DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 30, 1998

The Honorable Al Gore
President
United States Senate
Washington, D.C. 20510

Dear Mr. President:

Pursuant to the Financial Reports Act of 1988, I am pleased to submit the "1998 Report on Foreign Treatment of U.S. Financial Institutions." (In addition to printing it in hard copy, we are planning to make it available to the public on Treasury's web site.) This Report updates the National Treatment Studies completed by the U.S. Treasury in 1979, 1984, 1986, 1990, and 1994. The 1998 Report describes the presence and treatment of foreign financial services firms in the United States; reviews U.S. Government efforts to remove barriers to trade in financial services; and examines the degree of national treatment and market access afforded U.S. financial institutions in twenty-four banking markets and twenty-two securities markets.

Since these National Treatment Study (NTS) Reports to Congress began nearly twenty years ago, intensive multilateral and bilateral negotiations have led to very significant improvements in the terms on which U.S. firms compete in offering financial services abroad. The most recent is the General Agreement on Trade in Services (GATS) Round, completed in December 1997, which produced commitments that will give U.S. firms more secure or better access to many foreign markets.

Looking ahead, I would like to take this opportunity to recommend that the congressional mandate for these quadrenniel National Treatment Study Reports be removed. Although they have been valuable as an information source, there are now numerous private sources which provide information similar to that contained in NTS Reports, but on a broader range of countries and more frequently. Ending the NTS Reports will not mean any reduced commitment to resolving problems faced by our financial institutions overseas. There will be ongoing scrutiny of national treatment and various other aspects of market access within the World Trade Organization covering over 100 countries, and we shall otherwise continue our liberalization efforts bilaterally and multilaterally.

Sincerely,

Robert E. Rubin

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 30, 1998

The Honorable Newt Gingrich
Speaker
U.S. House of Representatives
Washington, DC 20515

Dear Newt:

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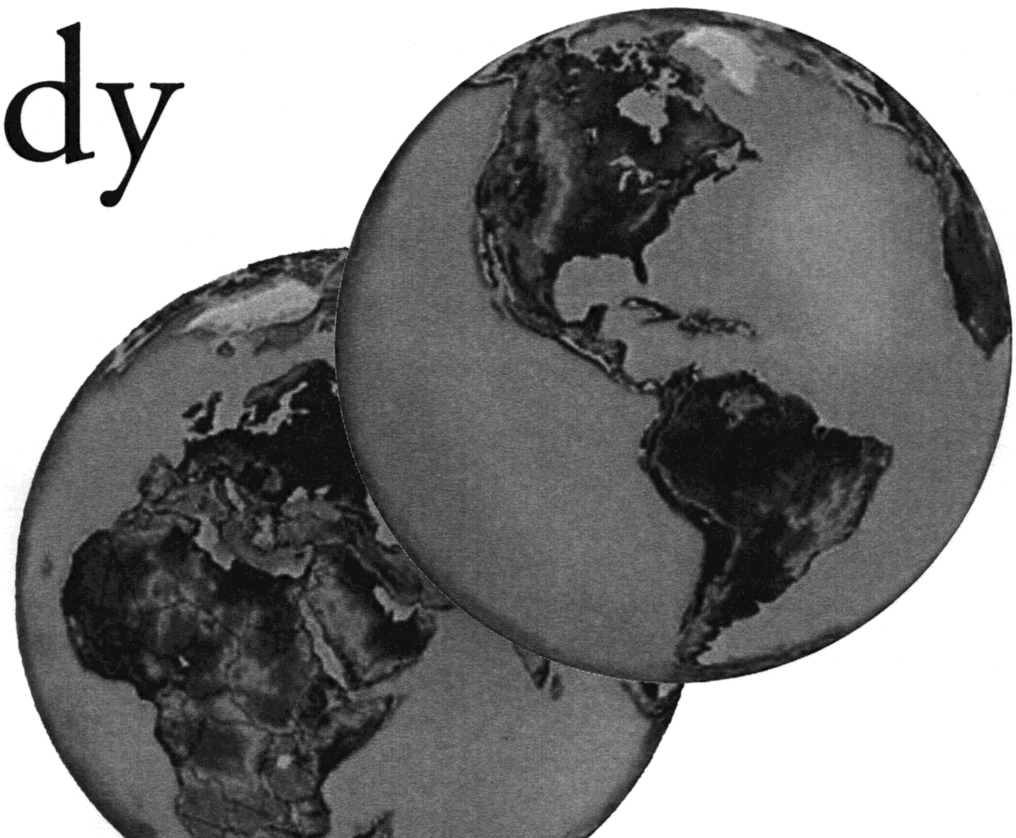
Sincerely,

Robert E. Rubin

National Treatment Study



1998

DEPARTMENT OF THE TREASURY

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PREFACE

The 1998 National Treatment Study is the third quadrennial report required by the Financial Reports Act of 1988 (Pub. L. 100-418, sec. 3601 *et seq.*; 22 U.S.C. 5351 *et seq.*). (The mandate for this periodic report is reproduced in the section "Legislative Mandate for 1998 Report.") The first report required under this act was prepared in 1990 and the second in 1994. There were also three NTS reports beginning in 1979, prepared under earlier legislation.

The Office of the Assistant Secretary for International Affairs (OASIA) of the U.S. Treasury Department and the Office of the Comptroller of the Currency (OCC) share responsibility for the preparation of the entire report. (The Acknowledgments section of this Report indicates the principal authors and editors of individual chapters.)

The 1998 National Treatment Study begins with an Executive Summary that gives an overview of the entire report. The main body of the study is divided into three parts. Part I describes the treatment of foreign financial institutions under U.S. law and the operations of foreign financial institutions in the United States. It contains two chapters that cover banking and securities, including futures and other derivatives markets. Part II contains one chapter which describes international financial services negotiations that were concluded at the end of 1997 and next steps anticipated beginning in 1999. Part III reports on the treatment of U.S. financial services firms in overseas banking and securities markets. It contains detailed descriptions of market conditions in 24 countries or regions. The chapters are presented in alphabetical order.

The country chapters cover major markets in which U.S. financial services providers confront significant impediments to the establishment or provision of financial services. The report also encompasses markets where significant improvements have taken place since the last National Treatment Study in 1994. The Treasury Department and the OCC solicited private sector views about which markets should be studied through a notice in the April 16, 1998 *Federal Register*. The countries chosen reflect the comments received. Also, drafts of the chapters were sent for review and comment to members of the U.S. financial industry and to financial and regulatory authorities in each market.

The study covers both the banking and securities markets in 22 countries, and banking only in two additional countries. One chapter describes in detail recent developments regarding the European Union's single market in financial services. Each chapter follows the same basic format: summary, description of the market, the presence of U.S. financial institutions, and the treatment of U.S. financial institutions.

The National Treatment Study is current as of June 30, 1998. Where possible, developments since that date have been incorporated.

LEGISLATIVE MANDATE FOR 1998 REPORT

The Omnibus Trade and Competitiveness Act of 1988
Subtitle G - Financial Reports

SEC 3601. SHORT TITLE

This subtitle may be cited as the "Financial Reports Act of 1988."

SEC 3602. QUADRENNIAL REPORTS ON FOREIGN TREATMENT OF UNITED STATES FINANCIAL INSTITUTIONS.

Not less frequently than every four years, beginning December 1, 1990, the Secretary of the Treasury, in conjunction with the Secretary of State, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities Exchange Commission, and the Department of Commerce, shall report to the Congress on: (1) the foreign countries from which foreign financial services institutions have entered into the business of providing financial services in the United States; (2) the kinds of financial services which are being offered; (3) the extent to which foreign countries deny national treatment to United, States banking organizations and securities companies; and (4) the efforts undertaken by the United States to eliminate such discrimination. The report shall focus on those countries in which there are significant denials of national treatment which impact United States financial firms. The report shall also describe the progress of discussions pursuant to section 3603.

SEC 3603. FAIR TRADE IN FINANCIAL SERVICES.

(a) DISCUSSIONS – When advantageous the President or his designee shall conduct discussions with the governments of countries that are major financial centers, aimed at:

> (1) ensuring the United States banking organizations and securities companies have access to foreign markets and receive national treatment in those markets;
>
> (2) reducing or eliminating barriers to, and other distortions of, international trade in financial services;
>
> (3) achieving reasonable comparability in the types of financial services permissible for financial service companies; and
>
> (4) developing uniform supervisory standards for banking organizations and securities companies, including uniform capital standards.

(b) CONSULTATION BEFORE DISCUSSION – Before entering into those discussions, the President or his designee shall consult with the committees of jurisdiction in the Senate and the House of Representatives.

(c) RECOMMENDATIONS – After completing those discussions and after consultation with the committees of jurisdiction, the President shall transmit to the Congress any recommendations that have emerged from those discussions. Any recommendations for changes in United States financial laws or practices shall be accompanied by a description of the changes in foreign financial laws or practices that would accompany action by the Congress, and by an explanation of the benefits that would accrue to the United States from adoption of the recommendations.

(d) CONSTRUCTION OF SECTION – Nothing in this section may be construed as prior approval of any legislation which may be necessary to implement any recommendations resulting from discussions under this section.

ACKNOWLEDGMENTS

The 1998 National Treatment Study is the sixth report of its kind. Like its predecessors, it is broad in scope in terms of geographic coverage, its description of individual banking and securities markets, and its range of international financial services issues covered. As with previous Studies, there were no full-time staff members assigned exclusively to its preparation.

The Office of the Assistant Secretary of the Treasury for International Affairs (OASIA) had overall responsibility for the preparation of the report and for the production of the final printed version of the Study. The Office of the Comptroller of the Currency (OCC) had primary responsibility for the editing of the banking chapters. The Department of State, particularly Embassy officers in overseas posts, played a key role by producing the initial drafts of the country chapters. Several other departments and agencies also contributed substantially, including: the Federal Reserve Board (FRB); the Securities and Exchange Commission (SEC); the Commodity Futures Trading Commission (CFTC); the Federal Deposit Insurance Corporation (FDIC); the United States Trade Representative's Office; and the Department of Commerce.

