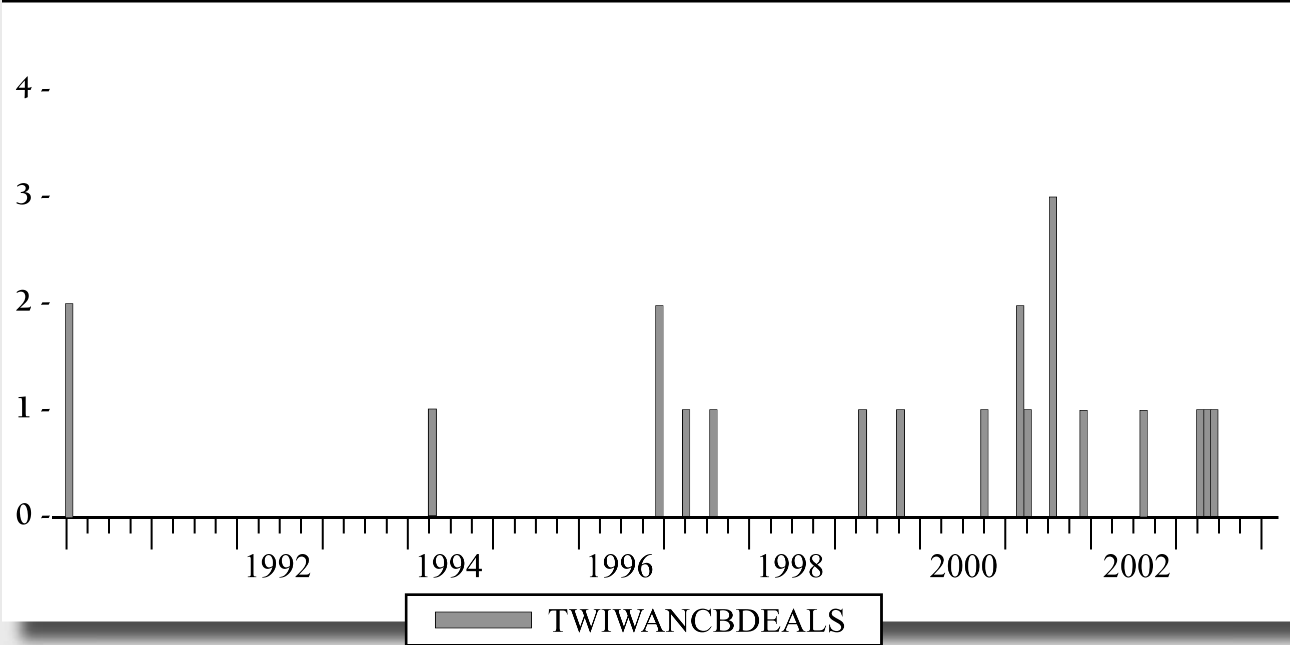
CHINESE TAIPEI

Chinese Taipei was not as directly impacted by the Asian Financial Crisis as some other Asian APEC economies and in fact reported GDP growth of 6.7% in the first year of the crisis, 1997.1 However, other sources of pressure to liberalize its financial system and reduce barriers to foreign investment were in place following a slow pace of liberalization and opening in prior decades. First, in 1998 foreign investors and the Asian Development Bank criticized Chinese Taipei for the slow pace of reform2; second, in joining the World Trade Organization, Chinese Taipei was under pressure to open its financial services markets; and third, there was a widespread belief in the government that consolidation of the banking and insurance industries was required to eliminate weak, undercapitalized firms making the financial system vulnerable to failures.

As the economy moved into recession in 2001, a new sequence of legislative actions followed a special session of the legislature to liberalize financial markets. As can be seen from the graph, foreign investment activity accelerated after the year 2000. Although the pace of foreign investment increased, foreign investment in financial institutions in Chinese Taipei was much less than in the other case economies, especially given the size of its economy. For example, the total cross-border investment in the Chinese Taipei financial sector over the period 1990 to 2003 was less than half the amount invested in Chile, although its economy (measure by gross domestic product) is more than three times larger than that of Chile.

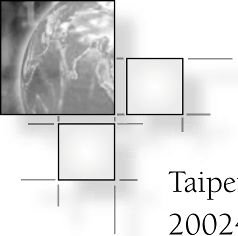


Foreign Direct Investment in Banking in Chinese Taipei

The focus of foreign direct investment activity in the financial sector in Chinese Taipei was not primarily new foreign investment in commercial banking institutions, despite the data shown in Table 4 of the main report. Examination of the actual acquisitions shows that $1.3 billion out of a total of $3 billion in foreign investment in financial services reflects the purchase by ABM-AMRO of Bank of America's retail businesses in India, Singapore, and Taipei that were headquartered in Taipei. In another transaction (no value reported), one American bank (Norwest Bank) bought the Taipei branches of another U.S. bank (Bank of New England). An additional $263 million represents purchases of three non-performing loan portfolios and thus do not represent transfers of control to foreign investors. Foreign bank branches operating in Chinese Taipei are relatively small: for example, in 2000 and 2001, foreign bank branches had 4.3% of the total deposits and 5.5% of the total loans in Chinese Taipei.3 To the extent that it has occurred, banking sector restructuring in Chinese Taipei resulted from mergers between domestic institutions and foreign direct investment has played a relatively minor role.

Non-Bank Cross-Border Acquisitions

The impact of foreign investment has been much greater in the insurance industry than in banking. Three foreign investments are the focus of our analysis of the impact of foreign direct investment in non-bank financial services in Chinese Taipei in the following discussion. Two of these new investments are in insurance: (1) Allianz Insurance Group (a New York subsidiary of the German insurance giant) bought 50% of a small Chinese Taipei insurance company, President Group (life and non-life), in June of 1999 (value not disclosed); and (2) Massachusetts Mutual Life, an U.S. company, bought 38% of slightly larger domestic company, Mercuries Life, in January, 2001, for $ 136.4 million. Allianz President Life had a share of total life insurance premiums in Chinese



Taipei of .48% in 1999 that grew to 1.11% by 20024. MassMutual Mercuries Life was larger with 3.32% share in 2001 growing to 3.46% by 2002. In 2002, the Massachusetts Mutual affiliate ranked 8th and Allianz's unit ranked 14th in terms of life premiums in Chinese Taipei. Allianz's non-life unit had a 3.1% share of non-life premiums in 2002 and ranked 15, up slightly from 1999, when it ranked 17.

The three largest life insurance companies in Chinese Taipei measured by share of life insurance premiums are domestic firms: Cathay Life Insurance (largest with a 31.53% market share in 2002); Nan-Shan Life Insurance (second with 15.8% share); and, Shin Kong Life Insurance (third with 12.91% share). The fourth largest firm is the U.S. firm Aetna's subsidiary in Chinese Taipei (20% of which was purchased in March 2001 by the Dutch ING Groep for $380 million) with a market share under 10%. The next three largest firms are all domestic. Thus, with over half the market as measured by premiums dominated by the three largest domestic firms and only three foreign firms represented in the top ten measured by market share (Aetna, Massachusetts Mutual, and Prudential, number 10), the life insurance market in Chinese Taipei is dominated by domestic companies.

The third major acquisition of a non-bank firm in Chinese Taipei was Citigroup's acquisition of 15% of Fubon Securities in April, 2001, for $ 241.6 million5. This acquisition was widely observed to be a passive investment by Citigroup with possible long-term strategic significance, but Citigroup has recently announced that it will sell its stake in Fubon Financial, the holding company for Fubon Securities. Financial market observers said the partnership between Citigroup and Fubon was "troubled" despite the fact that the Fubon investment is reported to have been Citigroup's largest investment outside Japan in Asia6. Because Citigroup has announced that it will withdraw from it investment in Fubon, we will not focus on this example of cross-border investment in financial services.

Benefits and Costs of Cross-Border Investments

To examine the impact of cross-border investment in financial services in Chinese Taipei, this analysis focuses on the foreign investments in two insurance companies, President Life and Non-Life and Mercuries Group. To go behind the data, we interviewed representatives of the Department of Insurance in the Ministry of Finance of Chinese Taipei and executives of the two firms7. Our conclusions are based on these interviews. We discuss the impact of these investments under "Benefits" and "Costs" below and provide a summary table for comparison to other case economies at the end of the section.

Benefits

The regulatory view presented by the Department of Insurance in the Ministry of Finance is that foreign investment stimulates competition in the insurance market. The official position is that Chinese Taipei welcomes foreign participation in the domestic insurance market. The Chinese Taipei Financial Supervisory Agency (FSA) takes over regulation of banks, insurance, securities, and firm examinations in July, 2004, and will continue to encourage joint ventures (involving 20% to 30%) of domestic and foreign firms. Foreign firms are to be accorded national treatment, although the FSA must approve all changes in stock ownership over NT$ 1 billion (around $30 million).

Specific benefits mentioned by insurance regulators that are derived from increased competition include improvements in asset-liability management (ALM), especially

important for insurance companies in the recent low interest-rate environment, new product development or introduction of products from abroad, and implementation of e-commerce to create efficiencies in operations and marketing. The main benefits of foreign investment thus come from increased competition and efficiencies in the market for life insurance products and improved risk-management and early-warning systems applied to Chinese Taipei life insurance company operations.

Private insurance firm executives provide concrete examples of these benefits of foreign investments. For example, President Life and Non-Life Insurance, prior to the Allianz Investment, was a 35-year old minor player in the Chinese Taipei life insurance market; the insurance unit of President Group was a small part of a large holding company that was an important player in the food industry (yeast and noodles) and also owned large stakes in the Starbuck's and 7-11 Convenient Store Chains in Chinese Taipei. Allianz took some time to develop successful innovations, but introduced a number of innovations that have led to profitability. Management claims that life premiums will reach $NT 42 million in 2004, up from around $NT 9 million in 2002.

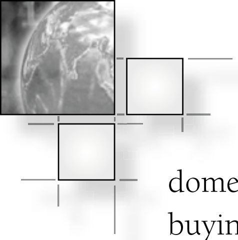
Among the innovations introduced by current management was hiring a United States-trained accredited actuary (many insurance firms in Chinese Taipei do not have actuaries) necessary to introduce sales of life-insurance savings products like variable universal life policies; these policies are offered elsewhere by Allianz and other insurance companies. Regulatory approval of these products, new to Chinese Taipei, was facilitated by the experience of the foreign investor in other major insurance markets and experience with the regulators with good reputations in jurisdictions like Germany and the United States.

An energetic management team began to look for new marketing and service delivery channels. For example, Allianz President developed a plan to use the ubiquitous 7-11 retail store outlets as convenient ways to renew auto policies. They also began to use the stores as means to reduce costs of filing auto-damage accident claims, introducing innovations like designing claims forms using standardized bar codes that can be faxed to claims processing centers from the stores. The company has also aggressively cross-sold its life products through cooperative agreements with major banks, like China Trust.

Allianz President Insurance has also introduced innovations in operations that have had a wide impact through insurance industry conferences and professional meetings in Chinese Taipei. Some examples of these innovations in the domestic insurance industry include application of activity-based costing to improve efficiency, specific techniques in balance-sheet management, and implementation of compliance systems and risk management techniques to lower costs of excessive risk exposures.

Another important development new to Chinese Taipei is Allianz President's emphasis on employee training and education, with 3 life and 6 non-life employees sent abroad for training. The firm has also started a "Future Leaders" program to develop and retain the best managers to support growth. All of these employee enhancement programs were unusual in the established domestic insurance market and among the smaller insurance firms.

The MassMutual Mercuries Insurance operation bears some similarities to the President Insurance situation: Mercuries Insurance was a small insurance company within a large diversified holding company: the Mercury Group owned Mercury Stores, pizza parlor chains, shoe stores, and so forth. However, Massachusetts Mutual retained the



domestic managers of the insurance unit after buying 38% of the company but does have four board seats out of nine, while the Mercury Group also has four.

MassMutual Mercuries has introduced several life insurance products into the Chinese Taipei insurance market, including universal life and single payment deferred annuities (SPDAs). As with Allianz President, new product regulatory approvals were facilitated by the company's experience from its foreign investor's home markets as well as its operations in Hong Kong and Japan.

Massachusetts Mutual has had a major impact on the firm's operations by installing a new chief financial officer (CFO) who established a system of deadlines and budget and sales targets similar to the U.S. parent firm's procedures; these changes were described as a real departure from the domestic firm's traditional operations. A new risk management officer position has been created and risk-management techniques like the use of derivatives and diversification of reserves into foreign assets introduced. An investment committee in Springfield, home of the parent company, reviews portfolio decisions of Mercuries Insurance.

