Chapter 7: Conclusion: Directions for Japan's Assistance in This Field

7.1 Issues of East Asian Financial Sectors

As discussed in the preceding chapters, the following are the issues facing the financial sector in East Asia:

1) Reforming and restoring the health of the banking sector. On the short term, strengthening the financial basis of banks and disposing of the bad debt accumulated in the Asian crisis; and on the medium term, a vision for recovery of the banks' finance mediating functions and development of the banking sector overall.
2) Legislation and institutional development for capital markets and institutional investors.
3) Improving the soundness and financial basis (corporate governance, corporate accounting) of businesses themselves, which are the subject of investment and financing.
4) Improving the efficiency of policies and systems related to government oversight and regulation.
5) Improvements based on international standards in legal frameworks, accounting standards, market regulations, and policies on management and supervision.

The above are not individual, independent issues, but closely interrelated with each other. There are also certain points that must not be ignored when considering the problems that are characteristic of developing countries. The following are the points to be kept in mind with regard to the countries that are the subject of this report.

First, it is important to consider the problems that may tend to emerge in the countries that are the subject of this report, compared to other countries with advanced market economies. For example, as described in Chapter 2, the banking sector is affected by market failings[35] caused by the inadequacies of the financial markets and the asymmetry of information in developing countries, as well as a wide range of government failings[36], which may occur in developing countries in particular. The study must be based on an understanding of the roles of the financial authorities and the markets with regard to these issues.

Second, study is needed on how to use the lessons learned from the Asian crisis. At the time of the crisis, various problems were brought to light, including the fact that excessive lending by banks (or borrowing by businesses) was based on the inflow of highly liquid

[35] Market failings: Although this can, of course, happen in advanced countries as well, in developing countries, which face more asymmetry of information, factors other than interest have a greater influence on lending by financial institutions. These factors may include the borrower's capital-asset ratio or business relationships with the financial institution. The financial institution's own financial status also has an impact, and there is an influence from market inadequacies such as the lack of a developed long-term capital market and the strong orientation of depositors toward short-term, high-interest investments. The following are some of the effects that may occur:

- Even for sound customers, banks may limit loan amounts to less than the amount requested by the customer (credit rationing).
- Banks may refuse to lend money even if the customer offers security (because no standards for assessing security have been established and it is difficult to exercise security).
- Banks may not provide long-term financing. (Banks are not willing to assume long-term risk because of anxiety concerning inflation or frequent changes in government policy, and because their depositors have a strong orientation toward short-term deposits.)

[36] Government failings: This includes erosion in lending motivation due to government intervention, as seen in Indonesia (for instance, when the high yields of government bonds used in government financing to banks make the banks reluctant to sell government bonds to provide loans to businesses), stagnation in lending growth because of the rapid tightening of prudential regulations to ensure soundness, and the confusion of social policy with financial policy (for instance, when the government essentially sets a target amount for banks to lend to small- and medium-size enterprises and forces them to reach that target, possibly leading to an increase in uncollectible loans).

foreign capital, and the problem of a mismatch between currencies and time periods in the procurement and operation of capital (for example, procuring dollars on the short term and operating with bahts on the long term). It is important to consider how to use these lessons to deal with the problems through the future application of rules for bank soundness. Attention should also be focused on the issues of how to manage private sector debt that has arisen since the crisis and how to deal with related issues.

7.2 Directions for Japan's Assistance

(1) Overview of Assistance

The roles to be played by Japanese ODA in East Asian nations are generally considered to cover a wide range of areas, including the following basic components of the financial infrastructure:

1) Establishing settlement systems, corporate information databases, and other systems
2) Promoting the disposal of the banks' bad debt and establishing institutions for the development of capital markets, etc.
3) Building a basic financial legislative infrastructure
4) Training personnel for credit reviews, financial statement preparation, etc.
5) Establishing programs for corporate accounting and tax affairs, etc.
6) Transferring expert knowledge in risk management, administration of securities markets, etc.

What kinds of assistance are the most appropriate, considering Japan's financial system? Consideration should be given to providing cooperation with a unique approach unlike that of other donors, based on the expertise that has been accumulated over the years in Japan's financial system, and making use of the knowledge learned through dealing with past problems and reforming financial institutions.

For example, indirect financing through banks plays, by far, the most important role in East Asian countries today, as it does in Japan. Therefore it will be effective for cooperation to make use of the roles that banks have played in Japan, particularly with regard to the banks' functions in monitoring and supplying capital to small- and medium-size enterprises (under the "main bank" system), as well as Japan's experience in measures implemented by the government and related institutions. Of course, it is not realistic to take the same functions and measures that have worked in Japan in the past and simply apply them in developing countries. Careful study is needed, including appropriate revisions based on each country's situation.

Concerning institutional development in the area of economic soft infrastructure, emphasis must be given to global standards, but it is also necessary to provide support in a careful manner with thorough consideration for each country's social characteristics and stage of development. In addition to the past approach of providing assistance to developing countries, it is important for Japan to work jointly with East Asian countries in building institutions from the standpoint of an equal economic partnership. For example, efforts are needed in joint research on issues that are common to all of East Asia with regard to institutions for accounting standards and market regulation and supervision, areas in which East Asia is currently under pressure to introduce international standards. To improve the effectiveness of assistance in promoting smoother trade and investment in East Asia, it would also be significant to advance cooperation for the promotion of private trade and investment activities, with an awareness of the business needs of Japanese corporations. For example, efforts are needed with regard to supporting the establishment of medium- and long-term financing in local currencies and promoting orderly, liberalized capital transactions.

It is also important to develop a comprehensive package from the standpoint of a closer economic partnership with East Asia, including cooperation in other institutional areas that support a market economy, in addition to the financial sector.

(2) Assistance Policies

Assistance in the financial sector must be continuous and long-term, based on a clear assignment of roles among government, academia, and the private sector, and beginning at the stage of plan proposal. In the future, based on the directions indicated in this report and the needs of the region and countries in question, the Japan International Cooperation Agency (JICA) should give priority to the following areas of cooperation in its study of technical assistance in this area:

1) Cooperation in sectors and fields where assistance will have an impact
2) Cooperation in institutional development and the public sector
3) Cooperation in fields where JICA can exercise its strengths, obtaining cooperation from other related institutions as well

Also, since it is difficult to provide cooperation through technological transfer on the private sector level in the area of finance, unlike the case of the manufacturing industry, it is necessary to pursue multilayered partnerships in human resource training and exchanges among the universities, private financial institutions, and government agencies of both sides.

Meanwhile, to build an environment in which active front-line personnel in related Japanese institutions can participate in assistance, it will be necessary to conduct educational activities within Japan on the need for assistance, build continuous partnerships with related institutions that cooperate in providing assistance, and take steps for institutional development toward a smooth supply of support personnel.

(3) Studying Assistance Options for Financial Infrastructure

To repeat a point that was made earlier, although capital markets are gradually emerging, the financial structure of East Asia cannot be said to have entered a phase of full-scale development. Banks are still at the center of the financial structure, and banks remain the overwhelming choice for fundraising by businesses. For small and medium enterprises and unlisted companies, which account for the majority of existing businesses, bank loans are the greatest external source of financing. Therefore, reform of the banking sector should be the top priority task in order to provide support in terms of capital to a wide range of businesses in East Asia, primarily in the manufacturing industry, and thereby to realize sustainable economic development.

With regard to reform of the stock and bond markets, the wide variety of related institutions and functions mean that institutional development in this area will require a great deal of time and money. Meanwhile, the focus can be kept relatively simple with regard to the banking sector, and improving the oversight, regulation, and management of banks can lead to improvement of their loan mediating functions. Therefore, in addition to being a priority issue, reform of the banking sector is an easier area to address than is reform of the stock and bond markets.

Therefore, looking at the support options listed in the table below, with regard to the priority issue of reforming the banking sector, Japan's future support could be focused on strengthening the supervisory and regulatory framework to suit each country's situation and strengthening the management of local banks. The areas of concurrent support that are needed in this regard are training a wide range of human resources, building the basic financial legislative infrastructure, and supporting proper accounting practices at businesses, especially small- and medium-size enterprises. It is important to consider the strength and urgency of each country's requirements on an individual basis, but at the same time, according to the progress of coordination in East Asian financial structures, it is necessary to pursue institutional development in the capital markets, improvement of corporate governance at listed companies, and improvement of accounting practices, including disclosure, and to build a wide range of legislative infrastructure and enforcement programs to accomplish these goals. This set of issues certainly cannot be resolved with support from Japan alone, but as stated in section 7.1, it is important to remember the standpoint of how to apply the lessons of the Asian crisis, along with the roles of the financial authorities and the markets in preventing a repetition of the market failings and government failings.

Support Options in Each Field of Financial Infrastructure

Field	Item of Assistance	Content
Banking Sector		
Measures for smoother loan mediation by banks	Improving lending credit review capabilities	Support for the preparation of review manuals and seminars on new risk management methods, ALM, ratings systems, and early warning systems
	Building databases of corporate information	Support for building information sources such as internal bank databases, information from clearinghouses on dishonored checks, and credit information institutions like Japan's Teikoku Databank, and support for expansion and strengthening of the disclosing functions of business registry offices
	Improving and expanding credit guarantee systems	Support for program expansion using Japan's expertise with regard to credit guarantee rates and reinsurance systems
Measures for sounder banking systems	Establishing settlement systems	Cooperation for rapid settlement system introduction
	Improving bank management and oversight systems	Support for the exchange of information among bank supervisors and preparation of inspection manuals
	Promoting debt disposal	Promoting stock conversion of debt, faster processing of disputes related to debt, and stronger capabilities of commercial courts
Capital markets		
Institutional improvement	Building a broker licensing system	Training human resources and supporting broker education and training
	Establishing listing standards	Supporting the establishment of listing standards for sound capital market development and improved corporate governance
	Formulating disclosure rules	Support for rule establishment
	Building bond trading and settlement systems	Support for system building
	Expanding the investor base	Lifting restrictions on investment in capital markets by institutional investors, enacting laws and regulations on investment trusts, revising purchase units, etc.
Management guidance	Improving market discipline	Guidance on market oversight with regard to stock price manipulation, broker oversight, listing reviews, and disclosure oversight
Personnel training	Training a wide range of human resources (including programs)	Education for officers at responsible government agencies, analysts, canvassers, and investors (dealers, fund managers, and individual investors)
Accounting		
Support for bookkeeping and accounting practices	Formulating accounting guidelines and audit guidelines	Support for accounting and correcting the gap between accounting standards and practices
	Improving the accounting skills of bookkeepers	Support for establishment of a bookkeeping certification program
	Preparation of financial statements at small- and medium-size enterprises	Support to promote the preparation of financial statements by introducing programs such as Japan's tax system and blue form income tax return system

	Research on accounting (including the training of human resources)	Support for expansion of accounting education, and conducting joint research among academics
Accounting at small- and medium-size enterprises	Establishing accounting standards for small- and medium-size enterprises	Support for research on practical accounting standards for small- and medium-size enterprises
Disclosure systems	Systems to evaluate and recognize disclosure	Support for introduction of systems to evaluate and recognize disclosure, like the one already introduced in Malaysia
Corporate governance		
Educational activities	Recognition systems	Support for the introduction of recognition systems
External monitoring	Systems for monitoring by banks	To be considered along with rules for greater transparency in internal loans, a characteristic of the industrial conglomerate structure in Japan, as well
	Verifying the suitability of regulatory frameworks under commercial law and securities and exchange law	Analyzing the obstacles to adherence to rules on responsibilities, duties, and authorities under the commercial law and securities and exchange law, and indicating corrective measures
	Financial oversight in universal banking operations	Guidance concerning oversight
	Preparation of consolidated financial statements	Advice concerning the preparation of consolidated financial statements
	Developing institutional investors	Education to expand monitoring functions
Internal monitoring	Strengthening internal audits and auditors	Support for related infrastructure and program building, identifying obstacles related to commercial law and securities and exchange law, and indicating response measures
	Introducing external director systems	Support for system introduction
	Training executive human resources	Seminars and other educational activities for executives
	Employee participation in management	Support for introduction of employee stock ownership plans (stock options and employee stock ownership associations)
Other	Improving transparency through computerization	Support for a leapfrog approach using information technology to improve the transparency of corporate accounting, the efficiency of tax affairs, and other aspects of governance
Financial legislative infrastructure		
Laws related to financial institutions and financial transactions	Central bank law, banking law, depositor protection law, and other laws related to financial institutions	Analyzing the laws regulating financial institutions and researching their consistency with government policy, the soundness of financial institutions, and the suitability of corporate governance structures
	Securities and exchange law, interest rate restriction law, laws on bills of exchange and checks, warranty law, and other laws related to financial transactions	In the area of laws regulating transactions in financial markets, research on the extent of government intervention, ethical values in trade, contractual concepts, and other aspects of market autonomy
Laws generally related to orderly markets	Corporate law, corporate registration law, contract law, accounting law, etc.	Analyzing the basic regulations established to improve the efficiency of market functions, clarifying the state of these regulations, and on that basis, determining the correlation in terms of their direct impact on the area of finance
	Bankruptcy law and other economic laws	Research on the enforcement agencies, implementing agencies, and executive agencies with regard to their organizational systems, human resources, and efficiency, because this area of law covers the improvement of market efficiency

Note: The underlined portions in the table above are the areas that the JICA should consider for priority involvement.

APPENDICES

Appendix 1. Comparison of Listed Companies in East Asia

	Malaysia	Thailand	Philippines	Indonesia	China
Large companies	Main Board of Kuala Lumpur Stock Exchange: 514 companies	Stock Exchange of Thailand: 379 companies	Philippine Stock Exchange: 229 companies	Jakarta Stock Exchange: 312 companies	Shanghai Stock Exchange: 621 companies, Shenzhen Stock Exchange: 507 companies
Total market value of large companies (Total market value/GDP)	$114,076 million (124.4%)	$31,502 million (26.1%)	$46,718 million (78.1%)	$29,782 million (20.1%)	$580,990 million (58.3%)
Small and medium-sized enterprises	Second Board of Kuala Lumpur Stock Exchange: 297 companies, MESDAQ:[1] 4 companies	MAI:[2] 1 company	—	—	—[3]
Total number of listed companies	815	380	229	312	1,128
Number of manufacturing companies included (Percentage of listed companies) (Percentage of domestic manufacturing companies)	262 (32.1%) (1.3%)	66 (17.3%) (0.1%)	25 (10.9%) (0.0%)	144 (47.8%) (0.0%)	711 (63.0%) (0.1%)
Number of domestic manufacturing companies	20,204	81,699	90,028	2,752,765	506,445
Manufacturing companies by size of company (number of employees)	1–4 employees: 6,076 companies, 5–1,999 employees: 14,049 companies, 2,000 or more employees: 79 companies	1–4 employees: 30,181 companies, 5–999 employees: 51,146 companies, 1,000 or more employees: 372 companies	1–9 employees: 79,032 companies, 10–99 employees: 9,350 companies, 100–199 employees: 752 companies, 200 or more employees: 894 companies	1–4 employees: 2,501,465 companies, 5–19 employees: 228,685 companies, 20 or more employees: 22,615 companies	Small: 482,518 companies, Medium size: 16,870 companies, Large: 7,057 companies
Companies with potential for future listing	79 companies with at least 2,000 employees: Revenues of 66.9 billion ringgits. Average: 850 million ringgits per company (about $220 million).	372 companies with at least 1,000 employees: Total of 754,000 employees. Average: 2,026 employees per company.	894 large companies: Revenues of 590.7 billion pesos. Average: 660 million pesos per company (about $30 million).	22,615 companies with at least 20 employees: Revenues of 249.6 trillion rupiahs. Average: 11.0 billion rupiahs pesos per company (about $4.6 million).	7,057 large companies: Added value of 7.8 billion RMB. Average: 110 million RMB per company (about $10 million).
Manufacturing industry GDP/Total GDP	12.0%	30.1%	31.6%	25.8%	42.7%

Source: Based on sources including "Asia's Stock Markets, 2001," Daiwa Institute of Research Ltd.; "Survey on the Current State of Asia's Small and Medium Businesses" (1996), Japan Small Business Research Institute; and "Issues for Sustainable Development in East Asia" (2001), Japan Bank for International Cooperation [all in Japanese].

[1] Established in 1999.
[2] Established in 1999.
[3] In January 2000, the China Securities Regulatory Commission (CSRC) announced the establishment of new markets for high tech companies in Shanghai and Shenzhen.

Appendix 2. Summary of Banking Sectors in East Asia

Thailand

Unit: billion bahts

		Number of banks		Number of branch offices		Total assets		Credit		Deposits		NPL ratio		CAR	
		12/1997	12/2001	6/1999	12/2001	12/1997	12/2000	12/1997	12/2000	12/1997	12/2000	6/1998	12/2001	12/1998	12/2001
Thailand	Commercial banks	35	13	3,845	3,701	{7,428.3	{6,640.2	{5,829.5	{4,335.4	{3,859.6	{4,491.1	31.0%	10.5%	10.9%	13.9%
	Foreign banks	20	18	NA	NA							5.5%	3.2%	NA	NA
	Finance companies	91	21	NA	NA	1,636.8	667.6	1,400.3	304.5	549.8	343.7	52.6%	9.5%	NA	NA
	Government related (See note)	6	6	NA	NA	1,078.9	1,407.6	789.3	986.7	418.0	692.1	NA	NA	NA	NA
	Total	152	58	-	-	10,144.0	8,715.4	8,019.1	5,626.6	4,827.4	5,526.9	32.7%	10.4%	-	-

Note: Government savings bank, agricultural cooperative bank, industrial credit corporation, government housing bank, and import and export bank. (The small business credit corporation is not included in assets, etc.)
Source: International Financial Information Center, monthly bulletin and website of Bank of Thailand

Malaysia

Unit: billion ringgits

		Number of banks		Number of branch offices		Total assets		Credit		Deposits		NPL ratio (See note 2)		CAR	
		12/1997	12/2000	12/1997	12/2000	12/1997	12/2000	12/1997	12/2001	12/1997	12/2001	12/1998	12/2001	12/1998	12/2001
Malaysia (See note 1)	Commercial banks	{35	17	{1,671	{1,758	{486.6	{513.6	214.1	244.2	231.5	283.2	10.3%	10.5%	11.7%	12.7%
	Foreign banks		14					62.2	80.7	69.1	85.6	NA	NA	NA	NA
	Finance companies	39	19	1,144	933	152.4	109.4	102.5	92.7	106.6	84.9	21.6%	12.8%	11.1%	11.4%
	Merchant banks	12	12	24	22	44.3	36.9	23.1	14.6	26.4	25.4	25.4%	26.2%	15.2%	19.0%
	Total	86	62	2,839	2,713	683.3	659.9	401.9	432.2	433.6	479.1	13.6%	11.5%	11.8%	12.8%

Note 1: Development finance organizations and discount houses are not included.
Note 2: The standard for NPLs is three months.
Source: International Financial Information Center, monthly bulletin and annual report of Malaysia Central Bank

Indonesia

Unit: trillion rupiahs

		Number of banks		Number of branch offices		Total assets		Credit		Deposits		NPL ratio		Foreign debt/Total debt	
		12/1997	12/2001	10/1997	12/2001	12/1999	12/2001	12/1999	12/2001	12/1999	12/2001	3/1999	12/2001	12/1997	12/2001
Indonesia	Nationally operated	5	5	1,853	1,807			152.1	159.9			47.5%			
	Private foreign exchange, private non-foreign exchange	92	80	4,331	3,988			61.5	107.8			76.9% 38.9%			
	Local development	27	26	825	857			13.6	17.1			17.0%			
	Merged and foreign banks	40	34	104	113			50.1	73.8			*			
	Total	164	145	7,113	6,765	1,006.7	1,099.7	277.3	358.60	617.6	797.4	24.4%	12.1% (See note)	15.8%	10.9%

* Merged: 64.6%, foreign banks: 49.9%

Note: For 12/1999 and later, only overall figures for commercial banks have been issued. As of Dec. 31, 1999, the overall NPL ratio was 32.8%.