Private Sector

On April 16, 1998, a notice appeared in the *Federal Register* soliciting public comment on significant denials of national treatment to United States banking organizations and securities companies in overseas markets. The Bankers' Association for Foreign Trade, the Investment Company Institute and the Securities Industry Association provided information and reviewed draft chapters. In addition, representatives of many U.S. financial services firms located abroad were consulted by U.S. Embassy officers during the preparation of the draft chapters.

Foreign Governments

The banking and securities authorities in the countries included in this report were provided an opportunity to comment on the relevant chapters and, in many cases, were requested to provide background information during the drafting of the chapters. Their comments were particularly valuable in confirming the accuracy of the descriptions of the markets under their supervision.

U.S. Government

A large number of U.S. government employees in Executive Branch agencies and in financial regulatory agencies contributed to the preparation of the 1998 National Treatment Study.

United States Embassies, Missions, and Posts

The Economic Sections, or, where available, Treasury Attache offices, of United States Embassies and Missions produced the initial drafts of the country chapters included in Section III of the Study.

ACKNOWLEDGMENTS

This process began in April 1998 and continued into the summer. Along with writing the initial versions of the chapters, Embassy officers were called upon throughout the Report's preparation to respond to Washington editors' requests. The unique situation of overseas posts, including their knowledge of local market conditions and access to host government officials, was a valuable resource.

The following lists the principal overseas authors of the Chapters:
Patrick Syring, John Kramer and Janet Potash, Argentina; Peter Gadzinski, Brazil; Robert Watts, Lorraine Takahashi and Paul Rohrlich, Canada; Russell Frisbie, Chile; Stephen Wickman, China, Michael Feldman and Judith Garber, Czech Republic; Gregory Berger, EU; Brian Goldbeck, Hong Kong; Michael Zorick, Hungary; Curtis Stone and Necia Quast, India; Brian McFeeters, Indonesia; Maureen Grewe, Japan; Kevin Honan, Korea; Tobias Glucksman and Christopher Marut, Malaysia; Shawn Flatt, Mexico; Don Cleveland and Terry Breese, Philippines; Richard Driscoll, Poland; Chever X. Voltmer, Russia; Robert Wang, Singapore; Lee Brudvig, South Africa; Simon Schuchat, Taiwan; Robert Fitts, Thailand; William Moeller and Perry Ball, Venezuela; and Jeff Zaiser, Vietnam.

State Department

David Nelson and John Merante of the Office of Monetary Affairs of the State Department played a key liaison role between Washington editors and drafters in the field. This included participation in the preparation and transmittal of instruction cables and generally facilitating communications between Washington and overseas posts.

Treasury Department

At the policy level, the study was conducted under the direction of David Lipton, Under Secretary for International Affairs. Timothy Geithner, the Assistant Secretary for International Affairs, and Caroline Atkinson, Senior Deputy Assistant Secretary for International Monetary and Financial Policy, both reviewed key chapters in the Report and provided guidance and comment on the preparation of the Executive Summary.

The Office of International Banking and Securities Markets of the Treasury Department was involved in all phases of the project from beginning to end. William Murden, Office Director, had overall responsibility for the direction of the project. Wilbur Monroe was responsible for the overall day-to-day coordination of tasking, editing, internal clearances, and the meeting of deadlines for submission of the report. He had lead responsibility for writing the Executive Summary. He and Warren Gorlick shared primary responsibility for editing of the securities chapters. Robert Kaproth provided editing, organizational, and computer expertise to the project in each and every facet. His efforts contributed directly to on-time project completion with fewer government employees having to become involved than in the past. Other IMB professional staff members, including Howard

Blacker, Gavin Buckley, John Conneely, Philip Mistretta, Teresa Rutledge, and Mike Yuenger, lent valuable assistance at critical moments in the project. During the summer and autumn, two volunteer student interns, Tiffany Williams and Kevin Williams, contributed to the project.

Treasury Department Desk Officers and regional Office Directors were asked to assist in the editing of submissions from the posts, and their expertise and views were periodically sought during the project. These included: for South America, Wes McGrew, Richard Johnston, Dwight Wolkow, Doug Smith, Rachel Bayly, and Christopher Walker; for Asia and the Near East, Todd Crawford, Joe Gagnon, Karen Mathiasen, Anthony Marcus, Max Dupuy, Carol Carnes, Gavin Buckley, Jason Singer, Patrick Stuart, Lyla Kuriyan, Laure Redifer, Chi Yin, and Chris McCoy; for South Africa, Ed Barber, Natan Epstein, and John Ralyea; for Eastern Europe and Russia, Nancy Lee, Juhan Jaakson, Erik Weisman, Brian Cox, and Andy Baukol; for Canada and the European Union, Joe Gagnon, Renee Mathieu, Ken Austin, and Greg Berger.

Matthew Hennesey, Whittier Warthin, and Andrew Velthaus of the Office of International Financial Services Negotiations and Marilyn Muench of the General Counsel's Office of the Treasury Department drafted Chapter Three on the GATS Agreement.

Francine Barber and John G. Murphy also provided legal guidance from the Office of the General Counsel.

Sara Sams, Manager of the Information Technology Learning Center of the Treasury Department, provided valuable computer expertise throughout the project. The Printing and Graphics Division was responsible for designing the cover of the NTS Report and for printing it in hard copy. Serena Eriksen, Internet Program Manager, was responsible for posting the National Treatment Study on the Treasury web site at http://www.ustreas.gov.

Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency was actively involved in the preparation of the banking chapters throughout the project. Arthur McMahon and Eileen Siegel, both of the International Banking and Finance Department of the Office of the Comptroller of the Currency, assumed primary responsibility for editing the banking chapters, under the overall guidance of John Abbott, Deputy Comptroller, and Jose Tuya, Director. Ms. Siegel was assisted by national bank examiner Anthony Palombo and by other staff members of the International Banking and Finance Department. They worked with Embassy officers, Treasury desk officers, and drew on other sources of information. Martha Clarke, senior attorney in the Office of The Counselor for International Activities, contributed to other chapters in the NTS Report.

ACKNOWLEDGMENTS

Other Departments and Agencies

Employees of several departments and agencies provided written contributions for the chapters on National Treatment Under U.S. Laws and/or Operations of Foreign Financial Institutions in the United States. Others commented on the country chapters:

Commodity Futures Trading Commission

Lawrence Patent, Division of Trading and Markets
Robert Rosenfeld, Office of International Affairs

Department of Commerce

John Shuman, Office of Finance, International Trade Administration
Faustino A. Perera, Office of Finance, International Trade Administration

Federal Deposit Insurance Corporation

Karen Walter, Division of Supervision
Christopher Spoth, Division of Supervision
Patricia Colohan, Division of Supervision
Leslie Sallberg, Legal Division
Mitchell Plave, Legal Division
Wendy Sneff, Legal Division

Federal Reserve Board

Christopher W. Clubb, Legal Division
Kathleen M. O'Day, Legal Division
Sandra L. Richardson, Legal Division
Sidney Key, Division of International Finance

Securities and Exchange Commission

Robert Strahota, Office of International Affairs
Rebekah Liu, Office of International Affairs

United States Trade Representative Office

Peter Collins, Office of Services, Investment and Intellectual Property
Laura Lane, Office of Services, Investment and Intellectual Property

EXECUTIVE SUMMARY

NATIONAL TREATMENT IN THE UNITED STATES

The prevailing policy of the United States has been, and continues to be, to provide national treatment to foreign investors in their establishment and operation of financial institutions within the United States. Several changes in U.S. law and regulation since publication of the 1994 National Treatment Study are relevant to the treatment accorded to foreign financial services firms. National treatment, defined as equality of competitive opportunity between foreign and U.S. firms, has been maintained in financial services, and, in some cases, expanded under U.S. law and regulation since 1994. Equality of competitive opportunity does not require identical treatment of foreign and domestic financial institutions. Differential treatment is sometimes necessary in order to accommodate legal and regulatory systems and banking structures in foreign countries that differ from those in the United States.

A number of key developments in the treatment accorded to foreign financial institutions in the United States have taken place since 1994. In banking, the supervision of the operations of foreign banks has been improved and streamlined, most individual states have enacted legislation that enhances the ability of both domestic and foreign banking organizations to expand geographically, the ability of banking organizations to engage in securities activities has been expanded, and several initiatives have been introduced to reduce regulatory burdens on both domestic and foreign banking organizations.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act), signed by President Clinton on September 29, 1994, established a federal framework for interstate banking and branching in the United States for both domestic and foreign banks. The Riegle-Neal Act affords foreign banks national treatment with respect to interstate banking and branching. More specifically, national treatment is now afforded to foreign banks in relation to nationwide interstate banking by acquisition, interstate branching by merger, and interstate branching by *de novo* establishment of direct branches. As of September 1995, interstate banking by acquisition was in effect in all 50 states and, as a result, any bank holding company including foreign banking organizations may acquire a bank subsidiary in any state without geographic restriction. With respect to interstate branching, in general, a foreign bank may establish and operate a federally or state-licensed branch or agency in any state outside its home state to the same extent as a domestic bank with the same home state as the foreign bank. In addition, a U.S. bank controlled by a foreign bank may establish branches outside its home state to the same extent as other U.S. banks.

The U.S. Congress has been considering and debating modernization of the U.S. financial system for many years. In the 105th Congress (1997-98), financial modernization legislation in the form of H.R. 10, the Financial Services Act of 1998, made significant progress but was not enacted. This legislation would have repealed provisions in the 1933 Glass-Steagall Act that restrict affiliations and interlocking management and employees between banks and firms engaged in securities underwriting. It would have created a new type of bank holding company – a financial holding company (FHC) – to control a securities underwriting firm and companies engaged in other types of financial activities, including insurance underwriting. Under the legislation, foreign banks could have been deemed to be FHCs, and the FRB would have been required to establish and apply standards that give due regard to the principles of national treatment and equality of competitive opportunity. The legislation also would have created another new type of bank holding company – a wholesale financial holding company (WFHC). A foreign bank that operates an uninsured branch, agency, or commercial lending company in the United States could have requested a determination from the FRB to be treated as a WFHC, subject to certain restrictions. Foreign banks that became FHCs or WFHCs under the legislation would have lost their grandfather rights to engage in nonbanking activities. In addition, the FRB would have been given the authority to impose restrictions on certain foreign banks that operate branches, agencies, or commercial lending companies in the United States that do not become FHCs or WFHCs within two years after H.R. 10 became law. Although H.R. 10 was not enacted, it is expected that the next Congress will again consider and debate legislation relating to financial modernization.