Call centers in Hong Kong and Springfield, Massachusetts, have been integrated into the domestic firm's operations to improve service and reduce costs and serves to integrate the company across borders. Training and cross-border experience has also been expanded at Mercuries Insurance. CFOs from the parent's operations meet in a conference to compare notes, and the parent also sponsors a pricing and actuaries conference.

Mercuries also emphasizes improved relations with insurance regulators due to its being part of a global insurance company. It can draw on parent company resources like actuaries to satisfy regulatory requirements for approval on new products. The company prior to the foreign investment had a history of capital deficiencies, but the joint-venture company recently was able to draw on the resources of the parent to meet a capital shortfall quickly and efficiently. The parent company's resources have also allowed the domestic firm to take advantage quickly of small investment opportunities.

Costs

None of the regulators and executives mentioned significant costs to the domestic economy or insurance industry due to foreign investment in that financial sector in Chinese Taipei.

Summary

Foreign investment in the Chinese Taipei insurance market has not turned the industry upside down. The changes induced have been marginal but significant, for example introducing new products already offered elsewhere and changing management in terms of establishing goals and measuring performance. Risk management techniques have been introduced and training programs enhanced. While not revolutionary, these impacts of cross-border investment have increased competition as demonstrated by the increasing share of the two target firms. Further, the long-run growth and profitability potential of the domestic insurance industry is enhanced by the increased focus and innovation introduced by the management of these domestic firms under partial foreign ownership. We summarize the main benefits in the table, "Benefits and Costs of Foreign Investment in Chinese Taipei," below. As a means of stimulating change within the domestic financial market, foreign investment will contribute to the long-run viability of the domestic financial market.

Table: Benefits and Costs of Foreign Investment in Chinese Taipei
Benefits
Product innovations
Demonstration effect of innovations facilitating regulatory approvals
Improved management focus and techniques
Emphasis on employee training
Development of new sales channels and marketing techniques
Introduction of new technology
Implementation of new risk-measurement and management techniques
Costs
No major costs to domestic economy were identified

(Endnotes)

[1] Yu Min-Teh (undated): http://www.adb.org/Documents/Books/Rising_to_the_Challenge/Sound_Practices/tap-bnk.pdf

[2] See, for example, the *Asian Development Outlook 1998* section on Taipei, China (pp. 55-57) published by the Asian Development Bank.

[3] The Central Bank of China *Annual Report 2001*, p. 36.

[4] All life insurance market share figures in the following discussion are from Ministry of Finance Department of Insurance *Annual Report 2002,* pp. 109ff.

[5] The *Wall Street Journal* (June 29, 2004) reported that Citigroup bought 15% of the Fubon Group in May, 2000, for $ 750 million in a privately negotiated transaction. The *Thompson Financial M&A Data Base* did not report the other parts of this transaction involving a 15% in the Fubon Financial Holding Company.

[6] Op. cit., p. C6.

[7] We met with Chen Wei-Lung, Deputy Commissioner, and Ray Chen, Assistant Director General, of the Department of Insurance; Bruce Bowers, Chief Executive Officer, and Karen Hwang, Deputy CEO, of Allianz President Insurance; and Andrew Lee, Bancassurance Manager, and C. Roy Meng, Vice President and Actuary, of MassMutual Mercuries Life. All the interviews were conducted in the interviewee's offices in Taipei in May, 2004.

Benefits of Financial Market Liberalization: Report to ABAC Working Group on Financial Market Liberalization

CASE STUDY OUTLINE

J. Kimball Dietrich
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SOUTH KOREA

South Korea was at the center of the Asian Financial Crisis of 1997. The following provides a contemporary description of the official interpretation of the causes of the Korean crisis in 1997:

> *Korea's external financial situation deteriorated sharply after October 23, [1997], following the decline in the Hong Kong stock market and the downgrading of Korea's sovereign risk status by Standard and Poor's. New external financing has virtually dried up and substantial difficulties are being experienced in rolling over the relatively large amount of short-term debt (estimated at $100 billion). The won depreciated by about 20 percent against the U.S. dollar though November 30; the stock market index fell by some 30 percent to a ten-year low. Gross official reserves declined sharply, with a large amount used to finance the repayment of short-term debt of Korean commercial banks' offshore branches. While the contagion effects of development in Southeast Asia contributed to the current crisis, the magnitude and speed of the deterioration in the financial situation owes much to the fundamental weaknesses in Korea's financial and corporate sectors*[1].

The severity of the crisis for the Korean financial system can be measured by some examples of the government's policy responses: Korea applied for and received financial support from the International Monetary Fund (IMF) and other governments and institutions at the end of 1997. By the end of 1999, the Korean government had closed five commercial banks, 17 merchant banks, and four life insurance companies, and orchestrated three mergers of commercial banks;[2] two large commercial banks, Seoul Bank and Korea First Bank, were taken over by the government with a 94% equity stake. The financial regulatory structure was completely overhauled, with all financial sector supervision and prudential regulation consolidated into the Financial Supervisory Service (FSS) with policy formulated by its associated Financial Supervisory Commission (FSC).

As part of the Korean commitment in the IMF Stand-By Arrangement for

funds negotiated at the end of 1997, substantial liberalization of foreign investment in the Korean financial service sector was required. For example, the agreement required the following economic program elements[3]:

Under "Restructuring and reform measures"

...A credible and clearly defined exit strategy will include closures as well as mergers and acquisitions by domestic and foreign institutions, provided the viability of the new groupings is assured...

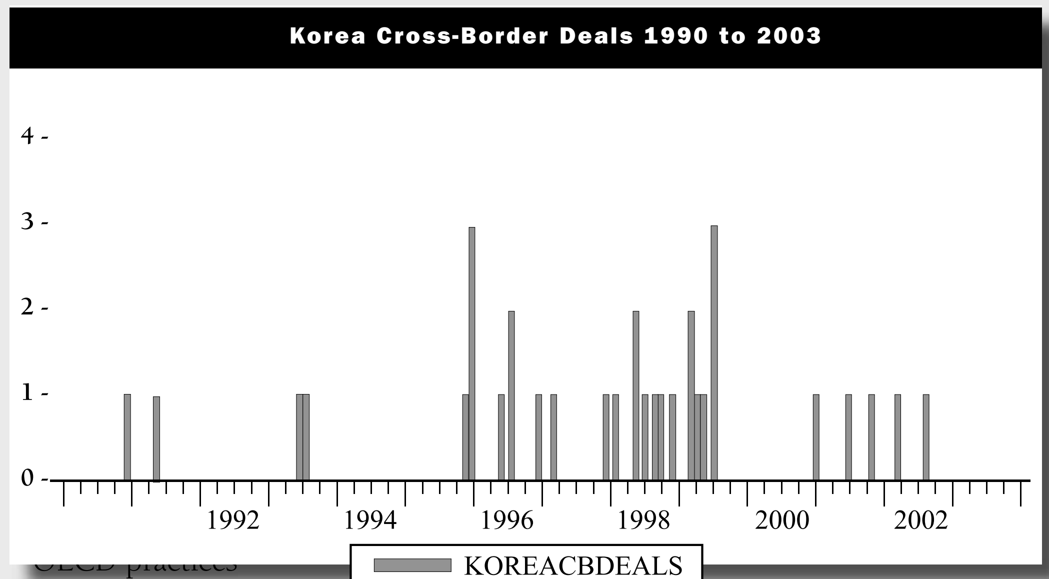
Under "Capital account liberalization:

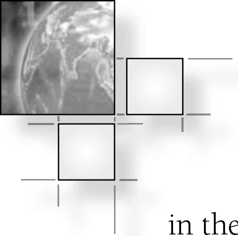
...The present timetable for capital account liberalization will be accelerated by taking steps to:

- Liberalize foreign investment in the Korean equity market by increasing the ceiling on aggregate ownership from 26 to 50 percent by end-1997
- Effective immediately, for foreign banks seeking to purchase equity in domestic banks in excess of the the 4 percent limit requiring supervisory authority approval, the supervisory authority will allow such purchases provided that the acquisitions contribute to the efficiency and of the banking legislation will be to the first special National Assembly the Korean purchases with OECD practices (with due safeguards against abuse of dominant positions)
- Allow foreign investors to purchase, without restriction, domestic market instruments

This liberalization of restrictions on foreign investment in the financial sector is reflected in the acceleration of cross-border mergers and acquisition activity in Korea starting in 1998, as shown in the chart below, "Korea Cross Border Deals 1990 to 2003."

Despite the seriousness of the Korean financial crisis and the IMF requirement to open the financial services sector to foreign investment as part of restructuring the financial sector, foreign direct investment in mergers and acquisitions in Korea is less than the amount invested in Chile over the period 1990 to 2003 and only about 14% more than Chile from 1997 to 2003, despite having an economy more than five times as large (measured by GDP). While direct investment in the form of mergers and acquisitions increased in a pattern similar to other APEC and case economies for this study after 1997, many more of the transactions involved the Korean government as a counter-party.





The pattern of foreign direct investment in the form of mergers and acquisitions is more heavily weighted toward the banking sector than in the other case economies: over 60 percent of cross-border transactions measured in dollar value is accounted for by the banking sector (around a third of the total number of deals). The second largest investment was in investment and commodity firms or dealers, nearly 19%, followed by other credit institutions. Insurance is relatively small, at under 10% of the total merger activity over the period.

In a 2003 and 2004 assessment of the financial sector in Korea, the IMF describes the banking sector as follows:

The results of banking sector restructuring were impressive: non-performing loans fell sharply, capitalization increased to well above Basel minima, both the number of institutions and employment were reduced significantly, and profitability was restored.

However, with respect to the non-bank sector, the progress is not assessed to be as substantial:

> Progress in restructuring non-bank financial institutions is, however, generally less advanced than in the banks. In particular, the *Financial Sector Stability Assessment (FSSA)* for Korea (IMF, 2003) notes that non-bank deposit taking institutions face soundness problems, the insurance sector remains financially weak, and supervisory oversight in a number of sub-sectors should continue be strengthened.[4]

The lower level of foreign capital investment in the insurance and other troubled non-bank financial sectors may in part be related to the slower progress in these financial service market segments.

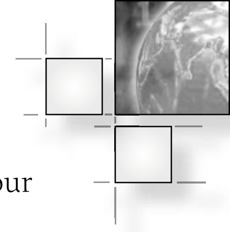
Foreign Direct Investment in Banking in South Korea

The largest bank in Korea, Kookmin Bank, with over 30 percent of deposits and loans, was formed in 2001 by a merger of Kookmin Bank with Housing and Commercial Bank (H&CB)[5]. Kookmin Bank had acquired assets of the DaeDong Bank in June, 1998, and merged with the Korea Long Term Credit Bank in December, 1998. H&CB likewise had acquired assets of a small DongNam Bank in June, 1998.

Following its small bank acquisitions, Kookmin Bank expanded its capital based through an investment of $500 million in June, 1999, when the American investment bank Goldman Sachs bought a 6.52% stake in the company through newly issued shares. ING invested $280.7 to buy new shares in H&CB to acquire a 10 percent stake in July, 1999. Although H&CB had entered a strategic alliance with ING which required the Dutch company to increase its ownership share, the merger of H&CB and Kookmin resulted in a suspension of ING's commitment to acquire additional shares.

The Kookmin Bank-related transactions account for about 20 percent of foreign investment in banking in Korea. In summary, two foreign firms, Goldman Sachs and ING, invested over three-quarters of a billion dollars, facilitating the creation of the largest bank in Korea. The surviving bank has raised additional capital (over 10 percent of its shares are traded on the New York Stock Exchange). While it is not clear what profits Goldman and ING will realize from their investments in what became Kookmin Bank, it is clear that these investments facilitated a government-sponsored workout of the problems of a number of smaller Korean institutions in a time of great risk and uncertainty.

Many other major transactions involved foreign investment in the banking sector:



Commerzbank of Germany invested more than $413 million in newly issued shares of Korean Exchange Bank (KEB) in two transactions in 1998 and 2000 to acquire 32.5 percent of the outstanding shares. Commerzbank also acquired a 45 percent stake in an affiliate, KEB Investment Trust, in February, 1999. In August, 2003, the American Lone Star Fund acquired 51 percent of KEB by investing $1.171 billion in newly issued shares (with an option to increase its ownership to 65.2 percent by acquiring convertible preferred sharesfrom Commerzbank and Export-Import Bank of Korea.) The Commerzbank and Lone Star investments totaling over $1.5 billion is about a third of total foreign investment in Korean banking. KEB is the sixth largest bank in Korea with less than 10 percent of total loans at nationwide banks in Korea.

