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Financial Liberalization and Prudential Regulation in East Asia: Still Perverse?

Andrew Walter

Institute of Defence and Strategic Studies
Singapore

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ABSTRACT

Most authors now accept that in the context of financial liberalization and deregulation, weak prudential regulation and institutions created substantial vulnerabilities in various Asian countries in the lead-up to the 1997-8 financial crises. The proposed solution, touted by the leading developed countries and the major international financial institutions and accepted by most governments in Asia, is to upgrade the domestic economic governance framework in key emerging market countries. A core element of recent IMF packages has been to facilitate a move from a ‘relational-patrimonial’ system of financial regulation towards a western-style ‘rules-based’ system of prudential regulation and supervision. At the same time, the process of financial liberalization begun in the 1980s in the crisis countries has been entrenched and accelerated by the IMF programmes of the late 1990s. I argue that in spite of all the efforts at regulatory upgrading, prudential regulation continues seriously to lag the process of financial liberalization. That is, sequencing remains perverse in most East Asian countries, essentially for political economy reasons. Implementation failures are rife in a number of crisis-hit countries. The international financial community has considerably underestimated the difficulty of upgrading domestic regulatory frameworks and institutions in the crisis countries. Formal convergence towards western regulatory standards has occurred, but divergence continues in practice given strong pressures for regulatory forbearance in countries with unresolved financial and corporate sector problems.

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FINANCIAL LIBERALIZATION AND PRUDENTIAL REGULATION IN EAST ASIA: STILL PERVERSE? ¹

Introduction

Initially, two explanations of the 1997-8 Asian crisis dominated the literature: an international and a domestic-level explanation. The first located the origins of the crisis in unregulated and volatile international capital flows (Radelet and Sachs 1998; Wade and Veneroso 1998). The domestic explanation focused on the ways in which cronyism, corruption and poor domestic governance generally exacerbated problems of moral hazard (Krugman 1998; Corsetti et al 1998). The latter explanation predominated in official circles in the developed world and arguably played an important role in the design of the structural reform packages attached as conditions of the IMF-led rescue packages (Blustein 2001).

Since then, there has been some convergence between these polarized positions (Eichengreen 2000; Hamilton-Hart 2000; Krugman 1999; Noble and Ravenhill 2000; Rosenbluth and Schaap 2002; Stiglitz 1998). This emerging consensus accepts elements of both of the early explanations. It accepts that domestic governance failures cannot explain why and when the crisis began, since such failures had persisted for some time before the crisis. However, domestic level factors rendered financial liberalization a much more dangerous proposition.² Thus, most commentators have largely accepted the core of the domestic explanation. In the context of financial liberalization and deregulation, weak prudential regulation and institutions created substantial vulnerabilities in various developing countries. As an IMF review in 2000 stated, ‘financial sector vulnerability was at the root of the Asian crisis.’ (Boorman et al. 2000: 5). The moral hazard problems

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¹ First draft, October 2002. Please do not cite without author’s permission (email: a.walter@lse.ac.uk).
² One prominent line of argument in the debate over the Asian crisis was that the IMF was mistaken in requiring so-called ‘structural’ reforms to the Asian countries, and that its conditionality should have concentrated only on its core areas of expertise in monetary and fiscal policy (Feldstein 1998). However, this was less a disagreement concerning the importance of an adequate financial regulatory framework than about the legitimacy and appropriate scope of IMF conditionality.
associated with a politically and economically important banking sector may be increased by financial liberalization that erodes bank profitability. That is, greater competition may lead banks to take greater risks to sustain levels of profitability previously ensured by government restrictions on competition in the banking sector. Consistent with this argument, studies on banking and currency crises have found previous financial liberalization to be a significant predictor of future crises (Demirgüç-Kunt and Detragiache 1998; Glick and Hutchison 1999).

The proposed solution, touted by the leading developed countries and the International Financial Institutions (IFIs), is also essentially domestic in character: it demands the upgrading of the domestic economic governance framework in key emerging market countries. A key objective of government policy, and a core element of the IMF packages, has been to facilitate a move from a ‘relational-patrimonial’ system of financial regulation towards a (western-style) ‘rules-based’ system of prudential regulation and supervision. In the meantime, the process of financial liberalization begun in the 1980s in the crisis countries has been entrenched and accelerated by the IMF programmes of the late 1990s. The conspicuous exception, in the early post-crisis phase, was Malaysia, which reversed its pre-crisis levels of financial openness. More recently, however, even Malaysia appears to be converging with this broad approach.

I argue that in spite of all the efforts at regulatory upgrading, prudential regulation continues seriously to lag the process of financial liberalization. That is, sequencing remains perverse in most East Asian countries, essentially for political economy reasons. The following section outlines briefly how the literature on the appropriate sequencing of financial liberalization gave little attention to governance/prudential regulatory preconditions. A third section outlines various political economy reasons why prudential regulatory standards have lagged financial sector liberalization, both before and after the crisis. A final section concludes. The argument is that the international financial community has considerably underestimated the difficulty of upgrading domestic regulatory frameworks in the crisis countries. Formal convergence towards western regulatory standards has occurred, but divergence continues in practice given strong pressures for regulatory forbearance in the crisis-hit countries.
Financial Liberalization: Sequencing Arguments and the Washington Consensus

There is a substantial literature on the appropriate sequencing of capital account liberalization that goes back to McKinnon (1973) and Shaw (1973). The broad policy conclusion of this literature was that financial sector ‘repression’, common in developing countries, should only be removed gradually, and only in the wake of other policy reforms. In particular, fiscal consolidation/tax reform and price stabilization should precede and facilitate domestic financial liberalization (raising real interest rates to encourage savings to flow into the banking sector). Exchange rate reform should precede the liberalization of the current account (trade). External financial liberalization should come last. As McKinnon (1973: 4) warned, ‘the absorption of substantial amounts of foreign capital during the [trade] liberalization process may … be a serious mistake.’ McKinnon was especially critical of the Latin American strategy of maintaining substantial trade restrictions whilst allowing in foreign direct investment, and held out the opposite Japanese strategy (which included controls on FDI as well as portfolio capital inflows) as a more appropriate model for developing countries.