In the securities sector, regulators have taken a number of steps to simplify access by foreign firms and issuers to the U.S. securities markets without compromising protection of U.S. investors. Disclosure requirements have been modified to facilitate access to U.S. capital markets, resales of certain restricted securities have been exempted from SEC registration requirements, and the SEC has issued no-action letters which ease the conditions under which investment advisers can register in the United States and provide advice to U.S. clients.

In addition to the federal regulatory scheme in the securities sector, the 50 states have securities laws known as "blue sky" laws. Most states require that securities offered in the state be registered with the state and, although most states have adopted the Uniform Securities Act of 1956, there are many variations among the states. This means that if an issuer makes a public offering in the United States, it must register or obtain an exemption from registration in each state where the offering will be made. This "blue sky" process does not differ substantially for domestic and foreign issuers. The National Securities Markets Improvement Act of 1996 revised Section 18 of the Securities Act to reallocate regulatory responsibility relating to securities offerings between the federal and state governments based on the nature of the security offering, and the SEC adopted new Rule 146 in connection with this revision. The two provisions apply to both domestic and foreign issuers.

Finally, in December 1997, the United States and other countries successfully concluded a financial services agreement under the General Agreement on Trade in Services (GATS). Although U.S. national treatment and most-favored nation (MFN) commitments as part of that agreement do not affect U.S. laws, those commitments will be potentially enforceable under dispute settlement once that agreement enters into effect. In conclusion, developments in U.S. law and regulation have been consistent with the principle of according national treatment to foreign financial institutions and have improved the access of foreign financial services providers to U.S. financial markets.

OPERATIONS OF FOREIGN FINANCIAL INSTITUTIONS IN THE UNITED STATES

The United States generally offers investor choice with regard to the form of entry that a foreign financial institution may use to establish a U.S. presence. The presence of foreign banks and securities firms has contributed importantly to the depth and liquidity of U.S. financial markets.

As of March 31, 1998, 271 foreign banks from 59 countries operated 469 agencies and branches, 108 U.S. banking subsidiaries, 21 Edge Act Corporations, and 3 New York State Investment Companies in the United States. As these data indicate, agencies and branches are the preferred form of operation, accounting for over 58 percent of the assets of the banking offices operated by foreign banks. Foreign banks also operate 144 representative offices and a variety of nonbanking financial companies in the United States.

Foreign banks initially entered U.S. markets primarily to serve the banking needs of U.S. affiliates of their home-country customers. However, in recent years, foreign banks have become more active in lending to U.S. businesses, often purchasing loans originated by U.S. banks. Since foreign banking offices are involved primarily in wholesale banking and they have only a small presence in retail banking, foreign bank activity is concentrated in the major U.S. financial centers. New York accounts for 71 percent of the U.S. assets of foreign banks, Chicago for 8 percent, and San Francisco and Los Angeles (combined) for 5 percent. The remaining foreign bank assets at U.S. offices are concentrated primarily in Miami, Houston, and Atlanta.

Banks headquartered in industrialized countries account for the predominant share of foreign bank activity in the United States. As of March 31, 1998, the reported assets of banks headquartered in the G-10 countries accounted for nearly 90 percent of all foreign bank assets in the United States. From year-end 1973 through March 31, 1998, the reported assets of U.S. offices of foreign banks increased from US$32 billion to US$2.1 trillion. Foreign banks currently account for about 20 percent of the assets of all banking offices in the United States, and they have booked about 28 percent of all loans to U.S. businesses at these banking offices.

The SEC maintains a policy of equal market access and national treatment, applying the same requirements to all broker-dealers, issuers, investment advisers, and investment companies under its jurisdiction, whether U.S. or foreign. Registered broker-dealers are not required to report to the SEC the extent to which they are owned by foreigners. As of June 30, 1998, over 1,100 foreign issuers representing 55 countries were filing reports with the SEC. Over 500 new foreign companies have entered the U.S. markets since January 1994. As of June 30, 1998, over 800 foreign companies were listed on U.S. stock exchanges.

As of June 30, 1998, approximately 420 foreign investment advisers were registered with the SEC out of a total of about 7,500 SEC-registered investment advisers. A substantial majority of the 420 foreign advisers have 50 or fewer clients, and only 19 have more than 500 clients. These advisers report giving advice to a broad range of clients, including individuals, banks and thrifts, investment companies, pension and profit-sharing plans, and corporations. The largest numbers of foreign investment advisers were from the U.K. (108) and Canada (45). A foreign money manager may organize an investment company in the United States on the same basis as a domestic money manager. As of June 30, 1998, approximately 1,340 U.S. investment companies managed portfolios consisting primarily of foreign securities. Assets of these funds totaled approximately US$470 billion.

According to the CFTC, as of May 1998, the numbers of its registrants who are foreign-based are as follows: 206 commodity trading advisors, 73 commodity pool operators, 1,882 associated persons, and six introducing brokers. In addition, 179 foreign firms were granted relief from registration as futures commission merchants based upon the CFTC's determination of comparability between the foreign jurisdiction's regulatory scheme and that of the CFTC. The majority (85) of these firms were based in the U.K.

IMPROVEMENTS IN NATIONAL TREATMENT ABROAD SINCE THE 1994 REPORT

1995 U.S.- Japan Financial Services Agreement

The Japanese Ministry of Finance and the U.S. Treasury Department concluded a comprehensive financial services agreement on January 10, 1995. The "Measures by the Government of Japan and the Government of the United States Regarding Financial Services" feature an extensive package of market-opening actions.

With respect to Japan's US$1.5 trillion asset management market, the agreement opens a much larger portion of the Japanese pension fund system to investment advisory companies, securing the opportunity for asset managers to manage funds on a specialized basis and reducing the costs of establishment and operation. The agreement also creates greater opportunities for foreign financial firms to participate in Japan's US$500 billion corporate securities market through liberalizing restrictions on the introduction of new financial instruments and introducing a domestic asset-backed securities market in Japan. With respect to cross-border financial transactions, the agreement promotes further integration of Japan's capital market with global capital markets by creating virtually unlimited opportunities for qualifying Japanese corporate investors to invest abroad, and for Japanese issuers to tap capital markets without restrictions on either the size or type of instrument being issued. Finally, the agreement features comprehensive obligations, building on the Japanese Administrative Procedures Law, to provide transparency in financial regulations and protections from administrative abuse.

Taken together, the agreement's commitments correct many of the market access problems experienced by foreign financial services firms in Japan. Implementation of the agreement has been monitored carefully and has been very successful. There is a consultative mechanism in the agreement that provides for regular review of implementation, and it has the capacity to look at new issues as appropriate. In this context, there is a set of qualitative and quantitative criteria by which progress made under the agreement has been assessed.

1997 GATS Financial Services Agreement

Over the past four years, the broadest advance in the treatment of U.S. financial service providers in foreign markets was achieved via the conclusion of a multilateral financial services agreement under the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO) in December 1997. This agreement achieved what previous rounds of negotiations, held under the Uruguay Round and again in 1995, had not: substantially improved market access and national treatment commitments for foreign financial services providers from a broad range of commercially significant countries.

The 1997 agreement covers all financial services and sectors, including: insurance and insurance related services, traditional banking services, securities and derivative related services, asset management, and advisory services. It included improved commitments from 70 members, including five members that made commitments for the first time. This brings to a total of 102 the number of WTO members with financial services commitments, a group which accounts for over 95 percent of world trade in financial services as measured by revenues.

Commitments in the 1997 agreement include significant improvements in terms of: (1) foreign firms' right to establish and expand operations; (2) foreign firms' right to full majority ownership of financial institutions; (3) guarantees that the existing rights of foreign firms in these markets will be preserved ("grandfathering"); and (4) the right to participate on the basis of substantially full national treatment. Several WTO members also either withdrew their broad MFN exemptions based on reciprocity or reduced the scope of such exemptions. These commitments will translate into significant improvements in the ability of foreign financial service to establish and compete in these markets.

The following are illustrative of some of the more significant steps toward financial liberalization under the 1997 GATS agreement.

- Japan bound on an MFN basis certain bilateral financial services agreements that it had reached with the United States.

- Canada committed to change its regime governing establishment of foreign banks to allow foreign banks to establish via direct branches.

- Indonesia grandfathered foreign participation in existing joint ventures, relaxed discriminatory capital requirements, and bound new entry for nonbanks and securities firms.

- Korea, among other things, eliminated ceilings on individual foreign equity participation in securities and asset management companies and allowed the establishment of branches and joint ventures of foreign asset management firms.

- Thailand fully grandfathered existing foreign bank branches and relaxed for ten years its 25 percent foreign equity limit for locally-incorporated banks and finance companies.

- Brazil confirmed and significantly expanded the scope of foreign firm establishment in its market and bound current practice for the entry of securities firms.

- Mexico extended national treatment to foreign pension fund managers and raised the allowable aggregate foreign participation level in the domestic financial sector.

For its part, the United States removed its prior broad MFN exemption and agreed that it would continue to maintain the substantial degree of market access and national treatment afforded under current laws, both federal and state. The United States also included a commitment to national treatment for foreign firms under the Riegle-Neal Act.

As comprehensive as the agreement is, it should be recognized that many participating WTO members did not commit to provide more liberal treatment of foreign service suppliers than was already their practice. Nonetheless, the 1997 financial services agreement guarantees foreign financial services providers certain levels of market access and national treatment and makes their overall operating environment more predictable because commitments are legally binding. The agreement also established basic principles and negotiating mechanisms, as well as a foundation of specific commitments, which could serve as a solid starting point for future multilateral negotiations in the financial services sector.