In June, 2000, an investor group led by J. P. Morgan together with the American investment firm Carlyle Group acquired 40.7 percent of Koram Bank for $432 million. In February of 2004, Citigroup announced that it would buy Koram Bank for $2.7 billion, representing a return of 130 percent for Carlyle (and presumably J.P. Morgan)[6]. Koram is the seventh largest of the eight nationwide commercial banks in Korea.

The Koram Bank purchase by an investor group and subsequent sale to a financial industry buyer raises interesting questions to both regulators and outside observers. First, can investors that are not banks be expected to operate banking assets effectively in a distressed sale? The large gain made by the investor group in Koram suggested either that their turnaround management team created significant value or that the reduced risks and uncertainty concerning the Korean financial market environment in the period 2000 to 2004 greatly reduced the required returns on Koram's banking assets. It is likely that both factors are responsible: Koram was worth more after four years than it was before so its management must have created value because four years is certainly enough time to ruin a banking franchise. Clearly the risks in Korean banking have been reduced in the last four years. The implication of these observations are that in any case the risks were perceived to be very large when the investor group established its position in 2000 and that risk capital was needed to restructure the Korean banking system.

The second question concerning non-bank buyers of banking assets is: Why did not a major bank acquire Koram in 2000? One answer that has been provided is that commercial banks who might have an interest in expanding their operations in Asia in general and Korea in particular were severely stressed by the Asian Financial Crisis themselves. Making strategic investments in a risky post-Crisis environment would have been difficult to sell a potential acquirer's top executives and shareholders. This explanation is plausible, but it is also just another way of illustrating the benefit provided by investment funds who are willing to make large investments, taking on high risk in a crisis environment, with the hope (not the promise) of high risk-adjusted returns from the later sale of a viable banking asset.

As discussed in the previous section, the Korean government took over two of the most distressed nationwide commercial banks, Seoul Bank and Korea First Bank (KFB). By the end of 1999, both banks had received over 8 trillion won in government assistance (about $600 million). These two banks followed very different paths over the following years. Newbridge Capital, a U.S. investment fund, acquired 51% of KFB for $415 million in an auction in 1998, completing the transaction in early 1999. The government was unable to find an acceptable buyer for Seoul Bank. We will compare the outcomes of these two banks as an

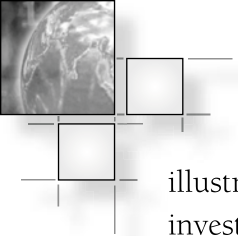


illustration of the benefits and costs of foreign investment.

Newbridge Capital assembled a team of executives to manage KFB who had wide experience in managing distressed deposit-taking institutions[7]. The management team installed an audit committee and thoroughly reviewed and revised the bank's procedures and policies. As of December 31, 2003, Newbridge Capital owned 48.6 percent of the bank, Korean Deposit Insurance Corporation (KDIC) owned 48.5 percent , and Ministry of Finance and Economics (MOFE) the remainder. The board of directors consists of a large majority of non-Koreans representing the investment firm.

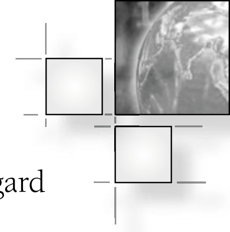
The private investor in KFB describes its strategy as follows:

> Newbridge pursues the acquisition of significant stakes and control investments-often together with local partners-throughout Asia in a broad range of industries. Newbridge's strategy focuses on playing a significant role-in partnership with management and fellow shareholders-in the development and execution of a shared vision aimed at maximizing shareholder value[8].

KFB has focused diversifying its lending and installing advanced risk-management techniques. For consumer lending, in 2001 KFB created a Decision Science Group that has developed its own risk management system that estimates a probability of default and loss given default for new customers (the ARM system) and for existing current borrowers (the BRM system). For corporate customers, KFB developed CRMS, a credit risk management system, with the U.S. consulting firm KPMG that likewise estimates probability of default and loss given defaults. Both consumer and corporate lending prices reflect risk-based pricing based on these systems. All risk exposures are monitored by a board-level asset-liability committee (ALCO).[9] As part of the effort to increase efficiency, from 1999 to 2003, employment at KFB dropped 12.6 percent, while employment in all banks in Korea has dropped about 10 percent[10].

The Newbridge Capital management team is generally positive about the climate for banking in Korea, emphasizing particularly the legal environment and the diligence of the Korean work force. Two aspects of doing business in Korea are challenging for KFB's top management: first, labor issues stemming from strong unions and cultural biases induce a resistance to incentive-based pay, job-assignment inflexibility, and hierarchies based on age and seniority. Second, there is constant and close scrutiny by regulators and the press. Regulators are a daily presence in the bank, whereas in the U.S. and elsewhere regulators are periodic visitors, and regulators often identify employee discontent and view that as a problem to be presented to management for attention. The Korean press eagerly looks for evidence of foreign bank investors enriching themselves at government expense and are generally suspicious of foreign ownership of banks and other corporations.

Seoul Bank could not be sold to private investors after the government acquired it as part of the IMF agreement in 1998, despite several attempts and some interest by HSBC in acquiring it with more than 51 percent ownership. Deutsche Bank was hired as a financial and restructuring advisor for the bank in 2000 and arranged for new management. From June, 2000, to October, 2002, the bank was run by Chungwon Kang, a Korean with extensive banking experience at Citigroup, Bankers Trust, and Deutsche Bank, the "first professional banker from a non-Korean bank to assume the leadership of a Korean bank."[11] Kang



wrote a detailed memoir of his experiences at Seoul Bank allowing us to compare and contrast the KFB and Seoul Bank experiences.

Labor issues were an important problem with Seoul Bank under the new management, even though managers were Korean. This is illustrated immediately when the bank's union joined a general strike of the Federation of Financial Unions in July 2000. Restructuring required an early retirement program, substantial reassignment of personnel, and an extensive training program. Seoul Bank's employment was reduced 14 percent (more than KFB) as a result of these programs.[12]

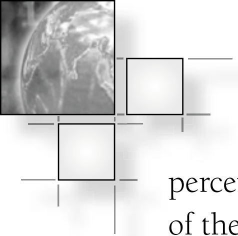
Seoul Bank's management focused on making the bank an attractive acquisition. Among its initiatives was building its retail business but the government owner was concerned about cost controls. The bank management's initiatives were compromised by the oversight and requirements of the government owner. A number of example of problems stemming from government interference with management's efforts to develop a viable commercial strategy can be cited:

> Shortcomings included lagging investment in equipment and premises, and not much change in employee welfare. These shortcomings were mostly due to cost-related restrictions imposed on the bank by the shareholder through memorandums of understanding.
>
> …KDIC did not accept our key management indicators and sent a revised set of indicators to be used. The revised target for cost ratio and adjusted revenue per employee targets were simply impossible to achieve…. This episode illustrates the extreme differences of opinion between KDIC, the government shareholder, and the commercially oriented management of Seoul Bank, and highlights the disregard of the board by the shareholder.
>
> The board did not have full management power to delegate to the CEO. They also had to sign the KDIC MOUs in conjunction with the recapitalization at the end of 2000, and were bound by them…. In this regard, they were furious when our investment plans for branch renovation were delayed due to cost targets in MOUs.[13]

In comparing the experience of Seoul Bank and KFB, Kang writes:

> Seoul Bank's new management consisted of mostly Koreans with a background in foreign finanicial institutions or rating agencies, while KFB's top management was supported by commercial shareholders with full management control. Although the government shareholder had assured management autonomy, Seoul Bank's management was constrained by MOUs with the shareholder and the regulator. The prompt corrective action order was lifted from KFB at the time of the sale to Newbridge; Seoul Bank's new management lived with it until the bank was sold to Hana Bank in December 2002. However, the performance of Seoul Bank during the 2001-June 2002 period was generally better than KFB.[14]

Seoul Bank was sold to Hana Bank in 2002 for approximately one billion won (about $833 million) in shares that required subsequent sale. A competitive bidder for Seoul Bank, Newbridge Capital, was willing to buy it for a roughly equivalent amount of cash and with a future participation in profits. The sale price to Hana Bank was at what some analysts believe corresponded at a share price about 88



percent above the value of shares at the time of the December 2000 recapitalization. This represents a substantially smaller gain that that associated with the Koram Bank, but Koram was held for a longer period.

Foreign bank acquisitions resulted in investment of substantial amounts of capital in the Korean banking system, but banking markets remain dominated by the three largest Korean banks, namely Kookmin Bank, Woori Bank, and Hana Bank. These three banks have over half the loans and bank equity in commercial banking in the economy. Foreign investments leading to a controlling interest in smaller nationwide banks, Koram and KFB, the seventh and eighth largest banks (out of a total of eight), have created viable banks following new competitive strategies under foreign top management. Minority positions have been taken by foreign investors, namely in KEB and Kookmin, that have bolstered the capital of these institutions but not caused a change in control.

Benefits and Costs of Cross-Border Investments in Banking in South Korea

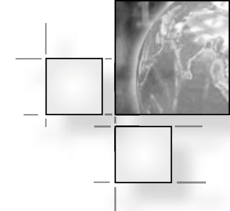
During the Asian Financial Crisis, Korean banks suffered enormous losses, eroding their capital to dangerous levels. Under the terms of a stand-by funding agreement with the IMF, Korean officials were under strong pressure to recapitalize and restructure the Korean banking system and were urged to allow foreign bank investments. Foreign banks in the period 1998 to 2000 provided substantial active and passive investments amounting to over $5 billion into a banking system when there was great uncertainty about the prospects for banks in the economy.

Currently the Korean commercial banking system is assessed to have made great progress towards the necessary restructuring for long-term viability. That system is still dominated by Korean banks in terms of loans, assets, and equity. Foreign investors actively manage only smaller Korean commercial banks. Yet there is a consensus that the foreign presence has had a catalytic role in the transformation of Korean banking practices. Foreign minority investors have opened channels of communication to large foreign financial firms and consultants. Many Korean bankers have visited headquarters or taken training courses in foreign institutions. Further, foreign owned banks have created a demonstration effect in terms of management structure and practice, and competition with foreign banking practices in banking markets have created an urgency about adopting modern banking practices like risk-based pricing and ongoing risk assessment of customers and products.

The cost associated with foreign competition is often associated with employment reduction, but all banks in Korea have reduced their number of employees. The reduction is less than it would have been if banks had not been able to survive for lack of capital and had not become viable in a more competitive environment in the long run.

Some cite the disappointment of Korean officials with the role of foreign investment in banking. During the Crisis years of 1997 and 1998, professional commercial bankers did not invest in Korean banks: they had their own problems from the crisis to deal with. However, passive investors and foreign investment fund have urged the Korean banks they invested in to adopt modern management techniques and implemented risk-measurement and –management systems.

Two active foreign investors took over management of two of the smaller Korean commercial banks: Newbridge Capital of KFB and Carlyle Group of Koram Bank. Koram became an attractive merger candidate, Citigroup, while KFB is still under Newbrdige's direction. KFB appears to be a reasonable



acquisition target in the future. The value of the banks where control was gained by investment investors was enhanced or at least preserved through their ownership as reflected in the Koram bank sale. All these foreign investors provided access to best practices in banking through visits and training courses. On the other hand, Korean managers under government supervision restructured another small bank, Seoul Bank, and that was sold to a larger Korean bank, Hana Bank.

The ultimate sale of these banks to foreign banking firms like Citigroup or HSBC does not threaten a reduction of banking services to domestic bank customers. For example, Citigroup will not exit the small business market acquired with the Koram expansion because this acquisition represents a part of its strategy to expand its presence in what it feels are important banking markets for the future: Korea, Mexico, and Poland. HSBC, should it or a similar bank acquire another Korean bank, is strategically committed to the retail and small business markets.

Foreign Direct Investment in Insurance in South Korea

Foreign investment in Korean insurance companies accounted for less than ten percent of the mergers and acquisition activity in the years 1990 to 2003. Prior to the Asian Financial Crisis, the French insurer AXA bought 50 percent of Dongbu Aetna Life Insurance in 1995 as Aetna left the life insurance business. During the crisis, MetLife bought the remaining 49 percent of Kolon Met Life it did not already own for $14.1 million in 1998, Hartford Life bought 60 percent of Kumho Life in 1999 for $100 million, and New York Life bought the 49 percent of Kohap New York Life it did not already own in 1999. The German company Allianz AG bought 100 percent of First Life Insurance Company in 1999.