There were important weaknesses in this literature. First, it said little about why in practice so many countries diverged from optimal sequencing. The assumption was that appropriate sequencing was essentially an intellectual problem to be discovered by economists and then applied by governments. Second, the role of prudential regulation of the domestic banking sector was barely mentioned in this early literature. This was an important gap since, as various financial crises would later show, the upgrading of the financial regulatory framework was arguably another essential prerequisite of financial sector liberalization.

Arguments about the optimal sequencing of reforms were somewhat strained by the triumph of the ideology of market liberalism from the late 1980s. Poland’s ‘big bang’ liberalization of 1990, to cite the most prominent example, effectively liberalized everything at once, well in advance of the construction of robust governance institutions.

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4 Diaz-Alejandro (1988, originally published 1985) argued that the Chilean crisis of the early 1980s was due to a combination of premature financial liberalization and lax prudential regulation.
appropriate to a market economy. McKinnon’s later (1993) book, firmly in the gradualist camp, argued that this kind of strategy was misguided, and that gradual sequencing, with foreign bank entry and capital account liberalization in particular coming last, was necessary (McKinnon 1993: 4-10). He made some passing remarks about institutional preconditions, such as the need to establish a framework of enforceable commercial law before the financial sector was liberalized (ibid., p.7). In chapter 7, he argued that an effective prudential regulation framework is especially crucial in countries experiencing macroeconomic instability.5 Although he accepted that effective prudential supervision was necessary even in macroeconomically stable countries, the emphasis on macroeconomic instability as a key source of financial sector misbehaviour was consistent with the dominant view of the time.

This dominant view was embodied in the so-called Washington Consensus on appropriate development policy of the early 1990s. The emphasis was firmly upon the combination of macroeconomic stabilization, trade and financial liberalization, with less attention to appropriate sequencing (Naim 1999). However, there was little attention given to the institutional/governance requirements of financial openness (with the possible exception of the now standard recommendation of central bank independence in monetary policy). Before and after the Asian crisis, the US government was also pushing financial liberalization for its own purposes, though it continued to argue that financial liberalization had welfare benefits for the countries involved (US Treasury 2000). As Lawrence Summers, then America’s deputy Treasury Secretary argued in 1997, ‘financial liberalization, both domestically and internationally, is a critical part of the US agenda.’ The IMF itself, with its limited institutional knowledge of banking sector regulation, was also guilty of the same myopia.

After the Asian crisis, the emphasis upon institutional and governance reforms, including the upgrading of prudential regulatory frameworks, has of course been much greater. But this has not entailed the rejection of the Washington Consensus; on the contrary, the consensus has merely been supplemented. Financial liberalization continues to be promoted as welfare enhancing, with the additional proviso that an effective

5 This is because macro instability creates positive covariance of default rates amongst bank borrowers, providing banks that have deposit bases guaranteed by the government an incentive to bet on favourable macro outcomes through overlending (McKinnon 1993: 90).
prudential regulatory framework is in place. Thus, the official Washington view has not been substantially altered: the dilemmas created by financial liberalization require not a return to financial repression and closure, but the construction of the necessary infrastructure to make the world safer for capital mobility. Larry Summers’ well-known airline metaphor captures the dominant view nicely, which is that financial liberalization is worth having despite the risks, and that the solution is to build a (domestic) regulatory infrastructure that can support it.

In keeping with this enhanced Washington Consensus, recent literature has explicitly recognized effective prudential regulation as a necessary precursor to financial liberalization (Williamson and Mahar 1998). In this view, the appropriate sequence is now macroeconomic stabilization, enhanced prudential supervision, and only then capital account liberalization. Barry Eichengreen (2000: 184) makes a similar argument:

problems in these areas [bank regulation, corporate governance, accounting, insolvency codes, etc] are too pressing to do nothing. If the Asian crisis has taught us one thing, it is that countries cannot restore exchange rate and balance of payments stability without rectifying deficiencies in their domestic financial systems…The particulars of these arrangements can differ – countries can reach these goals by different routes – but any country active in international financial markets must meet internationally accepted standards.

If it is suggested that the costs of this infrastructure may be too great, the standard response is that the required reforms are ‘necessary’ anyway, and that the benefits of having them extend well beyond the financial sector. However, it is very difficult to find serious assessments of the costs of domestic governance reform.

With this in mind, it is worthwhile enumerating just how extensive the ‘governance requirements’ of the new consensus have become. Mishkin (2001) argues that in order for financial liberalization to work and to make financial crises less likely, various institutional/governance prerequisites are necessary, including: 1) adequate prudential supervision, 2) high accounting and disclosure standards, 3) effective legal and judicial systems, 4) the facilitation of market-based discipline through entry and exit policies, competition policy, etc, 5) reduction of the role of state-owned financial institutions, and 6) elimination of too-big-to-fail in the corporate sector. These are in addition to the
standard macro- and micro-economic requirements of the early 1990s. As this list implies, this ‘enhanced’ Washington Consensus agenda is vast. Yet this ambitious new agenda was clearly reflected in the various structural conditionalities attached to the IMF-led rescue packages for Thailand, Indonesia and Korea (Kapur 2001, and see figure 1).