The 1997-98 Asian Crisis and Financial Services Liberalization

A principal objective of the United States in both bilateral and multilateral negotiations has been to achieve substantially full market access and national treatment in the financial services sectors of commercially important countries. Some Asian countries, as a result of the current economic and financial crisis, have encouraged foreign trade and investment in financial services as an important component of their overall plans for corporate and financial sector restructuring.

In Korea, prior to the current crisis, the government had begun an economic reform program to gradually liberalize financial markets and capital account transactions. Following the onset of the crisis in 1997, Korea entered into a stand-by arrangement with the International Monetary Fund

(IMF) and an economic program that included a significant restructuring of the corporate and financial sectors. As a result, restrictions on foreign investment in domestic equity, bond, and money markets have been eliminated and foreign direct investment has been substantially liberalized. Foreign banks and brokerage firms have been allowed to establish subsidiaries in Korea since March 31, 1998. The government committed to introduce legislation to allow the creation of mutual funds and the issuance of asset-backed securities by August 31, 1998. In addition, the government committed to accelerate the liberalization of foreign exchange transactions by September 30, 1998.

In Indonesia, rapid expansion of the financial sector in the 1980s and early 1990s resulted in a large number of banks with high levels of foreign debt and nonperforming loans. After the onset of the crisis in 1997, the government adopted policies to stabilize the economy, restructure the financial sector, and accelerate structural reforms. Corrective actions included, among other measures, the elimination of a 49 percent limit on foreign holdings of listed shares. The government committed to lift restrictions on branching by foreign banks by February 1998 and to amend the banking law to eliminate restrictions on foreign investment in listed banks by June 1998. It has taken other steps to revise the legal framework for banking operations, improve transparency and disclosure in banking, and eliminate most restrictions on bank lending other than those required for prudential reasons by December 1998.

In Thailand, where the current crisis began in July 1997, foreign entry and private investment in the financial system are being encouraged through the sale of intervened institutions (banks and finance companies) and the preparation of state banks for privatization. In addition, new inflows of foreign direct investment are being encouraged by conversion of the existing Alien Business Law into a new and more liberal Foreign Investment Law, covering a variety of business activities including brokerage services, by October 31, 1998. The government also intends to liberalize existing restrictions on foreign ownership of real property, allowing foreign investors to acquire or lease property under certain conditions, by October 31, 1998.

BANKING AND SECURITIES SECTORS IN PARTICULAR COUNTRIES

Banking

Argentina

The Argentine banking sector has undergone significant transformation in the past four years. Following the contagion effects of the Mexican financial crisis in 1995, Argentina's banking system has been substantially strengthened by economic recovery, consolidation, enlarged foreign bank participation and increased liquidity and capitalization. A ban on the issuance of new bank licenses was lifted in 1994. Foreign banks may establish in branch or subsidiary forms in Argentina, or by acquisition of shares in Argentine banks. Prudential lending limits for foreign bank branches are based on local paid-in capital, not the parent bank's capital, effectively removing much of the rationale for establishment of a branch. There are no additional restrictions on foreign banks' establishing or expanding their presence in Argentina. Merger and acquisition opportunities are available to U.S. banks on a par with other financial institutions. Rules and regulations governing banking operations are deemed to be transparent according to U.S. banks operating in the country and there is sufficient opportunity for them to comment on proposed changes in bank regulations. Argentina imposes no market access restrictions or capital controls. Central Bank restrictions on remittances by foreign banks have been eliminated.

Brazil

Foreign participation in Brazil's financial sector is regulated by the Brazilian Constitution. The establishment of new foreign branches or subsidiaries is prohibited, although actual government practice has allowed substantial foreign entry and expansion in recent years. Transitional rules permit exceptions on the basis of obligations under international agreements, reciprocity, or national interest. Work on a Complementary Law defining conditions for new or increased participation of foreign capital in the financial sector has progressed slowly, but it may be voted into law in 1999. A government toll is generally levied on newly entering foreign banks, either in the form of an outright payment or in some cases acceptance of doubtful assets of troubled institutions subject to central bank intervention. Trends in the Brazilian banking system since 1994 include: an increasing share of private sector banks and a declining share of government-owned banks in terms of total banking assets; a movement toward greater concentration among private sector banks; and a growing share of foreign bank ownership. In the 1997 GATS agreement, Brazil has offered to provide national treatment in banking, pending approval of the Complementary Law and subject to the provision that all members of senior management of financial services providers must be permanent residents of Brazil.

Canada

Foreign bank entry into the Canadian domestic banking market by branching continues to be restricted. Canada is the sole exception among G-7 countries in this regard. Canada, however, has pledged to introduce and to try to enact legislation that will permit wholesale foreign branch banking (but not retail branch operations) in Canada by mid-1999. Overall, prospects are improving in Canada in banking, as well as in other closely related areas, such as consumer finance, leasing, credit-card issuance, and mortgage insurance. As a result of the NAFTA accord, Canada accords U.S. banks a right of establishment and a guarantee of national treatment.

Chile

A new banking law approved in 1997 substantially enhanced prospects for new banking activity in Chile. The law stipulates objective parameters for new banks to enter the Chilean market, and it expands the types of activities in which Chilean and foreign banks may engage. Banks may establish subsidiaries for securities and insurance brokerage, leasing and factoring. Chilean banks are also permitted to engage in banking business overseas, through cross-border lending, the establishment of branches and directly investing in foreign affiliates. Many regulations effecting changes in the new law are still pending as of mid-1998. Foreign banks are allowed to establish either as branches or subsidiaries, but the Bank Superintendency apparently prefers branches because the legal liability of a foreign branch extends to the parent institution. Foreign branches are subject to lending limits based on local capital. Foreign banks can trade foreign exchange through the official exchange market. However, Chile retains some controls on international capital movements. One is a reserve requirement on all credit inflows except direct supplier credits. Firms are required to deposit an established percentage of the inflow in a non-interest-bearing reserve for a set period of time, or pay the central bank a tax equivalent to the interest which the government could have earned on the deposit if it had been made. The percentage rate applies for the first year of the transaction, and it pertains equally to domestic and foreign firms. However, the rate was lowered from 10 percent to zero in September 1998. Chilean regulatory practices are transparent and there have been no complaints from U.S. bankers contacted.

China
China's banking system is still heavily influenced by the legacy of the former economy. Treatment of foreign financial institutions is highly restrictive. Foreign banks are not permitted to conduct local currency business except at tightly controlled levels in limited geographical areas in Shanghai and Shenzhen. Participation is allowed only in defined areas of wholesale banking. Foreign branches and subsidiaries are permissible but are subject to several licensing and operating restrictions. The U.S. Treasury Department is engaged in an ongoing dialogue with China concerning an expanded role for foreign financial institutions in China in the context of its desire to join the WTO.

Czech Republic
Each of the three East European countries surveyed in the Report, the Czech Republic, Hungary and Poland, represents a success story in terms of treatment accorded foreign banks. The foreign bank industry in the Czech Republic has been free and growing and foreign banks are generally permitted to engage in the same range of financial activities as domestic banks. European banks currently dominate the foreign bank sector. U.S. bank activity is predominantly in the wholesale or investment banking spheres.

European Union
The European Union banking market consists of fifteen countries. Over ten years ago, the objective was to create a single market for financial services. Today, much of the legal framework has been established. A major step forward toward such a single market will occur at the beginning of 1999 when eleven member states will adopt the euro as their single currency. Within the EU banking market, any bank in any member country gains a "passport" to provide banking services through local branches or cross borders throughout the EU. U.S. bank subsidiaries and direct branches of U.S. banks established in any EU member state receive national treatment. As a result, concerns of U.S. banks in the EU are for the most part quite similar to those of their European counterparts, and they presently relate to different tax structures and differences in tax treatment across borders, which

are still obstacles to full realization of the single market.

Hong Kong

Hong Kong's monetary and financial regulatory structure remains autonomous following Hong Kong's reversion to Chinese sovereignty on July 1, 1997. It is now a Special Administrative Region of China. As of the end of 1997, there were 32 U.S. banks operating in Hong Kong. U.S. financial institutions give Hong Kong authorities high marks for fairness and transparency and say that Hong Kong does not discriminate in terms of competitive opportunities. No major barriers regarding market access or national treatment have been reported.

Hungary

In Hungary, as the privatization process has continued, the presence of foreign banks has expanded. Foreign banks may now establish direct branches, subsidiaries or joint venture banks, or may acquire shares in local banks. Three of the remaining four sectoral exceptions to the principle of national treatment are expected to end by 2000, the single exception being ownership of arable land by mortgage bank branches.

India

Foreign bank entry into India has gained momentum in recent years, after a long period of very limited access. The domestic banking sector, however, continues to be dominated to a high degree by public sector banks. India does not grant national treatment to foreign banks. Entry by foreign banks is based primarily on India's relations with the home country of each applicant bank; capital requirements, tax treatment, and the ability to open new branches are all less favorable for foreign banks than domestic banks. Foreign banks currently operate in India as branches, but the recommendation contained in a recent Banking Committee Report is that subsidiaries become the preferred form and that foreign bank subsidiaries meet higher capital requirements than local banks. According to the 1997 GATS agreement, India has pledged to allow on a gradual basis more liberal treatment of foreign banks.

Indonesia

Indonesia's banking sector is presently in dire condition owing to the economic crisis that swept through the region beginning in mid-1997. A major restructuring plan is now being implemented with the assistance of the IMF, the World Bank, and the Asian Development Bank. The scope of this task is enormous because of the depression-like conditions that undermine the health of previously sound banks, along with the economy as a whole. Currently, four U.S. financial institutions operate wholly-owned branches in Indonesia. All are permitted to provide a full range of banking services, although three concentrate entirely on corporate lending. Eight other U.S. banks have representative offices.

Japan
Foreign banks have long encountered difficulties in the Japanese banking market. These difficulties have been the result of the regulatory environment and the country's exclusionary business practices rather than a lack of national treatment, which has not been an issue in recent years. Some experts believe this situation in Japan could be about to change for the better as the 1996 "Big Bang" initiative to reform the financial system and other possible deregulation measures are introduced. In 1995, the U.S. Treasury Department and the Japanese Ministry of Finance signed a bilateral Financial Services Agreement covering such areas as the pension fund market for trust banks, the removal of restrictions on cross-border capital transactions, and greater transparency. One of the first liberalizing steps under the Big Bang initiative in 1998 was a comprehensive revision of Japan's Foreign Exchange Law. Restrictions on Japanese overseas deposits have been removed and citizens may now freely buy and sell foreign currencies. All of these changes are proving to be of benefit to U.S. and other foreign banks operating in Japan.