The Korean life insurance market is dominated by Korean firms, with the top three firms, Samsung Life, Korea Life, and Kyobo Life, accounting for over three-quarters of all life premiums in 2002 and with total foreign firm accounting for under 10 percent of premiums in Korea[15]. However, foreign insurance companies have been energetic in promoting sales of insurance by banks. By 2003 foreign banks and insurers had a market share of 32.1 percent of premiums sold through banks, where the top three domestic insurers had a share of 39.1 percent of the bancassurance market. Foreign insurers, lacking the extensive sales networks of the big domestic firms, have benefited with partnerships with local banks. By 2003, they had increased their market share of premium income by 30 percent to 13.6 percent of total life insurance revenue. Currently, life products sold through banks are limited to savings and pension products.[16]

Foreign investments in insurance have not been enough to eliminate the problems facing the industry as described in the IMF Financial Sector Stability Assessment cited above. However, agile foreign investors like New York Life, ING, Prudential, and MetLife, have seized on opportunities to reduce marketing costs to stimulate competition in the domestic insurance market. ING has entered into a joint venture with a small insurance company, KB Life, acquired by Kookmin Bank (the economy's largest); this firm is planning on introducing new wealth management products, like KB MyStar Annuity Plan[17], MetLife is interested in acquiring SK Life, another small Korean insurance company.

By participating in a revolutionary change in insurance marketing and indicating interest in expanding investments in the market, ING, MetLife, and other foreign insurers are contributing the restructuring of the insurance industry in Korea. Foreign competition is

threatening the top three domestic companies, all of which are associated with family-run conglomerates (chaebols), reducing costs of insurance and stimulating change in the industry.

Foreign Direct Investment in Securities and Trust Companies in Korea

Foreign investors have acquired large positions in several securities firms in Korea. From the U.S., Hambrecht and Quist bought a 28 percent stake in Ssangyong Investment and Securities in August, 1998. Salomon Smith Barney acquired the remaining shares of a joint venture with KEB bank that it did not own in 1999, providing an undisclosed amount of capital to that troubled bank. Prudential Insurance agreed in August 2000 to raise its stake in CJ Investment Trust and Securities to 60 percent over the following three years with a commitment to a $400 investment, adding to a $100 million purchase of equity in the firm made at the same time. Finally, Hong Kong's Regent Pacific Group bought over 64 percent of Daeyu Regent Securities Company over nine months in 1998 to 1999.

A number of other acquisitions involved foreign purchases of stakes in investment trust companies, investment firms, and specialized financial firms. In total, foreign firms invested about $2 billion in non-bank non-insurance firms in the period.

Benefits and Costs of Foreign Investment Outside Banking and Insurance

Many of these investments were in financial market segments singled out by the IMF as being particularly vulnerable after the Financial Crisis of 1997. It is difficult to develop details on the impact of these investments on financial market restructuring and the competitive environment. However, if for no other reason than the inflow of capital to selling banks, like KEB bank, and other firms in capital difficulties and the purchase of troubled merchant banks and other investment companies, it is clear that benefits of additional capital in a period of substantial risks was made available to the task of restructuring the Korean financial system.

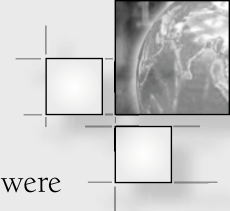
Most of the foreign investments were in distressed firms. To the extent that these firms survived as Korean joint ventures with foreign firms or as units of foreign companies, costs in terms of layoffs and lost franchise value were minimized. To the extent that new investors and managers introduced management techniques and risk-management methods not implemented before the crisis, these investments contributed to the efficiency and viability of the Korean economy and financial system.

Summary

Investments in commercial banking dominated the foreign merger and acquisition activity in Korea after the Asian Financial Crisis of 1997. However, substantial investments were also made in the threatened insurance industry and a large number of investments in the troubled investment trust company sector, merchant banks, distressed loan portfolios, and securities firms, not detailed in the discussion above. These investments at a minimum provided needed capital to restructure the Korean financial system in stressful and risky times. Many of the foreign investments outside of banking, though, have had a catalytic effect on competition and product innovation in non-bank financial services markets.

Benefits and Costs of Foreign Investment in South Korea

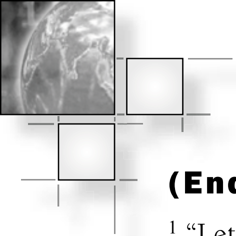
The most identifiable benefit from foreign investment in financial services in the Korean



economy was the substantial sums of capital that went into banking. However, even in the case of minority investments, Korean finance professionals benefited from the association with the foreign investors in terms of opening lines of communication to consultants, large financial institutions, and foreign training that had an un-measurable but large incremental approach to the development of management strategies reflecting the new realities of Korean financial services. A competitive environment with strict risk measurement and management and using risk-based pricing to earn essential risk-adjusted returns in a market not guaranteed by government bailouts and decision are made in a commercial competitive environment, free of government policy directives. Foreign investments have assisted in this transformation both directly and in the form of the demonstration effect against domestic competitors.

Costs to the Korean economy are hard to enumerate. d Korean government officials seem disappointed that the financial investments were not accompanied by investor expertise in the target industries, primarily banking. Investor groups acquiring control or major stakes in banks were perceived as "in it for the money" with a short-term profit horizon. However, the manager of the Korean government-owned bank outlined limitations on management from supervision and controls that limited the ability to implement commercial strategies. Banks owned by investor groups have retained those investments over substantial times periods and have modernized their procedures and management systems. One bank sold commanded a high premium when sold to a strategic investor. It is not clear that the risk capital funds from investment funds like Carlyle Group, Lone Star, and Newbridge Capital, that have invested in Korea during the Crisis period and its aftermath, have not contributed to the development of new financial institution managerial practices and strategic planning.

Table: Benefits and Costs of Foreign Investment in South Korea
Benefits
Source of risk capital at a time of extreme financial distress and uncertainty
Implementation of management techniques and controls fostering risk measurement and management and risk-based pricing
Private investors willing to take risks in implementing long-term business strategies not acceptable to government officials
Exposure to foreign financial institution management practice and their consultants
Stimulation of competition in some financial market segments
Costs
Acquisition by investment groups who are not strategic financial institution partners
Employment reduction in pursuit of efficiencies and profits for investors



(Endnotes)

[1] "Letter of Intent of the Government of Korea: Attachment: Korea – Memorandum on the Economic Program," December 3, 1997, posted on the IMF website, http://www.imf.org/external/np/loi/120397.htm

[2] IMF. 2000. "Republic of Korea: Economic and Policy Developments," Staff Country Report No. 00/11, February, Table IV.1, p. 72.

[3] Republic of Korea, "IMF Stand-By Arrangement Summary of the Economic Program," December 5, 1997, from http://www.imf.org/external/np/oth/korea.htm

[4] IMF. 2004. "Republic of Korea, Selected Issues," IMF Country Report No. 04/45, February, p. 50.

[5] The details concerning the formation of Kookmin Bank and the ownership positions of Goldman Sachs and ING are based on a discussion of the Kookmin Bank 2001 Form 20-F filed with the U.S. Securities and Exchange Commission as well as information derived from the Thompson Financial Mergers and Acquisitions Data Base.

[6] "Foreign Funds Audited in Asia – Tax Man Revisits Treaties That Spurred Investment After Crisis," Wall Street Journal, June 23, 2004, p. A15, cited the 130% return and also raised the issue over resentment raised by high returns, even if earned in the face of high risk.

[7] This discussion is informed by an interview with Bob Barnum, Chairman of the Board of KFB, conducted by Mary Locatelli, on May 10, 2004. Ms. Locatelli was a consultant to the Newbridge Capital management team at KFB and the author also discussed her experiences at KFB.

[8] KFB website (English version), www.kfb.com.kr, under "Introduction to Newbridge Capital"

[9] 2003 Annual Report, Korea First Bank, "Management's Discussion and Analysis," available on the bank's website.

[10] Korea Financial Supervisory Service, Monthly Statistical Bulletin, 2003-10, Table 18.

[11] Chungwon Kang, 2003, "From the Front Lines at Seoul Bank: Restructuring and Reprivatization," IMF Working Paper WP/03/25, p. 3.

[12] Op. cit., Table 3, p. 16.

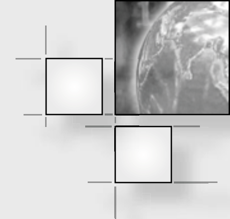
[13] Op. cit., pp. 25f and p. 34.

[14] Op. cit., pp. 28f.

[15] Financial Supervisory Service, *Life Insurance Statistics (2002)*, Table 36.

[16] Kim Yeon-hee, "big S. Koreans Insurers face heat from bancassurance," Reuters News, July 26, 2004, and Jin Hyun-joo, "Foreign life insurers on a roll: companies bask in local success of bancassurance," The Korea Herald, June 25, 2004.

[17] Andrew Peck, "The Dutch bank buys into bancassurance channel with Kookmin. ING takes 49% of KB Life," June 4, 2004, FinanceAsia.com.



Benefits of Financial Market Liberalization: Preliminary Report to ABAC Working Group on Financial Market Liberalization

CASE STUDY OUTLINE

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THAILAND

When the Bank of Thailand was forced to float the Thai Baht on July 2, 1997, amid heavy speculative pressures on the currency, it triggered a deep macroeconomic and financial crisis that soon spread over much of the Asia and other regions. Thailand's financial sector bore a heavy brunt of the crisis – a total of 56 finance companies were closed, 6 commercial banks were intervened[1] (one was closed and three were integrated into stronger banks) and only 23 securities companies out of 62 prior to the crisis survived[2].

During the crisis, there were strong pressures on Thailand to liberalize its financial system and reduce barriers to foreign investment. Externally, the International Monetary Fund required that Thailand free up foreign shareholding limits as one of the conditions for the financial loan package[3]. Internally, the limited availability of domestic capital and the need to recapitalize the financial institutions meant that foreign capital had to be invited into the country. Prior to the crisis, foreign shareholding was legally capped at 25%.

On November 1997, the government relaxed the foreign shareholding limits for the financial sector, for a period of 10 years from 1998. During this time, foreigners may – subject to Bank of Thailand approval – acquire a majority stake in Thai commercial banks. After 10 years, the foreign equity stake could not be raised further. There is a grandfather rule in which the foreign investors would not be forced to sell off their shares, but they cannot acquire new shares either. For banks with more than 49% foreign ownership, any subsequent capital injections into the banks will have to come from the Thai investors.

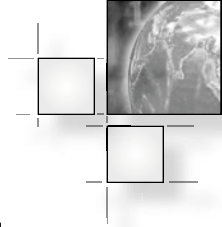
Similarly, foreigners can invest in securities companies without limit, with the condition that such foreigners must bring in at least 500 million baht of investment capital (about $12 million), and must have directors working in Thailand[4]. However, direct foreign ownership in insurance company remains restricted to 25% limit[5].

The relaxation of foreign ownership limits had led to an influx of foreign capital into the financial sector. During the period 1990-1996, there were a total of seven foreign investments (mergers and acquisitions) into the financial sector in Thailand, worth a total of 72.8 million baht (about $2 million). In 1997 and 1998, the number of foreign investment jumped nearly fivefold to thirty-four deals, with twenty five of those investments recorded at a total value of 2,213.4 million baht (about $53 million). Since then, the level of foreign investment into the financial sector has remained strong.

In January 2004, the Ministry of Finance and the Bank of Thailand released the Financial Sector Master Plan to guide the rationalization and consolidation of the financial sector over the next 5-10 years[6]. Henceforth, banks and other deposit-taking institutions will be licensed as commercial banks or retail banks. Commercial banks may provide all types of financial transactions, except for insurance underwriting, and brokering, trading and underwriting of equity securities. Retail banks will serve retail customers and SMEs subject to lending limit per customer, and may provide all types of financial transactions with the same exceptions as commercial banks. Retail banks are not permitted to conduct business related to foreign exchange and derivatives products.

Thailand Cross-Border Deals 1990 to 2003

Foreign banks will also be involved in the rationalization of the financial sector as two types of foreign bank licenses will be issued – subsidiaries of foreign banks and full branches of foreign banks. The subsidiaries will be allowed to enjoy the same scope of business as the commercial banks, and be allowed to open one branch inside Bangkok and metropolitan areas and three branches outside that city. Meanwhile, full branches will be allowed to engage in the same scope of



business as the commercial banks, but will not be allowed to open any branches.

Over the next three years, emphasis will be placed on encouraging qualified foreign stand-alone Bangkok International Banking Facilities (BIBFs) to upgrade to full branches or subsidiaries, with tax benefits for "Out-In" transactions discontinued (tax benefits for "Out-Out" transactions will remain)[7]. In addition, to upgrade its status to a bank subsidiary, the foreign-owned stand-alone BIBF must be the core institution for merger with, or acquisition of, at least another Thai financial institution (finance companies or credit foncier). Eventually, the BIBFs will become a part of commercial banks, thereby supporting "one presence" policy – a single banking license that removes distinction in the scope of business and making it redundant to have different types of financial institutions within the same group. After three years and contingent upon suitable economic conditions, new commercial banking license may be issued to new foreign investors to increase competition and efficiency in the financial sector.