The consensus is now captured in figure 2. In the standard scenario, countries typically move from quadrant I to II, creating moral hazard problems and greater financial fragility in the process. A number of the so-called ‘systemically important’ emerging market countries went through this process in the 1980s and 1990s. In the past, extensive restrictions on the financial sector, including barriers to entry, legal limits on the ability of financial firms to offer different financial services, the regulation of interest rates, branching limits, etc, may have served as a form of prudential supervision (quadrant I). By raising bank profits, they may reduce incentives for banks to engage in risky lending (Hellman, Murdoch and Stiglitz 2000). Banks in such regulatory environments typically
constitute a kind of protected oligopoly; their centrality to the domestic financial and political system ensures they are too important to fail (Rosenbluth and Schaap 2002). Close relationships between banks and bank regulators are common, and regulation is more relationship-based than rules-based. The moral hazard implications of such protective prudential regimes may require substantial limits on the operating freedom of banks. Once these kinds of restrictions on the operating freedoms of banks are removed, competition intensifies and relationship-based regulation breaks down. Since risk-taking by banks may become excessive, enhanced regulation according to a ‘rules-based’ framework becomes necessary (quadrant IV).

Figure 2: Combining Prudential Supervision and Financial Liberalization

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<tr>
<td></td>
<td>Low</td>
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<tr>
<td>I. Profit-padding regulation</td>
<td></td>
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<tr>
<td>II. Moral hazard danger</td>
<td></td>
</tr>
<tr>
<td>III. Excessive protection</td>
<td>Low</td>
</tr>
<tr>
<td>IV. Competitive regulatory</td>
<td>High</td>
</tr>
<tr>
<td>environment</td>
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[adapted from Rosenbluth and Schaap 2002: 8].

However, this simple matrix does not allow us to make a cost-benefit calculation about the net benefits of shifting from quadrant I to quadrant IV, not least when economists dispute the growth benefits of financial liberalization.6 This is doubly so because the consensus approach also underestimates the difficulties of governance reform. It is not simply a matter of adopting ‘international best practices’ in legal frameworks and operating principles for prudential supervision, and enhancing the ‘capacity’ of officials to

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6 For recent discussions, see Klein and Olivei 1999, and Arteta, Eichengreen and Wyplosz 2001.
understand and implement these new rules. If the rules change, but chronic governance failures persist, new and possibly even more devastating financial crises may occur.

The Political Economy of Financial Liberalization and Prudential Supervision

The standard pattern is for countries to ignore the wisdom of economists who have written about sequencing. In particular, many countries, developing and developed, have chosen to deregulate financial sectors and to open capital accounts well before other appropriate policy conditions are in place, including new and enhanced levels of prudential regulation and supervision of banks and non-bank financial institutions (NBFIs). Given the uncertain net benefits of financial liberalization, especially for developing countries, and the evidently large costs of financial crises (Barro 2001), the question arises as to why politicians would delay enhancing prudential supervisory frameworks.

Even some political scientists (e.g. Rosenbluth and Schaap 2002: 8) argue that financial liberalization and weak prudential supervision are such a dangerous combination that it is rare and unlikely to persist for long. However, it appears that perverse sequencing is the norm rather than the exception, and that it can persist for long periods. Indonesian financial liberalization, which began in the early 1980s, was followed by some (largely ineffective) efforts to raise prudential standards only in the early 1990s. Dramatic improvements to prudential supervisory frameworks typically follow rather than precede crises. Prime examples are the enhancements to the Federal Deposit Insurance Corporation (FDIC) Act of 1991 in the US in the wake of the S&L crisis, and the extensive reform programme of many East Asian governments in the wake of the regional financial crisis of 1997-8. But even then, as I argue below, this is usually insufficient.

Explaining the Demand and Supply of Prudential Regulation

There are various political economy reasons why perverse sequencing is the norm rather than the exception, and why it is likely to continue to be the case in a number of important developing countries in the Asian region. I do not investigate the relevant
hypotheses formally in this paper, partly because of the small number of cases, partly because the explanations are not mutually exclusive. However, I make comments as to their plausibility in the Asian context.

One possible explanation is that technical knowledge was imperfect concerning optimal sequencing, especially regarding the importance of enhanced prudential supervision. Even in the midst of the Thai crisis of July 1997, the comparatively good macroeconomic characteristics of countries like Indonesia, Korea and Malaysia led many commentators to downplay the likelihood of the crisis spreading beyond Thailand. But there are difficulties with this argument. First, in a number of countries, including Indonesia and Korea, there are indications that policymakers perceived the need to improve prudential supervision at the same time as financial liberalization was continuing. There were attempts in Indonesia, for example, to impose new limits on related party lending by banks in the early 1990s. Many developing countries adopted the Basle I capital adequacy ratios (CARs) in the early and mid-1990s. In Indonesia, Thailand and Korea, as in a number of other countries, the problem was often that these new prudential rules were simply not enforced.

A second explanation is that financial liberalization is simply much easier to implement than is enhanced prudential supervision. The former requires minimal institutional capacity, since it involves removing pre-existing controls. Thus, in countries with weak government, deregulation is the easier option. Enforcing new prudential rules may simply be impossible with existing bureaucratic resources. This may discourage policymakers from attempting to raise prudential standards in the first place, or to undertake financial liberalization first in the hope that stronger prudential rules and enforcement may be achievable in the longer term (particularly if they estimate the risks of this strategy to be limited). There is evidence that this strategy was indeed pursued by technocrats in various countries. However, the argument is more plausible in the Indonesian case than in the Korean. Even in the former case, resource constraints are very unlikely to be the only or even the main explanation of regulatory failure.