Korea
Korea is presently implementing broad-based reforms of its economic and financial system in cooperation with the IMF, the World Bank, and the Asian Development Bank. Included are measures liberalizing capital markets and the banking sector. Changes occurring in 1998 include permission for foreign banks to set up subsidiaries, removal of all restrictions on land ownership by foreigners, permission for foreigners to participate in non-hostile and hostile mergers and acquisitions of domestic financial institutions, and government encouragement of greater foreign investment in the financial sector. U.S. banks are prominent members of the foreign banking community, but total foreign bank assets still account for a relatively small 9 percent of total assets held by deposit money banks. Foreign bank activity is concentrated in wholesale banking as a result of the Korean regulatory environment. Local foreign branch bank capital continues to be the basis for determining a variety of funding and lending limits. The government maintains tight control over the introduction of new financial instruments and foreign banks are disadvantaged in their access to local currency funding.

Malaysia
Malaysia is another of the East Asian countries seriously affected by the economic and financial crisis that arose in mid-1997. Malaysia's response to the crisis changed abruptly in mid-1998 as it instituted selective capital controls aimed at stabilizing its currency and insulating its economy from external risks posed by short-term capital flows. Other policies were adopted to reflate the lagging economy. Malaysia strictly limits foreign bank entry and foreign bank activity within its borders. No new commercial banking licenses have been issued in over 15 years, and acquisition of existing domestic banks is so constrained as to make it unappealing to foreign financial institutions. Since 1994, all existing foreign branch banks have been obliged to incorporate locally, which has been costly. Employment of expatriates by foreign banks is also sharply limited. One example of the restrictions on the expansion of foreign bank activity is the prohibition on foreign banks' establishing new branches or operating off-site ATMs.

Mexico
Implementation of the North American Free Trade Agreement (NAFTA) at the beginning of 1994 and the Mexican financial crisis in 1995 had the combined effect of very significantly liberalizing Mexico's banking sector. The foreign bank presence in the form of subsidiaries, joint ventures, and acquisitions of local institutions has grown sharply in recent years. (Foreign bank entry in the form of direct branches is not permitted.) Foreign bank affiliates are allowed to provide the full range of banking activities, subject to minor exceptions and market share restrictions, with the latter due to expire by 2000. The Mexican government has been working with the Congress during 1998 to enact a financial reform package. Parts of that package dealing with the FOBAPROA bank insurance fund problem may be completed this year, while other parts dealing with regulatory reform will likely be carried over into 1999. As a result of the financial services chapter of NAFTA, Mexico accords U.S. banks a right of establishment and a guarantee of national treatment.

Philippines
The Philippines has a significant foreign bank presence, with foreign banks accounting for some 16 percent of all commercial bank assets. Entry of new foreign banks is restricted, however, and foreign banks must comply with additional restrictions in comparison with domestic banks. Capital adequacy ratios and legal lending limits are based on the locally incorporated capital of the branch. Limits are also applied on branching, ATMs, remittances on profits, and ownership of land and buildings.

Poland
Poland's banking system has also been expanding rapidly and foreign banks are playing a prominent role in this growth. The main national treatment issue for U.S. financial institutions has been the licensing policy of the National Bank, which requires a foreign applicant to either purchase or financially assist a troubled Polish bank. This issue is expected to disappear at the end of 1998 when Poland's OECD commitment to provide national treatment to banks from OECD countries takes effect. Prudential lending limits for foreign bank branches in Poland are based on local paid-in capital, thus effectively removing the advantage of establishing a branch.

Russia
Analysis of Russia's banking system and its treatment of foreign banks in this Study was hampered by the collapse of the country's financial system in August 1998. Very significant restructuring of the banking sector is certain, but the precise role and array of opportunities open to foreign banks remain to be determined. As of mid-1998, there were three wholly-owned U.S. banks and nine others with U.S. participation licensed to operate in Russia. While U.S. banks indicate that *de facto* they have not been subject to discriminatory treatment or restrained from engaging in any planned banking activities, there are Russian laws and regulations that are indeed discriminatory. For example, foreign banks must have higher minimum charter capital requirements, 75 percent of their employees must be Russian nationals, and their chief executive officer must meet specific language

and education criteria. Russia's accession to the WTO has not yet occurred and Russia has not submitted its offer on financial services.

Singapore
There are two banking markets in Singapore: the offshore Asian Dollar Market and the domestic market, with the former being three times as large as the latter. Singapore actively encourages participation by foreign banks in the offshore market, which is dominated by U.S. and other foreign banks. In contrast, the authorities have imposed a freeze on the number of banking licenses issued in the domestic market for over 20 years, claiming it is over-banked. Foreign banks previously established in the domestic market do not enjoy the same market access as domestic banks. Foreign ownership of domestic banks is limited to 40 percent.

South Africa
Many foreign banks currently operate in South Africa, but altogether they account for only about 7 percent of total bank assets. Since 1995, authorities have permitted foreign banks to open branches, but several important restrictions effectively eliminate the benefits that would otherwise result from such an operation. Foreign subsidiary banks are accorded national treatment and are not limited as to the scope of their activities or regulated differently from local institutions. The clearing system is owned and controlled by the four largest South African banks and all other banks must clear through the big four. A U.S. bank along with small domestic banks have been negotiating with the Reserve Bank to obtain membership, but thus far they have not been successful. In commercial banking, but not in investment banking, domestic banks are favored over foreign banks in bidding on government contracts.

Taiwan
Taiwan has substantially liberalized its banking sector over the past four years, but some vestiges of earlier licensing requirements and other restrictions on foreign banks still persist. The banking community is dominated by the public sector, which accounts for 60 percent or more of bank assets, bank deposits, and bank credit. Foreign banks take the form of either branches or representative offices. While there are no foreign subsidiaries, they are legally allowed. Fourteen U.S. banks are presently active in Taiwan. They concentrate on wholesale banking and are very active in the credit card business and foreign exchange trading in the interbank market. A current concern for U.S. banks is the fact that a government test of their ability to act as arrangers for large project loans is based on onshore minimum net worth and total asset requirements. This is a variant of the legal lending limits imposed on foreign banks in many emerging market countries, all of which have the effect of constraining foreign bank involvement in the domestic financial community.

Thailand
Thailand is another of the countries in East Asia to have been seriously affected by economic and financial turmoil since mid-1997. Severe problems in the country's banking sector have been blamed in part on inadequate regulation and mismanagement within institutions. Thailand is

currently implementing a reform program supported by the IMF which involves closure of the weakest financial institutions and recapitalization of those that are more healthy. Overall, the banking system is being restructured and banks that are state-owned or that were taken over by Thai authorities will be privatized. The presence of foreign banks has increased in recent years and they now account for approximately 19 percent of all commercial bank assets. As a result of Thailand's banking crisis, foreign banks have been encouraged to consider acquiring larger shares of existing Thai financial institutions. Nevertheless, several restrictions limit the expansion of foreign bank activities, including a limit on the number of branches, legal lending limits based on locally held capital of the foreign branch, and limits on the number of expatriate managers. Partly because of such restrictions, most foreign banks concentrate on wholesale bank activities in the Thai banking sector.

Venezuela
The Venezuelan banking sector has been recovering from a serious financial crisis in 1994-95 which resulted from, among other things, an economic recession, lax bank supervision, directed lending, and poor credit practices. In response, the government and bank supervisory authorities took various steps to stabilize the banking sector, including: passage of new legislation which strengthened the supervisory authority; termination of government-directed lending to the farm sector; and encouragement of greater foreign penetration of the banking sector. The foreign bank presence in Venezuela now accounts for 48 percent of total banking sector assets. Foreign banks may now enter the market through acquisition of shares in an existing bank or other financial institution, through creation of a new bank or other financial institution wholly owned by a foreign bank or investors, or establishment of a branch of a foreign bank or foreign financial institution. Previous restrictions applied to already-established foreign banks which prevented them from expanding or offering a competitive range of services have been lifted. There are no branching restrictions on foreign banks and they are allowed to establish ATMs. However, local capital of the branch rather than the parent's consolidated capital is used to compute the branch's legal lending limit and other capital-driven thresholds. Under the 1994 bank law, banks can engage in securities activities, although in practice foreign banks participate through separately established securities firms. The only barrier with respect to national treatment is a provision in the banking law that permits the government to take into account "economic and financial conditions, general and local" and insist on reciprocity when deciding on an application for entry. The government has not used these powers to date against U.S. firms.

Vietnam
Vietnam is in the early stages of opening its national banking sector to foreign banks. It currently sharply restricts the ability of foreign banks to provide a full range of services and to expand operations in local currency. Vietnam does not currently apply consistent, transparent criteria in its dealings with foreign banks.

Securities

Argentina
Argentina's securities market is small in comparison to its banking sector. Argentina has no market access restrictions or capital controls, and it does not discriminate on the basis of domestic or foreign ownership. U.S. banks and securities firms participate in the market as branches or subsidiaries. There are no restrictions on Argentine access to foreign markets or foreign access to Argentine markets.

Brazil
Brazil's securities markets are the largest in Latin America. The Sao Paulo Exchange is the largest both in Brazil and regionally, and it has been growing rapidly. Nevertheless, market capitalization as a percentage of GDP remains low and the market for new domestic issues is thin as larger Brazilian firms are attracted to cheaper, more flexible opportunities abroad to offer securities and place commercial paper. The number of American Depositary Receipt (ADRs) offers has increased significantly. Main participants include universal banks, large public and private pension funds, mutual funds, and other banks operating through approved subsidiaries. Foreign firms wishing to enter Brazil's securities markets were barred from doing so by law in 1988, but previously existing foreign firms were grandfathered. A transitional rule provides for exceptions to the law based on national interest, obligations under international agreements, and reciprocity. Expected enactment of a Complementary Law will provide for new foreign entrants and the increase of existing foreign investment. Foreign securities and brokerage firms in Brazil may underwrite, broker and trade in domestic securities and hold seats on the stock exchanges. They face no barriers to doing business in the country. In recent years, new foreign firms have entered the Brazilian securities market primarily as minority partners in joint ventures with domestic companies.