Source: International Financial Information Center, 2001 annual report and website of Bank Indonesia

Philippines

Unit: billion pesos

		Number of banks		Number of branch offices		Total assets		Credit		Deposits		NPL ratio		CAR	
		12/1997	12/2000	12/1997	12/2000	12/1997	6/2001	12/1998	12/2001	12/1997	12/2001	12/1998	12/2001	12/1998	12/2000
Philippines	Private commercial	54	45	4,024	4,205	2,513.0	3,097.0	1,542.5	1,575.2			10.4%	17.0%	17.5%	15.6%
	Foreign banks included (See note)		13					(155.7)	(253.6)			(7.9%)	(4.9%)		
	Deposit	117	112	1,272	1,279	208.4	249.7								
	Rural	832	790	883	1,122	57.6	70.9								
	Total	1,003	947	6,179	6,606	2,779	3,417.6								
	Nonbank financial institutions	7,085	5,097	3,030	4,026	610.3	693.4								
	Total	8,088	6,044	9,209	10,632	3,389.3	4,111.0								

Note: Excludes local affiliates of foreign banks.

Source: International Financial Information Center, website of Philippine Central Bank

China

Unit: billion RMB

		Number of banks		Number of branch offices		Total assets		Credit		Deposits		NPL ratio (See note 2)		Deposits/GDP	
		12/1998	12/2000	12/1998	12/2000	12/1999	9/2001	12/1999	9/2001	12/1999	9/2001	9/2001	12/2001	12/1997	12/2000
China	State commercial	4	4			69%	65%	74	65%	64%	61%	27%	25%		
	Other commercial	13	12			9%	12%	7	10%	8%	11%				
	Urban credit	3,240	3,330			5%	4%	5	5%	6%	5%				
	Rural credit	NA	39,515			9%	10%	10	12%	12%	12%				
	Other		157 (See note2))			8%	9%	4	8%	10%	11%				
	Total	-	43,018			100%	100%	100	100%	100%	100%			110.0%	138.5%
						13,255.7	14,954.9	9,373.4	10,897.3	10,877.9	13,911.5				

Note 1: Reported by the four largest commercial banks only. Numerical levels such as the NPL ratio are not announced on a regular basis.
Note 2: Foreign banks.
Source: International Financial Information Center, website of People's Bank of China, newspaper articles

Appendix 3. Summary of Securities Markets in East Asia

	Malaysia	Thailand	Philippines	Indonesia	China
Major securities exchanges					
Securities exchange	Kuala Lumpur Stock Exchange	Stock Exchange of Thailand	Philippine Stock Exchange	Jakarta Stock Exchange	Shanghai Stock Exchange and Shenzhen Stock Exchange
Trading hours	Mon.-Fri. 9:00-12:30, 14:30-17:00	Mon.-Fri. 10:00-12:30, 14:30-16:30	Mon.-Fri. 9:30-12:00	Mon.-Fri.[4] 9:30-12:00, 13:30-16:00	Mon.-Fri. 9:30-11:30, 13:00-15:00
Main index of stock prices	KLSE composite index	SET index	Manila composite index	Jakarta composite index	Shanghai/ Shenzhen A Share index, B share index
Number of listed companies[5]	811	379	229	312	1,128
Total market value (million US$)[6] (percent of GDP)	106,182 (115.8%)	31,502 (26.1%)	46,718 (78.1%)	29,782 (20.1%)	580,990 (58.3%)
Annual trading cost (million US$)[7]	58,503	21,366	7,167	13,036	734,852
Turnover ratio[8]	55.1%	67.8%	15.3%	43.8%	126.5%
Listing criteria	(1) Paid-in capital of 60 million ringgits. (2) Profit recorded in each of the past three years, totaling at least 30 million ringgits, with net profit of at least 8 million ringgits in the most recent year. (3) At least 1,000 ordinary shareholders with capital of less than 100 million ringgits, and 1,250 shareholders with capital of 100 million ringgits or more. (4) At least 25% of total outstanding shares are	Major revisions in June 2000 liberalized the numerical criteria and strengthened internal management and corporate governance. Formal criteria (general): (1) Paid-in capital of at least 200 million bahts. (2) At least 600 minority shareholders, holding at least 20% of paid-in capital if paid-in capital is less than 500 million bahts. (3) Sale of outstanding shares: At least 15% of paid-in capital if paid-in	New criteria were approved by the SEC in May 2000. The stock exchange is not divided into a first and second board, but two sets of criteria (first board and second board) are applied for listing. The first board criteria are: (1) Concerning capital, the minimum par value is 1 peso in commerce and industry. Authorized capital stock of at least 400 million bahts, and paid-in capital of at least 100 million pesos or at least 25% of authorized capital	First board criteria: (1) At least three years since company was founded and commenced business. (2) Total capital of at least 300 billion rupiahs. (3) Profitable operations for two years (at least 20 billion rupiahs in pretax profits in the most recent closing of accounts, and pretax profits for the two most recent years totaling at least 30 billion rupiahs). (4) Revenues from core	There is no distinction for A shares and B shares. (1) Approved by the securities commission of the State Council. (2) At least 50 million RMB of paid-in capital. (3) At least three years since company was founded, and profitable operations in each of the three most recent years. (4) At least 1,000 shareholders owning shares with par value of at least 1,000 RMB, and not

[4] On Fridays, trading hours are 9:30-11:30 and 14:00-16:00.
[5] As of July 31, 2001.
[6] As of July 31, 2001. Figures based on local currencies are converted at the exchange rate in effect at the end of the period. "Percent of GDP" means the total market value divided by GDP in 2000. (The corresponding figures are 125.3% for the U.S. and 70.9% for Japan.)
[7] For the one-year period of FY 2000. Figures based on local currencies are converted at the exchange rate in effect at the end of the period.
[8] Annual trading volume (2000) divided by the total market value (as of July 2001).
[9] Regulations affecting shareholders owning 5% or more of outstanding shares after a company is newly listed, the company's executives, and related persons.

	Malaysia	Thailand	Philippines	Indonesia	China
	outstanding shares are held by ordinary shareholders who own at least 1,000 shares apiece.	capital is less than 500 million bahts. (4) Under the same management for at least 1 year. (5) Business continued for at least the past three years; net profit of at least 30 million bahts in the previous year; revenues of at least 2 billion bahts in the previous year or ordinary shares having market value of at least 1.5 billion bahts. (6) Total shareholders' equity of at least 200 million bahts. (7) Silent period:[9] Six-month prohibition on selling 35% of paid-in capital.	stock. (2) At least 7 directors, and at least 1,000 shareholders. (3) Consolidated pretax profits in each of the three preceding years totaling at least 50 million pesos, with this figure equal to at least 10 million pesos in each of those years. (4) If the aggregate market value of shares is less than 1 billion pesos before a capital increase, the minimum subscription price is 100 million pesos or 25% of the aggregate market value of shares, whichever is greater.	business make up 60% of cash flow from operations. (5) Ordinary shareholders: At least 100 persons, or owning at least 35% of paid-in capital. Total number of shareholders: At least 1,000.	less than 25% of the total number of outstanding shares must be issued to ordinary shareholders. (5) No legal violations or false financial statements within the past three years. (6) Recommended by one or two commission members. (7) Satisfying all conditions of laws and regulations.
Environment and institutions affecting the securities markets					
Regulations on securities	(1) Bumiputra policy: Limits on stock ownership by foreigners, priority allocation of publicly tendered shares to Bumiputra investors, etc. (The goal is 30% ownership of all companies. The current level is about 20%.) (2) Restrictions (guidelines) on investment by foreigners: Companies may limit the ownership ratio of foreigners to a maximum of 30% in their articles of association. Approval by the foreign investment council is required for investments of 5 million ringgits or more, or for acquiring stock with 15% or more of voting	(1) Exchange controls: Capital gains can be remitted to home country without restriction. (2) Restrictions on stock ownership by foreigners have been abolished.	(1) Foreign currency restrictions: In the case of an investment in the Philippines that is financed by foreign currency, the investor registers with the central bank when purchasing pesos. After registration, the capital and investment returns can be converted to foreign currency. (2) Restrictions on investment by foreigners: Land ownership is limited to companies with 60% funding by persons with Philippine citizenship. Therefore, many companies limit stock ownership by foreigners to a maximum of 40%. The Foreign Investment	(1) Exchange restrictions: There are generally no restrictions by exchange controls with regard to investing and remitting funds from abroad to Indonesia or from Indonesia to abroad. (2) Restrictions on investment by foreigners: Since the regulations were liberalized in September 1997, listed stocks other than bank stocks may be 100% owned by foreign investors.	(1) Exchange restrictions: Legitimate profits may be remitted to other countries.

		Malaysia	Thailand	Philippines	Indonesia	China
		rights. However, these restrictions have been provisionally eased following the economic crisis.		Negative List provides the regulatory details.		
	Taxation of securities	(1) Taxation of distributions: Companies pay dividends to shareholders after deducting a 30% corporation tax. (2) Capital gains: Not taxed. (3) Corporation tax: 28% tax rate.	(1) For corporate investors, a capital gains tax of 15% is generally withheld. Capital gains are not taxed for individual investors. (2) Stamp tax is 0.1% for persons with high stock values or trading amounts.	(1) Taxation of distributions: Not taxed for residents. Non-residents are taxed at 35% (corporate) or 30% (individual). (2) Capital gains: Not taxed when selling stock exchange listed shares. Income gained by residents from sales outside stock exchanges is taxed (10% for corporations).	For residents, distributions and interest are added to other income for aggregate income tax, and the regular income tax rates are applied. For foreign investors, who are non-residents, a 20% tax on distributions is generally withheld.	Income tax of 20% is withheld on distributions. Capital gains are not taxed. At present, distributions and capital gains from B shares (foreign investment shares) are exempt from income tax for foreign investors.
	Disclosure	The 1965 corporation law established a framework for financial reporting and disclosure. It protects the interests of investors and shareholders, and prohibits insider trading. In March 1999, the stock exchange introduced strengthening measures centered around the introduction of quarterly reports.	Requirements on regular reporting to the SEC: (1) Quarterly financial reports after simple audit. (2) Audited annual or semiannual financial reports. (3) Annual reports. (4) Additional information (within 3 months after end of accounting period).	Requirements on regular reporting to the SEC: After any important management decision that is likely to affect stock price, such as distributions or a purchase or merger, the company must report by telephone or fax within ten minutes, and submit a written explanation within two hours.	Reporting requirements: (1) Audited annual reports. (2) Semiannual reports (unaudited) within 60 days after the end of each six-month period. (3) Quarterly reports (unaudited). (4) Any important matters. (5) At least two weeks before the annual general shareholders meeting, companies must send annual reports, containing the content required by the Capital Market Control Agency, to shareholders and the capital market management bureau.	July 1999 securities law. Information for public disclosure is classified as interim reports, annual reports, and extraordinary reports. These are submitted to the China Securities Regulatory Commission (CSRC) and the stock exchanges.
	Accounting	The British system is used. Both MIS and IAS are used, and the Malaysia Accounting Standard Board (MASB), established in 1997, has announced new standards. Three sets of standards exist side by side. However, since	TAS. Any matters not provided for in TAS are according to IAS, Financial Accounting Standards Board (FASB), and American Institute of Certified Public Accountants (AICPA), in that order of priority.	Generally the same as American accounting standards.	Accounting standards are the same as the U.S., based on the accounting principles prepared by the Indonesia Institute of Certified Public Accountants in 1983.	Economic reforms include a shift from the former Chinese accounting system, which was suited to a planned, controlled economy, to a capitalist system. The International Accounting Standards (IAS) is being introduced, following a basic

	Malaysia	Thailand	Philippines	Indonesia	China
	2000, listed companies must follow the MASB standards.				policy announcement in 1995 on the introduction of IAS.
Regulatory authority	• Ministry of Finance • Securities Commission (SC) • Foreign Investment Commission (FIC)	• Ministry of Finance • Securities and Exchange Commission (SEC)	• Securities and Exchange Commission (SEC) • Philippine Securities Industry Association[10] • Investor Protection Fund[11]	• Ministry of Finance • Capital Market Control Agency[12]	• China Securities Regulatory Commission (CSRC)
	Malaysia	Thailand	Philippines	Indonesia	China

Source: Prepared by this subcommittee, based on sources including "Asia's Stock Markets, 2001," Daiwa Institute of Research Ltd., and "Development of China's Share System and Stock Markets" (December 1994), Japan Securities Research Institute [both in Japanese].

[10] Reports concerning industry views on the development of securities markets, issued as a voluntary regulatory organization of securities companies.

[11] Under the revised securities law, securities companies must contribute 10,000 pesos to the investor protection fund upon licensure, and thereafter 0.002% of their total execution price every month. When a securities company declares bankruptcy, in general the customer accounts are transferred to a different securities company. However, if such transferal is impossible, the customer accounts are compensated after liquidation of the securities company. If funds from liquidation are insufficient, compensation is paid from the investor protection fund.

[12] Its administrative authority covers substantial investigation for market listing.

Appendix 4. The State of Japanese Banks in East Asia

	Thailand	Malaysia	Indonesia	Philippines	China
	Dec. 2001	May 2001	Dec. 2001	Oct. 2001	Oct. 2001 (See note 2)
Branch offices	3	0	1	2	25 (number of branch offices)
Offshore branch offices	3 (including 2 banks with combined branch offices)	5	—	—	
Local affiliates	—	1	4 (merged)		8 (leasing companies, etc.)
Capital participation in local banks	2 (capital participation in finance companies)	3 (estimated)	NA	4	—
Offices with staff stationed overseas	4	5	6	2	49 (number of offices)
Credit extended by Japanese banks to the country (See note 1)	118 (9/2001)	63 (9/2001)	96 (9/2001)	32 (9/2001)	117 (9/2001)
Japanese banks' share of all reporting banks (%)	28.8	13.0	24.1	15.4	19.7
Comments	In 1993, the prohibition on offshore branch offices was lifted, and 14 foreign banks received approval. In 1996, the prohibition on full branch offices was lifted, and 7 foreign banks received approval.	Since 1974, foreign banks can establish only offshore branch offices.	Since 1968, foreign banks may not enter using the branch office format. In October 1988, the establishment of merged banks was liberalized.	In May 1994, a law on entry by foreign banks was enacted. A total of ten banks from Japan, North America, Europe, and Asia have established branch offices.	In January 1997, restrictions on handling of RMB by foreign banks were eased. (8 foreign banks in the Shanghai area began handling RMB, including 4 Japanese banks, and 3 more Japanese banks were added later.) In Shenzhen, 4 Japanese banks handle RMB.

Notes:
1. Information from the BIS quarterly report. The unit is $100 million. Balances include financing from other sources than local branch offices and local affiliates.
2. Information from Japan Association for the Promotion of International Trade.

Appendix 5. East Asian Countries' Responses to Financial Crisis and Liberalization of Financial Regulations (Summary of measures taken since 1997)

	Thailand	Malaysia	Indonesia	Philippines	China
1997	March: 10 finance companies (FC) with poor performance were ordered to increase capital or encouraged to merge. May: Baht transactions with non-residents were restricted. June: 15 FCs in poor financial condition were ordered to suspend operations. Trading on offshore markets was restricted (introduction of two-tier exchange rates). July: Crash of the Thai baht. Exchange rates were allowed to fluctuate freely. The official discount rate was raised to 12.5%. Aug.: 42 FCs were ordered to suspend operations. An official framework for financial support was established, led by the IMF and Japan. Sept.: Bank concentration was required for export payments. Oct.: The government announced its financial reconstruction policy, including eased restrictions on foreign investment, establishment of the Financial Reconstruction Agency (FRA), and transferal of the deposits and credits of failed FCs to FRA. Dec.: Announcement of the liquidation of 56 FCs.	Early in the financial crisis, the government ensured liquidity by depositing funds into banks and debenture and bill operations. The government's stance is to accept the market level of interest rates.	March: Foreign banks were required to provide loans to small and medium-size companies. April: The reserve requirement was raised to 5%. Aug.: The central bank raised interest rates to protect the rupiah, then lowered them. Nov.: 16 small private banks closed. Special assistance loans were extended to private banks.	June: Restrictions on real estate loans. July: Foreign exchange restrictions to protect banks, including restrictions on non-resident transactions and positions. Sept.: Strengthening of foreign exchange restrictions to protect banks. Oct.: Stricter definition of uncollectible debt. Establishment of general nonperforming loan reserves. Stricter standards for nonperforming loan allowances. Mandatory allowances for questionable debt.	Jan.: China Agricultural Trust & Investment Corporation was closed. Aug.: The Shanghai and Shenzhen stock exchanges came under the direct control of the China Securities Regulatory Commission.
1998	Jan.: Two-tier exchange rates abolished. Bank established to take over prime assets of the 56 FCs. Nonperforming assets auctioned by FRA. Aug.: Announcement of comprehensive financial reconstruction policy, including the establishment of standards for	Jan.: The central bank announced the protection of all deposits. June: An institution was established to purchase uncollectible debt (Danaharta, 100% government financed). Aug.: Major strengthening of regulations on capital transactions,	Jan.: A policy was announced to stabilize the financial system, including guaranteeing all deposits and reorganizing the bank sector by recapitalization. The Indonesian Bank Restructuring Agency (IBRA, a public asset management company) was established.	March: Announcement of a stepwise increase of banks' minimum capital (3 stages). Abolition of foreign exchange bands. May: Lowering of deposit reserve ratio (8%). Aug.: Strengthened restrictions on banks' foreign exchange	Feb.: Increased capital at 4 large state-owned commercial banks. March: Mandatory deposit reserve ratio unified and lowered (from 13% to 8%). June: Closure of China New Technology Venture Investment Corporation. Strengthening of some aspects of foreign exchange

	Thailand	Malaysia	Indonesia	Philippines	China
	nonperforming loan reserves, injection of public funds into financial institutions, establishment of private asset management company (AMC), and disposition of nationalized commercial banks. Dec.: Krung Thai Bank absorbed a nationalized commercial bank.	including stronger regulation of non-residents' ringgit accounts, stronger regulation of ringgit denominated security purchasing by non-residents, and prohibition of trade settlement in ringgits. Establishment of a recapitalizing institution (Danamodal, 100% financed by central bank). Sept.: Founding of a corporate debt restructuring committee (central bank). Restrictions on international OTC trading of Malaysian stock.	Feb.: IBRA selected problem banks. March: A banking reform law was enacted, including lifting of restrictions on foreign investment in domestic banks, transferal of bank controlling authority to the central bank, and granting of special authority to IBRA. April: 7 problem banks were ordered to suspend operations, and the 7 banks came under IBRA supervision. Aug.: Operations were frozen at 3 banks under IBRA supervision, and 4 banks were temporarily nationalized. Sept.: A recapitalization program was announced.	positions. Oct.: Raising of deposit reserve ratio (10%). Dec.: World Bank approved loans to reform the financial sector (with a reform program to regulate sound management and improve transparency).	controls. Prevention of improper outflow of foreign currency. Prevention of superfluous sale of RMB. July: Trial implementation of five-category system for credited loans in Guangdong. (Nationwide introduction began in 1999.) Aug.: Approval of RMB services by foreign banks in Shenzhen. Oct.: Closure of Guangdong International Trust and Investment Corporation. Dec.: Passage of China's first securities law.
1999	Full-scale establishment of private asset management companies. Nov.: The bank established to take over prime assets of 56 FCs was sold to UOB.	March: Restrictions lifted on remittance of investment capital to home country. Taxes imposed on remittances instead. April: Two-tier system abolished. July: Announcement of a plan to reorganize the central bank and local banks and form 6 groups. Sept.: Easing of investment taxation. Danaharta purchased debts with a cumulative total of 41% of financing. Oct.: Easing of conditions for reorganization of banks, central bank.	March: Announcement of master plan for bank reorganization (recapitalization for banks in 3 categories). May: Enactment of new central bank law (to strengthen independence of the central bank). Recapitalization was begun for 23 banks. Oct.: Recapitalization was begun for state-run banks.	July: Deposit reserve ratio lowered to 9%. Dec.: Banks required to conduct separate management for each foreign currency.	Jan.: People's Bank of China reorganized its branch offices (establishment of orderly regional finance). Aug. Expanded scope of approval for RMB services by foreign banks (Shanghai and Shenzhen). Nov.: Mandatory deposit reserve ratio lowered (from 8% to 6%). Four asset management companies established to purchase and collect nonperforming assets of four major commercial banks.
2000	May: Krung Thai Bank established an asset management company.	Feb.: Decision to reorganize local banks into ten groups. April: Announcement of the integration of local securities companies. July: Announcement of eased restrictions on the issuing of securities.	April: Recapitalization of state-run banks. June, July, Nov.: Bank recapitalization.	Jan.: Foreign exchange restrictions on Japanese currency. May: Enactment of a new general banking law. Oct.: Stronger controls on capital movement. Liquidity reserve ratio raised to 4%.	
2001	July: TAMC, an asset management company using public funds, was established. Oct.: TAMC began purchasing uncollectible loans.	Jan.: Eased taxation of investments. 7 of the 10 recapitalized banks completed repayment to Danamodal. Feb.: Announcement of a capital		July: Liquidity reserve ratio raised to 7%. CAR minimum ratio set at 10%. Sept.: Law enacted to control financial laundering.	Jan.: Law enacted on the administration of trust & investment companies, regulating matters including the scope of operations by trust & investment

	Thailand	Malaysia	Indonesia	Philippines	China
		market master plan. Liberalization planned for regulations on foreign investment and trading. March: Announcement of a financial sector master plan. Promotion of a sounder, more efficient domestic financial industry.			companies. May: Bank of China announced uncollectible loan ratios according to new standards.