Under the Financial Sector Master Plan, the authorities also seek to remove regulations that impede financial sector efficiency including relaxing the limit on the number of expatriate staff for a commercial bank that the Bank of Thailand will give endorsement to the Immigration Office and removing the requirement that a foreign bank branch must lend and maintain exposure in Thailand no less than 70% of total deposit and borrowings raised in the country.

Thailand and Australia have recently concluded a free trade agreement between the two countries. However, financial services have been excluded from the free trade agreement, as the Thai government insisted that it needs to strengthen the local financial institutions first before opening the industry to foreign competition[8]. Thailand's approach towards liberalization of the financial sector has been selective and happened out of necessity and not of policy[9], as evidenced by the temporary relaxation of the foreign ownership limit during the crisis years and the restricted time-window (10-year period rule) for the foreign investment. And to bring the current regulations closer with the grandfathering rule at the end of the 10-year period (whereby foreign investors would not be forced to sell off their shares), a bill on financial services act is circulating in the Thai parliament to raise the foreign ownership limit from 25% to 49%. It is envisaged by industry executives that over time, the foreign shareholding in the currently foreign-majority owned banks will be diluted towards the 49% level as new shares will be issued for Thai investors.

Foreign Direct Investment in Banking in Thailand

Prior to the financial crisis in 1997, many of the commercial banks in Thailand were either family-owned or state-owned. The relaxation of the foreign shareholding limits, amidst the need for foreign capital to recapitalize the banks, had helped to change the banking landscape. Four foreign banks bought majority stakes in four of the smallest commercial banks. On December 1997, the DBS Bank of Singapore agreed to increase its stake in the Thai Danu Bank from 3.4% to 52% for $124.7 million. Thai Danu Bank was then renamed DBS Thai Danu Bank. In mid-1998, a Dutch bank, ABN Amro acquired a 77% stake in Bank of Asia for a total of $181.5 million. On September 1999, Britain's Standard Chartered Bank acquired a 75% stake in Nakornthon Bank, the second oldest bank in Thailand, for $319.3 million, and the bank was renamed Standard Chartered Nakornthon Bank. Lastly, Radanasin Bank, created during the crisis with the original mandate to purchase and manage good assets of wound-up financial

institutions, was merged with one of the six banks the government intervened in (Laem Thong Bank) and was privatized, with the sale of majority stake (75%) to United Overseas Bank of Singapore for $382.5 million. Radanasin Bank was renamed UOB Radanasin Bank.

In terms of total assets, as of December 2003, Bank of Asia is ranked the 9th largest (out of a total of 13 commercial banks), DBS Thai Danu Bank is the 10th largest, Standard Chartered Nakornthon Bank is the 11th largest while UOB Radanasin is the smallest commercial bank in Thailand[10]. Each of the four foreign-majority owned banks holds between 0.9% and 2.7% of total assets in the banking sector, and their combined total assets would amount to only 6.3% of the total banking assets held by the thirteen commercial banks. In comparison, the five largest commercial banks (Bangkok Bank, KrungThai Bank, Thai Farmers Bank, Siam Commercial Bank and Bank of Ayudhya) account for 75% of total assets in the banking sector.

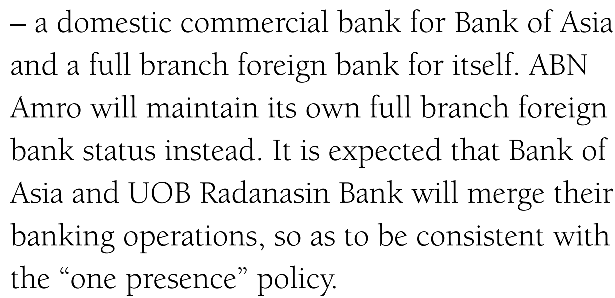
In terms of domestic branches, the numbers for the four foreign-majority owned banks are small as well, accounting for 6.9% of total bank branches in the banking sector. Moreover, most of their branches are concentrated within Bangkok.

Foreign Shareholdings in Thai Commercial Banks

Banks	**Foreign Ownership (%)**	
	Mar-97	May-00
Banks acquired by foreign banks		
Bank of Asia	6	77
DBS Thai Danu Bank	9	62
Standard Chartered Nakornthon Bank	6	75
UOB Radanasin Bank	—	75
Banks with Thai majority ownerships		
Bangkok Bank	25	49
Bank of Ayudhya	25	32
Siam Commercial Bank	25	45
Thai Farmers bank	25	49
Source: Montreevat, Sakulrat		

Meanwhile, foreign shareholdings in other commercial banks have increased as well, as several of the larger banks have been successful in attracting foreign capital on their international road shows to raise capital for their recapitalizing needs. In 1998 and 1999, the banking sector has attracted $2.3 billion and $2.5 billion, respectively, in foreign direct investment, accounting for 46% and 77% of the total foreign direct investment into Thailand[11].

With the release of the Financial Sector Master Plan in 2004, the consolidation within the banking sector has already taken place, with the involvement of two of the four foreign-majority owned banks. In July 2004, ABN Amro sold its stake of 80.77% shares in Bank of Asia to the United Overseas Bank, in a deal worth an estimated $550.4 million. Under the new "one presence" policy, ABN Amro will no longer be allowed to hold two banking licenses



– a domestic commercial bank for Bank of Asia and a full branch foreign bank for itself. ABN Amro will maintain its own full branch foreign bank status instead. It is expected that Bank of Asia and UOB Radanasin Bank will merge their banking operations, so as to be consistent with the "one presence" policy.

Also, in July 2004, DBS Thai Danu Bank was involved in a merger involving itself, Thai Military Bank and Industrial Finance Corporation of Thailand. DBS Bank will become a strategic shareholder with a 16.1% ownership stake in the merged bank, which will retain the name Thai Military Bank, cede management control to the current management team at the Thai Military Bank, and it will assume an advisory role instead. The merger will create the 5th largest bank in Thailand with 677 billion baht ($17 billion) in total assets, and 462 branches nationwide. This merger was the first announced within the Financial Sector Master Plan to create a universal bank, and the government is following it closely for possible use of the merger's success as a model for other banks to follow in the consolidation of the financial sector.

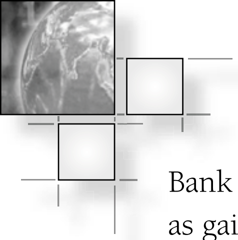
Benefits and Costs of Cross-Border Investments in Banking in Thailand

Bank regulators and executives welcome the entry of foreign banks into Thailand as it helps to create more competition and innovation in the banking sector. However, from the regulatory standpoint, the official policy is not to allow a full foreign bank, but foreign bank with a subsidiary or branch. This is to provide some measures of protection for the local commercial banks as they prepare for the competition from the foreign competitors equipped with more advanced technology, consumer-marketing skills and more innovative and profitable banking products. However, new entry of foreign financial firms into non-banking activities has been encouraged, for example, GE Capital providing finance lending, such as auto-loans. This is to close the gap in the marketplace left behind by the closure of 56 finance companies during the financial crisis.

One of the immediate benefits to foreign investment in banking sector in Thailand is that it helped to shore up the balance sheets of the four local banks taken over by foreign banks during the crisis years. Supported by strong foreign parent banking groups, this has helped to restore some stability into the banking sector, and allowed the authorities to focus more resources into resolving the balance sheet problems at larger banks.

Credit risk management is another area that has benefited from the entry of foreign investors into the banking sector. Risk management and credit controls are new concepts for the Thai banking sector, as prior to the crisis, most banks did not have risk management and credit limits were not fully enforced. ABN Amro has established separate risk management division in Bank of Asia which sets credit policy and reviews credit proposals, as well as providing the tools and techniques for quantifying the risk levels. The bank is now adopting a disciplined approach towards implementing Basel II requirements. Similarly, Thai Military Bank is learning from DBS Bank on risk management and corporate governance practices, with Thai bank officers having gone to Singapore to see and learn from the DBS Bank's risk management system, and to learn from the experiences of the risk management officers there.

Thai Military Bank also seeks to gain leverage from access to DBS Bank's regional banking network, with the latter's strong presence in Singapore (largest bank), Hong Kong (4th largest bank), Indonesia, the Philippines and China. This allows Thai Military



Bank to service its clients better overseas as well as gaining client referrals from DBS Bank for business in Thailand.

With the merger, DBS Bank will become a service and information technology provider to Thai Military Bank. This includes supplying new banking products especially in areas of private banking (a new concept in Thailand), investment banking (especially in capital leasing and, equity and debt fundraising) and treasury (such as derivatives). This will result in significant cost savings for Thai Military Bank as it does not have to invest much capital and time on product development. Similarly, Thai Military Bank hopes to benefit from DBS Bank's excellent processing and operational IT systems. With the merger, back office operations will be reorganized and centralized into a single operations center. In the new system, bank branches will be released from their back office responsibilities (such as credit analyses and credit approvals, which will now be transferred to the centralized operations center) and thus be able to focus 70-80% of their time on front office operations such as marketing products to clients.

Other examples of foreign-owned banks leading the way in innovation, especially in the new area of consumer banking, include the focus on e-banking, specifically Bank of Asia's launch of mini-branches in subway stations and supermarkets as well as joining with specialized state banks to offer cash management services in the provinces in order to expand its market nationwide, and UOB Radanasin's launch of a flexible mortgage-loan package with low interest rates[12].

The cost to domestic bank employees of foreign investment in the banking sector has been kept low. This can be attributed to the retention of the local management team and culture. For example, Bank of Asia has only six or seven expatriate staffs from ABN Amro while the merged Thai Military Bank will retain most of its local management team. Throughout its ownership by ABN Amro, Bank of Asia has also maintained its local face, as a Thai bank rather than as a foreign bank.

There are several issues of concern towards the entry of foreign banks into the Thai banking sector. One of them is job security and retrenchment in the late 1990s and early 2000s as many banks were forced to cut costs, including staff retrenchment (with or without the early retirement scheme), in order to compete with the foreign banks[13]. Another issue concerns the level-playing field as the local banks have to satisfy the "national duties" of serving clients in the poorer rural areas which are less profitable – on average, 28% of the branches of the local banks are located in Bangkok, compare with 56% for the four foreign-owned banks[14]. In the Financial Sector Master Plan, the authorities are seeking to address this issue, including the requirement that three of the four branches for the subsidiary of foreign banks be located outside of Bangkok and metropolitan areas.

Foreign Direct Investment in Insurance in Thailand

Since the financial crisis in 1997, there has also been more foreign direct investment into the insurance sector due to the need to recapitalize the balance sheets of the local insurance companies. However, unlike the banking and securities sectors, the government did not relax the 25% foreign shareholding limit in the local insurance companies, as the authorities was concerned that the local industry was not strong enough to face full foreign competition. There are 24 local life insurance companies, with 17 of them being joint-ventures with foreign investors, and the average level of foreign shareholding in those companies was 21% as of December 2002[15]. The only foreign life insurance firm is AIA (a unit of AIG) with a market leading 40% share

of the life insurance market. There are 66 local companies and five foreign companies in the non-life insurance sector, five local companies in the health insurance sector and three companies in the reinsurance sector. 50 companies in the non-life and health insurance sectors are joint-ventures with foreign investors, with the average foreign shareholding of 13% as of December 2002.

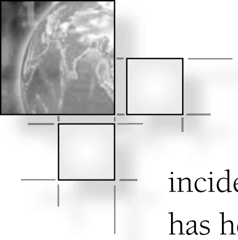
In the life insurance sector, the top six companies have a combined 90% market share. Despite the small market shares, the smaller insurance companies have been reluctant to merge because most are family-owned operations and thus are concerned over the issue of management control.

The biggest reported foreign deal in the insurance sector is US-based New York Life's joint venture in Siam Commercial Life Insurance (and thereafter renamed as Siam Commercial New York Life Insurance) for $18.1 million in April 2000. 25% of the shares are held by Siam Commercial Bank and other shares are listed on the Stock Exchange of Thailand. Another large foreign deal is UK-based Royal Insurance Holdings' purchase of a 20% ownership in Syn Mun Kong Insurance for 17.9 million in September 1995. Other notable foreign deals are $11.3 million purchase for 100% ownership of Asia Dynamic Insurance by Malaysia's Kurnia Insurance in August 2001, Germany's Allianz AG purchasing a 25% ownership stake in CP Life Insurance in June 2000, for an undisclosed amount, and an earlier 10% ownership stake in Navakij Insurance for $1.8 million in July 2000, and Switzerland's Zurich Versicherungs GmbH purchasing a 25% ownership in National Life Assurance for $4.6 million in July 2000 and another 25% ownership in Thai Metropole Insurance in March 1997 for an undisclosed amount. US-based Nationwide Global Holdings also raised its shareholdings in Thai Prasit Nationwide from 25% to 100% for an undisclosed amount in October 2001, but Nationwide has since withdrawn from the Thai insurance market, as did two other international insurers.