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7 Author interviews, Ammar (Thailand, March 2002); Soedradjad (Indonesia, May 2002).
A third set of explanations focuses on political institutions. It is sometimes argued that democratisation has hampered the institutional reform process in East Asian countries, notably in Thailand before the crisis, and in Thailand and Indonesia after the crisis. By contrast, the comparatively unreformed polities of Singapore and Malaysia have by many accounts achieved better results. In the case of Thailand and Indonesia, there has been a sharp increase in the number of veto players since 1997-8, who may block reform at key points in the political process (see table 1). The post-crisis constitutional reforms in Thailand have created a system of checks and balances that has substantially weakened the ability of the central government to achieve reform. The result has been a prolonged delay in key legislative reforms, including a proposed new companies act, Bank of Thailand independence, and outstanding weaknesses in the bankruptcy code. In Indonesia, a much more powerful but fragmented parliament has also complicated the reform process, not least in the area of judicial reform (see below). By contrast, in Singapore and Malaysia, fewer veto players have made reforms politically easier. Although plausible, this argument is not wholly convincing: the democratic political systems of countries (and substantial constraints on the executive branch) like the UK, US and Australia have not been an obstacle to these countries adopting enhanced prudential regulatory frameworks.

### Table 1: Political-institutional Characteristics, 5 Asian Countries

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<tr>
<td>Indonesia XCONST=6</td>
<td>PR (closed list)</td>
<td>Civil law</td>
<td>Families, state (banks)</td>
<td>Yes (BI); plans 'FSA'</td>
</tr>
<tr>
<td>Thailand XCONST=7</td>
<td>PR</td>
<td>Civil law (?)</td>
<td>Families, state (banks)</td>
<td>Not yet (BOT)</td>
</tr>
<tr>
<td>Korea XCONST=6</td>
<td>Mixed</td>
<td>German</td>
<td>Families, companies, state (banks)</td>
<td>Yes? (FSS/FSC)</td>
</tr>
<tr>
<td>Malaysia XCONST=4</td>
<td>Plurality</td>
<td>Common law</td>
<td>Families, state (banks)</td>
<td>No (BNM)</td>
</tr>
<tr>
<td>Singapore XCONST=3</td>
<td>Plurality</td>
<td>Common law</td>
<td>Families, state (banks)</td>
<td>No (MAS)</td>
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Electoral laws may also affect the incentives for elected politicians to undertake prudential reform. Rosenbluth and Schaap (2002) discuss how centrifugal and centripetal electoral systems create tendencies for politicians to cater to the preferences of the median voter. The Institutional Reform Index, which measures the extent to which institutional reforms have been completed, suggests a positive correlation between political stability and the implementation of necessary reforms. This indicates that institutional reform is not only influenced by the political context but also by the broader institutional environment.
voter or to narrow electoral interests respectively. Politicians in centripetal electoral systems tend to resist raising prudential standards because it may undermine the position of banks, who are often substantial contributors to political financing and play important roles in local economies.\(^8\) Proportional representation rules in particular tend to create weak parties, with politicians appealing to organized interests rather than the median voter. Again, the greater success in prudential reforms of Malaysia and Singapore (as compared to Indonesia and Thailand) might be due in part to this difference, but it is unlikely to be the whole story.

A fourth explanation focuses on legal frameworks. Most notably, the common law legal frameworks inherited from Britain by Malaysia and Singapore appear to have left these countries with much more effective corporate law (in general, see La Porta et al 1998a, 1998b). Bankruptcy systems in particular are much more effective in the ex-British colonies than in other Asian countries.\(^9\) This may counterbalance two other institutional factors which otherwise tend to bode poorly for effective prudential supervision and which are generally shared across the countries in table 1: ownership structures dominated by families and the state, and politically subordinate supervisory institutions (except, in theory, Bank Indonesia since 1998). The problem with the legal origin hypothesis is that it does not specify why countries so ‘burdened’ with civil law frameworks do not simply change them. Explaining this may require attention to electoral rules, veto players, and so on. In the case of Indonesia, a new ‘state-of-the-art’ corporate bankruptcy regime has been rendered ineffective by extensive judicial corruption and incompetence.

A fifth set of explanations focuses on distributional factors and sectoral interests. Hamilton-Hart (2000: 110) argues that financial liberalization typically precedes the enhancement of prudential supervision for a simple reason: the benefits of financial liberalization are concentrated (amongst borrowers and some financial sector firms), while the costs are diffuse and often delayed. Conversely, the benefits of prudential supervision

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\(^8\) One example is Japan, where local banks they have been heavy lenders to nokyo, or private agricultural cooperatives, which are electorally influential (Amyx 2000: 139).

\(^9\) In Thailand, the backlog in the commercial court runs up to 10 years. In Indonesia, despite the new bankruptcy framework, IBRA (the state-owned bank asset management agency) has yet to win a case in the commercial court. Most commentators agree such outcomes are due to a combination of incompetence and high levels of corruption.
(preventing crises) are diffuse, while the costs are concentrated. This means that organized lobbies have strong incentives to push for financial sector liberalization, but financial sector lobbies have little interest in pushing for enhanced prudential supervision, the costs of which may fall mainly upon them. Large borrowers may also oppose stricter prudential regulation if this raises the costs of finance. In countries such as Indonesia, Thailand and Korea, where company groups often used related banks and NBFIs as a source of intra-group financing, the costs of imposing and enforcing new rules limiting related lending and single/group lending limits were particularly costly for powerful lobbies.