Appendix 6. Donors' Views on the Financial Systems and Policies of East Asian Countries

	Financial markets, and supervisory management systems to foster financial markets	Financial infrastructure building	Reforming and stimulating the financial sector
Thailand	• The framework for financial supervision was put in place by the end of 2000. (IMF) • It is necessary to develop a bond market to handle long-term capital needs. There is a particular lack of long-term funds for the infrastructure sector, and it is necessary to develop local government bond markets. (ADB) • Banks and finance companies issue about half the total value of corporate bonds, and the real estate sector accounts for 22%. It is necessary to broaden the scope of bond issuers and increase the attractiveness of the bond market. (ADB) • To make the bond market more attractive, tax incentives are needed. (ADB)	• Although two public credit information organizations were established after the financial crisis, they are still not functioning adequately because the proposed credit bureau law has not yet been passed. (WB) • Tax cuts have been implemented to stimulate capital markets. (WB) • A more efficient settlement system has been developed for the bond market. (WB) • There is concern over negative effects from one single credit rating company. (ADB)	• Bank operations are vulnerable because of uncollectible debt. (WB) • The government's policy is to expand loans to state-run businesses, but these require less capital because of the recession. (WB) • State-run banks have inadequate risk management skills. (WB) • Government policies are not providing an incentive for banking reform. (WB) • There is a widespread emphasis on security for loans to small and medium enterprises. (WB) • Financial institutions are one reason for Thailand's lowered productivity. The profitability of finance companies is ignored in decision making. (WB) • There is concern over the level of uncollectible debt, which remains high. (IMF) • Uncollectible debt has not been dealt with thoroughly. (ADB) • Financial institutions have not been reorganized thoroughly. (ADB)

References include: "Country Overview," WB; "IMF Consultation," IMF Public Information Notice; "A Study of Financial Markets," ADB; and "The Banking Industry in Emerging Market Economies: Competition, Consolidation and Systemic Stability," BIS Paper (Aug. 2001).

	Financial markets, and supervisory management systems to foster financial markets	Financial infrastructure building	Reforming and stimulating the financial sector
Malaysia	• A plan for bank integration and consolidation was announced (July 1998), promoting recapitalization and consolidation to strengthen banks. (WB) • Guidelines on credit risk management were put into effect in 2000. (WB) • 51 banks were consolidated by August 2001. (IMF) • Based on central bank policy, banks have played a leading role in indirect financing. (ADB) • The government has promoted policies for facility modernization, increased deposits, and competition among banks. (ADB) • Although institutions to dispose of NPLs were established in a timely fashion, they have floundered since then. (ADB) • The central bank has advanced credit risk management methods (other than country/transferal risk). • Measures like those of the IMF package need to be pursued thoroughly, and the following specific measures are needed. (ADB) • Strict application of prudential limit (one-company rules, etc.) • Establishment of an independent organization for review of insurance operations. • Although efforts have been made by the securities and exchange commission, etc. to establish disclosure standards, inadequacies were revealed in 1997, damaging market credibility. • Securities market trading was limited in 1998 to prevent speculation, damaging the trust of foreign investors, etc.	• The legislative system is being developed in accordance with international standards. (WB) • Measures like those of the IMF package need to be pursued thoroughly, and the following specific measures are needed. (ADB) • Announcement of a schedule for market liberalization. • Clarification of the policy decision process, and announcement of important decision items. • More fundamental planning to deal with the credit crunch. • Concentrated fostering of financial institutions to lead in internationalization through the introduction of a two-tier system. • The equity market has contributed to private sector development, and progress has been made in stock market mechanization. (ADB) • The government has made efforts to improve ratings companies, PDS guidelines, and information supplying organizations. (ADB)	• Uncollectible debt is again on the increase. (WB) • The main reasons for the financial crisis were government directed lending, inadequate competition, and a lack of prudential regulations. (ADB) • To avoid turmoil, capital regulations were introduced (1998) along with pegging the exchange rate to the dollar and easing the standards for NPL recognition. (ADB) • Measures like those of the IMF package need to be pursued thoroughly, and the following specific measures are needed. (ADB) • Free participation of domestic and foreign investors in uncollectible debt disposal, and greater transparency in price determination. • Transferal of politically connected loans and commitments to government accounts. • Stronger disclosure of NPL information, other than debt related to real estate and stock purchases. • Decreasing loans with full government guarantees. • Promoting diversification of fundraising methods other than deposits in financial institutions. • Although efforts are continuing to develop a secondary securities market, an obstacle is posed by reserves related to holding government bonds, etc. (ADB)

References include: "Country Overview," WB; "IMF Consultation," IMF Public Information Notice; "A Study of Financial Markets," ADB; and "The Banking Industry in Emerging Market Economies: Competition, Consolidation and Systemic Stability," BIS Paper (Aug. 2001).

	Financial markets, and supervisory management systems to foster financial markets	Financial infrastructure building	Reforming and stimulating the financial sector
Philippines	• Cronyism exists within the government. (WB) • Although banks are relatively sound, one problem is money laundering. (IMF) • Major improvements are needed in information disclosure by financial institutions. (ADB) • Stronger prudential regulations are needed. (ADB) • It is important to promote competition in the financial sector. (ADB) • To increase banking competition and efficiency, privatization and the entry of foreign banks are needed. (ADB)	• The banking system has been stabilized. (WB) • Reinforcement is needed in the bank accounting system and disclosure. (ADB) • The bankruptcy law and other legislation need to be reviewed. (ADB)	• Credit extension by banks has declined over the past 3 years. (WB) • The financial sector must adapt to the developing capital requirements of industry. (ADB) • The financial sector has overcome the Asian currency crisis and is relatively sound. (IMF)

References include: "Country Overview," WB; "IMF Consultation," IMF Public Information Notice; "A Study of Financial Markets," ADB; and "The Banking Industry in Emerging Market Economies: Competition, Consolidation and Systemic Stability," BIS Paper (Aug. 2001).

	Financial markets, and supervisory management systems to foster financial markets	Financial infrastructure building	Reforming and stimulating the financial sector
Indonesia	• There are plans to establish a Financial Sector Supervisory Institution (FSSI), but it is also necessary to strengthen the supervisory capabilities of the central bank. (WB) • A stronger financial supervisory system is needed. (IMF) • It is important for the financial supervisory institution to be independent. (ADB) • The banks' accounting system is very similar to international standards. (ADB)	• The government established a commercial court to shorten bankruptcy procedures, but the government needs to take a strong stance for effective administration of those procedures. (ADB)	• Banking reform slowed down in the first half of 2001. (WB) • Structural reform of banking is delayed. (IMF) • Large state-owned banks have liquidity problems. (IMF) • The lack of human resources in the financial sector is a problem. (ADB) • Lending regulations are an obstacle to the efficient extension of credit. (ADB) • The lending regulations should be abolished. (ADB) • Training is needed for banking staff to maintain the quality of bank loans. (ADB)

References include: "Country Overview," WB; "IMF Consultation," IMF Public Information Notice; "A Study of Financial Markets," ADB; and "The Banking Industry in Emerging Market Economies: Competition, Consolidation and Systemic Stability," BIS Paper (Aug. 2001).

	Financial markets, and supervisory management systems to foster financial markets	Financial infrastructure building	Reforming and stimulating the financial sector
China	• Financial liberalization has speeded up in preparation for WTO membership. (WB) • The central bank is considering wide-ranging reform of the financial system. (WB) • Business tax on banks is being reduced. (WB) • There is inadequate disclosure in the financial sector (WB, IMF). • The framework of the financial supervision system has been changed. (WB) • The securities market is developing rapidly. (WB) • Listing regulations were eased in March 2001. (WB)	• The central bank is considering promotion of the introduction of international accounting standards. (WB) • Confusion still exists in the content of regulations on securities trading. (ADB) • Taxation of securities trading is not fully controlled at the central government level, and there is concern over a perception of inequality by taxpayers. (ADB)	• Improving profitability is an urgent issue for the financial sector. (WB) • The four largest state-owned banks are financially troubled. (WB) • There has been a case of improved financial performance after commercialization of a state-owned bank: Bank of China. (WB) • There is a need for examination and improvement in legislative and accounting systems and banks' credit analysis, risk management, and staff training. (IMF) • The government needs to deal with the problem of uncollectible debt, ease bank lending restrictions, expand banks' independence in credit operations, improve accounting and auditing systems, and develop money markets. (ADB)

References include: "Country Overview," WB; "IMF Consultation," IMF Public Information Notice; "A Study of Financial Markets," ADB; and "The Banking Industry in Emerging Market Economies: Competition, Consolidation and Systemic Stability," BIS Paper (Aug. 2001).

Appendix 7. Current Issues in Accounting and Auditing System and etc. (in East Asia overall)

		Companies	Financial institutions and stock exchanges	Financial infrastructure and systems
Direct financing	Financial data (profit & loss, balance sheet, cash flow)	• Lack of thorough accounting procedures • Inaccuracy of the financial information that is prepared • Preparation of arbitrary financial information • Inadequate capabilities for preparing financial data (ledgers, timely quarterly settlement reports, etc.), and lack of human resources in this area	• Inadequate capabilities of businesses for information gathering • Inadequate determination of the financial status of companies that have been listed	• Small number of managers and human resources with financial knowledge • Lack of databases (management indices)
	Disclosure	• Inadequate awareness of disclosure • Lack of thorough financial disclosure • Lack of timely information • Information released only in the local language	• Inadequate checking of basic matters that are disclosed • Failure to take steps for resolution of discovered problems	• Lack of means and systems for disclosure • Lack of fundamental statistics on industry, etc. for analysis of company information • Inadequate concept of sanctions on business management that betrays expectations • Need for development of ratings organizations • Lack of adequate securities analysts (quality and quantity)
	Accounting standards	• Inadequate understanding of accounting standards • Inadequate follow-up on changes in accounting standards • Difficult to compare business management against previous standards	• Lack of human resources who are familiar with the accounting standards • Inadequate follow-up on changes in accounting standards	• Weak leadership by the organizations establishing accounting standards • Inappropriate business accounting system (establishment of legally mandated reserves for the risk of currency collapse in foreign currency denominated debts and credits, evaluation and revision of delinquent loans and excess inventory) • Major discrepancies from international accounting standards
	Accountants and tax accountants	• Accountants do not state their views, putting business first. • Accountants have inadequate capabilities for business auditing and analysis. • Arbitrary utilization of accountants • Strong tendency to rely on accountants in accounting procedures.	• Inadequate capability for evaluation of accountants' competence • Exaggeration and mistrust of business auditing results	• Inadequate development of programs to train accountants • Inadequate scope of accountant qualification systems • Lack of opportunities for accountants to provide business guidance (Audit memoranda need to be submitted in a timely and appropriate way.)
	Auditing systems	• Lack of thorough internal audits • Inadequate lines of communication with business executives	• Lack of complete functions for continuous checking on business management	• Low level of trust for the auditing system • Lack of social and financial penalties • Inadequate effort to recover the trust of foreign investors

		Companies	Financial institutions and stock exchanges	Financial infrastructure and systems
Indirect financing	Financial data (profit & loss, balance sheet, cash flow)	• Inaccuracy of prepared financial information • Arbitrary handling of financial data by owner operators • Lack of human resources with knowledge of bookkeeping and accounting • No widespread adoption of the blue form income tax return system • Weak internal management system (lack of separation between business accounting and household finances)	• Lack of staff members with a basic knowledge of bookkeeping and accounting, and inadequate development of programs to train human resources • Inadequate capabilities for collecting and analyzing business financial information (internal bank ratings, use of such information in loan conditions, early collection, etc.) • Inadequate leadership toward client businesses	• Inadequate promotion of bookkeeping and accounting (bookkeeping certification, improved commercial education, etc.) • Inadequate adoption of computerized financial accounting systems
	Disclosure	• Passive attitude toward disclosure of information • Inadequate content of disclosed information	• Lack of supervisory capabilities and strict guidance for finance companies • Inadequate capabilities for checking and analyzing disclosed information • Inadequate business review expertise to supplement limited disclosure information (expertise in local investigation, gathering client information, qualitative review skills, etc.)	• Lack of business credit information organizations • No widespread use of ratings systems for small and medium businesses • Lack of fundamental statistics on industry, etc. for analysis of company information
	Accounting standards	• Inadequate knowledge of accounting standards (Unaudited businesses and businesses audited under the corporation income tax law lack a full awareness of accounting standards, and conduct disclosure and accounting procedures according to the corporation income tax law.)	• Lack of human resources who are familiar with the accounting standards • Inadequate follow-up on changes in accounting standards	• Weak leadership by the organizations establishing accounting standards • Inappropriate business accounting system (establishment of legally mandated reserves for the risk of currency collapse in foreign currency denominated debts and credits, evaluation and revision of delinquent loans and excess inventory) • Major discrepancies from international accounting standards
	Accountants and tax accountants	• Accountants are kept too busy to conduct business analyses. • Accountants are expected to handle all aspects of accounting procedures themselves. • Accountants do not state their views, putting business first. • Arbitrary utilization of accountants	• Inadequate capability for evaluation of tax accountants' competence • Exaggeration of business auditing results	• Inadequate development of programs to train tax accountants • Inadequate scope of tax accountant qualification systems • Lack of opportunities for tax accountants to provide business guidance
	Auditing systems	• Lack of thorough internal audits • Inadequate lines of communication with business executives	• Little attention given to auditor programs • Inadequate capability for evaluation of auditors' competence	• Inappropriate auditing system for privately held companies
		Companies	Financial institutions and stock exchanges	Financial infrastructure and systems

Appendix 8. State of Corporate Governance in East Asia

	Thailand	Indonesia	Philippines	Malaysia
Stock ownership	[1] Majority ownership by family businesses, [2] Family business pyramids, mutual shareholding, deviation from the principle of one vote per share			
Highest capital market ownership ratio by one family business		16.6%	17.1%	
Capital market ownership ratio by top ten families	46.2% or more	57.7% or more	52.5% or more	28.3% (top 15)
Family business fundraising trends	Increasing reliance on external loans	Increasing reliance on external loans	Increasing reliance on external loans	
Bank control by family businesses	Control of most financial and securities companies (lower proportion since the crisis)	Control of most financial and securities companies (lower proportion since the crisis)	Control of most financial and securities companies	
ROA	10.8% (1988)	9.4% (1988)	7.1% (1988)	5.4% (1988)
Family business profitability and growth	Advantageous for family business format	Advantageous for family business format	Advantageous for family business format	
Operating costs	Lower costs than bank-led and equity market-based systems (flexibility)	Lower costs than bank-led and equity market-based systems (flexibility)	Lower costs than bank-led and equity market-based systems (flexibility)	
Management by banks	Bank reorganization is underway	Bank reorganization is underway		Bank reorganization is underway
Financial evaluation (indices)				
Systems related to ratings	6.25	3.98	2.73	6.78
Governmental corruption	5.18	2.15	2.92	7.38
Accounting standards	64	NA	65	78
Per capita GNP (1997)	$2,800	$1,110	$1,220	$4,680

Source: Based on Haider A. Khan (1999), "Corporate Governance of Family Business in Asia: What's Right and What's Wrong?," ADBI Working Paper 3. Financial evaluations were determined by assigning numerical scores to each item. A higher score means a better evaluation.

Note: Compared to the countries listed in the table above, China has a unique situation with a preponderance of state-owned businesses. Some important points for corporate governance are improving the accounting and auditing systems, including information disclosure on off-balance transactions; and stronger authority for directors, including guaranteeing independent management in the case of state-run businesses (OECD). Meanwhile, doubts remain concerning the supervisory capabilities of state-owned banks with regard to state-owned businesses and so on.

Field Study Analysis of Current Situation
(Indonesia, Thailand and China)

INDONESIA

Indonesia's financial and capital markets are driven by the country's banking sector. Since the 1997-98 Asian currency crisis, however, the balance of outstanding loans by banks has fallen dramatically, owing to a decline in bank lending associated with the chaos in the banking system, as well as the transfer of non-performing loans to the Indonesian Bank Restructuring Agency (IBRA). Although there has been a steady increase in fundraising through the stock market as an alternative means of financing, including capital increases paid in by owners, issuance of bonds has remained limited.

Table 1 Scale of the Indonesian Financial and Capital Market (Ratios to Nominal GDP)

(Ratios, %)

	1997	2001
Outstanding bank loan balance	60	21
Aggregate market value of listed stock	25	16
Outstanding balance of government bonds	-	44
Outstanding balance of corporate bonds	3	1

(*Source*: Bank Indonesia, others)
Note: Capital injections to banks are included in the balance of government bonds for 2001.

1. The Capital Market

(1) Institutional and Policy Framework

Competent Government Agencies

The major government organs related to the capital market consist of the Ministry of Finance, the Capital Market Policy Council, and the Indonesian Capital Market Supervisory Agency (Badan Pengawas Pasar Modal, BAPEPAM). The Ministry of Finance formulates policy concerning the securities market, while BAPEPAM handles actual supervision and operation of capital markets. BAPEPAM's functions include suggesting policies for, as well as writing and implementing, regulations relevant to the capital markets. At present, preparations are being made for creating a financial services authority, the Pembentukan Otoritas Jasa Keuangan (OJK), in 2003, which will consolidate all supervisory authority related to banks, securities firms, insurance companies and other financial institutions. This development has made it necessary to undertake a review of BAPEPAM's functions.

Further institutions include the Association of Indonesian Securities Companies (APEI), which is an industrial association of securities companies, and the government-run rating agency PEFINDO, but it cannot be said that either of these entities fully function in their intended roles in the capital market.

Legal System

The Capital Market Law (1995) is the governing law for the capital markets. Prior to this law, the legal system was based on The Emergency Law on the Securities Exchange (1951-52) and the many modifications based on, and actions taken at, the direction of the Minister of Finance. Passage of the Capital Market Law served to concentrate jurisdiction of the capital market to BAPEPAM, but there are some areas where the authorities of the Bank Indonesia and BAPEPAM are still not entirely clear. As part of the ongoing preparations for establishing the OJK, work is being done on revision of the Capital Market Law.