Benefits and Costs of Cross-Border Investments in Insurance in Thailand

For Siam Commercial New York Life Insurance, the benefits generated by the foreign ownership have been tremendous. Before New York Life came in as a strategic foreign owner and partner, Siam Commercial Life Insurance was not fully utilizing its partnership with its co-owner, Siam Commercial Bank. Then, it had four distribution channels – agency, worksite marketing, corporate (bundling with housing loans by Siam Commercial Bank and Government Housing Bank) and group life. New York Life introduced two additional distribution channels to Siam Commercial New York Life Insurance – affinity market (direct selling in a niche market with special products and sales teams) and bank-insurance. The insurance firm and Siam Commercial Bank are now working much closer than before on bank-insurance products, and the effective partnership has resulted in Siam Commercial New York Life Insurance becoming a market leader in that product segment.

Risk management is another area where Siam Commercial New York Life Insurance has benefited from its foreign parent company. Prior to 2000, Siam Commercial Life Insurance never had a compliance department as it was not required by the insurance regulations. New York Life has since established an in-house compliance department, with an emphasis on documentation and a monitoring system where employees are constantly reminded to check their compliance levels. Monthly reports are sent to New York Life's head office documenting the number of complaints and

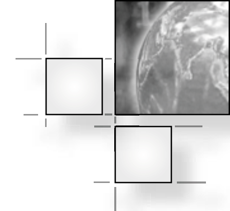


incidences, as well as compliance levels. This has helped the company to be more focused and more disciplined. Also, in the past, there is no in-house auditing unit. Now, an in-house auditing department, separate from compliance department, has been established. New York Life also sends its audit team to Thailand to audit the Thai operations as well as to impart knowledge to their Thai counterparts. In addition, Siam Commercial Bank has started to send its audit team to Siam Commercial New York Life to work with and learn from the New York Life's audit team. Under the current regulation, every insurance company is required to have an internal audit team but internal compliance is not compulsory. Siam Commercial New York Life Insurance, though, leads the industry by having an in-house compliance department and other major local insurance companies have started to implement similar systems.

New York Life has also introduced a new model in agency distribution in Thailand. Previously, every insurance company copied the base-shop model popularized by AIA. New York Life introduced a career-shop model in its local affiliate, with a more systematic training that covers not only sales techniques but also how to manage a successful career as a full-time agent. Siam Commercial New York Life Insurance is targeting a 50%-50% division of its agents between the two agency models (currently, 30% of the agents working are under the new model). In the two years since its introduction, it has been found that agents working under the new model are more productive than those working under the base-shop model. As the career-shop model proves itself to be more efficient over time, it is likely that more of the local insurance companies will adopt the model into its agencies.

Employee training and benefits have also improved since New York Life bought a majority stake in Siam Commercial New York Life Insurance. Now, employees attend yearly conferences abroad where they are exposed to new products and business models/processes that New York Life would like to implement in various areas of operations such as human resource, corporate, actuary etc. As a result, every aspect of the company's operations has improved, and the employees feel privileged to be selected to participate in these conferences to broaden their knowledge and improve their skills. In addition, employee benefits have been raised from local standards to international standards. The salary structure and non-monetary benefits, such as medical benefits that cover immediate family members, have improved. New York Life has also introduced a second provident fund for Siam Commercial New York Life Insurance employees, providing full employer's matching contributions into the fund for employees who stayed with the company until their retirement. Issues on job security in a still-uncertain economic environment in 2000 were also tackled by New York Life. On the first day of assuming control of the Thai operations, the new CEO announced an objective of not laying off any employee, but rather, a hiring freeze may be imposed on certain departments. This provided a morale booster for employees. These positive measures taken to improve the employees and maintain high morale have paid off, with first-year premiums rising from 300 million baht ($7.5 million) a year in the first year of operations under New York Life to 300 million baht a month by the end of the fourth year under majority foreign ownership.

As can be seen above, Siam Commercial New York Life Insurance has seen tremendous benefits from the majority-stake foreign investment by New York Life. To that end, executives at Siam Commercial New York Life Insurance attributed the success to New



York Life's long-term strategic view towards its investment in Thailand, its understanding of the insurance business and its patience in motivating the Thai operations to dramatically improve their business performance, without tinkering too much of the company's local culture. It certainly helps that the two expatriates, the chief executive officer and the chief financial officer, brought in to manage the Thai operations have long working experiences in Asia and they understand the local culture and thinking. However, as noted earlier, three foreign insurers have left Thailand, and while we did not manage to interview any of them, industry executives have attributed the failure of these foreign insurers to their impatience and apparent reluctance to inject more capital, as well as possibly disrupting too much of the local operations, triggering a possible backlash from the agents who are deemed to be a powerful force in the business.

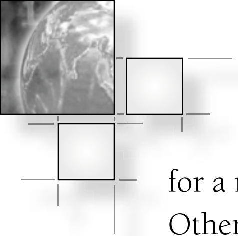
Foreign Direct Investment in Securities in Thailand

Before the financial crisis in 1997, most securities companies were Thai-owned, and foreign involvement was typically in the form of joint investment or co-management agreement, trading volume agreement or other similar agreements, where the foreign partners usually established representative offices in Thailand to produce research and to make business contacts[16]. The financial crisis caused balance sheet and liquidity problems in many Thai securities companies[17], leading to the opening of the securities sector to the inflow of foreign direct investment into the industry. By the time the financial crisis was over, many securities companies saw ownership change hands to foreign shareholders, were merged or closed down. Only 23 companies survived the crisis, of the 62 in existence before then.

The most active foreign investors in the securities sector came mainly from Singapore and the US. Singapore's Kim Eng Securities bought a 100% ownership stake in Nithipat Capital and Securities for $31.2 million in June 1998 and a 92.73% ownership stake in Yuanta Securities (Thailand) for 18.1 million between May 2001 and January 2002. Kim Eng Securities later merged the two securities companies and renamed it Kim Eng Securities(Thailand). Another Singaporean securities company, Vickers Ballas Holdings, bought a 100% ownership stake in Nava Securities for $53.42 million between December 1997 and January 2000. Other Singaporean investors entering the Thai securities industry are Phillip Brokerage, DBS Securities and Overseas Union Bank.

The largest U.S. investment in the securities industry was Merrill Lynch's purchase of a 51% stake in Phatra Securities for $62.9 million in June 1998, renaming it Merrill Lynch Phatra Securities. Merrill Lynch's direct involvement did not last long, though, as on December 2003, a local management team bought out Merrill Lynch 51% ownership stake. Merrill Lynch, though, still retains strong business and research relationships with Phatra Securities (which reverts back to its original name) through several formal agreements. Other US investors entering the Thai securities industry are Morgan Stanley & Co, Credit Suisse First Boston, Lehman Brothers Holdings and Comlink.

For many of these foreign-majority owned securities companies, the new business strategies were driven by their foreign parent companies. Some left their Thai operations to operate in the same way as before. One of them is Kim Eng Securities which retains the local Thai management team and remains active in the retail market. Kim Eng Securities (Thailand) has now increased its business by thirty times since 1997 to 1,073 billion baht ($27 billion) in 2003 in clients' annual total turnover value,



for a market leading 12% share of the market[18]. Other securities companies, such as Merrill Lynch Phatra Securities, pulled out of the retail market to concentrate on high margin institutional investor market.

Benefits and Costs of Cross-Border Investments in Securities in Thailand

An almost immediate benefit gained from having strong foreign parent companies is earning respect for financial strength (backed by resources of the foreign parent company) and strengthened corporate governance. While Phatra Securities was already known as a local securities company providing high standard of services, it gained even more respect when it became Merrill Lynch Phatra Securities and adopted the Merrill Lynch practices and standards, which are governed by the US Securities Law, into its business operations. This adoption of Merrill Lynch's international standards went smoothly and remains with Phatra Securities even after the management buyout in 2003.

Another key area of benefits from having foreign parent companies is the introduction of strict control of the business operations. Both Kim Eng Securities (Thailand) and Merrill Lynch Phatra Securities saw a new management system of proper auditing, strict internal controls and compliance, and risk management. For Kim Eng Securities (Thailand), the control department of the parent company in Singapore oversees the credit levels in Thailand to ensure that they are manageable, yet competitive enough for the Thai operations and their clients.

Access to regional and international networks has also generated benefits for Kim Eng Securities (Thailand) and Merrill Lynch Phatra Securities. For Kim Eng Securities (Thailand), this allows for establishing good research standards as it now has access to a wider audience of international investors. This improved research standards, in turn, allows Kim Eng Securities (Thailand) to use it as a key factor to remain very competitive in the local market. Kim Eng Securities (Thailand) sees itself as occupying a niche position, with local retail investors as its main client base and with more international-standard research in a larger selection of stocks, also providing good service for international funds investing in small caps stocks in emerging markets. Similarly, for Merrill Lynch Phatra Securities, having Merrill Lynch as a strategic owner/partner helps them develop research products that incorporate Merrill Lynch global knowledge into their research reports. Merrill Lynch also introduced a new distribution channel for research reports through an electronic system, which allows the local clients to gain quick access to the local research reports as well as Merrill Lynch's global research reports and analyses.

The local securities companies have also been able to benefit from technology transfer from their foreign parent companies. Merrill Lynch has admitted Merrill Lynch Phatra Securities into its computing network with access to various applications that never existed in the local securities company before. These includes a client database that helps to arrange informational flows between analysts and their clients, an electronic distribution network for research products and an order routing system that allows clients to place their orders electronically. Kim Eng Securities (Thailand) also received strong support from its foreign parent company to establish an internet-based research platform. This system was a standardized regional platform established among regional Kim Eng Securities' securities operations in Singapore, Malaysia, Thailand, Indonesia and the Philippines, and procured through a single vendor which resulted in significant savings, such as reduced time for

trial and error testing, and implementation of the system.

There was also more training for the employees. For Merrill Lynch Phatra Securities, Merrill Lynch Asia has introduced core training programs in each area, for example, professional skills, management skills or communication skills. Apart from these core training programs, additional training programs requested by each department were also arranged in response to their needs. This represents an improvement over the training system in the past which was to provide training to management and staff based on training needs of each business unit. Kim Eng Securities (Thailand) has also invested more on training its staff, and has sent employees to Taiwan (which has a similar securities branch network in Thailand) to learn from the securities system there.

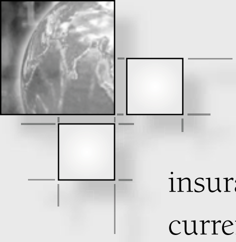
The securities regulator, Securities and Exchange Commission, and industry executives have noted that there has not been any significant costs to the industry due to the infusion of foreign capital. In addition, unlike the banking sector, there was no generalized unemployment in the securities industry.

Summary

Foreign direct investment has significantly altered the financial sector landscape in Thailand. Prior to the crisis, most of the companies in the financial sector were Thai-majority owned. However, the pressing needs for capital to recapitalize the balance sheets of companies adversely affected by the financial crisis caused the Thai government to temporarily relax the 25% foreign shareholding limits in the banking and securities sectors.

With the door swung open in the banking and securities sectors, it is not a coincidence that most of the innovation and efficiency has occurred in those sectors, relative to the insurance sector. Although the four foreign-majority-owned banks are among the smallest in Thailand, the entry of DBS Bank, United Overseas Bank, ABN Amro and Standard Chartered into the banking sector has been a catalyst for change, especially in forcing the local banks to cut costs, raise efficiency levels and adopt new technology to serve their clients better. In addition, with the Financial Sector Master Plan aiming to create universal banks, this competitive task has become more important as banks seek to expand their business and differentiate themselves from their competitors. Thai Military Bank, in its merger with DBS Thai Danu Bank and the Industrial Finance Corporation of Thailand, is seeking to compete better with the bigger Thai banks by harnessing its strategic partnership with DBS Bank through the provision of innovative products and more advanced technological platforms. Similarly, one key basis for the sale of Bank of Asia from ABN Amro to United Overseas Bank is to allow these two small banks (Bank of Asia and UOB Radanasin Bank) to attain a larger combined banking presence in order to increase its scope of penetration into the banking industry as well as to generate economies of scale from the expected merger.