Post-crisis: Explaining Formal Convergence with Regulatory Forbearance

The above discussion helps to understand why prudential regulation was limited in various Asian countries before the crisis, and why enhancements to prudential supervisory frameworks tend to follow crises. Politicians in Asian countries since 1997 have come under considerable pressure from voters and the IFIs to be seen to raise prudential standards. Furthermore, large debtors and banks have found it much more difficult to oppose such reforms compared with the pre-1997 period. However, there is no easy way out for governments when the banking sector is burdened with high non-performing loans (NPLs), since raising prudential standards may also raise the fiscal costs of crisis resolution if this in turn requires the government to recapitalize banks. In such circumstances, the costs of raising prudential standards may be high for the financial sector itself, for heavily indebted firms and sectors, and for the median voter. This in turn can unleash a political struggle over the distribution of resolution costs. Politicians may try to square the circle by raising formal prudential standards, but encouraging the financial supervisory authorities to forbear in terms of their implementation, even if this raises the ultimate cost of resolving the financial sector problems.

Whether banks themselves favour full recognition of NPLs and government recapitalization, or continued regulatory forbearance, depends on the relative costs of these strategies. When the supply of funds for bank recapitalization is limited (as most notably in Thailand and Indonesia), bank owners tend to favour forbearance in the hope that future government support may be forthcoming, or that the cost of new equity will eventually fall
so as not to dilute their control. The severity of the conditions attached to bank recapitalizations is another factor. In Thailand and Korea, recapitalizations entailed the removal of incumbent management, the writing down of existing shareholders’ equity stakes, the publicization of past lending practices, and in some cases prosecution. In many cases insolvent banks have had no choice but to accept government intervention, entailing closure or recapitalization.

However, the government itself may have an incentive to underestimate the required level of recapitalization of banks, and thus to forbear once it acquires such banks. New owners of privatised banks may also favour forbearance. In Indonesia, the costs (to existing owners and management) of recapitalization have sometimes been sufficiently limited to make recapitalization an appealing option. In order to encourage private sector bank owners to contribute new equity funds (up to 20% of the recapitalization; the government contributed 80%), their equity was not fully written down, and incumbent managements were left in place. The result, as in the case of BII, was that management continued to siphon off bank funds to related party borrowers.

Regulatory Forbearance After the Crisis: the Case of CARs

Of course, regulators in the crisis-hit countries strenuously deny that they are engaged in regulatory forbearance. They claim that they strictly implement new rules relating to loan classifications and provisioning for NPLs, and that discretion is effectively ruled out by new automatic prompt corrective action (PCA) rules. Typically, such rules have been closely adapted from the US FDIC model, which were rewritten in 1991 in the wake of the S&L crisis. As noted above, both internal and external pressure has required these countries to raise their formal regulatory standards to ‘international’ levels. However, this has simply meant the opponents of reform have concentrated their efforts on undermining the implementation of the new prudential rules. This outcome might be described as *formal regulatory upgrading with continued regulatory forbearance.*

If, as argued above, the demand for regulatory forbearance has increased since the crisis, there is also little doubt that it continues to be supplied in practice, whatever the

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protestations of regulators. The ambiguity of the rules themselves facilitates forbearance, as does the fact that regulatory interpretations of the rules are often hidden from public view. The political dependence of bank regulators in the region has been another facilitating factor. However, as noted above, the degree of legal autonomy enjoyed by bank regulators in Asian countries bears little relationship to the effectiveness of regulatory improvements. In the case of Indonesia, a newly independent Bank Indonesia is subject in practice to considerable pressure from parliament.

In this section, I focus on the way in which official capital to (risk-weighted) asset ratios – the Basle CARs – may overstate the real levels of capital in banks. This also makes official CARs very difficult to compare across countries.

**Loan Accounting Rules**

Countries account for NPLs very differently, though there has been some convergence in loan accounting standards in recent years towards the US system. Loans are typically defined as under-performing when an outright default occurs, and when repayments are classified as ‘overdue’. However, the time period by which such loans are judged overdue can make much difference. In Korea and Japan before the crisis, loans were judged non-performing if repayments were overdue for more than 6 months, compared to the US standard of 90 days. Most countries in the region have, since the crisis, converged upon the 90-day standard.

Ambiguity arises in the application of this rule, however. Loans with concessional terms (those that have been restructured via extended maturities or reduced interest rates) may or may not be included in the definition. This can have a big impact in crisis countries. The definition of concessional terms may also be more or less strict. In Indonesia today, both the banks and the regulator (BI) classify as ‘pass’ many loans that have been restructured. The IMF has forced BI to include a separate line for restructured but passed loans in its monthly reporting requirements for banks, so that in principle one can add these back in to official NPLs. However, the relatively small numbers of

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11 This system classifies loans as pass, special mention (sometimes ‘precautionary’), substandard, doubtful and loss (see Comptroller of the Currency 2001: 36-7).
restructured loans reported by Indonesian banks (see table 2 at the end of this paper) raises questions as to whether this requirement encourages banks not to report some problem loans as restructured.

In Thailand after the crisis, debt classified as doubtful or loss was reclassified as substandard when a debt restructuring agreement was signed. Debt classified as substandard or special mention remained in that category until 3 months of repayments or 3 instalments were fulfilled, after which they are upgraded to the pass (accrual) category. This less conservative standard (compared to the US, which requires 6 months of repayments) was further relaxed on 10 April 2000, allowing the immediate reclassification of restructured loans to accrual status that satisfy certain criteria. However, Thai banks are not required to report the total amount of such restructured debt in accrual status, unlike in Indonesia.

In Korea, the adoption of US-style ‘forward-looking criteria’ (FLC) for loan classification since 1999 has possibly provided it with a more strict classification system than those in Southeast Asia. FLC systems rely heavily upon credit rating skills within banks and on the part of ratings agencies. In less developed countries like Thailand and Indonesia, such skills are often lacking, and few firms have credit ratings. Even in Korea, only the largest firms are rated, so that banks must also rely on backward-looking criteria (credit history) in loan classification. Thus, the difference between Korea’s system and those of Indonesia and Thailand may be less in practice than at first appears. Furthermore, in contrast to loan classification systems that rely only upon a borrower’s repayment history, FLC introduces an element of judgement and hence room for discretion.