Table 2. Indonesian Capital Market Blueprint 2000-2004

General Strategy	Emphasis	Specifics
1. Corporate Governance		
	a. Legal system reform	• Simplification of procedures for general meetings of shareholders, protecting shareholder rights at general meetings, disclosure of the board of directors and executive compensation, public access to annual reports, establishment of audit committees, etc. • Improvement of legal systems related to transfers of ownership, capital increase at par, formation of companies, and mergers and tie-ups of companies, etc.
	b. Diffusion of awareness of, and implementation of, corporate governance	• Diffusion of knowledge among market participants, supervisory agencies, self-regulating organizations, etc. • Establishment of a Corporate Governance Center and provision of guidance and evaluations on corporate governance to corporations.
2. Harmonization of Rules and Legal Systems		
		• Legal adjustments in accordance with the shift to a paperless market (in particular, eliminating the differentiation in taxation between company founder's shares and ordinary shareholder's shares) • Transfer of regulatory functions related to banks, brokers, insurers, pension funds, venture capital firms, etc., to the to-be-founded OJK by the end of 2002 (Law 34, 1999). Legal changes regarding the functions of BAPEPAM in connection therewith. • Coordination of BAPEPAM and the stock exchanges, CGC, CSD and other capital market related organizations, for overall improvement of the performance of the capital market. • Promotion of cooperation by international organizations. As a member of ASEAN and the WTO, Indonesia, and particularly BAPEPAM, will abide by the ASEAN Coordinating Committee on Services and General Agreement of Trade in Services of the WTO. • BAPEPAM, as a member of IOSCO, will comply with bilateral accords on money laundering
3. Overall Development of Information Technology and Human Resources		
	a. Information Technology	• Development of comprehensive technology enabling market participants to cope with the pace of progress in information technology. In addition to expecting improved transparency from the development of information technology, market participants should acquire easier access to market information.
	b. Human Resources	• Assurances that all market participants have the same level of knowledge and capabilities. • Promotion of market development through avoidance of inefficient allocation of capital • Enabling market participants to have the same direction for development • Improvement of efficiency of development programs. • Sharing of resources including knowledge by market participants.
4. Assurance of Safety and Service Quality that Complies with International Standards		
		• Establishment of a central custody institution to implement paperless transactions and listing procedures, establishment of a network for foreign-currency transactions, establishment of same-day settlement, and reduction of tax barriers relating to the lending of securities (following the G30-IOSCO recommendations).
5. Market and Product Development		

General Strategy	Emphasis	Specifics
		• Expansion of the base of securities issuers (by promotion of listings by means of privatization of government corporations, SMEs, and cooperatives) • Strengthening the stratum of domestic investors (fostering of individual investors through development of human resources and information, and fostering institutional investors through organized and comprehensive training of pension funds and insurance companies) • Improving the status of the OTC markets • Development of derivative products such as futures, options and swaps, as a means to reduce the volatility of assets; expansion of the business of securities companies in association therewith, and improving the liquidity of the spot markets • Encouraging the issuing of bonds as a means of financing by companies, including asset backed securities, medium term notes, and mortgage bonds (secondary mortgage facilities, or SMF) • Improving the trading and settlement systems to accommodate the growing complexity and diversity of bond products

(*Source*: BAPEPAM)

Capital Market Policy

At the present time the Indonesian Capital Market Blueprint 2000-2004 (see Table 2) constitutes the basis for policy formulation in the Indonesian capital markets. Almost none of the goals of its predecessor, Indonesian Capital Market Blueprint 1996-2000, were achieved, mainly due to the Asian currency crisis. The current blueprint seeks to build markets that are highly competitive internationally and thereby enable them to be a driving force for the country's development. For the time being, emphasis is being placed on the recovery of the market's operational functions, and development of market participants, in view of the stagnation of the market's development subsequent to Asian currency crisis. Specific subjects being emphasized include corporate governance, harmonization of rules and legal systems, development of technology and human resources. Further steps include actions to enhance disclosure and other areas, and thereby improve the status of the government bond market, and particularly the over-the-counter (OTC) market, which for practical purposes is the principal market for trading government bonds.

(2) Present Conditions of the Capital Market

Stock market

The Jakarta Stock Exchange (JSX) was opened by the government in 1977 and was privatized in 1992, while the Surabaja Stock Exchange (BES) was opened by the private sector in 1989. A parallel market was opened in 1989 and was absorbed by the BES in 1996. Since then the nation has had two exchanges. In July 2000 the JSX reorganized listed shares into the Main Board and the Development Board, however the adoption of this two-board system has a strong appearance of offering relief to companies that are in danger of being de-listed.

In 1999, a proposal was made to merge the BES with the JSX, since most of the companies listed on the BES are also listed on the JSX and the transaction volume on the BES was only 2-3% of that on the JSX. Nevertheless, this suggestion was rejected under strong opposition from shareholders in the BES, and the BES has since put its emphasis into enhancing its function as a bond market in order to coexist with and in a different niche from the JSX.

The stock markets are characterized by a concentration of shareholding into a select group of individual investors, a high percentage of shares owned by the government and crossholding, which results in a low percentage of actively traded shares. Consequently even a small trade in shares can cause a significant impact on share prices. Although the scale of the market at JSX is on the order of Rp 300 trillion, because of crossholding and the other factors listed above, floating shares amount to around 30% of capitalization. Moreover, even during the first quarter of this year when trading was active and at the level of Rp 500 billion per day, this was less than 1% of the floating shares. Further, participation by foreign investors is limited and whereas prior to the Asian currency crisis this group did about 70% of trading volume, their share has steadily declined to about 20% for all of 2001.

Recent privatization of government companies has resulted in frequent issues of government owned stocks and initial public offerings (IPOs). In March of this year 51% of the shares the government owned in the national Bank Central Asia (BCA) were sold to Farallon Capital, an American investment company, while government-held shares in Bank Niaga are to be sold and 24 state-owned companies are scheduled to be privatized within the year. The government intends to apply the proceeds, which will amount to Rp 6.5 trillion, to offsetting the budget deficit and to redeeming bonds, but employees of the entities as well as residents in the communities where they are located oppose privatization, so there is no guarantee that there will not be political intervention in setting sales prices.

Table 3. The Indonesian Stock Market

		1995	1996	1997	1998	1999	2000	2001
Number of listed companies		248	267	306	309	321	347	379
Issued shares outstanding (million shares)		11,111	25,343	51,459	62,719	714,461	811,563	826,771
Rp billions of value of issued shares (RP bil)		35,395	49,981	70,880	75,941	206,687	225,820	231,028
Volume traded (million shares)	Jakarta	10,646	29,532	76,599	89,621	178,478	134,532	156,908
	Surabaja	1,717	1,548	4,986	2,228	7,029	6,207	14,406
Value traded (RP bil)	Jakarta	32,357	75,730	121,386	99,658	147,880	122,784	114,285
	Surabaja	5,252	4,100	10,844	3,118	13,199	9,634	2,854
Market cap (RP bil)	Jakarta	152,246	215,026	159,930	175,729	451,815	259,621	239,259
	Surabaja	158,686	178,960	141,641	157,859	407,721	225,802	197,899
Stock index (1982 = 100)	Jakarta	513.85	627.43	401.71	398.04	676.92	416.32	392.04
	Surabaja	366.07	568.58	351.95	351.51	566.57	267.63	220.89

(*Source*: Bank Indonesia, others)

Table 4. Sectoral Composition of Indonesian Listed Companies

(% of all listed companies)

	1995	1996	1997	1998	1999	2000	2001
Agriculture	1.3	1.6	1.8	2.1	2.9	2.7	2.5
Mining	0.9	1.6	2.1	2.1	2.2	2.1	2.5
Chemicals, etc.	21.0	17.4	16.7	17.3	18.1	18.6	18.1
Other manufacturing	18.3	18.6	16.7	16.6	16.6	17.2	15.9
Consumption goods industry	13.1	14.6	13.5	13.1	13.4	12.7	13.1
Construction & real estate	7.9	7.5	8.2	8.7	10.1	10.7	10.6
Public services & transportation	3.1	4.0	3.9	4.2	4.7	4.5	4.0
Finance	19.7	18.2	20.2	20.4	17.3	16.5	16.2
Commerce & services	14.8	16.6	17.0	15.6	14.8	15.1	17.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(*Source*: Jakarta Stock Exchange)

Bond Market

The bond market in Indonesia is extremely undeveloped in comparison to the bond markets in other ASEAN countries. The Indonesian government had issued almost no bonds before the Asian currency crisis. Since 1998 (following the crisis), government bonds have been issued on the scale of Rp 660 trillion (about 51% of GDP) so that Bank Indonesia could supply liquidity (through the Bank Indonesia Liquidity Facilities, BLBI), inject funds into the banking sector, and accomplish other policy objectives. After this, the extent of government bond holdings concentrated in the banking sector, including foreign banks, rose to about 70%, because the banks that had received injections have continued to hold those bonds, in addition to managing funds in the government bond market because of the low risk and for the favorable interest income. A further market characteristic is that there is almost no disclosure of information on the issuing corporations whose paper is traded over the counter, so it is not possible to obtain an understanding of this part of the bond market.

Issuers of private bonds are concentrated in the finance, real estate and infrastructure (power, roads, etc.) sectors and there are almost no issues offered by manufacturers. Whereas 94 publicly issued bonds are listed on the BES (as of the end of 2001), there is a polarization in terms of credit risk on the part of issuers, together with many issues bearing a non investment grade, therefore the scale of the market has not really grown. Corporate issues have increased of late, as a means of raising funds for debt disposal. The country's largest processed food maker, Indofood, has issued 5-year notes and plans to use the proceeds to redeem debt and expand business operations.

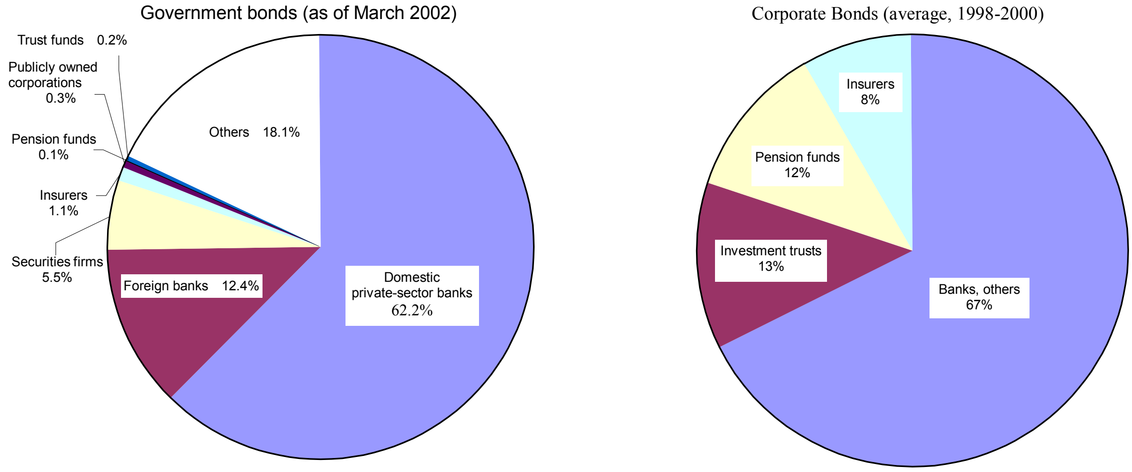


Fig. 1. Shares of Bond Ownership, Indonesia

Table 5. The Indonesian Corporate Bond Market

(Rp bil)

	1995	1996	1997	1998	1999	2000	2001
Number of listed issues	50	55	70	70	76	91	94
Rp billions of total par issued	8,694	11,536	18,741	18,891	23,174	28,787	31,662
Rp billions of outstanding issues	7,056	9,897	15,605	14,505	15,909	22,384	20,735

(*Source*: Bank Indonesia, others)

(3) Current Challenges

Challenges that the stock market faces today include the sale of shares by the government, expansion of floating shares resulting from privatization and the education of investors. Particular mention should be made of factors discouraging institutional investors from investing in stocks: the ease with which the market is moved by factors such as domestic political situations, and, on the investor side, a shortage of fund managers and analysts.

An urgent, inescapable issue for the bond market is improvement of the liquidity in government bonds. Because many banks are under pressure to maintain or improve their BIS capital adequacy ratios, they have a disincentive to sell government bonds as the risk of holding these instruments is low and interest income is assured, and banks have little incentive to finance private corporations. An experiment is being made, however, in loan-to-bond swaps, wherein the Indonesian Bank Restructuring Agency (IBRA) exchanges restructured assets for government bonds held by commercial banks, thereby reducing the country's financial burden while at the same time providing funds to the productive sector. Nevertheless, many banks have been cautious about participating since the increment of their risk assets would oblige them to build up their reserves. Furthermore, as stated in the 5-Year Market Blueprint mentioned above, there is a particular need for improvement of the OTC market in order to develop secondary markets, as the OTC market actually accounts for much of the activity in the marketplace.

2. The Banking Sector

(1) Institutional and Policy Framework

The Competent Government Agencies

The agencies of supervision and monitoring of the banking sector are Bank Indonesia (the central bank) and the Ministry of Finance. Financial policy is set by the Financial Sector Policy Committee, chaired by the Minister of Finance, and by the Financial Sector Evaluation Committee, chaired by the governor of Bank Indonesia. The central bank, in addition to determining financial policy, supervises banks, issues banknotes, and controls and supervises the funds settlement system. Authority to license and supervise banks was transferred from the Ministry to the central bank by the amendment of the Banking Act (Act of the Republic of Indonesia Number 7 of 1992 Concerning Banking). At the same time measures were taken to ensure the independence of the central bank, but as the governor and deputy governors are appointed by the President, the central bank cannot be said to be fully independent. Supervision of financial institutions (banks, insurers, pension funds, brokers, venture capital firms, etc.) is to be transferred to the OJK, which is to be established in 2003. The purpose of establishing the OJK is to have an entity dedicated to supervision and monitoring in order to achieve stability in the financial sector, while Bank Indonesia will concentrate on financial policy.

Legal system

The new Banking Act (which came into force in 1992, and the amended Banking Act (which came into force in November of 1998), are the principal laws governing the banking sector. The latter eliminated restrictions on foreign investment in Indonesian banks, and transferred the authority to license and supervise banks from the Ministry of Finance to Bank Indonesia. Work is being done on drafting a new Central Bank Law in connection with the upcoming establishment of the OJK.

Policy

At the present time the core policies for building the banking sector are the financial system stabilization policy (1998) that was announced for the purpose of restructuring the financial sector after the Asian currency crisis, and the Master Plan for Bank Restructuring (1999). Since the start of these programs, financial restructuring has been pursued under the leadership of the government and mainly the IBRA, including reorganization and consolidation of the banking sector and selling off assets. The banking sector has been restructured with the working objective of attaining a capital adequacy ratio (CAR) of 8% by the end of 2001. The five banks that did not attain this target were merged.* Plans call for accelerated sale of non-performing loans within the year in order to dissolve the IBRA in July 2003 rather than the scheduled February 2004.

* They are the government owned Bali Bank, as well as four commercial banks that received government funds, i.e., Bank Universal, Patriot Bank, Bank Prima Expres, and Artha Media.

(2) Present Conditions in the Banking Sector

The banking sector consists of state banks, domestic privately owned banks, consortium banks, and foreign banks, as well as regional development banks that have the primary purpose of providing medium or long term finance for regional development. There are also savings-and-loan institutions, in addition to these commercial banks; an example is the Bank Perkeditan Rakyat. As a consequence of the restructuring that has followed the Asian currency crisis the number of banks operating in Indonesia has decreased but there are still many banks that are in weak condition and further restructuring appears to be necessary.

The outstanding balance of credit provided by commercial banks has fallen drastically since the currency crisis. Although the balance has grown year-on-year since the end of 2000, it has barely recovered to the level of about 50% of what it had been, in part because of the transfer of non-performing loans to IBRA. It is characteristic of bank credit that the largest share of the balance is that provided by national banks, although they make up only 3% of the total number of banks.

Table 6. Indonesian Commercial Banks

Number of commercial banks

	1995	1996	1997	1998	1999	2000	2001
<Number of banks>							
All commercial banks	240	239	222	208	173	164	159
State-run banks	7	7	7	7	5	5	5
Regional development banks	27	27	27	27	27	26	25
Private banks	165	164	144	130	92	81	80
Foreign & consortium banks	41	41	44	44	49	52	48
<Percent of total>							
All commercial banks	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State-run banks	2.9	2.9	3.2	3.4	2.9	3.0	3.1
Regional development banks	11.3	11.3	12.2	13.0	15.6	15.9	16.4
Private banks	68.8	68.6	64.9	62.5	53.2	49.4	50.3
Foreign & consortium banks	17.1	17.2	19.8	21.2	28.3	31.7	30.2

Total assets

	1995	1996	1997	1998	1999	2000	2001
Value (Rp bil)	308,618	387,477	528,875	762,428	789,356	984,500	1,039,925
<Percent of total>							
All commercial banks	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State-run banks	39.7	36.5	38.2	40.0	49.6	51.3	49.7
Regional development banks	3.2	2.8	2.3	1.9	2.4	2.6	4.3
Private banks	47.8	51.8	47.0	46.2	36.9	35.6	35.3
Foreign & joint venture banks	9.8	9.2	14.2	13.0	13.0	12.5	10.4

Loans

	1995	1996	1997	1998	1999	2000	2001
Value (Rp bil)	234,611	292,921	378,134	487,426	225,133	269,000	307,594
<Percent of total>							
All commercial banks	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State-run banks	39.8	37.2	40.5	45.3	49.9	37.9	38.1
Regional development banks	2.2	2.2	2.0	1.3	3.0	3.8	5.0
Private banks	47.6	51.2	44.6	39.7	24.9	30.6	33.1
Foreign & consortium banks	10.3	9.4	12.9	13.7	22.2	27.7	23.8

(*Source*: Bank Indonesia, others)

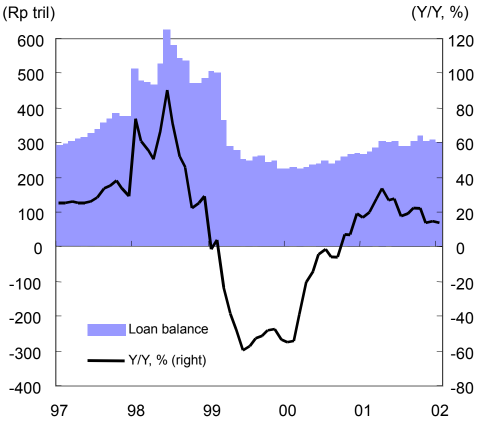


Fig. 2. Indonesian Bank Loans

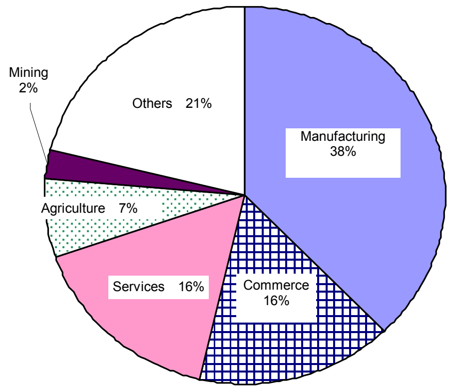


Fig. 3 Shares of Loans by Sector, Indonesia (as of end of 2001)

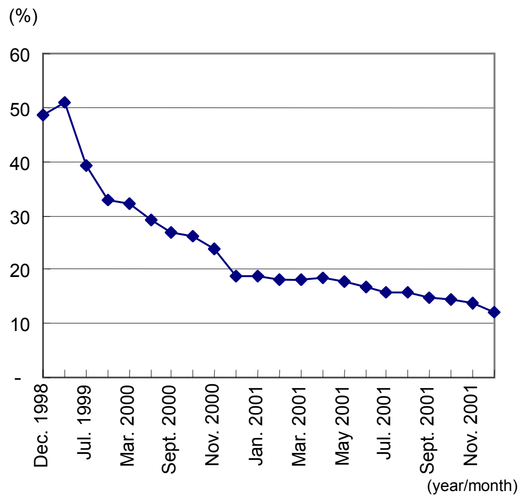
(*Source*: Bank Indonesia, others)

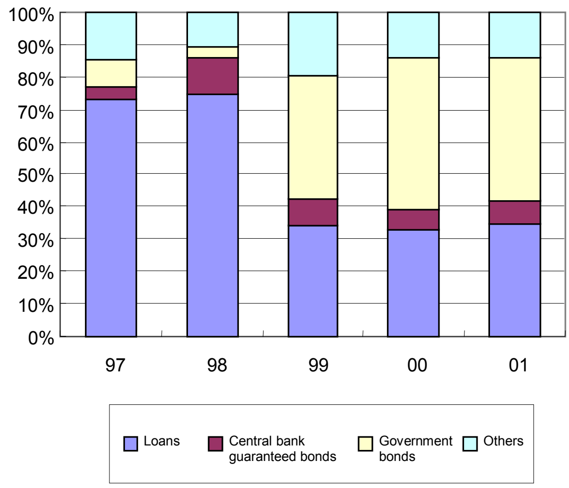
(3) Issues

The most important subject for the banking sector now is the recovery of its function as a financial intermediary. This is a matter of (1) recovery of soundness, (2) the sale of banks under IBRA, (3) privatization of state-run banks, and (4) reform of the structure of ownership and of prudential standards for the conduct of banking business on the part of banks in the private sector.

Since the currency crisis, non-performing loans have been transferred to the IBRA. While this has lowered non-performing loan ratios and facilitated the gradual recovery of profitability, many of the banks have chosen to hold government bonds and Bank Indonesia bills (SBI) for their low risk interest income, rather than make loans to the private sector, which has received only a small allocation. One reason for this phenomenon is that under the commitment made to the IMF, all banks are required to achieve 8% capital adequacy ratios by BIS standards, whether they engage in international business or not. Consequently, they have little incentive to sell their government bonds and make corporate loans that would require them to build reserves. A further factor is the lack of attractive borrowers since the corporate sector is still in the midst of debt restructuring. The disposal of non-performing loans transferred to IBRA as of the end of 2001 has stayed at the level of about 40%. It also appears that because of the issue of finding funds to redeem bonds, the government may believe that it is better for banks to continue to hold bonds than to pass them into the hands of general investors.