Chile
Chile's securities exchanges have also been growing rapidly during the 1990s, but are still relatively small and also tend to be illiquid and concentrated. There is no legal discrimination or restriction against foreign securities firms, although they are required to operate through Chilean subsidiaries. Direct purchases of Chilean securities by U.S. investors are permitted, but economically discouraged by requirements that foreign investors maintain their Chilean investments for at least one year and deposit some percentage of their capital in a non-interest-bearing account with the Central Bank. Investment in foreign securities by Chilean citizens is limited.

China
Foreign securities firms are severely restricted from involvement in China's securities markets by discriminatory regulations and lack of market transparency. Foreign securities firms cannot establish local branches or subsidiaries but may establish representative offices which are limited to offshore activities and to making transactions on the stock exchange in "B" shares only. Foreign firms are required by regulation to hire their Chinese staff through an "approved labor supplier." China has

still not passed a national securities law and there has been no indication when that may occur. Despite these and other shortcomings, many U.S. securities firms remain optimistic about the longer-term prospects for the Chinese market. In numerous bilateral and multilateral discussion, including in the context of China's application to enter the WTO, the U.S. Treasury Department has sought significant liberalization of China's securities market, including permission for foreign financial institutions to participate in the underwriting and trading of renminbi-denominated securities. However, there are no indications that China will soon allow an expanded role for foreign securities firms beyond setting up joint ventures in tightly restricted markets.

Czech Republic

Securities markets in the Czech Republic are developing but are still characterized by fragmentation, a lack of transparency, and occasional fraud and trading bottlenecks. U.S. securities firms deal in cross-border transactions or government securities and derivatives rather than the equity or corporate bond markets. The Czech government places no restrictions on the entry or establishment of foreign securities firms and foreign investors may purchase Czech equities through brokers. There are no restrictions on foreign ownership of publicly-traded securities. U.S. firms report no cases of discriminatory treatment.

European Union

The European Union is in the process of creating a single market for securities services. The cornerstone of the system is the "single passport" to provide investment services throughout the EU, which is provided by the Investment Services Directive. Taken as a whole, the EU securities market is larger than Japan's but smaller than that of the United States. Anticipation of European Monetary Union at the beginning of 1999 has been prompting further integration among securities markets of member states. Over 50 U.S. firms are involved in EU securities activities, and plans for significant expansion are going forward as the EU securities business is expected to grow rapidly. The EU is committed to provide access to its securities markets on an MFN basis, including the freedom of establishment. To the extent U.S. securities firms have concerns in EU markets, they are concerns that are shared by all institutions in the market, foreign and domestic.

Hong Kong

The Hong Kong Stock Exchange ranked ninth largest in the world in market capitalization in 1997, down from sixth largest in 1993. This drop was due to regional financial turmoil in late 1997. The exchange has been playing a significant and growing role in raising equity capital for China's state-owned enterprises. U.S. financial institutions have a substantial and rapidly expanding presence in Hong Kong. A survey of major U.S. bank and nonbank financial institutions regarding their Hong Kong operations revealed no substantive concerns about national treatment. Respondents generally viewed Hong Kong as the most open environment in Asia within which to do business. The regulatory environment was regarded as fair and transparent. There appears to have been no impact on the treatment of U.S. financial institutions as a result of the July 1997 reversion of Hong Kong to Chinese rule. In recent months, as regional financial market turmoil intensified and Hong Kong markets came under increasing pressure, the Hong Kong government departed from its usual non-interventionist, market oriented policy and intervened in stock, futures and currency markets, spending some US$15 billion. Some analysts have expressed concern about the government's involvement in markets, both as a regulator and participant. Government spokespersons responded by saying the action which occurred in August was a one-time divergence from their customary policy.

Hungary
The Hungarian securities market has grown very rapidly in recent years, but trading has been volatile. There are some suggestions that market regulation should be strengthened. Foreign firms enjoy discrimination-free access to brokerage licenses and over half of the existing brokerages have some foreign ownership. Banks and other financial institutions must set up dedicated, separate subsidiaries to trade in Hungary's securities markets. Participation by U.S. firms is small relative to that of firms from Western Europe.

India
India's securities markets have grown to significant size in recent years. This is a result in large part of economic reform in the wider economy which freed industry from controls on investment and expansion. At the same time, regulatory reforms and infrastructure development have been taking place in India's securities markets. Companies are now allowed to issue equity at market-determined prices; the issue process has become more flexible; and India's capital markets are open to foreign investors. U.S. and other foreign financial institutions (FFIs) have established joint ventures with local financial institutions in such areas as investment banking, asset management and consumer finance. U.S. firms also underwrite offshore securities issues by Indian companies, and they manage and market mutual funds. U.S. institutional investors account for some 60 percent of cumulative net investment by foreign institutional investors in India. The major barriers to market access in the securities industry that remain to be addressed by authorities include: the removal of discriminatory restrictions on the ability of FFIs to trade for their own account or for the account of customers; and the inability of foreign securities firms to operate on the Indian stock exchanges directly instead of working through registered Indian brokers to execute transactions.

Indonesia
Before the economic and financial crisis began in mid-1997, Indonesia's fledgling capital market had been expanding rapidly. Nevertheless, some analysts blamed the absence of a well-developed bond market in Indonesia as partly responsible for the ensuing financial crisis. Many rapidly growing Indonesian companies had financed their expansion by borrowing abroad during the 1990s, running up large private offshore debts denominated in foreign currency. When the exchange rate crisis hit in 1997, those domestic companies faced loan repayments in domestic currency terms that were suddenly impossible to meet. U.S. and other foreign securities firms enjoy good access to the Indonesian securities market, both as purchasers of securities and as brokers. Foreign securities firms must still operate through joint ventures with domestic firms, but discriminatory capital

requirements on foreign firms are expected to be removed in 1998. Relatively tight limits on the number of foreign personnel who can be employed by securities firms continue to be applied.

Japan

Several developments in the past few years have helped to partially liberalize Japan's securities markets. The 1995 agreement between the U.S. Treasury Department and the Japanese Ministry of Finance was mentioned earlier in this Executive Summary. Another important development was the Japanese government's "Big Bang" deregulation initiative, announced in 1996. Various legal and regulatory changes are now underway as part of a broad effort to achieve "free, fair, and global" financial markets in Japan by 2001. Many barriers to Japanese securities markets, identified in previous National Treatment Study Reports, have been or are now being addressed. Remaining problems include the lack of freedom to offer new securities products due to a discretionary and time-consuming new product approval process, limited access to the domestic lead-underwriting business, and inadequate transparency of the regulatory process.

Korea

The Korean securities market is in the midst of fundamental change as the country is implementing a reform and restructuring program in cooperation with the IMF and other international financial institutions. The program involves significant capital market liberalization. In the course of recent events, foreign participation in domestic equity and bond markets has been substantially liberalized. Government interference with and manipulation of equity market prices has been scaled back and the regulatory authority for the securities industry has been reformed. Foreign firms may now establish subsidiaries as well as branches. Foreign investors play a growing role in stock market trading; bond markets are now open to foreign investors. Many regulatory and legal barriers for foreign securities firms and foreign investors have been removed, although limitations remain on the operations of representative offices. Branch offices have to meet minimal capital requirements depending on their business activities. Consultation with foreign firms about regulatory changes has improved. Current issues of major concern to foreign firms are primarily ones of need for more market liquidity and transparency rather than national treatment.

Malaysia

Prior to the 1997 financial crisis in East Asia, Malaysia's securities market had grown into one of the most active and diverse Asian markets, outside of Japan. Foreign ownership in Malaysian stockbroking companies is limited to 49 percent of paid-in capital. Only one U.S. securities firm holds a large minority stake in such a domestic firm. New licenses for joint-venture securities firms providing brokering and underwriting services are subject to an economic needs test. Up until selective currency controls were implemented in September 1998, U.S. firms interested in a Malaysian portfolio generally operated through subsidiaries in the regional hubs of Hong Kong and Singapore. Foreign firms are permitted to register in Malaysia as investment advisers and to conduct market research for overseas clients. Although there are generally transparent rules governing Malaysia's financial and capital markets, the financial authorities maintain substantial discretionary authority when approval is required for certain transactions.

Mexico
The implementation of the NAFTA in 1994 opened the Mexican securities market to U.S. and Canadian firms. Under NAFTA's national treatment guarantee, U.S. securities firms and investment funds, acting through local subsidiaries, have the right in principle to engage in the full range of activities permitted in Mexico. U.S. and Canadian firms are subject to gradual relaxation in market share limitations during NAFTA's transitional period, which will end in 2000. In 1995, the Mexican government liberalized regulations governing investment in Mexican financial institutions. The 1995 reforms also permitted foreign institutions to acquire Mexican financial institutions and convert them into affiliates without being subject to capital limits, and there have been two cases where foreign financial institutions have taken advantage of this opportunity. There have been no further developments relative to Mexican securities market regulation since 1995.

Philippines
The Philippine securities market is small and relatively underdeveloped. Trading is concentrated in government securities, with about half of government paper carrying maturities of less than one year. Branches of U.S. banks operating in the Philippines are active traders of foreign exchange and government securities, including futures. Foreign securities broker/dealers may enter the Philippines securities markets as wholly-owned, locally incorporated, broker/dealers. For investment houses, which are allowed a broader range of securities activities, foreign participation is limited to 60 percent ownership. The foreign ownership limit on firms engaged in trust activities and mutual fund management is 40 percent. After entry, there are no further distinctions made between wholly or partially-owned foreign and domestic firms.

Poland
Poland's securities markets continue to grow and develop in sophistication but at this stage they are still thin and are considered to be in the developmental stage. Poland extends national treatment to U.S. firms offering financial services in connection with issuance and trading of securities. A number of U.S. investment banks in Poland provide advisory, underwriting, and fund management services.