Provisioning Rules

Banks are typically required to set aside ‘loan loss provisions’ against outstanding loans. The US system requires different percentages of total loans to be set aside as provisions, depending upon the classification of each loan according to the accounting rules. For example, the new Thai system requires the following percentages of loan loss provisions for each category of loan: Normal, 1%; Special Mention, 2%; Substandard, 20%; Doubtful, 50%; Loss, 100%. Thus, lax accounting rules will overstate real capital
by the total amount that would, under stricter rules, be set aside as additional loan loss provisions.

Furthermore, regulators in Thailand and Indonesia allow banks to deduct from required loan loss provisions the value of collateral (up to 75% of such value in Indonesia, up to 90% in Thailand) attached to each non-performing loan. This assumes that in the event of default, the bank could collect the assumed value of the collateral. Of course, this may not be the case, depending upon the nature of the collateral, the country’s bankruptcy code and judicial system, and how the collateral is valued. In the case of Thailand, the BoT defines the market value of collateral as ‘the probable price on the date of the collateral asset valuation or appraisal under normal market conditions with no transaction costs (nor taxes).’\textsuperscript{12} The ‘normal market conditions’ clause, and the poor quality of valuation firms in Thailand, suggests that collateral is often overvalued, and banks therefore comparatively under-provisioned. Indonesia has a slightly more conservative policy relating to collateral. However, there, as in Thailand, the ability of banks to collect attached collateral through the court system in a timely manner is poor, casting doubt upon the value of such collateral to banks. In Korea, as in the US, collateral is taken into account when classifying loans as substandard or below, though it is not explicitly deducted from the provisioning requirement (Comptroller of the Currency 2001: 37; KorAm Bank, \textit{Annual Report 2001}: 41-2). However, the outsider is largely in the dark concerning the manner in which this classification is done.

\textbf{Deferred Taxes}

Companies, including banks, are often allowed to carry forward losses as assets that can be offset against taxes in future years. These deferred tax assets often have value for a limited period (say 3 or 5 years), but their value depends on the assumption that the bank will enjoy future taxable profits sufficient to utilize the value of the asset. If not, assets will be overstated and their value may subsequently need to be written down, reducing capital. In Japan, for example, where losses can be carried forward for 5 years, Fukao (2002: 5) argues that the likely unprofitability of Japanese banks going forward

\begin{footnotesize}
\textsuperscript{12} BoT, \textit{‘Regulations for Collateral Valuation and Appraisal,’} \url{http://www.bot.or.th/bothomepage/notification/fsupv/2541/thtm/RCVA_DOC}, accessed April 1, 2002. Italics added.
\end{footnotesize}
makes deferred tax assets another source of overstatement of CARs. A similar argument could be made in the case of the many poorly profitable banks in Thailand and Indonesia.

Sources of Capital

A bank’s liabilities such as shareholder equity and subordinated debt make up core capital. However, cross-shareholdings, which are common in a number of Asian (and European) countries, may reduce the real level of capital. If a bank is part of a corporate group, related companies may provide a significant proportion of its equity capital. Supervisors are increasingly attempting to ensure that they supervise financial institutions on a consolidated basis, so as to ensure that capital is not double-counted in this way. However, not all regulators (including those in Thailand and Indonesia) have such authority yet, though they claim to ensure such cross-shareholdings are taken into account in calculating CARs.

Other problems arise over the inclusion of non-equity instruments in bank capital. In Indonesia, IBRA-issued recapitalization bonds form the bulk of Indonesian banks’ reported CARs. If such bonds are held on a banks’ investment book, as most are, they are valued at par (on the argument they are risk-free). If they are held on the trading book they must be marked-to-market, but this can be difficult because of the illiquidity of secondary bond markets. In Thailand, regulators allowed banks to issue expensive hybrid debt instruments (CAPs and SLIPS) and to include these in Tier I capital, as long as maturities were at least 10 and 5 years respectively.\(^\text{13}\) The Bank of Thailand claims these are Basle-compatible, but officials at the BIS are doubtful.\(^\text{14}\) (In the US, approved subordinated debt instruments are only allowable as Tier II capital: Comptroller of the Currency 2001: 40). This makes the official Tier I CAR in Thailand incomparable to those of other countries. In Japan, Fukao (2002: 5-6) argues that real bank capital is systematically overstated because related life insurance companies hold substantial proportions of banks’ subordinated debt (and in turn, the life companies’ debt of which is often held by the banks). The MOF and subsequently FSA have also exercised

\(^{13}\) Such capital must also be fully amortized in the last five years of maturity. Early redemptions are not permitted without BoT permission, which is a problem as the cost of such capital is currently very high, with coupon rates between 15-23\%. This makes it likely that BoT permission for redemption will be granted after 5 years, in 2004.

\(^{14}\) Author interviews, Hong Kong, April 2002, and Thailand, March 2002.
forbearance regarding required capital for these insurance companies, which are often chronically weak.

Unrealised Capital Gains and Losses

Basle rules permit regulators to allow banks to allow up to 45% of unrealised capital gains as Tier II capital; in fact, many developing countries allow up to 100%. This, and how much of unrealised losses banks are required to deduct from capital, can vary. In the case of Thailand, 70% of land and 50% of building revaluation values can be incorporated in Tier II capital. In Indonesia and Korea there is no such provision. Although Japanese authorities tightened loan loss provisioning rules in 1998, they simultaneously loosened the rules relating to unrealised capital gains and losses, and allowed banks to include unrealised gains from real estate assets.