A further issue is that of the blanket guarantee arrangement that has been the main frame for stabilizing the financial system. Essentially this system should be converted into a deposit insurance system under conditions in which the financial and banking system remain stable, while at the same time avoiding ethical issues. Nevertheless, the concentration by investors into deposits because all deposits are guaranteed would present concerns of future increase in financial burden, and consequently some adjustment would be necessary, such as setting an upper limit.





(*Source*: Bank Indonesia, others)

Fig. 4. Ratio of Non-performing Loans, Indonesia

Fig. 5. Composition of Assets of Indonesian Commercial Banks

3. Accounting

(1) Institutional and Policy Framework

The birth of modern accounting in Indonesia was during the Suharto era, when the Indonesian Accounting Institute (IAI) adopted a code of professional behavior in 1972, and a system of accounting standards in 1973. The IAI had been gradually modifying its accounting standards largely on the basis of American standards, in keeping with the economic development of the county. In 1994, however, a policy shift was made in favor of using International Accounting Standards (IAS), with support from the World Bank.

The fundamental framework for the accounting system is provided by the Law no. 1 of 1995 concerning Limited Liability Companies (Udang-udang Perseroan Terbatas) issued by the President.[1] This directive established the legal underpinnings for stock companies and required the preparation of financial statements. Chapter 4 of this law requires preparation of an annual report that must be made public within 5 months of its approval by the board of directors.

The Financial Accounting Standards Committee is responsible for formulating the country's accounting standards. Since 1994, under the auspices of the World Bank, the IAI has adopted standards that are close to being translations of the IAS.

[1] Promulgated in March 1995, effective March 1996.

There are in all 65 accounting standards (PSAK), and they are broadly consistent with those of the IAS.[2] The IAI–involved in all areas in which accountants are active, including managerial accounting, education, public accounting, quality control, ethical standards, auditing, audit certificate, research and studies, and consulting—has started to adapt IAS to match conditions prevailing in Indonesia.[3]

Accounting standards are set by the IAI.[4] Work is done by 10 accountants and 2-3 assistants, with internal review by an ad hoc committee. This committee is formed from representatives of BAPEPAM, the Securities and Exchange Commission, tax authorities, Ministry of Finance, the General Accounting Office, securities analysts and others. It has three broad tasks, (1) drafting of new standards, (2) review and revision of standards, and (3) adoption of standards. When new standards are to be proposed, they are drafted, public hearings are held, comments and criticism are solicited, and then the committee is asked to undertake an authentication.

Auditing under Indonesian corporate law, is required for public corporations, banks, insurers, leasing companies, securities companies, foreign investment companies and all others having total assets above a certain level.[5]

(2) Present Conditions in the Accounting System

Regarding the level of quality of accounting practice, a system of certified public accountants was begun in 1997; there are adequate schooling facilities for accountants, and there is rigorous monitoring of the level of practical capabilities of accountants.[6]

It is necessary, nevertheless, to note that in the field of accounting in Indonesia at present there has been a loss of trust in American accounting firms subsequent to the Enron affair, and this has become a major social issue even in Indonesia. Owing to the loss of confidence in Indonesian accounting standards, which are based on those of the United States, the loss of stability of accounting firms, concern regarding the level of salaries, and other factors, students have lost interest in studying accountancy, and if this leads to a failure in enrolling superior students for accounting study programs, it may lead to difficulty in maintaining quality in auditing.

It cannot be said, however, that knowledge of bookkeeping has become adequately diffused at companies. At many SMEs, conditions are such that as a practical matter it is difficult to attain an adequate level of accounting. A tendency for company owners to lack awareness of the need for accountants lies in the background of this situation, in addition to factors such as application of accounting standards of the IAS even to SMEs. Although at the time of formulating the accounting standards there was some discussion of differentiating between large companies and SMEs, what has happened is that they are to be

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[2] According to interviews with the Ministry of Finance's Bureau of Audit Supervision, Indonesia's accounting standards had been based on those of the United States, but IAS was introduced in 1994 as part of an IBRD support project and by 1997 95% of the standards conformed to IAS. Indonesian standards, however, are based on an acquisition cost basis, differing thereby from the IAS. After the currency crisis, different accounting standards have been adopted for cooperative associations, the forestry industry, life and non-life insurers, banks, mining, and other special industries.

[3] These conditions conformed to GAAP but also reflected economic conditions. In 2001 there was a review of standards for wear and tear of assets, contingent liability, estimated debt, real estate accounting, tax accounting and estimated tax obligations, under pressure from the IMF.

[4] The basic frames of standards were adopted in 1994.

[5] SMEs are not obliged to be audited. They submit financial statements only to tax authorities. Companies having capital of Rp 2.5 billion or more are required to be audited. At present, only about 25% of all companies are audited.

[6] About 25,000 accountants are registered in Indonesia, of which about 3,000 are active. A new certifying exam was introduced 4 years ago, and about 200 persons have passed the new exam. The exam covers 5 subjects. To be certified as a public accountant, a person must graduate from a college accounting program, pass the examination, and have at least 3 years of practical experience.

uniformly applied. Nevertheless it is now said that the time has come for a review of this situation, in light of the low level of effectiveness of application of the standards to SMEs.

(3) Present Issues

] The issues that the Indonesian accounting system now faces are as follows.[7]

- The greatest challenge is that of widely diffusing knowledge regarding accounting. It is important that there be a spread of bookkeeping knowledge, expansion of the tax accountant system,[8] reforming management awareness of corporate accounting through measures that include awards programs, broad-based development of human resources, and wide educational and promotional activities.
- There are many areas in which Indonesia would benefit from support by other countries in the accounting field, including: (1) establishing foreign exchange accounting procedures suitable for a country with a weak currency, (2) improvement of accounting information systems to augment the competitiveness of SMEs, (3) improvement of accounting systems on the part of local governments, and (4) formulation of new audit standards. In addition, as assistance that utilizes the Japanese experience, mention can be made of providing incentives related to taxation in order to raise the level of SME accounting (such as the "blue form return" system).

[7] Based on field interviews by this working group. (May 2002).

[8] Tax accountants are certified by the Ministry of Finance and become a member of the Tax Accounts Institute. The examination they sit for is called BREVET and passing grades are required for the three subjects of individual income tax law, corporate tax law, and international law. A suitable college degree and practical experience are prerequisites for sitting for the examination.

THAILAND

The structure of Thailand's financial and capital market is heavily biased toward the banking sector. Prior to the Asian financial crisis, the balance of bank lending greatly exceeded 100% of the gross domestic product. Starting in 1993 when Thailand created an offshore market, large amounts of foreign capital entered the country and brought about a sharp rise in stocks and real estate values. Because financial institutions used funds in foreign currency that they had procured over the short-term to make domestic loans collateralized by real estate, when the baht dropped it resulted in sharp escalation of dollar-denominated debt while at the same time the appraised value of the real estate collateral fell in value, generating a sizable amount of non-performing loans. The financial market then ceased to function. In response to the crisis in the banking sector brought about by the banks' balance sheet condition of short-term liabilities exceeding long-term assets, and a currency mismatch, the government moved to develop the capital market, and especially the stock market, as a means for procurement of long-term finance.

Table 1. Scale of the Thailand Financial and Capital Market

(Ratio to nominal GDP, %)

	1997	2001
Bank loan balance	121	74
Stock market capitalization	23	32
Balance of government bonds	5	22
Balance of corporate bonds	3	5

(*Source*: Bank of Thailand)

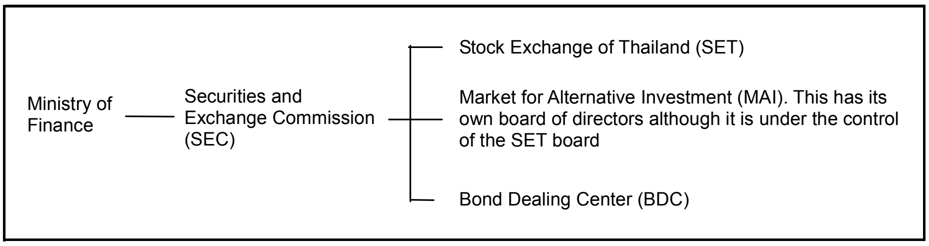
1. The Capital Market

(1) Institutional and Policy Framework

Competent Government Agencies

Thailand's Securities and Exchange Commission (SEC), which has 400 employees (of which 40 monitor the listed companies), was established on the basis of the Stock Exchange Act enacted in 1992. In addition to supervision of the capital market, the SEC has authority over the entire range of policy for development of the market. It has the authority to authorize exchange listings and license securities brokers, and although the Stock Exchange of Thailand (SET) has its own criteria and rules for listing, no company can be listed without SEC approval. Similarly, regarding disclosure, reporting to the SET is voluntary, but to the SEC it is mandatory.[9] There are, in addition, industrial organizations, notably the Association of Securities Companies (ASCO), the Association of Finance Companies, and the Investment Counsel Association. Thai Rating and Information Services (TRIS) and Fitch Thailand (a subsidiary of Fitch IBCA) are the country's rating agencies.

[9] Financial statements (income statement and balance sheet) must be filed for each quarter, and annual reports must be filed within four months from the end of the fiscal year..



(*Source*: Daiwa Institute of Research.)

Fig. 1. Structure of Thailand's Capital Market

Legal System

The Securities and Exchange Act (B.E. 2535 (SEA) is the major law on the capital market. Preceding laws are the 1974 Securities and Exchange Act and the 1984 Amended Law for the Stock Exchange of Thailand. Scheduled changes include enactment of an investors protection act within this year, and amendment of the Public Limited Company Law to enhance the functioning of annual general meetings, to promote transparency of boards of directors, and to improve corporate disclosure.

Capital Market Policy

Following the Asian financial crisis there was a re-recognition of the need to nurture capital markets, and in August 2000 SET announced a 5-year plan for revitalizing the securities market. Divided into short-, medium- and long-term phases, the plan includes the start of options trading, conversion of the exchange into a joint stock corporation, and provision of market access to overseas investors. Since the announcement, commissions have been fully deregulated (October 2000), and nonvoting depositary receipts (NVDRs) for foreign investors have been introduced (June 2001).[*] Nevertheless the market remained slack in part due to a no-action period in the run-up to national elections in early 2001.

Emphasis on invigorating the stock market was given special emphasis in a series of measures for activating the capital market, announced in March 2001 by Prime Minister Thaksin's administration. The main components of the program, consisted of privatizing state corporations and tax incentives for newly listed companies. Regarding the latter, those companies listing in the coming 3 years will have their corporate tax rate reduced, from 30% to 25% (for the first 5 years after listing), and the tax rate for SMEs listing on MAI is to be reduced to 20%.

The market has remained weak, however, despite these measures, owing to the weakness of the economy and the impact of the September 11 terrorist attacks in the United States. In view of this, the Ministry of Finance announced its Thai Capital Market Master Plan in January 2002. According to the plan, 6 committees, one for each of its areas of emphasis, are to be formed in order to study actionable policies. The salient points include that the SEC will evaluate and rate corporate governance, and will provide benefits to companies that demonstrate superior corporate governance, as well as that the SET will provide financial support privatized corporations and SMEs to list on the exchange. One step that has already been taken is the Opportunity Fund (of 10 billion bahts) that was established early this year by the SET, with joint investment from the Government Pension Fund and Krung Thai bank.

[*] NDVRs provide foreign investors with equal treatment in capital increases as well as in the right to receive dividends, but do not carry voting rights. Thai NVDR, a special purpose entity controlled by SET, acquires shares on behalf of

foreign investors. Since holding of shares through an NDVR is not recognized as foreign ownership, this vehicle makes it possible for foreign investors to hold shares in excess of the foreign shareholding ratio.

Table 2. Main Features of Thailand's Master Plan for the Capital Market (January 20022)

Basis of Master Plan	
1)	Rebuilding of the capital markets through enhancement of corporate governance
2)	Improving the quality and increasing the quantity of listed companies
3)	Attracting both domestic and foreign investors
4)	Strengthening the intermediary institutions
5)	Reforming the structure of the supervision system to enhance the development of the capital markets
6)	Enhance efficiency of infrastructure to reduce transaction costs
Policies over the Near Term	
1)	Providing support for reduction of par value shares on the part of listed companies (to 10 bahts or below)
2)	Promotion of dividend payments by listed companies, and issuance of warrants and preferred shares
3)	Establishment of the Thai Opportunity Fund (30 billion bahts) with joint investment from the civil servants pension fund (Government Pension Fund, GPF), Krung Thai Bank and the Stock Exchange of Thailand
4)	Establishment of a venture capital fund, jointly by the IFCT, SIPC, GPF and others, to promote investment in SMEs

(*Source*: Thailand Ministry of Finance)

(2) Present Condition of the Capital Market

Stock market

The Bangkok Stock Exchange was established in 1962, but low interest in raising capital through the stock market, and a low level of investor understanding of stock transactions, kept trading from growing and early in 1970 the exchange was closed. When development of the domestic capital market was made a condition for World Bank development finance in the World Bank warning letter of 1969, however, the Thai government began to work at fostering its capital markets. In 1975, SET was established and trading began.

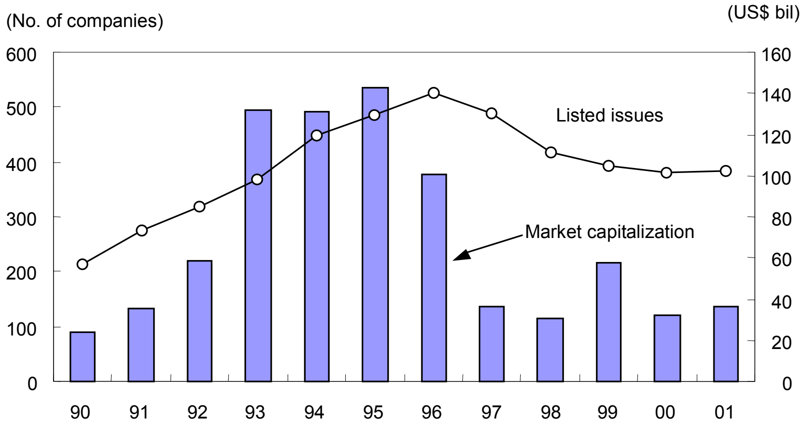
SET is a non-profit entity operated by its members. Five different trading systems are used as they are designed for different scales of transaction and different types of instruments:

1. Main Board: For trades of 1,000,000 or less shares, units trusts, or warrants
2. Big Lot board: For trades of more than 1,000,000 shares (or 3,000,000 bahts)
3. Foreign Board: For foreign issues
4. Odd Lot Board: For odd lot trading
5. Special Board: For government bonds, and bonds and convertible bonds issued by government-owned corporation, for 1,000,000 shares (or 3,000,000 bahts) or less

Delisting of companies having poor performance, and reluctance on the part of companies towards becoming newly listed, resulted in a steady decline in the number of listed issues, from a peak in 1996. It is believed that reluctance to list was due to the judgment by many companies that the demerits of listing (disclosure) outweigh the merits (raising capital).

The largest sector in the market is bank shares, led by Krung Thai Bank; they account for 20%.

The Market for Alternative Investment (MAI) was opened as a second market, for SMEs, in 1998. When it was decided in 2000 to promote listings by IT companies, requirements were eased, so that prior business performance was no longer a criterion, but only 4 companies were listed on this basis (as of the end of March 2002). Among the reasons for this poor start is the lack of trust in the accounting and management of SMEs.



(*Source*: SET.)

Fig. 2. Trends of the Stock Exchange of Thailand

Table 3 Thai Market Capitalization by Sector

	No. of listed issues	Market capitalization (Bil. bahts)	Share (%)
Banking	14	359	19.3
Energy	11	259	13.9
Communications	12	238	12.8
Building materials	20	181	9.7
Finance, brokerage	23	101	5.4
	24	91	4.9
Entertainment	8	80	4.3
Electric power	8	80	4.3
Transportation	8	60	3.2
Commerce	13	51	2.7
Paper & pulp	4	48	2.6
Food service	22	47	2.5
Others	216	267	14.3
Total	383	1882.2	100.0

(Note: Common stock only, as of March 2002)
(*Source*: SET)

The first major characteristic of the stock market is that share prices are easily moved by light trading, because of the low percentage of floating shares and a high level of market capitalization. This is particularly the case for issues in which the government holds stock, such as Krung Thai Bank and Thai Air. A second feature is that because institutional investors are not a strong presence, there is a high ratio of individual stockholders, who tend to be speculative, buying and selling in short cycles. At the present, most assets of financial institutions are invested in bank deposits and bonds; only about 10% is allocated to stocks. Third, there is a tendency for trading to be concentrated in the banking, telecom, finance and securities sectors. Speculative trading in issues in these sectors can be done easily because the total market capitalization is comparatively high and there is substantial liquidity. Mention can also be made of the decline in trading by foreign investors. Before the Asian financial crisis they did more than 70% of the trading but now have a share of about 30%.

Recently, there have been frequent sales of government owned stock and IPOs for the purpose of privatizing state-owned companies, as part of the policy of invigorating the stock market. Besides the successful IPOs of Internet Thailand and Thai Petroleum (PTT) last year, it is planned to sell off, and list, more than 15 corporations, including Krung Thai Bank and Thai Air. Because the total market value of all shares in the state owned corporations targeted for privatization accounted for 40% of SET market capitalization as of the end of 2001, if these listings are successful, it is expected that they will contribute to a more active market as there will be a considerably larger number of floating shares, but there is also some cause for concern that the market will not be able to easily absorb the new paper.

Table 4. Thai SOE Privatization Plan

Schedule for Privatization of Thai SOEs

	Name of Enterprise Slated for Privatization	Proposed date	Remarks
1	Internet Thailand PLC (Inet)	4th quarter of 2001	
2	PTT Public Company	4th quarter of 2001	
3	Thai Airways International	4th quarter of 2001	Postponed to 2002
4	KrungThai Bank	4th quarter of 2001	Postponed to 2002
5	Bangkok Metropolitan Bank	1st quarter of 2002	Postponed to 2002
6	Siam City Bank	1st quarter of 2002	Postponed to 2002
7	Telephone Organization of Thailand	2nd quarter of 2002	Postponed to October 2002
8	Communication Authority of Thailand	3rd quarter of 2002	Postponed
9	Thailand Tobacco Monopoly	3rd quarter of 2002	Postponed from the first half of 2003
10	Airport Authority of Thailand	3rd quarter of 2002	
11	Government Housing Bank	3rd quarter of 2002	
12	Port Authority of Thailand	3rd quarter of 2002	
13	Government Savings Bank	4th quarter of 2002	
14	Electricity Generating Authority of Thailand	3rd quarter of 2003	
15	Metropolitan Electricity Authority	4th quarter of 2003	
16	Provincial Electricity Authority	4th quarter of 2003	
17	Metropolitan Waterworks Authority	4th quarter of 2003	
18	Provincial Waterworks Authority	4th quarter of 2003	

← 93%of shares to be sold by 4Q

Source: Ministry of Finance.

Incubating Individual Investors in Thailand

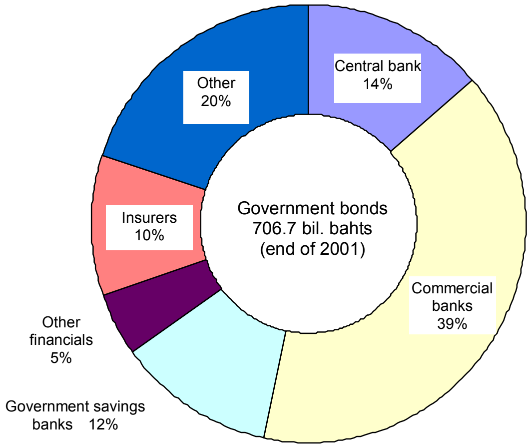
Educational programs intended for existing and future investors in equities at present consist of activities to promote awareness of the importance of the capital markets, including a radio program (about 10 minutes) and interviews with celebrities that are published in a women's magazine. A student program has been prepared to help college students become acquainted with the market while still in school. A non-academic program offered by SET teaches the basics of the stock market and the mechanism of trading. Tax incentives are provided for pension funds, state corporations, listed companies and others as a measure for developing institutional investors.