Russia
The very considerable progress made in Russia over the last four years with respect to securities market development, legislation, and regulations was overshadowed by the collapse of Russian financial markets in mid-1998. Prior to the 1998 upheaval, Russia's financial sector had become one of the most dynamic and market-oriented in the entire economy. The primary regulator, the Federal Commission for the Securities Market, was established and began to exert its authority through licensing procedures and through creation of a regional network. Regulation and enforcement were hard-pressed to keep up with the explosive growth in securities market activity. Prior to the 1998 market collapse, key issues included: the need for stronger protection of shareholders' rights; an

improved tax regime; and domestically-based clearing and settlement infrastructure. Investment firms with U.S. participation do not report any discriminatory treatment. Only resident firms can be licensed by the securities regulatory agency to conduct professional securities market activities in Russia.

Singapore
Foreign securities firms generally have the same right to establish and offer financial products in Singapore as do domestic firms, with respect to government securities, unit trusts, and financial futures. There are restrictions, however, on the extent to which foreign stockbroking firms can trade in the equity securities markets for Singapore resident clients. Singapore residents face no capital controls or restrictions in obtaining offshore financial instruments. Foreign companies can participate in underwriting foreign issues of local companies without restriction. There are restrictions, however, on the issuance of offshore Singapore dollar-denominated securities. One year ago, the Singapore government set up a Stock Exchange Review Committee to consider and recommend changes in the operation of Singapore's stock exchange as part of a broad effort to liberalize the financial services sector. In May 1998, another government-appointed committee proposed adoption of a U.S. system of regulation based on maximum disclosure and minimum exchange regulation in order to generate greater vibrancy in securities markets. It remains to be seen what changes in law or regulation result from these efforts.

South Africa
Foreign participation in South Africa's securities markets has increased significantly in the past three years. U.S. firms have established a presence in the equities, bond, and derivatives markets and are expanding their involvement. Financial authorities expect to present to Parliament a carefully coordinated array of regulatory proposals within the next year aimed at bringing South Africa's regulatory and supervisory structure into conformity with global best practices. This will facilitate transition to unrestricted cross-border financial transactions based on national treatment.The turmoil in international markets in mid-1998 and a global reassessment of risk by foreign investors is expected to place continued pressure on South Africa's securities markets to bring regulatory, corporate governance, disclosure, and technological standards fully into line with those of major markets abroad.

Taiwan
There has been significant liberalization of Taiwan's securities sector over the past four years. A one-year waiting period to upgrade a representative office to a branch has been dropped; almost all foreign ownership restrictions have been abolished; limits on foreign ownership in futures brokerage firms have been lifted; foreign and domestic securities firms face the same capital requirements, and after establishment may provide the same services; and most restrictions on repatriation of capital and earnings by foreign institutional investors have been removed. Nevertheless, U.S. securities firms continue to face discriminatory treatment in several areas. For example, U.S. and other foreign qualified institutional investors are subject to an investment limit per investor. The US$7.5 billion

limit on aggregate foreign investment in the Taiwan Stock Exchange was replaced by foreign ownership limits in listed firms. (These limits on foreign ownership in a listed company have been raised over the past four years and are due to be removed entirely by 2000.) All in all, however, the overall environment for securities firms operating in Taiwan remains restrictive. Capital and exchange controls are still in effect for large transactions and impede a range of operations, as do limitations on foreign institutional investors.

Thailand

The securities markets of Thailand were among the fastest-growing in the region during the 1980s and 1990s. However, the markets were badly affected by the economic and financial crisis that began in mid-1997. Various measures have been taken to shore up the securities market, including easing restrictions on foreign ownership of domestic securities firms. Until recently, U.S. securities firms did not have a significant direct presence in Thailand, and instead relied on representative offices and several minority holdings in domestic finance/securities companies. U.S. firms have been active in underwriting offshore debt and equity issued by Thai companies for several years and have been involved in underwriting and managing both offshore and domestic mutual funds. U.S. portfolio investors have been active participants in Thailand's equity market. Since the onset of the financial crisis, U.S. securities firms have been involved in advising on financial restructuring for listed companies and on privatization.

Venezuela

Securities markets in Venezuela are relatively small compared to its banking sector, and small relative to Brazil's securities markets. In Venezuela, banks may engage in a full range of securities activities, although participation has typically been through fully-owned securities firms. Reform of The Capital Markets Law, which awaits ratification by the Senate, will strengthen the regulatory environment of Venezuela's equity markets. Foreign banks and securities firms may engage in fund management activities, subject to authorization. There are no barriers to the introduction of new financial products, although some transactions may require prior approval of the regulatory authority.

FUTURE LIBERALIZATION

Although bilateral and multilateral negotiations over the years have improved market access and national treatment for U.S. financial institutions, problems remain in many important markets. The problems identified in detail throughout this study present a challenge for U.S. financial institutions and the U.S. government.

The first step the United States can take to encourage financial market liberalization is to ensure that the commitments contained in the 1997 Agreement on Financial Services within the GATS enter into force on a timely basis. Countries have until January 29, 1999, to ratify the agreement concluded in December 1997. If ratified in that time frame, the agreement will enter into effect on March 1, 1999. This will start a new era in which U.S. authorities will be able to enforce as obligations countries' commitments using the WTO dispute settlement process. Over time, this process will result in the development of WTO case law which will be an important guide for resolving future conflicts among WTO member countries concerning market access and national treatment.

The 1997 agreement is only the beginning of a process to achieve progressively higher levels of liberalization in the global financial services trade. The GATS provides for successive rounds of services negotiations and requires that a new round of negotiations start by January 1, 2000. Although WTO members will need to decide on the scope and modalities of these negotiations, and their relationship to other efforts, a further round of financial services negotiations is expected to be part of the agenda. In addition, approximately 30 countries are negotiating to accede to the WTO, including Russia, China, Saudi Arabia, and Taiwan. The United States will continue negotiating with these countries to ensure that they make commitments that meet the standards set within the GATS in the financial services sector.

The United States will also continue to promote financial market development and liberalization of financial services trade in various regional fora.

- In the Summit of the Americas process, the United States is working with Latin American countries to promote financial market development, capital market liberalization, and enhanced financial regulatory cooperation. Negotiations will begin in 1999 for a Free Trade Agreement of the Americas that will aim to achieve full liberalization of trade and investment in the Western Hemisphere by 2005. Financial services negotiations will be an integral part of this process.

- Under the NAFTA, the United States continues to consult with Canada and Mexico on the implementation of the agreement and possible further market opening via cross-border trade in financial services and establishment of commercial presence through direct branches.

- Over the past three years, the members of the Organization for Economic Cooperation and Development (OECD) have been negotiating the Multilateral Agreement on Investment (MAI). Although negotiated by OECD countries, the MAI would be open to non-OECD countries willing and able to take on its obligations. Good progress has been made on the basic elements of investment liberalization and protection, but the MAI has also raised some important issues unrelated to investment in the financial services sector, which will need to be addressed.

- Under the Asia-Pacific Economic Cooperation (APEC) forum's Finance Ministers' process, the Treasury Department and U.S. regulatory agencies will continue to engage counterparts from other Asia-Pacific countries on the development and liberalization of domestic capital markets, improving prudential regulation of these markets, and other policies for promoting financial stability. To date, the APEC Finance Ministers' discussion of these issues has served as an important impetus for financial liberalization.

Part I

Treatment and Operations of Foreign Financial Services Firms in the United States

NATIONAL TREATMENT UNDER U.S. LAWS AND REGULATIONS[1]

INTRODUCTION

The prevailing policy of the United States has been, and continues to be, to provide national treatment to foreign investors in their establishment and operation of financial institutions within the United States. The adoption of a policy of national treatment by the United States arose from the conviction that competition in financial services is healthy and beneficial. The U.S. financial markets, U.S. borrowers, U.S. investors, and the economy as a whole have benefitted from the presence of foreign financial institutions. The openness of U.S. financial markets helps to reinforce U.S. efforts to encourage greater financial market liberalization in foreign countries that do not yet provide substantially full market access and national treatment.

The purpose of this chapter is to highlight changes in U.S. law and regulation since publication of the 1994 National Treatment Study that are relevant to the treatment accorded to foreign financial services firms. This chapter draws upon the 1994 Study in order to provide a context for discussion of new developments but, to the extent possible, it avoids repetition of material set out in previous studies.

This chapter is organized into six sections, including this Introduction. The second section discusses the application of the principle of national treatment. Section 3 examines the treatment accorded foreign banking organizations under U.S. banking law. Sections 4 and 5 provide parallel accounts of the treatment of foreign institutions active in U.S. securities and futures markets. These sections also address regulations affecting the ability to introduce new products into the U.S. securities, options, and futures markets. Concluding remarks appear in Section 6.

THE APPLICATION OF THE PRINCIPLE OF NATIONAL TREATMENT

In the financial services area, U.S. policy has been to accord national treatment to foreign financial institutions under U.S. law and regulation. As practiced, national treatment accords substantially the same treatment to foreign financial institutions in the United States as is extended to U.S. financial firms in like circumstances. This ensures that national treatment affords equality of competitive opportunity to foreign financial institutions in the U.S. market. This approach provides a level playing field in the United States for foreign and domestic financial institutions. This chapter highlights the extent to which national treatment, including equality of competitive opportunity in financial services, has been maintained and, in some cases, expanded under U.S. law and regulation

[1] The information contained herein has been reviewed by the staffs of the contributing departments and agencies, but should not be deemed interpretative advice of the respective staffs, or regarded as legally binding guidance.

since 1994.

Assuring equality of competitive opportunity may require differential treatment of foreign financial institutions compared to domestic financial institutions. Providing identical treatment may not always be sufficient to ensure that foreign financial institutions enjoy equality of competitive opportunity in U.S. financial markets or that prudential concerns are met. Differential treatment is sometimes necessary in order to accommodate legal and regulatory systems and banking structures in foreign countries that may differ from those in the United States. Providing equality of competitive opportunity, therefore, sets a higher standard of fairness than *de jure* national treatment, based simply on identical treatment in law and regulation.