Weak Auditors

Regulators are often dependent upon external auditors discovering problems relating to bank loan accounting and provisioning practices. Even when regulators have a permanent on-site supervisory presence in large banks, which is increasingly common, they may not have the capacity to monitor all accounting decisions. However, auditors have often been found to be incompetent, or willing to collude with banks. In a number of East Asian developing countries, international accounting firms tended to franchise their name to local auditors without being concerned about staff quality. And of course, even the international accounting firms have sometimes failed to live up to their reputation. Thai and Indonesian officials complain that auditors have become so concerned about the possibility of regulatory sanction for poor auditing that they are now excessively conservative. However, the local reputations of the international accounting firms continue to vary widely in the region.

Assessment: How Well-Capitalized are Asian Banks?

For all of the above reasons, bank capital ratios should generally not be compared either across time or across countries. A further consideration reinforces this conclusion.
In much of East Asia, where lending is often to related parties, the quality of assets may be low as compared to those of banks in other countries (Asian Policy Forum 2001: 12; Shirai 2001a: 59-60; Rojas-Suarez 2001). In such circumstances, required CARs should arguably be higher than for banks in advanced countries. Indeed, some East Asian countries, including Hong Kong and Singapore, require CARs to be considerably higher than the 8% Basle minimum. However, the Basle Committee has given no guidance as to how much higher these requirements need to be in the case of emerging market countries, presumably in part because of the political sensitivity of the issue.

Some suggest abandoning traditional CARs and other ratios (liquidity, NPLs, net profits, earnings, etc) altogether for emerging market countries and recommend greater reliance on alternative market-based indicators. These include banks’ interest rate spreads, deposit rates, interbank rates and loan growth (Rojas-Suarez 2001; Shirai 2001a: 60). Others try to recalculate CARs using more conservative accounting. For example, Fukao (2002: 6) estimates that if the Japanese regulatory authorities adopted conservative definitions in the above areas, the real level of capital of major Japanese banks would have been less than 1% in September 2001, compared to the official average of 10.7%.

At the end of the first quarter of 2002, the average risk-based Basle CAR of the top 25 US banks was 12.41%. On the face of it, Asian banks have converged towards this level: Thai banks’ average CAR was 13.1%, while that for Korean and Indonesian banks was 10.8% and 19.3% respectively. For some Indonesian banks, official CARs are in excess of 30%. There is little doubt, given the above considerations, that this convergence is more apparent than real. As a first cut towards comparing East Asian developing country CARs with those in the US, I simply focus on pure equity capital, given the evident problems with the definition of capital in the Basle regime. The (unweighted) average for the top 25 US banks’ equity capital to total asset ratio was 7.97%. On this measure, officially Asian banks score worse than US banks, but not disastrously so (table 2). Indeed, Indonesian and Thai banks appear better capitalized than Korean banks, which is not in accordance with general opinion.

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But there are good reasons to believe that even this picture is misleading, particularly for Indonesian and Thai banks. As noted above, their ability to deduct the value of allowable collateral from provisioning requirements may artificially inflate equity capital. If such collateral is overvalued and/or uncollectable within a reasonable time frame, this will require additional provisions in the future, reducing equity capital. As a worst-case calculation, I assume the value of such collateral is zero. Second, there is a widespread concern that Indonesian and Thai banks have engaged in superficial restructuring of problem loans. If so, restructured loans classified as ‘passed’ or merely precautionary/special mention should attract a higher provision than the small amounts usually required. Here, I assume these restructured loans should attract a ‘substandard’ provisioning requirement of 20% (which is not especially conservative), and subtract from equity capital the increased provision that would result from such a reclassification.

A further possibility would be to assign an extra provisioning requirement to all related party loans, but this is difficult to do since data on how much of such loans are already provisioned for is generally unavailable. Indeed, data availability is a real problem generally, calling into question the claims made by regulatory authorities in these countries that their financial sector accounting is now fully transparent. Thai banks are required to provide figures on the value of collateral that may be deducted from provisioning requirements, but they do so infrequently, often only in annual reports. Furthermore, they do not provide data on the (re-)classifications of restructured loans. The opposite situation prevails in Indonesia. As for Korea, the regulatory authority requires banks to apply an apparently more sophisticated procedure for loan classification based on FLC, but in practice the manner of loan classification (and the role that collateral may play in mitigating credit risks) is very non-transparent. We must simply take the word of the authorities that such standards are applied as rigorously in Korea as in the US. A number of bank analysts in Asia dispute this.

Lacking key data for each country makes comparison very difficult. However, the figures for adjusted equity in table 2, at least in the Thai and Indonesian cases, are indicative of the problems that remain in the banking sector in those countries. Generally, there is little doubt that real equity to asset ratios amongst banks in these countries are much lower than US banks, and in a number of cases may be negative. Although the calculations in table 2 are rough, on US criteria it is likely that a number of Thai and
Indonesian banks remain at least ‘significantly undercapitalised’ and in some cases ‘critically undercapitalised’ (Comptroller of the Currency 2001: 43ff). On US rules, this would trigger a mandatory requirement for a capital restoration plan, which, in the Thai and Indonesian context, would require either bank closure or further injections of state funds into banks. Either way, the negative fiscal implications would be substantial. The government debt to GDP ratio is around 100% in Indonesia, and 65% and rising in Thailand. As noted earlier, this provides a good reason for the authorities to continue to forbear with respect to financial supervision.