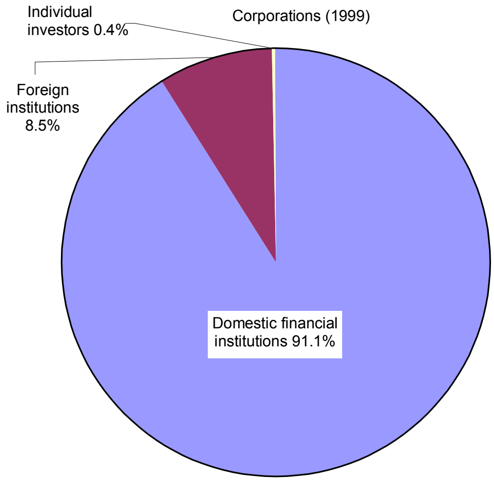
Bond Market

Even prior to the Asian financial crisis, work at development of the capital market took place with emphasis on improvement of the bond market, including the formation of the Bond Dealers Club (BDC) to provide a venue for bond trading, and by establishing a rating agency. Development of the market has been retarded, however, because prior to the Asian crisis the government, enjoying budget surpluses, issued few bonds, and commercial banks adopted a buy-and-hold policy. Issuance of government bonds was increased following the crisis, to provide the means for rebuilding the financial sector, among other objectives, so that the ratio of outstanding government debt to GDP rose about four-fold from 1997 to 2002 when it reached 22%. With this increased supply of bonds, there was some diversification in the range of ownership, but the commercial banks continue to have a share of about 40%, and the speed of development of the secondary market has not been great. Advances have been made with regard to the management of the bond market and incubation of the market, by steps including establishing the Public Debt Management Office within the Ministry of Finance, as a central institution for actions such as reducing risk in public finance. The March 2001 policy to invigorate the capital markets included enactment of the Public Debt Management Law for the purpose of stabilizing the supply of government bonds, and amendment of the Securitization Law to remove tax barriers in connection with the securitization business, and thereby promote improvement of the balance sheets of financial institutions, as measures for the long range development of the bond market.

The scale of the corporate bond market is extremely small. Bonds can only be issued by large corporations that are willing to make disclosure and are capable of obtaining a rating. As of the present only about 30 companies have done so. Private placements are the most common as issue procedures are simple, and the paper is for the most part in the hands of domestic institutional investors.

(Note: The Association of Securities Companies established the Bond Dealers Club in 1994, as a broker's market. Initially, the BDC was a part of the Association. In 1997 it was converted into the Bond Dealing Center, as a self-regulating organization that would also concentrate on improving the system for the secondary bond market)





(*Source*: Bank of Thailand, others.)

Fig. 3. Shares of Ownership of Bonds

(3) Current Issues

Challenges faced by the stock market include achieving an increase in floating shares by releasing government-held shares and from the privatization of SOEs, as well as incubating an investor base, and particularly institutional investors.10 Channeling part of the immense savings of the household sector to the stock market can be expected to stabilize the market over the long term, and assist in the absorption of shares sold by the government or offered as part of the privatization process. Further, new listings have been few because accounting standards applicable to privately owned companies are lax, and window dressing and tax evasion by these companies are common, so that there is a lack of incentive to make public offerings that would require more rigorous accounting and disclosure. Because of this, it is desirable to create an environment that would offer advantages to listing, through steps that include applying certain accounting standards to privately held companies as well, and improving tax enforcement.

The challenges for the bond market are those of fostering a benchmark for government bonds, and increasing liquidity. The percentage of government debt issues to GDP in Thailand has risen sharply since the currency crisis, and the country will have to continue to issue bonds for the foreseeable future. At the time of issuing these bonds it will be necessary to adjust the issuing dates and the maturity periods make them into financial products that are attractive to the market. Further, in accordance with recommendations of the IMF and IBRD following the currency crisis, some steps have already been taken to provide the framework needed for the market to develop, such as measures related to the stock market, the Bond Dealing Center, and rating agencies, so that the current challenge is to improve the effectiveness of this framework.

[10] SET is in the process of establishing an organization that will have the objective of educating individual investors.

2. The Banking Sector

(1) Institutional and Policy Framework

Competent Government Agencies

Rather than being centralized, several government ministries supervise financial institutions in Thailand. The Bank of Thailand handles supervision and oversight of commercial banks, the Ministry of Finance handles this function for special financial institutions affiliated with the government, the Ministry of Commerce is responsible for insurance companies, and the Ministry of Agriculture handles savings cooperatives. In addition to supervision of commercial banks, the Bank of Thailand implements financial policy, controls foreign exchange activities, issues banknotes, and performs other functions. Financial policy is now based on inflation targeting as recommended by the Bank of Thailand's Financial Policy Committee that was established in June 2000.

Legal System

Conforming to the split pattern of governmental supervision and regulation of financial institutions, laws governing those institutions are diverse, and include the Central Bank Law for the Bank of Thailand, the Bank Law for Commercial Banks, and the Finance Companies Law for finance companies. The Financial Institution Law, which is now being drafted, will combine these laws into one, and strengthen the powers of the central bank.

Policy

The financial system has been restructured according to the comprehensive policies for that purpose announced in October 1997 and August 1998, subsequent to the Asian financial crisis. In the course of restructuring, finance companies that were making losses were ordered to cease operations and were shut down in large numbers, financial institutions were recapitalized through injections of public funds, and asset management companies (AMCs) were established. In July 2001 the first governmental asset management company, the Thailand Asset Management Company (TAMC) was set up and began purchases and workouts of non-performing loans (NPLs) under the guidance of the government.

Work is now underway to draft a 5-year program for improvement of infrastructure, with modernization of the financial system as the ultimate objective. The program is being prepared by a committee composed of representatives of the government, SEC, banks in the private sector, insurers, and others, and drafting is scheduled for completion within the year. The program is expected to include steps to improve the competitiveness of the core banking sector so that financial services will be provided to areas inhabited by approximately 30 million people, or about half the population.

(2) Present Conditions of the Banking Sector

The Bank of Thailand, commercial banks, finance companies, and a variety of governmental, specialized institutions make up the financial institutions of Thailand. Commercial banks hold a particularly dominant share; they account for about 70% of each of the sector's gross assets, credit balance, and deposits taken in. Besides supervision of commercial banks, the Bank of Thailand, as the government's bank, maintains accounts for the government and government corporations and is able to finance up to 25% of the current budget by unsecured short-term lending to the government. Finance companies are uniquely Thai institutions, as they are permitted to engage in both the banking business, with certain exceptions, and the securities business. They increased and grew rapidly from the latter half of the 1960s when the ability of commercial banks to expand was curtailed, and local commercial banks and foreign banks saw an opportunity to make inroads in commercial banking by setting up finance companies. Since the 1990s, however, many of their loans to finance real estate acquisition have become nonperforming, and following the Asian financial crisis many finance companies have closed or have been sold to foreign interests as part of the restructuring that is taking place.

Table 5. Scale of the Financial Sector

Gross assets

	1994	1995	1996	1997	1998	1999	2000	2001
Gross assets of all financial institutions (Bil. bahts)	5,836	7,343	8,391	10,173	9,934	9,010	8,719	8,714
<Share, %>								
Commercial banks	69.8	69.0	68.1	73.0	72.1	77.4	76.2	75.9
Finance companies	21.1	21.7	21.7	16.1	15.1	8.1	7.7	6.6
State institutions	9.1	9.3	10.1	10.9	12.7	14.5	16.2	17.5
The Government Savings Bank	3.1	2.9	2.8	2.8	3.8	4.8	5.5	6.3
Agricultural banks, coops	2.2	2.2	2.6	2.3	2.7	3.1	3.6	4.3
The Industrial Finance Corporation of Thailand (IFCT)	1.6	1.6	1.7	2.1	2.0	2.1	2.3	2.4
The Government Housing Bank	1.9	2.1	2.6	3.0	3.7	3.9	4.1	3.9
Exim Bank	0.3	0.4	0.4	0.6	0.5	0.6	0.7	0.6
The Small Industrial Finance Corporation (SIFC)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1

Loans

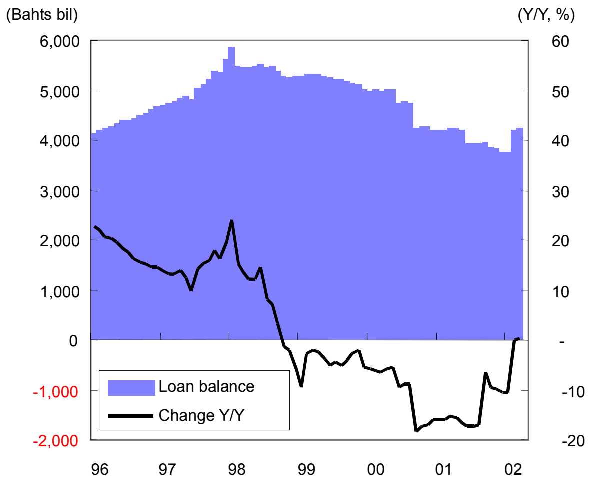
	1994	1995	1996	1997	1998	1999	2000	2001
Loans of all financial institutions (Bil. bahts)	4,637	5,858	6,788	7,844	7,201	6,121	5333	4980
<Share, %>								
Commercial banks	71.3	69.8	69.1	73.0	73.6	81.9	79.0	75.8
Finance companies	22.3	23.3	22.9	17.5	16.0	5.7	5.6	6.6
State institutions	6.4	6.9	8.0	9.4	10.4	12.4	15.4	17.6
The Government Savings Bank	0.6	0.6	0.7	0.8	1.0	1.1	1.5	2.3
Agricultural banks, coops	2.2	2.2	2.5	2.5	2.9	3.6	4.8	5.6
The Industrial Finance Corporation of Thailand (IFCT)	1.6	1.6	1.8	2.2	2.1	2.5	3.1	3.5
The Government Housing Bank	2.2	2.4	2.9	3.6	4.1	4.6	5.2	5.6
Exim Bank	0.0	0.1	0.1	0.3	0.3	0.5	0.7	0.6
The Small Industrial Finance Corporation (SIFC)	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1

Deposits

	1994	1995	1996	1997	1998	1999	2000	2001
Deposits at all financial institutions (bil. bahts)	3,481	4,169	4,686	4,850	5,287	5,232	5,527	5,804
<Share, %>	71.4	70.0	69.8	79.6	79.5	80.9	81.3	80.4
Commercial banks	71.4	70.0	69.8	79.6	79.5	80.9	81.3	80.4
Finance companies	21.9	22.3	23.1	11.3	9.5	7.4	6.2	6.2
State institutions	6.6	7.7	7.1	9.1	11.1	11.7	12.5	13.4
The Government Savings Bank	4.5	4.3	4.4	4.9	5.9	6.8	7.2	7.9
Agricultural banks, coops	0.9	2.0	1.3	1.4	1.7	1.9	2.1	2.3
The Industrial Finance Corporation of Thailand (IFCT)	--	--	--	--	--	--	--	--
The Government Housing Bank	1.2	1.4	1.5	2.8	3.5	3.0	3.2	3.2
Exim Bank	--	--	--	--	--	--	--	--
The Small Industrial Finance Corporation (SIFC)	--	--	--	--	--	--	--	--

(*Source*: Bank of Thailand.)

Following the Asian financial crisis, slow progress in handling the nonperforming loan issue and a drop in demand for capital resulted in a low level of new credit extended by the commercial banks. The level of credit as of the end of 2001 had fallen to about 60% of its peak, in part owing to the transfer of NPLs to TAMC. At the start of 2002, however, the Bank of Thailand eased the required ratio of the reserves for bad debts and the standards for classifying loans on the part of financial institutions, with the objective of providing capital to the private sector, with the result that in February, the balance of bank loans increased year-on-year for the first time since September 1998. The recent increase in bank lending is partly explained by their targeting the low-risk home mortgage market, so that it cannot be said that all companies are experiencing an increase in the supply of capital.



(*Source*: Bank of Thailand)

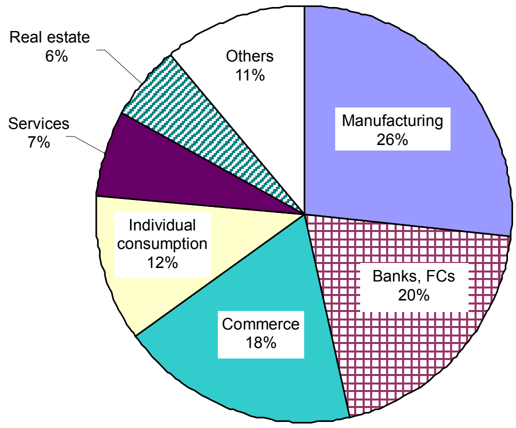


Fig. 4. Trend of Commercial Bank Lending

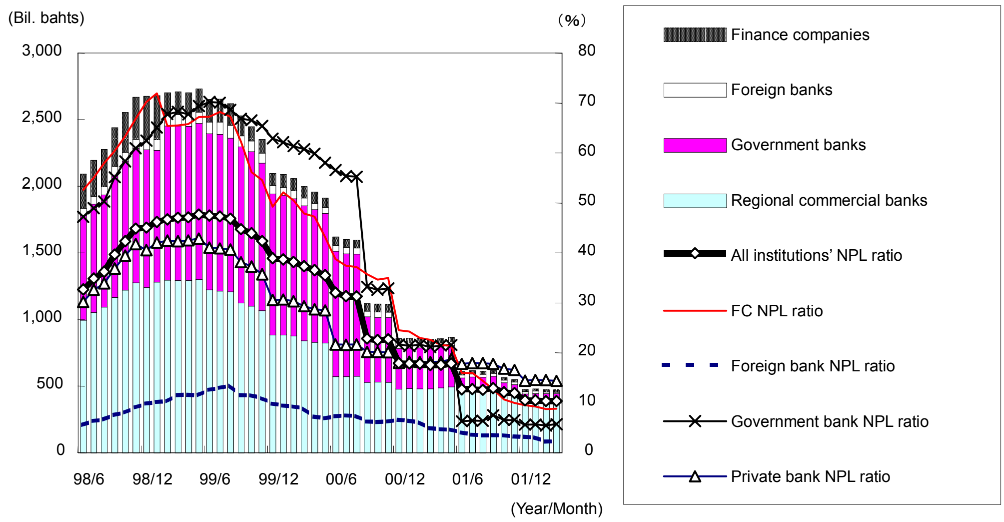
Fig. 5. Lending by Borrower Sector (End of 2001)

(3) Issues

The most significant challenges for the financial sector are those of accelerating the bad debt workouts by financial institutions and the restructuring of corporate debt. The NPL ratio at all financial institutions combined has declined from the peak of 47% to 10.3% as of March 2002, but much of this progress is attributed to the transfer of NPLs to the asset management companies, including the government's TAMC. After the transfer, little has been accomplished in disposing of the loans, and the NPL ratio including those held by the AMCs remains high, at the 30% level. It must be said that a fundamental resolution of the issue continues to remain in the distant future. There have been instances of loans becoming nonperforming for a second time, after rescheduling and after forgiving of interest, and while compared to the situation prior to the currency crisis there has been considerable progress in disclosure involving the financial restructuring which centers on the Financial Institutions Development Fund (FIDF), little is publicly known regarding transfers to TAMC and the handling of the loans at the TAMC. Moreover, from the borrower side there is no justification for expecting an increase in bank loans, as many companies have not solved their issues of excessive debt burdens. TAMC began buying NPLs in October 2001, but since the sale of loans by private institutions is voluntary, most buying has been from governmental institutions, and the amount acquired, 700 billion bahts, is well below the initial target of 1.3 trillion. Although the NPL ratio at government-run commercial banks has declined to 5.7%, the ratio at private commercial banks has improved only to 14.4%.

From a flow viewpoint, however, a gradual improvement is evident in the earnings environment for financial institutions, with the separation of NPLs from their balance sheets and the strong demand for loans to individuals. This has shifted importance for the sector to the issue of debt restructuring by the major source of demand for credit, the corporate sector. Debt restructuring has not made adequate progress because of, in part, the nature of the laws governing collateral and bankruptcy, in addition to which the danger of a moral hazard in the corporate sector continues to exist. This is the presence of "strategic NPLs," or loans that are in arrears despite the borrowers' having the ability to repay. These borrowers prefer to refrain from repaying in view of the prospects for the lender's canceling the obligation, forgiving the interest, or offering to restructure at more favorable terms and conditions. It would be necessary to put into place a framework for placing a degree of pressure on debtor companies to restructure.

While large companies work at reorganizing their debt, the SMEs, a potential source of capital demand,[11] do not have reliable financial statements or methods of accounting. In addition, financial institutions also have credit limits and thus must be cautious about making loans. It appears that customary lending to family businesses is continuing as in the past, and the existence of a financial system not using the usual direct or indirect financial methods are reasons that the restructuring and development of the financial system is making slow progress.



(*Source*: Bank of Thailand.)

Fig. 6. Thailand's NPL Ratio

3. Accounting

(1) Institutional and Policy Framework

Thailand's accounting system is based on the Accounting Act. On this basis, corporate

[11] The Thai government is pursuing a promotion program for SMEs. This began with the preceding Democratic Party administration, but under the Thaksin administration an emphasis has been given to the micro level, and on promotion of international industry. The SIFC, and the People's Bank, which is a financial institution serving the rural and micro enterprise sectors, have been established towards these ends. Although it was decided to set up institutions patterned after public financial institutions in Japan, there are differences of opinion within Japan concerning the best method to provide financing to SMEs, and Japan should give advice concerning abuses that can occur, based on its experience.

law (the Civil and Commercial Code, and the Public Company Act[12]), as well as the Securities and Exchange Act require detailed accounting records that must be kept or financial statements that must be prepared.

The Accounting Act (2002) makes it mandatory for all business entities other than public limited companies to keep accounting records, prepare balance sheets and profit and loss statements, in precedence over other laws and regulations related to accounting. Specifically, it provides for compliance with accounting standards, accurate keeping of books, management of books of account, submission of audited financial statements, and retention of financial records for 5 years.

The Audit Act (1962) places the Board of Supervision of Auditing Practices (BSAP) in charge of auditing of companies, by giving it authority to license audit firms, cancel licenses, establish renewal procedures and other matters. Further, all companies are to be audited. All companies in Thailand are required by the corporate tax law to register audited financial statements with the Department of Commercial Registration. They also must file tax forms based on a completed tax audit with the Revenue Department of the Ministry of Finance. In practice, however, companies capitalized at 5 million bahts or less, or with sales of 3 million bahts or less, are not at the present time required to be audited under the corporate tax law.

Accounting standards are drafted by the Institute of Certified Accountants and Auditors of Thailand (ICAAT) and subsequent to legal processes are enacted as Financial Accounting Standards (FAS). While standards that are close to International Accounting Standards have been adopted, Thailand has deferred adopting some international standards, including those for mergers (IAS 22) and segmented financial statements (IAS 14).

(2) Present Conditions

The new Accounting Act was enacted in 2000, and at the present time the relevant institutions such as the Ministry of Commerce and the Stock Exchange are engaged in discussions concerning various issues surrounding its application.

For example, there is the argument that a large scale corporation need not comply with international accounting standards if it is not listed. A further argument holds that the requirement to hire a qualified accountant, as set forth in Paragraph 19 of the law, is onerous in the case of SMEs. Furthermore, the law is to be applied to public limited companies, foreign companies, joint ventures, partnerships and others, but it can be argued that accounting requirements should vary according to factors such as the type of company or the type of business.

Much attention is being given to the application of the law to SMEs. Given that Thai accounting standards are becoming more close to IAS compliance, there is awareness that it will be very difficult to apply these standards to SMEs and not just large corporations. It has therefore been advocated that the accounting standards must distinguish between large and small companies, and that there is also a need to draft separate accounting standards for SMEs. This issue is currently being addressed by the ICAAT.[13]

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[12] The Public Company Act distinguishes between a private limited company and public limited companies. The first is governed by the Civil and Commercial Code (1948), the second by the Public Company Act (1978). Regulations concerning the latter are stricter than those for the former but there is no intrinsic advantage to the latter and it is said that it is to the advantage of a company to list while still remaining a limited company.

[13] According to interviews at the ICAAT, at the last general meeting of the ISAA (a part of UNCTAD concerned with accounting; 200-300 persons attended the meeting) the matter of SMEs' accounting was brought up. ICAAT stated that participation by Japan, China and Korea was needed in the future for reasons that include having a stronger administrative capability.

(3) Issues

Issues concerning the accounting system in Thailand can be summarized as follows:[14]

- Rapid introduction of the IAS has caused disruption in actual implementation of accounting[15]
- Because it is difficult, as pointed out above, to apply IAS to SMEs, it is necessary to draft separate standards for this sector with a view to promoting the broad diffusion of bookkeeping and accounting. Present conditions are such that if SMEs are required to do accounting, they would confront a shortage of public accountants and would be unable to put this into practice. Moreover, they would have no incentive to disclose company information by preparing and submitting financial statements.
- Although the ICAAT does exist, there is no law that makes membership a requirement,[16] making it difficult to implement specialized education on an ongoing basis (CPE). ICAAT holds seminars and other activities as educational activities for its member accountants. It offers about a hundred courses (2 days to 2 weeks in duration) annually, on subjects such as audit practice, new standards, development of CFO abilities, and so on. The content of these, however, is inadequate, and there are limits to these activities as they are performed only in Bangkok, and none of them have been held in rural areas. It is necessary that a system be created that enables good quality auditing services to be supplied to SMEs, by the improvement of the quality of the accountants
- There is a serious shortage of personnel working within companies who are capable of preparing financial statements.