On the other hand, there has been little consolidation in the insurance sector, due to perhaps the over-protection by the government (the 25% direct foreign shareholding limit remained throughout the financial crisis years). Many of the smaller family-owned insurance companies are content to help themselves to the lower end of the market (with the top six companies, including AIA, controlling about 90% of the market). Few new insurance products have been introduced from abroad, due to heavy regulations in Thailand, even on pricing of products. The regulators have been very cautious in approving new products, as the regulatory stance is that the products must benefit the people, such as low cost



insurance and student insurance. As such, it currently takes a long time for a new product to be approved for introduction into the local insurance market.

Benefits

Foreign direct investment in the financial sector has contributed to the stability and efficiency of the financial sector through the crisis years. With limited domestic capital as the financial crisis created liquidity and solvency problems in most local companies, the entry of foreign capital has brought some measure of stability into the financial sector, as foreign companies bought into viable financial institutions and recapitalize them. Also as importantly, this allows for modern model of administration to come into the country as the foreign parent companies established more rigorous control systems such as in-house auditing, compliance and risk management.

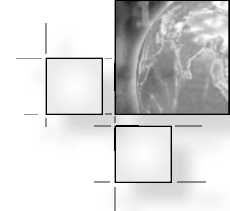
Access to regional and international networks has generated benefits for the banking and securities companies with strategic foreign investors/partners. Together with the adoption of more advanced informational technology platforms, these have allowed the local companies concerned to raise their service standards to international level as they are now serving a wider client base. As a result of higher levels of service standards, those companies have become more competitive even in the local retail market, and higher service standards have become one of the key strategies used to differentiate them from the competition.

New products and new distribution channels have also been introduced into Thailand by the foreign-majority owned financial companies. In that regard, there is significant cost savings as not much capital and time are needed to develop and introduce a new product brought in from the outside.

Costs

Thus far, there have not been much appreciable costs to foreign direct investment into the financial sector in Thailand. The only issues of concern were the retrenchment in the banking sector in late 1990s as banks rationalized their operations and seek to improve their efficiency, and the question of fair level-playing fields with regard to the foreign banks and their lack of service in the rural and less profitable areas.

Table: Benefits and Costs of Foreign Investment in Thailand
Benefits
Provided capital for recapitalization needs and required for stability in financial sector
Improved control systems for auditing, compliance and risk management
Access to regional and international networks
Technological advances
New products and new distribution channels
Improved staff training programs
Costs
Employment adjustments in the banking sector
Issue of fair-level playing field in the banking sector



(Endnotes)

[1] International Monetary Fund, 1999. "Thailand Letter of Intent, September 21, 1999".

[2] Securities and Exchange Commission, Thailand. 2002. "First Decade of the Thai SEC and Capital Market in Thailand (1992 – 2002)"

[3] Ibid.

[4] Ibid.

[5] Chua, Hak Bin. 2003. "FDI in the Financial Sector: The Experience of Asean Countries Over the Last Decade". Monetary Authority of Singapore.

[6] Bank of Thailand. 2004. "Financial Sector Master Plan" (http://www.bot.or.th/bothomepage/BankAtWork/FinInstitute/FISystemDevPlan/ENGVer/pdffile/eng.pdf).

[7] BIBFs was created in 1993 for banks issued with offshore banking licenses to provide three types of services: banking to nonresidents in foreign currencies and Thai baht ("out-out" transactions), banking to domestic residents in foreign currency only ("out-in" transactions), and international financial and investment banking services.

[8] This analysis is based on our discussions with the officials at the Bank of Thailand and the Department of Insurance, Ministry of Commerce.

[9] Securities and Exchange Commission, Thailand. 2002. "First Decade of the Thai SEC and Capital Market in Thailand (1992 – 2002)"

[10] Bank of Thailand website (www.bot.or.th)

[11] Montreevat, Sakulrat. 2000. "Impact of Foreign Entry on the Thai Banking Sector: Initial Stage of Bank Restructuring", Economics and Finance No. 5 (2000), August 2000, Institute of Southeast Asian Studies.

[12] Ibid.

[13] This also related to the issue of raising efficiency levels in the banking sector, as some estimates have shown that foreign banks staff an average of 10 or less employees per branch while Thai banks are more likely to have closer to 30 employees per branch. See Chua, Hak Bin. 2003. "FDI in the Financial Sector: The Experience of Asean Countries Over the Last Decade". Monetary Authority of Singapore.

[14] Bank of Thailand website (www.bot.or.th).

[15] These figures were provided by Mr. Paisan Chotipaibulpan from the Department of Insurance, Ministry of Commerce during our interview.

[16] Securities and Exchange Commission, Thailand. 2002. "First Decade of the Thai SEC and Capital Market in Thailand (1992 – 2002)"

[17] Prior to the end of 1999, there were 2 types of securities companies – a stand-alone securities company and a finance and securities company. Most of the securities companies facing initial severe balance sheet problems and had to be intervened came from the latter classification. For example, out of the 16 original finance companies suspended on the even of the crisis (in June 27, 1997), 12 of them were finance and securities companies. By end 1998, 23 finance and securities companies and 22 securities companies were closed down by the authorities.

[18] Securities and Exchange Commission, Thailand. 2002. "First Decade of the Thai SEC and Capital Market in Thailand (1992 – 2002)"

Table 1: Cross-Border Mergers and Acquisitions in Financial Services

Panel A: Foreign Investment in Financial Services (US$ millions and number of transactions)*

	1990 - 1996		1997-1998		1999-2003			Total
Economy	Total Value	Number	Total Value	Number	Total Value	Number	Total Value	Number
Australia	3,069.6	60	1,014.0	20	8,399.0	65	12,482.6	145
Chile	1,801.0	11	1,125.4	9	4,159.3	15	7,085.7	35
China	108.0	4	196.5	5	2,317.4	44	2,621.9	53
Chinese Taipei	18.2	5	50.6	2	2,943.2	16	3,012.0	23
Hong Kong	2,667.0	57	4,131.0	30	12,706.0	71	19,504.0	158
Indonesia	338.0	15	188.0	7	922.5	21	1,448.5	43
Japan	226.6	4	2,029.2	5	21,727.0	35	23,982.8	44
Malaysia	945.6	22	84.9	7	1,304.8	15	2,335.3	44
Mexico	1,032.5	10	1,737.5	14	25,581.9	34	28,351.9	58
New Zealand	4,041.0	23	1,060.8	13	4,668.5	15	9,770.3	51
Philippines	322.7	19	150.3	10	536.4	16	1,009.4	45
Singapore	459.6	24	167.1	8	1,666.9	28	2,293.6	60
South Korea	259.0	4	381.2	3	5,635.1	28	6,275.3	35
Thailand	72.8	7	2,213.4	25	1,073.1	23	3,359.3	55
Vietnam	6.3	2	0.0	0	15.0	2	21.3	4
Totals	15,367.9	267	14,529.9	158	93,656.1	428	123,553.9	853

**Total value of transactions for which acquisition costs are provided by source*

Panel B: Foreign Investment in Financial Services (total number of transactions)**

Economy	1990 - 1996	1997-1998	1999-2003	Total
Australia	60	20	65	145
Chile	11	9	14	34
China	17	23	121	161
Chinese Taipei	5	2	16	23
Hong Kong	57	30	71	158
Indonesia	15	7	21	43
Japan	11	14	67	92
Malaysia	22	7	15	44
Mexico	10	14	34	58
New Zealand	23	13	18	54
Philippines	19	10	16	45
Singapore	22	8	27	57
South Korea	4	3	28	35
Thailand	7	34	40	81
Vietnam	3	0	6	9
Totals	286	194	559	1,039

***Total number of transactions including those for which acquisition costs are not provided by source*
Source: Thompson Financial Mergers and Acquisitions Data Base available through December, 2003 as of May, 2004

Table 2

Panel A: Investment in Financial Services (US$ millions with number of transactions in parentheses*) 1990-2003

Economy	Australia	Chile	China	Chinese Taipei	Hong Kong	Indonesia	Japan	Malaysia	Mexico	New Zealand	Philippines	Singapore	South Korea	Thailand	Vietnam
Australia	48,459.3 (381)				355.8 (7)	78.0 (3)		4.4 (1)	24.0 (1)	1,662.7 (18)		35.5 (3)		4.1 (1)	2.6 (1)
Canada	65.5 (5)	256.7 (3)	0.0		0.5 (1)	60.7 (3)	703.3 (2)		893.6 (4)	32.0 (1)	6.4 (1)	48.4 (2)		0.0	0.0
Chile		7,002.0 (37)													
China	0.0 (1)		1,499.2 (30)	29.4 (1)	1,189.3 (20)						10.5 (1)	9.3 (1)			
Chinese Taipei			0.0	16,610.8 (34)	110.7 (6)		0.0				71.8 (2)			120.2 (3)	10.0 (1)
Hong Kong	122.9 (4)		1,169.2 (23)	8.8 (2)	19,073.4 (319)	30.0 (1)	0.0	133.8 (4)			56.1 (7)	328.4 (7)	188.7 (3)	0.0	
Indonesia					45.1 (1)	1,442.5 (31)						71.5 (2)			0.0
Japan	84.0 (2)		161.6 (4)	32.2 (2)	321.6 (3)	1,72.2 (5)	241,967.8 (240)	13.7 (2)			138.7 (4)	16.6 (2)	338.7 (5)	11.1 (1)	
Malaysia	104.1 (5)		22.4 (2)	2.2 (1)	39.9 (7)	299.0 (12)		19,694.1 (363)		1,423.1 (5)	99.4 (7)	86.2 (9)		103.9 (4)	
Mexico									22,230.2 (59)						
N. Zealand	147.6 (6)				190.6 (2)					5,490.5 (51)					
Philippines					112.5 (2)						4903.3 (55)	183.7 (2)			
Singapore	173.5 (7)		16.8 (5)	0.1 (1)	8,562.4 (33)	492.2 (9)	8.3 (1)	653.2 (13)		557.5 (2)	477.2 (8)	14,324.4 (116)	30.0 (1)	909.1 (14)	
S.Korea			8.5 (1)									7.2 (1)	11,454.8 (55)		5.0 (1)
Thailand		154.8 (1)	0.0		46.4 (2)	225.0 (1)					12.5 (2)	15.7 (1)		2,154.8 (104)	0.0
Vietnam															3.7 (1)
USA	2,385.8 (15)	522.5 (6)	799.4 (7)	777.0 (6)	428.3 (6)	81.0 (3)	16,702.2 (27)	14.7 (2)	17,172.6 (21)	192.4 (5)	60.3 (2)	110.5 (4)	4,059.1 (14)	1,259.2 (10)	
Europe	5,345.6 (39)	3,377.8 (18)	781.3 (10)	2,162.3 (10)	3,543.6 (28)	56.8 (3)	2,580.8 (6)	311.2 (7)	8,522.1 (25)	1,004.9 (9)	17.7 (3)	1,228.2 (8)	1,412.4 (10)	707.8 (16)	
Others	1,031.5 (19)		158.7 (7)	3.2 (1)	276.0 (9)	10.9 (3)	3,638.5 (6)	23.3 (10)		6.1 (1)	0.0 (1)	191.7 (11)	268.4 (4)	70.4 (5)	5.0 (1)
Total Investment	57,919.8 (484)	11,313.8 (65)	4,617.1 (89)	19,626.0 (58)	34,296.1 (446)	2,885.3 (74)	265,600.9 (282)	20,848.4 (402)	49,842.5 (110)	10,369.2 (92)	5,853.9 (93)	16,657.3 (169)	17,752.1 (92)	5,340.6 (158)	26.3 (5)

Panel B: Investment in Financial Services (Total number of deals) 1990-2003

Economy	Australia	Chile	China	Chinese Taipei	Hong Kong	Indonesia	Japan	Malaysia	Mexico	New Zealand	Philippines	Singapore	South Korea	Thailand	Vietnam
Australia	659			2	9	5		3	1	30	2	6		2	1
Canada	7	3	1	1	6	5	2		4	1	1	2		1	2
Chile		60													
China	1		92	2	29						2	4			
Chinese Taipei			4	54	9		1				2			4	1
Hong Kong	8		30	4	383	3	1	8			8	13	6	1	
Indonesia					1	58						3			1
Japan	3		6	2	7	7	567	7			7	5	5	2	
Malaysia	7		2	1	21	15		961		5	12	29		5	
Mexico		1							80						
N. Zealand	14				2					99					
Philippines					3						104	1			
Singapore	10		11	3	55	17	5	25		2	11	239	1	20	
S. Korea			1									1	96		2
Thailand		1	1		3	3					2	1		145	1
Vietnam															4
USA	37	13	17	13	17	8	40	5	42	8	9	10	24	16	
Europe	63	26	18	16	58	9	20	14	31	11	6	24	14	22	
Others	27		11	1	18	6	6	32	2	9	2	18	6	7	1
Total Investment	836	104	194	99	621	136	642	1,055	160	165	168	356	152	225	13