For the Thai banks that have provided recent information on their deductible collateral, subtracting it from equity capital reduces the weighted average equity to asset ratio of Thai banks by over 7%. The Bank of Thailand and the Thai banks would no doubt claim this is wholly unreasonable, but in a system where collection of collateral may take years, where valuations are questionable, and when the BoT itself remains under the ultimate control of the Ministry of Finance, outsiders may reasonably believe that current rules inflate the real equity base of the banking system. Furthermore, Thai banks and the BoT, as noted above, do not provide data on the accounting for restructured loans. If superficial restructuring is still going on in Thailand, as many analysts believe, accounting for it would further reduce the real equity bases of Thai banks.

Indonesian banks are required to submit monthly information to BI, which then publishes some of the data on the BI website. This does not include information on the value of collateral attached to loans, but it does include data on the reclassification of restructured loans. Perhaps the surprising thing about the latter is that the numbers are so small, though many commentators claim that the practice predominates in Indonesia (it is well to remember that the majority of Indonesian corporations remain effectively bankrupt). As noted earlier, Indonesian transparency in this regard may give banks incentives to understate restructured loans. If so, the published figures may underestimate the impact of any loan misclassification on banks’ equity to asset ratios. Furthermore, given the extent of the problem of realizing collateral in a largely dysfunctional legal system, if this were fully accounted for, it is likely that real bank equity to asset ratios would be much lower than those published. Finally, the apparently healthy published

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16 Various interviews, Jakarta, May 2002.
bank equity to asset ratios in Indonesia reflect as much the collapse of bank intermediation in the Indonesian economy since the crisis as anything else.

All this is not to argue that all is well with Korean banks. Some argue that the government has continued to put pressure on banks to lend to important companies in difficulty, such as Hynix semiconductor, and that the regulatory authorities have exercised forbearance on these loans. Hynix loans were often classified until late 2001 as ‘precautionary’, requiring a relatively low 2% provisioning requirement (subsequently, Korean bank creditors were required to write down substantial values of these loans). This case raises concerns as to whether the full extent of problem loans in the Korean banking system has been recognized.

Conclusion

This paper has argued that the enhancements to the prudential regulatory framework in the crisis-hit East Asian countries are less substantial than they appear to be at first sight. Although most prudential systems in East Asia since the crisis have converged broadly around the minimum Basle CAR of 8%, basic US (FDIC) loan classification and provisioning rules, and international accounting standards, regulatory forbearance remains endemic. Particularly in Indonesia and Thailand, the pattern might be described as one of formal convergence but continued divergence in practice.

One implication is that domestic political and institutional factors are more important than are external factors in explaining the degree of real convergence. After all, the IMF required the crisis-hit countries of Asia to adopt best practice regulatory frameworks as part of the conditionality packages of 1997-8. Furthermore, some argue that international investors will force convergence in regulatory standards on the crisis countries. However, the results of such external pressure have not been notably successful, with the possible exception of Korea. Indonesia and Thailand have certainly improved many of their formal prudential rules, but the level of real compliance / enforcement remains poor in both cases. Furthermore, Malaysia’s substantially better.

17 The same could be said of other areas such as corporate governance, where again convergence amongst the crisis-hit countries has been restricted to the formal adoption of ‘independent’ directors, audit committees, and compliance directors.
performance on financial restructuring has been achieved despite that country’s pariah status in the eyes of the IMF and, for a time, international investors.

A further implication of the forbearance argument is that perverse sequencing continues to be the norm in the crisis-hit countries. Many economists, and the IFIs, might be accused of blithely recommending deep political and bureaucratic reform without adequately understanding the difficulties of achieving successful reforms of this kind. The problem with the official solution is that, at least in the short to medium term, it places an enormous burden upon the governance capabilities of the state. A rules-based system of regulation does not entail an overall reduction of state intervention in the economy. On the contrary, in some areas it requires dramatically enhanced monitoring capabilities (such as in bank supervision) and enforcement capabilities (given that the number of explicit rules has been greatly increased). Furthermore, in most cases the need for government recapitalizations of banks has led to a great accumulation of financial and non-financial assets in the hands of government agencies. Although this was intended to be temporary, in most cases the sale of state assets has been delayed (due to slower than expected growth, ongoing difficulties in resolving NPLs and corporate restructuring, and weak bankruptcy regimes). The result is that this has created additional opportunities for rent-seeking and political patronage in countries like Indonesia and Thailand.18

Indeed, to the extent that continued governance failures are recognized by the IMF and other agencies, this tends to lead to the conclusion that greater ‘market discipline’ is a necessary supplement to strengthened prudential regulatory standards. In practice, this has bolstered the case for further financial deregulation and (in principle) a government withdrawal from active intervention in the financial markets. Remaining controls on interest rates have typically been removed, and capital controls have been discouraged.19

The result may be a continuing gap between financial liberalization and weak prudential regulation. This may matter less in an environment in which banks have been very

18 For a general discussion of this ‘grabbing hand’ view of prudential regulation, see Barth, Caprio and Levine 2001. They contrast this political economy view of regulation with the standard ‘helping hand’ view of government assumed by most economists.

19 Hellman, Murdoch and Stiglitz (2000) argue that simply introducing new capital requirements (which many emerging market counties made the centrepiece of their regulatory policies in the 1990s in the wake of the Basle I accord) may have the perverse effect of eroding the franchise value of banks, providing them with further incentives to gamble. They argue for the retention of deposit interest rate ceilings in the interim before enhanced prudential regulation is achieved.
unwilling to make new loans to corporations, as in Indonesia and Thailand. However, even the recent rapid growth of consumer lending in a number of countries should raise concerns about the ability of the new ‘best practice’ regulatory arrangements in Asia to prevent future crises.
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**Sources:**
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**Notes:**
Foreign-owned banks are omitted. Shareholders' equity and assets are calculated from the most recent information available, usually from end December 2001 to April 2002.
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