From the conditions as described above, the major assistance needs in Thailand would be (1) guidance, joint study and other activities for the drafting of accounting standards for SMEs, (2) training in accounting practices especially for SMEs, and in the operation of computers for accounting applications, and (3) training and education of public accountants. There is a need for technical cooperation in a wide range of fields in regard to the process of complying with the new Accounting Act (of 2000), and the need in all of these areas is urgent.

[14] Based on field interview studies by this working group in March 2002.

[15] According to field interviews (including the Bangkok Branch of The Bank of Tokyo Mitsubishi), it was stated that among other things there are differences of opinion between accountants concerning market price accounting.

[16] Thailand has approximately 9,000 public accountants, of which 7,000 are members.

CHINA

Banks have traditionally occupied the central role in China's financial structure, but in recent years they have accumulated immense sums of non-performing loans, which has made it more difficult for the banking sector to satisfy the corporate sector's requirements for financing. The stock market on the other hand has experienced rapid growth since its initial establishment in the 1990s, and is beginning to fulfill a vital function.

Table 1. China's Financial Structure

(Ratio to nominal GDP, %)

	1990	1995	2000
Balance of all financial institutions' loans	95	88	113
Stock market capitalization	7	6	55
Balance of government bonds	5	6	16
Balance of corporate bonds	1	1	1

(Note) Par value of issued stock is used as a proxy for market capitalization.)
(Source: China Statistical Yearbook)

1. The Capital Market

(1) Institutional and Policy Framework

Competent Government Agencies

The State Council Securities Commission (SCSC) was established in October 1992 as the organization for centralized macro-management of the securities market, and the China Securities Regulatory Commission (CSRC) was formed as its executive branch. At the outset the CSRC was placed in supervision and regulation on the basis of law, the SCSC in charge of drafting securities policy, and some responsibilities were given to the PBC, but in October 1998 all functions were concentrated at the CSRC.

Legal System

China's first securities law was put into force in July 1999. Composed of 12 chapters and 214 articles, it has the following as its main features.

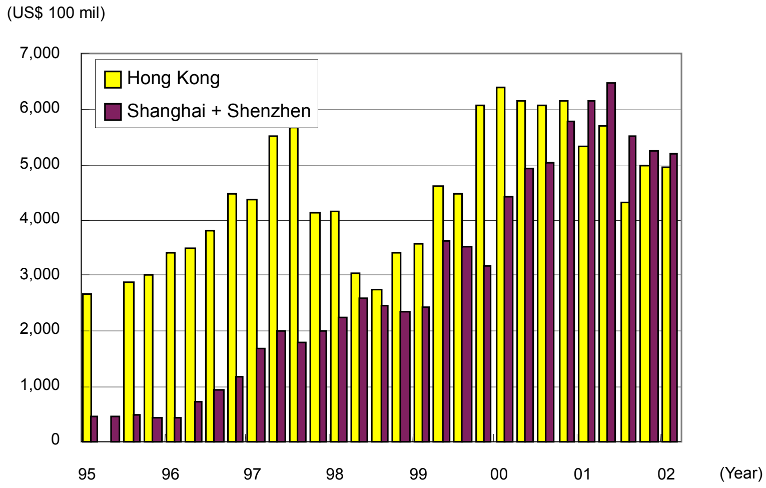
- The main supervisory agency is to be the State Council's China Securities Regulatory Commission.
- Securities business may not be carried out together with the banking, trust, or insurance business.
- Securities firms must keep their own accounts and customer accounts separate.
- State-owned enterprises and state-owned holding companies are prohibited from trading listed stocks on the stock exchange.
- Bank funds may not be diverted to the stock market.
- Foreign capital may not be invested in A stocks.

Features

Under socialism in China the very opening of a stock market had the appearance of being a radical experiment and was adopted as a special kind of system. That is, a distinction was made between listed A stocks that could be purchased with renminbi, and B stocks that could be traded by foreign investors using foreign currency. In the case of the SOEs, which account for a major share of China's listed companies, there are three categories of stocks, namely national stocks (owned by the nation), corporate stocks (held through crossholding by corporations), and individual stocks (held by general, individual investors). Only the individual stocks could be traded on an exchange. Because of this the percent of issued stocks that could be traded as of 2001 was only 33.2%.

(2) Development and Present Situation of the Stock Market

Securities exchanges were opened in Shanghai in December 1990 and in Shenzhen in July 1991. In only 10 years, the combined market capitalization of the two came to exceed that of the Hong Kong market, making it the second largest in Asia. This is a reflection of expansion of the A stock market against the background of strong policy measures for invigorating the market, and low interest rates.



(*Source*: Bloomberg)

Fig 2. Size of the Chinese and Hong Kong Stock Markets

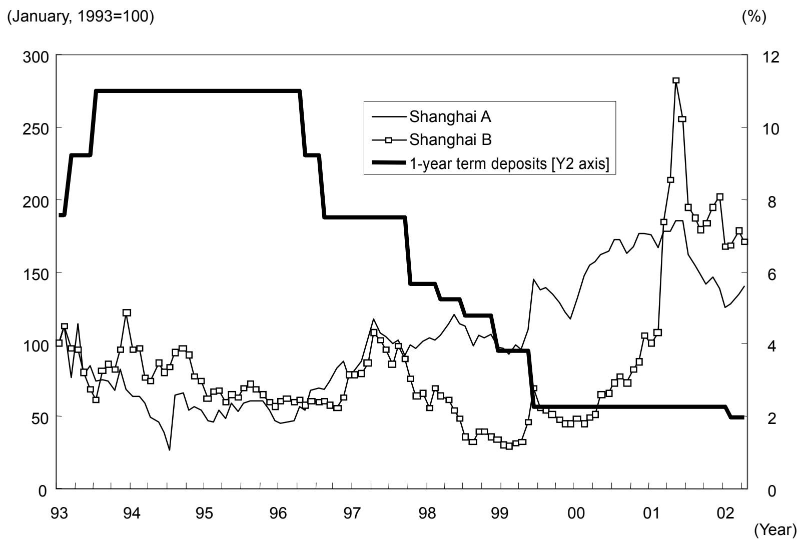
Table 3. Outline of the Chinese Stock Market

		Number of listed issues	Market capitalization (US$ 100 mil)	Daily trading (US$ mil)
		[May 2002]	[Dec. 2001]	[2001]
Shanghai	A stocks	602	3,254	995
	B stocks	54	79	146
Shenzhen	A stocks	488	1850	673
	B stocks	57	75	115
[Hong Kong Main Board]		[754]	[4,983]	[1,029]

(*Source*: Bloomberg)

The B stock market, in contrast, has been shunned by foreign investors, and until recently activity has been low and prices have been soft. The ability of foreign investors to buy Chinese stocks in the Hong Kong market obviated the need to participate in the undeveloped mainland market. Starting in the early 90s, Chinese corporations gained access to the Hong Kong market by either listing stocks of subsidiaries or by buying listed companies ("red chip" companies). Then, from 1993, Chinese companies became able to list in the Hong Kong, as well as New York, Singapore, London and other major markets.

In reaction to these conditions, the Chinese government made it possible for domestic investors to trade B stocks, provided that they do so using foreign currency. As a result, stock prices doubled in a short period.



(*Source*: Bloomberg)

Fig. 3. Chinese Stock Prices and Interest Rates

(3) Issues in and Measures for the Stock Market

Given the brief history of only slightly more than 10 years, the Chinese stock market continues to be a high-risk market that faces significant challenges.

1) Market Reliability and Transparency

The first issue is one of market reliability and transparency. Considerable filing of false earnings reports, price manipulation, insider trading, and other illegal acts are evident.

Amid growing complaints even from the National People's Congress (NPC) that emphasized these issues in the stock market, a series of market control and supervision policies were introduced from mid-2001. First of all, a wide crackdown was initiated on price manipulation and window dressing of accounts, at listed companies and even at accounting firms, and enforcement was made more rigorous than before. Stricter regulations were also enacted, including revision of settlement periods from twice a year to quarterly. The number of companies reporting losses increased. The first instance of delisting of a company took place in April 2001, after Shanghai Narcissus Electric Appliance Co., Ltd., reported a loss for four consecutive years. Since then other companies have been delisted, and starting in December delisting criteria were made more severe. Nevertheless there are still concerns about the integrity and transparency of the market, and stock prices have remained low under the enhanced controls.

2) Immature Investment Approach

With this prevailing situation of poor reliability and transparency, maturation of investors has not progressed as it should, and the market has been characterized by high volatility and instability. The development of the capabilities of institutional investors has been retarded, and individual investors are more inclined to trade stocks on the basis of rumor or hearsay rather than on corporate fundamentals.

The government has attempted to address this situation by authorizing a greater number of investment funds and by raising the limit of investment in stock permitted for insurance companies. Results have not been as expected by the government, however, as the media has reported on suspicions that 10 investment funds have engaged in large scale price manipulation and have become ringleaders in causing disorder in the stock markets, and in fact there is an undeniable possibility that these changes have merely become a new breeding ground for concessions. It appears that it will be a long time before there exists a sound body of domestic investors.

In the background of the immature investment stance of individuals, moreover, is the fact that there are few companies that have sought to earn profits over the long term and thus are suitable for long-term investment. The real situation is that in the December 2001 settlements, of the 1,154 listed companies, 114 or 9.9% reported losses.

The government must bear much of the responsibility for this. There has been a tendency in approving companies for listing to base decisions not on fundamentals but on the strength of their connections to local governments, and the selecting standards have only recently been clarified. Further, until recently the companies that were of most importance to the nation were not listed because of concerns that this would undermine the government's decision-making authority.

3) Difficulty of Selling State-Owned Stocks

As stated above, floating stocks amount to only one-third of total stocks in the case of SOEs that constitute the predominant listed companies, and this phenomenon has distorted prices.

The government adopted the Provisional Measures on Disposing Off State Shares to Finance National Social Security Funds in June 2001 to rectify this situation, providing therein that when an SOE issues new stocks, government-owned stocks equivalent to 10% of the funds raised are to be sold, and the proceeds of this must be transferred to the Social Security Fund. The decision in the mid-1990s to switch the main vehicle for social security from SOEs to a social security system based on pensions had created a serious shortfall of funds in the Social Security Fund, and this measure sought to obtain some of these funds from the stock market. At the same time the government indicated its intention to promote managerial reform by giving a stronger voice to ordinary investors, through reducing the percentage of stocks held by the national government.

Concern has arisen, nevertheless, that the sale of government-owned stocks will create an oversupply of stocks, and this combined with the measures for tightening regulation of the market has caused stock prices to fall by 30% through the latter part of October, from their historic high during mid-2001. In order to prevent the market from falling further, on October 23, the CSRC announced it would suspend the sale of stocks, and prices ceased to fall.

A halt to the sale of government-owned stocks was thus unavoidable as there were signs that a substantial deterioration in stock prices would undermine corporate plans to obtain financing, and would contribute to social uncertainty through reducing investor assets. Nevertheless not a few domestic and foreign investors were disappointed by the governments revealing its continued stance of interfering in markets.

4) Delay for the Chinese Version of NASDAQ

The government has announced a vision of reform in which it will merge the existing Shanghai and Shenzhen markets into one market in Shanghai, and create a second-tier growth market in Shenzhen for SMEs and venture companies, with a primary objective of fostering high technology industries, as the Chinese version of NASDAQ.

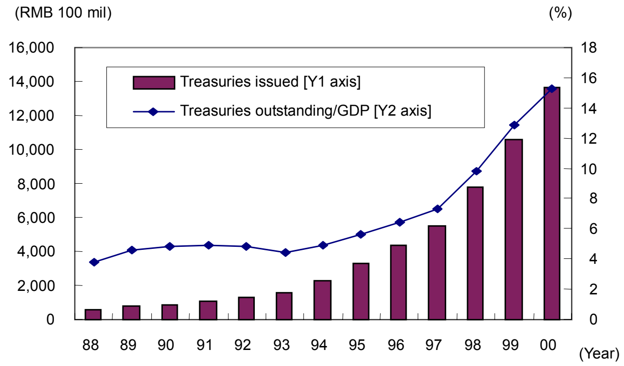
Opening of this new market, which had been scheduled for autumn of 2000, has been greatly delayed. Besides the worldwide slump in stock prices for hi-tech companies, which started with the drop in the United States market in mid-2000, stock prices in China have fallen by a wide margin since the latter half of 2001. Although it is understandable that the government would not want to further weaken prices of existing stocks by starting a new market at this time, this has been greeted with discontent from the several hundred hi-tech companies that have been preparing for listing.

Given that we are now in an age of exchange mergers throughout the world in order to improve market efficiency, merging these exchanges and launching a second-tier market will be an important element of reform. Nevertheless there are not a few who claim even now that it is too early to launch a new market given the disorder that exists in existing markets. The first issue is the importance of achieving reliability and credibility, which are fundamental requirements of a market, and to that end it is necessary to improve the oversight and supervision of the markets, and eliminate any suspicions. If existing exchanges are to be combined then it is also desirable to have an overall reform at this stage that delists inefficient companies that have been listed on the exchange, and targets companies that are suitable for investment.

Authorities are under pressure to tackle the difficult challenge of endeavoring to stimulate and provide proper oversight that promotes the sound development of stock markets, particularly given the importance of the roles that the stock markets need to play, which include functioning as a mechanism for improving corporate governance at SOEs and as a source of Social Security funds in association with changes such as the entry of foreign securities companies and the opening of markets to foreign stockholders prior to entry into the WTO.

(4) The Bond Market and Its Issues

No securities were issued between 1959 and 1980, until budget deficits in 1981 led to the issuance of Treasury bonds. Treasury issuance has grown rapidly since 1994, when central bank borrowing as a means of providing fiscal support was ended. The balance of Treasuries experienced further growth from 1998 because of the government’s aggressive fiscal policy with the objective of supporting the economy, and amounted to RMB 1.3674 trillion as of the end of 2000.



(*Source*: China Financial Yearbook.)

Fig. 4. Balance of Treasury Bonds Outstanding

The urgency of improving the secondary market has increased in keeping with the sharp rise in the balance of Treasuries. China issues two types of bonds: one, a treasury bond, is primarily sold to banks and brokers; the other, for individuals, is a savings bond. The T-bonds account for about 60% of the total issue amount, are purchased primarily by financial institutions, and are traded only in the interbank market or on the Shanghai and Shenzhen exchanges. They have not been offered to individuals. Individuals who purchase savings bonds cannot sell them and they must be held until maturity.

There are signs of reform ahead. In June 2002, banks were authorized to sell T-bonds at their teller windows, and they have been well received by individual investors. Further, it has been reported that steps will be taken to establish an over the counter market for T-bonds in which banks, brokers, institutional investors, and individuals can participate.

The foregoing notwithstanding, speculation in the T-bond futures market in 1995 touched off wild fluctuation in bond prices and included many cases of illicit trading, which led to closing of the market. It has not been reopened yet. Thus the secondary market also faces the challenge of providing stimulation while at the same time assuring market integrity.

The total issue of corporate bonds through the end of 2000 was RMB 86.1 billion, or only one-sixteenth that of T-bonds. In the Tenth Five-Year Plan (2001-2005), however, mention is made of the need for developing the corporate bond market, and such development is expected.

2. The Banking Sector

(1) Institutional and Policy Framework

Competent Government Agencies

Banks are monitored and supervised by the People's Bank of China (PBC) in its capacity as the central bank in accordance with the Central Bank Law (which was put into effect in March 1995). The PBC has found it difficult to exercise complete autonomy, however, as the regional governments have strong influence over the bank's branches. This has led to institutional reform whereby the banks' branches, which had been opened in every province, were reorganized into a network of nine branches, one for each newly defined economic bloc.

Legal System

The Commercial Bank Law (effective from July 1995) is the basic law governing the banking sector. This law states that commercial banks are responsible for their own management, risks, profit and loss, and liabilities, on the basis of management principles for profitability, stability, and liquidity, free of intervention by other institutions, corporations, organizations, or individuals. Stabilizing regulations are also imposed on banks, which include requirements that they have capital adequacy ratios of 8% or higher, deposit-loan ratios of 75% or lower, and quick ratios of 25% or higher, as well as restrictions on large-scale loans (to 10% or less of capital).

In July 1995, a directive on lending was issued, on a provisional basis, with the intention of normalizing lending. Provisions in this directive included types of loans, durations, interest, rights and obligations of borrowers and lenders, and management of loans. These were made applicable not only to lenders such as banks, trust and investment companies, finance companies, lease companies, urban and rural cooperatives and others, but also to borrowers. From 1997 the regulations were permanently adopted.

History of Banking Reform

Reforms in the mid-90s encouraged the commercial banks to consider the profitability of their lending, rather than solely comply with national policy, but despite this, loans to inefficient state-owned enterprises increased by a wide margin and led to the issue of the accumulation of non-performing loans.

Banking reform has continued following the occurrence of the Asian financial crisis, which aroused awareness of the risk inherent in the weaknesses of the financial system, and because of the increased competition following the market opening associated with membership in the WTO. These changes have made it evident that the banks must achieve international standards for stability and profitability in order to withstand the rigors of international competition.