Table 2 *(continued)*

Panel C: Investment in Financial Services from Asia and Total Cross-Border Investment (US$ millions and percent)

Region	Australia	Chile	China	Chinese Taipei	Hong Kong	Indonesia	Japan	Malaysia	Mexico	New Zealand	Philippines	Singapore	South Korea	Thailand	Vietnam
Asian Total	484.5	154.8	1,378.5	72.7	10,427.9	1,155.4	8.3	800.7	0	1,980.6	866.2	718.6	557.4	1,144.3	15
Total	57,919.8	11,313.8	4,617.1	1,9626	34,296.1	2,885.3	265,600.9	20,848.4	49,842.5	10,369.2	5,853.9	16,657.3	17,752.1	5,340.6	26.3
Percent Asian	0.84	1.37	29.86	0.37	30.41	40.04	0	3.84	0	19.1	14.8	4.31	3.14	21.43	57.03
Percent Foreign	16.33	38.11	67.53	15.36	44.39	50.01	8.9	5.54	53.39	47.05	16.24	14.01	35.47	59.65	85.93

Source: Thompson Financial Mergers and Acquisitions Data Base through December 2003: Panel A numbers are for transactions with values; Panel B are total transactions

Table 3: Investment by Financial Services Industry Segment 1990 - 2003

Panel A: Investment by Financial Services Industry Segment (US$ millions and number of transactions)

	Commercial Banks and Bank Holding Companies		Insurance		Investment & Commodity Firms/Dealers		Credit Institutions		Totals	
Economy	Value	Number	Value	Number	Value	Number	Value	Number	Value	Number
Australia	16,116.4	36	12,274.3	80	27,504.6	345	2,024.6	23	57,919.9	484
Chile	7,526.8	22	2,280.0	26	1,324.5	15	183.0	2	11,314.3	65
China	1,663.9	8	1,149.6	9	1,803.7	72	0.0		4,617.2	89
Chinese Taipei	13,107.9	14	3,639.4	9	2,784.4	30	94.2	5	19,625.9	58
Hong Kong	12,600.6	36	535.0	19	20,448.4	381	712.1	10	34,296.1	446
Indonesia	2,142.6	30	213.9	15	392.9	25	136.0	4	2,885.4	74
Japan	210,715.1	58	22,297.8	56	13,156.5	109	19,431.6	59	265,601.0	282
Malaysia	8,704.3	47	1,682.8	35	9,643.8	295	817.4	25	20,848.3	402
Mexico	33,264.9	45	8,454.7	32	8,042.5	30	80.3	3	49,842.4	110
New Zealand	5,714.9	16	1,052.8	13	3,382.3	54	219.2	9	10,369.2	92
Philippines	5,282.7	35	146.6	13	365.6	41	59.1	4	5,854.0	93
Singapore	11,585.1	9	959.5	20	3,414.6	130	698.0	10	16,657.2	169
South Korea	10,290.8	22	1,356.9	10	4,674.7	50	1,429.9	10	17,752.3	92
Thailand	1,905.5	15	198.3	31	1,475.6	91	1,757.8	21	5,337.2	158
Vietnam	15.0	2	0.0	0	11.3	3		0	26.3	5
Totals	340,636.9	395	56,241.6	368	98,425.4	1,671	27,643.2	185	522,947.1	2,619

Panel B: Investment by Financial Services Industry Segment (total number of transactions)

Australia		50		167		573		46		836
Chile		27		41		30		6		104
China		22		20		150		2		194
Chinese Taipei		24		16		49		10		99
Hong Kong		50		30		523		18		621
Indonesia		52		26		54		4		136
Japan		155		87		272		128		642
Malaysia		60		45		917		33		1,055
Mexico		53		48		49		10		160
New Zealand		21		22		107		15		165
Philippines		68		26		65		9		168
Singapore		14		30		294		18		356
South Korea		35		25		78		14		152
Thailand		32		47		123		23		225
Vietnam		7		2		4		13		26
Totals		670		632		3,288		349		4,939

Source: Thompson Financial Mergers and Acquisitions Data Base through December 2003; Panel A numbers are for transactions with values; Panel B are total transactions

Table 4: Cross-Border Investment by Finfacial Services Sector

Panel A: Foreign Investment by Industry (US$ millions and number of transactions)

	Commercial Banks and Bank Holding Companies		Insurance		Investment & Commodity Firms/Dealers		Credit Institutions		Totals	
Economy	Value	Number	Value	Number	Value	Number	Value	Number	Value	Number
Australia	2,954.6	10	2,720.9	28	5,626.3	102	1,180.3	5	12,482.1	145
Chile	5,079.1	12	1,598.4	17	253.5	5	154.8	1	7,085.8	35
China	670.3	5	1,043.9	7	907.7	41			2,621.9	53
Chinese Taipei	1,577.9	4	572.2	4	816.8	12	45.0	3	3,011.9	23
Hong Kong	10,142.2	20	526.7	16	8,406.9	117	427.9	5	19,503.7	158
Indonesia	794.3	15	187.5	10	330.8	14	136.0	4	1,448.6	43
Japan	3,705.0	5	10,456.7	18	333.8	6	9,487.1	15	23,982.6	44
Malaysia	1,194.4	9	349.9	10	633.3	24	157.7	1	2,335.3	44
Mexico	19,148.8	18	4,966.4	18	4,194.2	20	42.4	2	28,351.8	58
New Zealand	5,661.8	14	949.9	7	2,976.6	31	181.7	2	9,770.0	54
Philippines	811.1	14	28.7	6	152.5	22	17.0	3	1,009.3	45
Singapore	879.2	2	454.3	11	1,113.6	46	29.5	1	2,476.6	60
South Korea	3,791.7	11	542.4	4	1,168.0	17	773.1	3	6,275.2	35
Thailand	1,451.0	7	95.6	11	587.1	33	1,225.5	4	3,359.2	55
Vietnam	15.0	2			6.3	2			21.3	4
Totals	57,876.4	148	24,493.5	167	27,507.4	492	13,858.0	49	123,735.3	856
Percent	46.8%	17%	19.8%	20%	22.2%	58%	11.2%	6%		

**Total value of transactions for which acquisition costs are provided by source*

Panel B: Foreign Investment by Industry (number of transactions)

Australia		10		28		102		5		145
Chile		12		16		5		1		34
China		5		9		60		1		75
Chinese Taipei		4		4		12		3		23
Hong Kong		20		16		117		5		158
Indonesia		15		10		14		4		43
Japan		9		24		32		27		92
Malaysia		9		10		24		1		44
Mexico		18		18		20		2		58
New Zealand		14		7		31		2		54
Philippines		14		6		22		3		45
Singapore		2		11		43		1		57
South Korea		11		4		17		3		35
Thailand		7		11		33		4		55
Vietnam		4		2		3		0		9
Totals		154		176		535		62		927

Panel C: Foreign Investment as Percent of Total

Australia	18.3%	27.8%	22.2%	35.0%	20.5%	29.6%	58.3%	21.7%		
Chile	67.5%	54.5%	70.1%	65.4%	19.1%	33.3%	84.6%	50.0%		
China	40.3%	62.5%	90.8%	77.8%	50.3%	56.9%	n/a	n/a		
Chinese Taipei	12.0%	28.6%	15.7%	44.4%	29.3%	40.0%	47.8%	60.0%		
Hong Kong	80.5%	55.6%	98.4%	84.2%	41.1%	30.7%	60.1%	50.0%		
Indonesia	37.1%	50.0%	87.7%	66.7%	84.2%	56.0%	100.0%	100.0%		
Japan	1.8%	8.6%	46.9%	32.1%	2.5%	5.5%	48.8%	25.4%		
Malaysia	13.7%	19.1%	20.8%	28.6%	6.6%	8.1%	19.3%	4.0%		
Mexico	57.6%	40.0%	58.7%	56.3%	52.2%	66.7%	52.8%	66.7%		
New Zealand	99.1%	87.5%	90.2%	53.8%	88.0%	57.4%	82.9%	22.2%		
Philippines	15.4%	40.0%	19.6%	46.2%	41.7%	53.7%	28.8%	75.0%		
Singapore	7.6%	22.2%	47.3%	55.0%	32.6%	35.4%	4.2%	10.0%		
South Korea	36.8%	50.0%	40.0%	40.0%	25.0%	34.0%	54.1%	30.0%		
Thailand	76.1%	46.7%	48.2%	35.5%	39.8%	36.3%	69.7%	19.0%		
Vietnam	100.0%	100.0%	n/a	n/a	55.8%	66.7%	n/a	n/a		

Source: Thompson Financial Mergers and Acquisitions Data Base through December 2003; Panel A numbers are for transactions with values; Panel B are total transactions; Panel C percentages are as of Table 3 total values

Table 5: Market Capitalization of Commercial Banks (US$ million)

Economy	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Canada	244,784	326,542	316,315	366,996	487,509	569,353	544,664	804,015	844,290	704,737
USA	4,485,040	5,136,199	5,067,016	6,857,622	8,484,433	11,308,780	13,451,350	16,635,110	15,104,040	13,810,430
Chile	29,644	44,623	68,196	73,861	65,941	72,047	51,867	68,228	59,940	56,735
Mexico	139,282	201,034	130,444	90,827	106,673	156,762	91,807	154,050	125,277	126,652
Hong Kong	172,119	385,525	269,802	303,934	449,628	413,434	343,630	609,679	623,492	506,700
Indonesia	12,038	32,953	47,241	66,585	91,016	29,105	22,104	64,087	26,834	23,006
Japan	2,399,023	2,999,972	3,720,205	3,667,666	3,089,106	2,216,717	2,495,852	4,547,216	3,157,368	2,251,981
Malaysia	94,277	220,679	199,600	223,121	307,906	93,714	98,667	145,445	116,935	118,981
Philippines	15,283	40,342	56,837	58,904	80,694	31,362	35,317	48,093	51,556	21,327
Singapore	49,088	133,219	135,174	148,778	150,219	106,663	94,673	198,989	153,179	117,451
South Korea	107,448	139,420	191,779	181,956	138,818	46,052	121,157	395,667	171,587	232,070
Chinese Taipei										
Thailand	58,259	130,560	131,479	141,537	99,839	23,541	34,911	58,371	29,490	36,342
Australia	144,809	204,944	220,112	246,870	313,912	297,414	329,328	430,446	373,841	374,936
New Zealand	15,363	25,604	27,323	32,032	38,770	30,560	25,138	28,250	18,875	17,845

Table 6: Percentage of Total Employed in Finance, Insurance, Real Estate and Business Services

Economy	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Canada	13.79	13.98	14.15	14.55	14.71	15.10	15.56	15.63	15.82	16.00	16	16.26
USA	10.61	10.85	11.02	10.96	11.19	11.40	11.75	12.03	12.21	12.34	12.48	12.83
Chile	5.15	5.79	5.98	6.44	6.97	7.00	7.47	7.22	7.91	7.56	7.84	7.9
Mexico	3.29	3.29	3.20	3.26	3.86	4.05	3.81	3.74	3.77	3.86	3.83	3.89
Hong Kong	8.47	10.33	11.35	11.76	11.75	12.69	13.07	13.97	13.96	14.70	14.79	15.13
Indonesia	0.72	0.71	0.82	0.76	0.81	0.75	0.70	0.71	0.98	1.24	1.24	1.36
Japan	8.48	8.48	8.51	8.60	8.65	8.77	9.10	9.27	9.56	9.81	10.01	10.25
Malaysia	4.25	4.47	4.60	4.76	4.91	5.22	4.95	5.28	4.96	5.20	5.1	5.27
Philippines	1.89	2.03	1.96	2.14	2.48	2.44	2.46	2.56	2.44	2.82	2.79	2.98
Singapore	10.88	10.89	12.04	14.89	14.08	14.94	15.66	15.98	15.40	17.19	17.29	18.23
South Korea	6.46	7.05	7.51	8.01	8.50	9.00	9.28	9.49	9.90	10.12	10.6	11.06
Thailand												
Australia	12.75	12.31	13.03	13.63	13.78	14.28	14.91	14.83	15.57	15.71	16.07	16.73
New Zealand	10.75	9.96	10.20	10.68	11.18	12.89	12.86	13.06	12.90	12.72	12.66	13.03

Source: International Labor Organization (through Euromonitor)