Table 2. Banking Reform Timeline

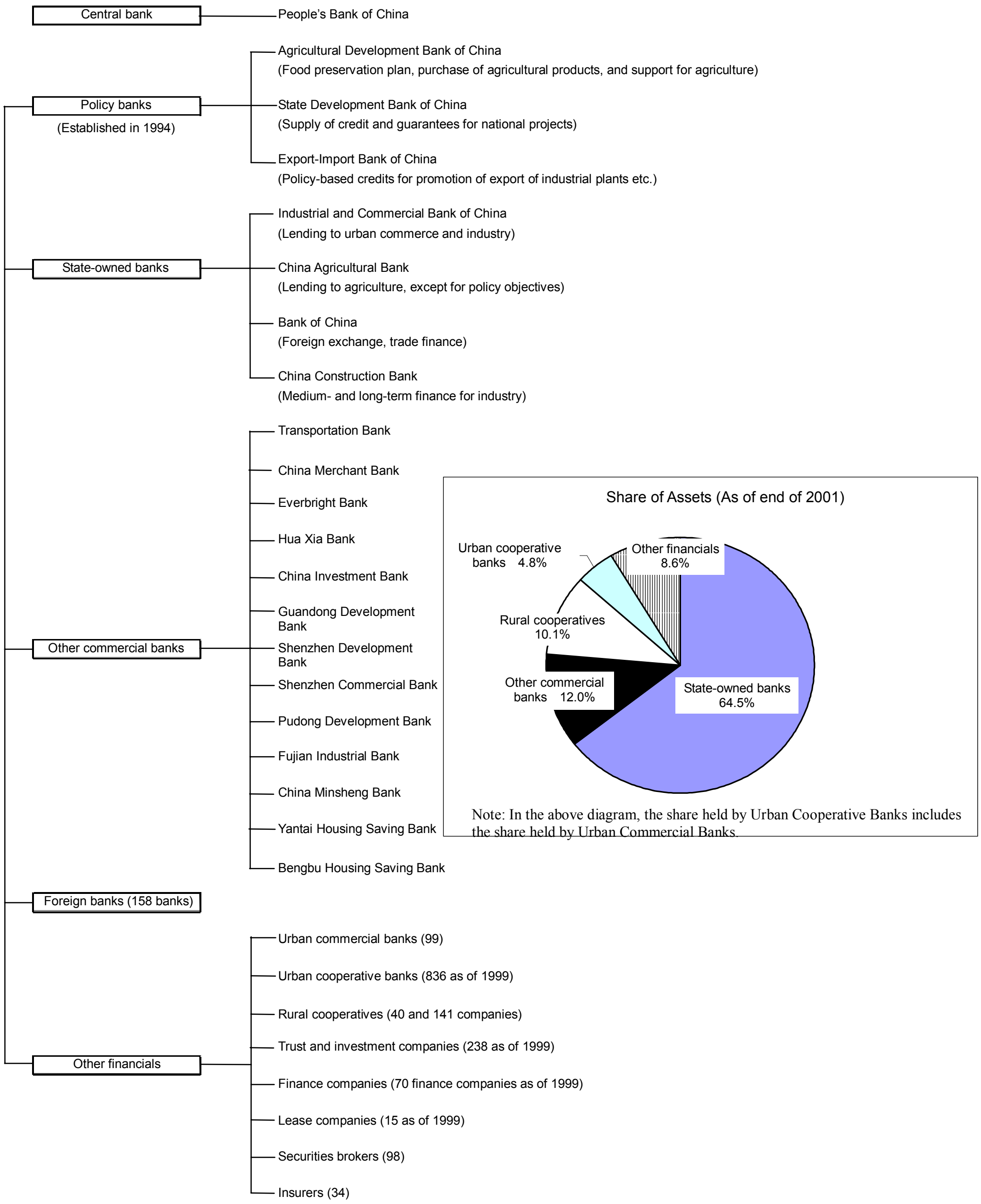
1993	July	Then Deputy Premier Zhu Rong Ji is given the additional duty of Governor of the People's Bank of China (PBC), in order to restore financial order following excessive lending in violation of prudential regulations
	Oct.	Start of trading in Treasury bond futures
1994	Jan	Unification of the dual exchange rate system (there had been official rates and market rates; in Jan.)
		Founding of the policy banks: State Development Bank (April), Export-Import Bank of China (April), and Agricultural Development Bank of China (Nov.)
1995	March	PBC designated as the central bank (Central Bank Law)
	May	Commercial Banking Law (effective from July)
		Bills Law (effective Jan. 1996)
		Insurance Law, Secured Transaction Law (effective Oct.)
		Treasury bond futures trading stopped
1996	Jan.	Start of nation-wide interbank market
	April	Start of open market operations in Treasury bonds
	July	Lending regulations announced (loan type, duration, rights and obligations of borrowers and lenders, etc., regulated)
1997	Jan.	China Rural Development Trust & Investment Corporation ordered to stop operations
	April	Currency Policy Committee formed within the central bank
1998	Jan.	Lending restrictions abolished for the four large state-owned banks
	March	Decision to promote the "Three Major Reforms" (regarding SOE, financial sector and administration) at the same time is made at the first session of the 9th National People's Congress
	April	Announcement of new categories for loan obligations (provisional basis; previous 4 categories replaced by 5; target of end-1999 for nation-wide application)
	June	Hainan Development Bank shut down (the first commercial bank to close)
	Aug.	Injection of RMB 270 billion into the four large state-owned banks
	Aug.	Existing central bank branches reorganized on basis of 9 regional blocs (to eliminate interference by local governments, and strengthen central bank supervision functions)
	Oct.	Liquidation of Guangdong International Trust and Investment Company announced
	Dec.	Securities Act (effective July 1999)
1999	Jan.	Reorganization announced for regional state-affiliated trust and investment companies (consolidation of 239 [as of end-1998] to 40)

	Feb.	Law for penalties for financial law violations formulated
	April	New organizations that will buy NPLs from the large state-owned commercial banks are established: Cinda (associated with the China Construction Bank, April), Oriental (Bank of China, Oct.), Great Wall (Agricultural Bank of China, Oct.), and Huarong (Industrial and Commercial Bank of China, Oct.)
	Oct.	Brokers forbidden from providing loans by receiving stocks as collaterals
		Insurance companies forbidden to buy securities investment funds
	Nov.	Tax on individuals' deposit interest introduced (20% of interest income)
2000	Sept.	Liberalization of foreign-currency loan interest and large-scale deposit interest
2001	Jan.	New regulations for supervision of trust and investment companies (intended to effect consolidation of these companies in view of NPL issues threatening the continued existence of some)
	Feb.	Purchase of B stocks by domestic investors approved
	April	First delisting on the Shanghai Stock Exchange (an electrical appliance maker that had 4 years of losses)
	June	Promulgation of the Provisional Measures on Disposing off State Shares to Finance National Social Security Funds (When new stocks in a state-owned enterprises are sold, the equivalent of 10% of funds obtained are to be through sale of government stocks and the proceeds are to go to the Fund)
	Oct.	Temporary suspension of the Provisional Measures introduced in June (as measure for stabilizing stock prices after a major downturn in the market)

(*Source*: Press reports, etc.)

(2) Banking Sector Reform, and Present Situation

Four wholly state-owned commercial banks—the Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China—dominate finance in China. As of December 2001, their assets accounted for 64.5% of the gross assets of all financial institutions. Until the establishment of three policy-lending banks in 1994 (the Agricultural Bank of China, the State Development Bank of China, and the Export-Import Bank of China), they functioned both as policy-based lenders and commercial banks. Since these three banks have been created, however, the state owned commercial banks have focused solely on commercial banking. Other banks include nationwide commercial banks, regional banks set up as private banking businesses, other private banks, and foreign banks.



(Note: Unless otherwise indicated, the numbers of each type of institution are as of 2000.)
(*Source*: China Financial Yearbook, People's Bank of China Statistical Handbook, others.)

Fig. 1. Summary of China's Financial Institutions

(3) Issues, and Directions for Reform

1) Non-performing Loans

The first issue in China's banking sector is that of non-performing loans (NPLs). As a consequence of accumulating unprofitable loans, especially to the SOEs, the four major state-owned commercial banks have become saddled with a huge amount of NPLs. The four banks in combination have sold at book value a total of RMB 1.4 trillion of NPLs to the asset management companies (AMCs) that were formed, one per bank, in 1999. But as of the end of 2001 the NPL ratio for the four banks combined was still high, at 25.37%. The People's Bank of China (PBC) has indicated its intention that the NPL ratio is to be improved by 2-3% per annum, and reach 15% in 5 years' time, but many foreign affiliated financial institutions doubt that this will be attained.

Moreover, the assets that had been sold to the AMCs by the end of 2001 came to less than a tenth of net assets, and the recovery rate, at 21%, indicates the slow rate of improvement of the situation. One significant issue that this presents is the question of who will be responsible for the difference between the book value and the collected value. It is generally recognized that inasmuch as the government has decided that the assets are to be transferred at book value, it is the government that should absorb any loss. In our meetings at the four major banks we were clearly told, “the government is eventually going to take care of the losses at the AMCs.” This in turn presents concerns about a growing ethics issue in the form of an expectation that additional transfers of NPLs will further reduce liabilities in the future.

2) Incapability of the Banking Sector to Satisfy Capital Demand

The directives to the four state-owned commercial banks to reduce their ratios of NPLs has combined with a lack of sufficient expertise in credit evaluation to create a further issue in the form of an inability to satisfy the demand for credit on the part of high-growth non-state owned corporations such as small and medium sized enterprises (SMEs). Many instances of SMEs having to rely on paying high interest for funds in the informal sector testify to this.

There appears to be a difference of opinion among the competent authorities regarding the promotion of improved financing for SMEs.

China regulates deposit rates, and authorizes a premium for SME credit to a maximum of 30% over the standard rate (At present, interest for a 6-month loan is ordinarily 5.04%, and consequently the ceiling for SME loans for that duration is 6.55%). The basic view at the PBC is that interest rates should be raised to match an increase in risk, and it has indicated an intent to raise the interest premium from 30% to 50%. According to the Monetary Policy Department of PBC, however, opposition from the State Economic and Trade Commission (SETC) has prevented this change.

Further, the SETC is policy-finance oriented. Establishment of a new institution for policy finance has been proposed, but the PBC has spoken out against it, and a proposal has been made that the State Development Bank of China, a policy bank which mainly provides project finance, lend funds to urban commercial banks for loans to SMEs.

At the macro level, even though outstanding growth has been achieved by SMEs, it is not unreasonable to state that it is not easy from a commercial perspective to lend to SMEs under the current restrictions on interest rates. That SMEs lack a strong capital base, and are deficient in regard to their stability, is not limited to China. This is further compounded by the fact that in China there is a lack of reliable corporate information.

Considering the high level of risk, and given the reluctance of banks to lend to SMEs on a commercial basis, the importance of policy finance is undeniable, even if only as a model case. In such a case, however adequate accountability is required by means of assuring transparency in the use of the funds, as well as the objectivity and reliability of corporate information.

Ultimately, it would be necessary to deregulate loan interest rates, inasmuch as a result of their regulation has been to make it difficult to adopt interest rates consonant with the level of credit risk, preventing the development of the financial intermediation function in China.

3) Urgency of Improving Competitiveness Subsequent to WTO Accession

Isues of the competitiveness of China’s banks have become all the more evident by the market opening that has followed accession to the WTO in November 2001. With accession, the restriction preventing foreign banks from engaging in foreign-exchange activities with Chinese businesses and individuals was eliminated, and the number of cities where foreign companies could engage in renminbi services was increased from the original two, Shanghai and Shenzhen. According to reports there has been a rush of customers asking to open foreign-currency accounts at the foreign banks, and in cities where renminbi services has been approved, there have been many instances of customers changing from regional institutions to foreign banks. A questionnaire survey in Shanghai indicates that four persons in ten there would like to try using a foreign bank.

Collecting on loans to loss-making state-owned enterprises, and reduction of personnel levels, continues to be difficult for the four state-owned banks, and is hindering the improvement of their profitability. At the same time foreign banks are making inroads into their business by use of their international networks, offering high quality service, and attracting customers with a diversity of products. Moreover, in competing for outstanding personnel, the four banks cannot offer salaries comparable to those at the foreign banks, giving cause to expect the shortage of human resources to increase in severity. Naturally the foreign banks cannot equal the domestic networks of China's banks, but the situation is not one that allows the domestic banks to feel secure.

WTO accession further means that foreign banks will be allowed to enter the market for providing renminbi services to Chinese enterprises within two years from accession, and will be allowed to offer renminbi services to individual Chinese within five years, so little time is left before competition with foreign banks begins in earnest.

4) Delayed Deregulation of Interest Rates

Three policies were adopted by China in 2000 concerning the deregulation of interest rates over the coming three years:

- Foreign-currency interest before renminbi interest
- Loan interest before deposit interest
- Rural areas before urban areas

The first step taken was deregulation of foreign-currency loan interest and large-deposit interest rates, starting in September 2000. Since then there has been no significant progress. Conversely, the regulation of small-scale foreign-currency deposit interest, applicable solely to regional banks, has been made applicable to foreign banks subsequent to accession.

Frequent reports have been made, after accession, of the expanded presence of foreign banks, but the competent authorities cannot avoid imposing some constraints on their competing with domestic institutions, and therefore it is difficult to proceed with interest rate deregulation in the manner that had been initially expected.

China's Issues and Needs
(Memorandum by Associate Prof. Sayuri Shirai, Keio University, during the field study)

- China has been working at banking reform since 1994. First, three policy banks were created in 1994, and the policy finance function was shifted from the four major wholly state-owned banks to the three new policy banks, in order to reform bank management, and also because of the necessity to clarify managerial responsibility resulting from the growth in non-performing loans. Moreover, the right to appoint branch managers was transferred from the regional governments to the central government in order to reduce the intervention of regional governments in bank finance decisions. Formation of several new banks was authorized and there was some deregulation of interest rates. Improvement of accounting standards and prudential regulations were made mandatory.
- Even though policy finance was taken out of the hands of the state-owned banks, they still receive loan requests from the central government and state-owned enterprises that require large-scale finance, for the development of West China and for infrastructure improvement projects. Loans by state-owned banks for state-owned enterprises accounts for 70% of all loans. Further, ownership of Treasury bonds by the four banks on average rose from 3% of total assets to 11% in 2000. Similar ratios are seen at other banks.
- A credit crunch has occurred with the increased pressure on the government to reduce the non-performing loans in connection with accession to the WTO. The credit crunch has become more serious as a result of introduction of the lifetime responsibility system at state-owned banks. Further, the base-lending rate of the People's Bank of China has a ceiling, and the limit for small business loans is 30%. The limit for lending to rural cooperatives is 50%. Even though the banks are given some discretion in freely determining interest rates within a certain range, the upper limits are not high enough. As a result supply has failed to meet demand, and loan transactions take place on the black market at very high interest rates. This has had the effect of forming a credit crunch for companies that are not state owned.
- Therefore, although it is necessary for China to have a policy of improving capital adequacy ratios and balance sheets, this has also encouraged a shift from loans to the holding of Treasuries, and the country faces a particular challenge in increasing loans to non-state-owned companies.
- Further, despite these banking reforms, the return on assets of the four banks during the 1994-2000 period was no better than the 0.1 to 0.2% level. Moreover the oligopoly position of these four banks has continued with the stock of these banks in the total deposits of all banks holding steady at the 70% level since 1996. Further, even though RMB 1.4 trillion of NPLs were transferred to asset management companies in1999, the NPL ratio has remained high, at about 25%. Therefore, the banking reforms cannot be said to have had a substantial effect.

- Balance sheets of the four banks are by no means healthy in appearance, because of the high ratio of NPLs and their inadequate capital adequacy ratios, but their continued existence is made possible by the growth of deposits taken in by the banks. A shift of deposit assets has recently become evident, moreover, from other urban banks (almost all owned by either regional governments or SOEs, except Minsheng Bank) to the four banks, because of a feeling on the part of the population at large that since the central government owns these four banks completely, the central bank will guarantee their deposits. Rapid growth in bank deposits is also explained by a lack of asset allocations options for the Chinese people, in that other types of financial institutions are underdeveloped.

- Furthermore, banking reform must be taken as one with the issue of SOEs. Because almost all of the 1,100-odd listed companies are government owned, there is virtually no procurement of capital in the stock market by non-government-owned companies. Banking reform thus constitutes an urgent task that must be addressed in order to alleviate the credit crunch afflicting non-government owned SMEs.
- Given the above, possible assistance from Japan would first include technical support in connection with new banks on the private sector level. Reform of the four large banks involves political issues and is likely to take considerable time. Licensing of new banks is thus one way to quickly achieve reform in banking. It is planned, furthermore, to approve the entry of foreign banks in the near future, as part of changes associated with WTO accession. These banks, however, are likely to concentrate on doing business with foreign companies and leading Chinese companies, and on interbank business, as they will lack domestic networks. It is therefore necessary to keep in mind that liberalization of barriers to entry is not likely to immediately lead to increased competition with existing banks that have extensive banking networks.
- Second, interest spreads in China will inevitably narrow as liberalization of rates proceeds, resulting in narrower profit margins for fund-supplying institutions. This would make it necessary for the banks to diversify their business (such as by entering brokerage business). New prudential rules and internal risk management systems will be needed if banks assume new risks through diversification. Given that Japan is facing these issues itself, it is probably a poor model, but it would be possible to provide technical cooperation, including lessons learned.

3. Accounting

(1) Institutional and Policy Framework

Corporate law provides the basic legal framework for China's accounting system. The Corporation & Company Law was proclaimed on December 29, 1993, as Directive number 16 issued by the President of the PRC. It required companies to maintain books and publish financial statements.

The Accounting Law[17] requires all organizations in China to comply with the accounting procedures provided for by the law.[18] The law sets forth general provisions, regulations for accounting supervision, accounting bodies and accounting personnel, and legal responsibility.

Under the Accounting Law, authority for setting accounting standards resides with the Ministry of Finance's Department of Administration of Accounting Affairs (DAAA). The Basic Standards for Business Enterprises provides the framework for all aspects of the accounting system, in keeping with the Accounting Law. The objective of these Standards is to unify accounting standards, and assure the quality of accounting information.

In 1995 China announced its basic policy toward introducing International Accounting Standards (IAS), in which it decided to introduce IAS on a gradual basis. This can be said to indicate that China has entered a new stage in view of considerations such as raising funds on international capital markets.

[17] Passed in 1985, amended in 1993 and 2001.
[18] Accounting Law, Article 2.

(2) Present Conditions of the Accounting System

Three major reforms have been accomplished thus far in the accounting system. The first is in the formulation of basic standards and practices for corporate accounting. In keeping with requirements attending the transition to a market economy, work on drafting 30 basic standards was begun in 1992, with assistance from the World Bank, and as of now, 16 have been adopted.[19]

Second is the announcement of the "Corporate Accounting System"[20] in 2000. This system provides uniform, national standards, set by the Ministry of Finance, that give consideration to actual conditions in China, and are not direct adaptations of IAS. Therefore, while giving due attention to international accounting practices, they also have characteristics specific to China with regard to the valuation of financial products,[21] and accounting regulations in connection with transactions between related companies,[22] so Chinese accounting has retained some of its own characteristics.[23]

Third, the Accounting Law was amended in late 2001 with the intention of achieving greater harmonization with IAS.[24]

(3) Issues

The following are the major issues in the field of accounting.[25]

- Amendment of the Accounting Law (end of 2001) bringing Chinese accounting closer to IAS is useful for procurement of capital overseas, but does not include small business within its scope. The Ministry of Finance is working on "Small Business Accounting Standards" and expects to complete work by the end of 2002. It appears, however, that a shortage of technology and experience in this field has been encountered in the work of drafting standards.
- As a consequence of the great changes recently made in accounting standards, some confusion has been evident on the part of those charged with preparation of financial statements or auditing.[26]

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[19] In 1993 the DAAA released the Accounting Standards for Business Enterprises (ASBE). These provide the general framework for corporate accounting. An Accounting Standards Committee was formed within the DAAA in 1998 and has been working at drafting and revising standards. Use of the standards is mandatory under law, which is one of the unique features of China's accounting system, and apparently they interview foreign and domestic specialists at the time of amending the standards, in order to make the standards reflect actual practice.

[20] These correspond to Japan's Regulations on Financial Statements, Etc., and set forth particulars such as the elements of accounting guidelines (including the principles of accounting and the content and statement of line items) as well as the details of line items, and the form and method of preparation of financial statements.

[21] Acquisition cost, not market value, is used.

[22] Separate rules are necessary in connection with these transactions because many transactions between related companies are set at a price that differs from the market price.

[23] In addition, R&D expenses must be written off each year whereas IAS No. 38 provides for treatment of them as deferred assets.

[24] This incorporated amendments of some items that did not match the Chinese situation. Major revisions were for (1) asset valuation, and (2) non-cash transactions. Concerning asset valuation, many of the listed companies are state-owned that were listed in order to utilize the potential of capital procurement and improved image for attracting superior personnel, but without fully going through major reforms to make them more like private companies. There are instances in connection with either the listing of an SOE or SOE merger when re-valuation of assets according to IAS would disclose that the assets were over-valued. In China, where the basis for valuation is not sharply defined, the valuation of company assets can easily be an artificial valuation and as a result stock prices are inflated, so when actual conditions become known prices can collapse, causing considerable damage. Regarding non-cash transactions, the standard reverted to the Chinese practice of using the same prices when equal value is exchanged, and the payment differential when different values are exchanged.

[25] Based on field interviews by this working group in June 2002.

[26] The Corporation Law requires all limited liability companies to have annual audits. Listed companies are required by the Securities Exchange Law to have midterm and full-year financial statements audited. SOEs receive separate accounting audits under the Accounting Audit Law. According to field interviews (including the Deloitte Touche Tohmatsu China office), audits of SOEs are a matter of work at the local level, and since several years ago foreign accounting firms have been

- There is a shortage of public accountants,[27] and bookkeepers working in corporations[28] and there is a particularly serious issue in terms of quality and quantity among small businesses. It is important that the operations of the professional accountants association be strengthened as a means of developing CPAs.
- It is only SOEs, listed companies and foreign investment companies that are required to have outside audits. For all other companies, there are tax audits by the tax authorities, but there are still doubts about the quality level of "company auditing."[29]

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contracted for this work. According to the Accounting Audit Law, SOEs consist of (1) corporations receiving subsidies, (2) public interest corporations, (3) state-owned enterprises, and (4) state-owned asset holding companies.

[27] Public accountants are chartered by the Chinese Institute of Certified Public Accountants. There is a uniform national examination, and two categories of CPA, the professional accountant who is a person engaged in an accounting firm or elsewhere and doing audit work (about 55,000 persons) and non-professional CPAs who work in government or public companies (about 70,000). The CICPA drafts its own accounting standards and ethical rules for CPAs.

[28] "One qualification available for bookkeepers at corporations is that of a "corporate accountant." Corporate accountants must satisfy two requirements: accountant licensing (not to have prepared false financial statements, and to pass an examination, are required), and to be publicly certified (meaning having passed an annual standard national examination; practical experience is required in order to sit for the exam). First-level qualification has been granted to 1,790,000 persons, and medium-level qualification to 500,000). Nevertheless corporations are not required to hire a qualified corporate accountant. Moreover small businesses are eligible to make use of the "contract bookkeeping system" in which they do not need to employ a qualified person but can have an agent keep their books.

[29] Based on interviews at Deloitte Touche Tohmatsu China on June 6, 2002.