This same definition of national treatment has been the foundation of U.S. efforts to encourage other countries to liberalize their financial markets. As in the United States, identical treatment of foreign and domestic financial institutions may not always be sufficient to ensure equality of competitive opportunity in foreign markets.

NATIONAL TREATMENT UNDER U.S. BANKING LAW

Entry and Operation of Foreign Banks in the United States

The United States generally offers investor choice with regard to the form of entry that a foreign financial institution may use to establish a U.S. presence in banking. The dual banking system in the United States provides the opportunity for either a federal or state license.[2] The principal forms of establishment are: a federally or state-chartered commercial bank subsidiary; a federally or state-licensed branch or agency; a representative office; an Edge Corporation subsidiary chartered by the Federal Reserve; an Agreement Corporation organized under state law but subject to Federal Reserve regulation; and investment companies organized under New York State law.

Establishment of branches or agencies of foreign banks is prohibited by law in some states of the United States, but those states that are considered important financial centers permit foreign bank branches and/or agencies – e.g., New York, California, Illinois, Texas, Florida, and Georgia.

Edge Corporations are specialized entities that engage in international or foreign banking and other international business activities. Both domestic and foreign banks are permitted to establish Edge Corporations. These companies are not subject to restrictions on interstate branching (see Interstate Banking and Branching below).

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[2] The Office of the Comptroller of the Currency (OCC) charters national banks and licenses federal branches and agencies. Individual state banking authorities license state banks, branches, and agencies.

Branches and agencies are the preferred form of establishment by foreign banks; there were 296 and 173, respectively, at the end of March 1998. In addition, there were 108 foreign bank-owned bank subsidiaries, three investment companies, and 21 Edge Corporations and Agreement Corporations. These U.S. operations of foreign banks control US$1.2 trillion in assets, approximately 24 percent of the total assets of the U.S. commercial banking system. In addition, there were about 144 representative offices of foreign banks in the United States.[3]

The International Banking Act of 1978

Foreign banks with U.S. branches or agencies were first subjected to federal regulation with the passage of the International Banking Act of 1978 (IBA). The IBA required foreign banks operating offices in the United States to maintain reserves against deposit liabilities and limited their activities and geographic expansion in the United States in accordance with the comparable limitations applicable to U.S. banking organizations.

The IBA, in providing for the first time for federally licensed branches and agencies of foreign banks, required that such branches or agencies generally operate under the same restrictions and conditions applicable to a national bank operating at the same location.[4]

As originally enacted, the IBA did not extend to foreign banks a number of federal requirements imposed on U. S. banks. For example, it did not require a foreign bank to meet uniform national

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[3] Source: Federal Reserve Board.

[4] Pursuant to the IBA, the OCC, the licensor and primary supervisor of federal branches and agencies, requires the parent bank to establish and maintain a *capital equivalency deposit* (CED) with a Federal Reserve member bank. Prudential in nature, the CED is technically a pledge of assets to the OCC calculated as a percentage of third-party liabilities of the branch or agency; the CED provides a cushion of protection for depositors and other creditors. Lending, investment, and other limits for federal branches and agencies are *not* limited by the CED; rather, they are based on the consolidated worldwide parent capital. A few states have explicit *asset pledge requirements,* which are similar to a CED and broadly constitute the amounts the chartering authorities expect all foreign banks to have in the jurisdiction in order to do business. In addition, *asset maintenance requirements* may be imposed by state or federal authorities on a case-by-case basis in circumstances where serious prudential concerns have been identified. The amounts imposed generally represent a specified percentage excess of qualifying assets over third-party liabilities of the branch or agency.

The Federal Deposit Insurance Corporation (FDIC) has an asset pledge requirement for foreign banks with insured branches. The amount to be pledged must be equal to 5 percent of the average of the insured branch's third-party liabilities for the last 30 calendar days of the most recent calendar quarter. Whenever the FDIC is obligated to pay the insured deposits of an insured branch, the assets pledged will become the property of the FDIC to be used to the extent necessary to protect the deposit insurance fund. The pledged assets can be held at a depository institution in any state, but the foreign branch must get prior written approval of the FDIC of the selected depository institution. Additionally, an insured branch of a foreign bank is also subject to an asset maintenance requirement. The branch is required to maintain on a daily basis eligible assets in an amount not less than 106 percent of the preceding quarter's average book value of the branch's third party liabilities.

standards for foreign bank entry into the U.S. market, nor did it provide for a federal role in the licensing or termination of a state-licensed branch or agency of a foreign bank. The Congress saw the need for additional federal regulation of foreign banks in the United States largely as a result of concerns raised by the alleged fraudulent or illegal activities of foreign banks such as the Bank of Commerce and Credit International (BCCI) and Banca Nazionale del Lavoro (BNL).

Foreign Bank Supervision Enhancement Act of 1991

Problems in bank supervision, principally those associated with BCCI and BNL, led to the enactment of the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), which strengthened the federal regulators' supervisory authority with respect to foreign banks. The FBSEA authorized greater federal oversight of foreign banks in order to ensure that multistate U.S. offices of foreign banks were regulated, supervised, and examined within the same broad framework as U.S. banks. The FBSEA amended existing U.S. law in several ways, most notably with respect to uniform standards and creating a federal approval requirement for all foreign banks seeking to establish U.S. offices, whether licensed by federal or state authorities. (Certain of these provisions were amended in 1996. See discussion of 1996 legislation below.)

Establishing offices. Section 202(a) of the FBSEA amended the IBA to require prior approval of the Federal Reserve Board (FRB) for the establishment of state-licensed and federally licensed branches and agencies, and representative offices of foreign banks, or to acquire ownership or control of a commercial lending company. This is in addition to the existing licensing approval by the federal regulator – OCC – or state primary regulator, mandated by the IBA. It further provided mandatory and discretionary criteria for FRB approval of applications to establish offices.

Under the statute, the FRB may not approve applications to establish branches or agencies unless it determines, among other things, that: (1) the applicant foreign bank engages directly in banking outside the United States; (2) the applicant foreign bank is subject to comprehensive supervision on a consolidated basis by home country authorities,[5] subject to certain narrow exceptions discussed below; and (3) the foreign bank has furnished the FRB the information necessary to assess adequately the application. In considering applications for representative offices, the FRB may take into account the same standards applicable to the establishment of branches and agencies and may impose any additional requirements that it determines are necessary.

Although requiring that applicant foreign banks be subject to comprehensive consolidated supervision (CCS) is not necessarily the norm worldwide, it is consistent with the "minimum

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[5] This requirement has been interpreted by the FRB to mean, among other things, that the applicant's home country supervisor receives sufficient information on the worldwide operations of the foreign bank (including the relationships of the bank to any affiliate) to assess the foreign bank's overall financial condition and compliance with law and regulation.

standards" established by the Basle Committee on Bank Supervision in 1992. The federal banking supervisors have emphasized multilateral and bilateral outreach activities that encourage foreign supervisors to implement a system of CCS, explain what such a system should entail, and provide technical assistance to achieve that end, if requested.

Authority to terminate offices. The FBSEA also permits the FRB to order a foreign bank that operates a state-licensed branch or agency or commercial lending company subsidiary in the United States to terminate its activities if the FRB finds that the foreign bank is not subject to CCS by its home country supervisor, and the home country authorities are not making demonstrable progress in establishing arrangements for comprehensive supervision or regulation of the foreign bank on a consolidated basis, or it has reasonable cause to believe that the foreign bank or an affiliate has committed a violation of law or engaged in an unsafe or unsound banking practice in the United States.

With respect to federal branches or agencies, the FRB may transmit a recommendation to the Comptroller of the Currency that the license should be terminated. The FRB may also order the termination of the activities of a representative office on the basis of the standards, procedures, and requirements applicable to branches and agencies.

Bank acquisitions. Section 207 of the FBSEA made foreign banks maintaining a branch, agency, or commercial lending company in the United States subject to section 3 of the Bank Holding Company Act of 1956 (BHC Act) in the same manner and to the same extent as U.S. bank holding companies. Following this change, if a foreign bank maintaining a branch or agency in the United States wishes to acquire more than 5 percent of the voting shares of a U.S. bank or bank holding company, it must file an application with the FRB under the BHC Act. Foreign banks generally must meet the same standards as U.S. banks, including capital position and financial resources, when acquiring bank or nonbank subsidiaries in the United States.

Retail deposits. Section 214(a) provides that no foreign bank may accept or maintain *retail* deposits of less than US$100,000, except through an insured banking subsidiary. Branches that were insured prior to December 19, 1991, are grandfathered.

Examinations and Federal Reserve examination fees. The FBSEA clarifies and strengthens the FRB's authority to make sure that multistate foreign bank operations are examined in a comprehensive and coordinated manner. The FBSEA also requires that each branch and agency of a foreign bank be examined at least once each year. Section 203(a) further authorizes the FRB to examine any office, subsidiary bank, commercial lending company or affiliate of a foreign banking organization, coordinating to the extent possible with the other relevant supervisors.

Section 203(a) also states that the cost of such examinations that the Federal Reserve undertakes shall be assessed against and collected from the foreign bank or its parent holding company only to the extent that domestic banks are charged. The FRB is not required to impose fees on domestic banks that it examines, although all U.S. banks are assessed to some extent for federal banking supervision.

The FDIC does not charge fees for its examinations. Insured institutions pay an insurance premium, which is based on the amount of their insured deposits and their financial condition. The OCC assesses fees based on the size of the bank or branch or agency.

Limitations on powers. The FBSEA prohibits state branches or agencies from engaging in any activity that is impermissible for a federal branch or agency unless the FRB determines that the activity is consistent with sound banking practices, and in the case of an insured branch, the FDIC has determined that the activity would not pose a significant risk to the deposit insurance fund.

Limits on loans to one borrower. Similarly, under the FBSEA, state branches and agencies are subject to the same loans-to-one-borrower limitations that are applicable to federal branches and agencies, i.e., the limits applicable to national banks.

Reporting of stock loans. Because of the experience with BCCI, in which that institution was found to have acquired illegal control of several U.S. banks through loans to nominees, Congress amended section 7 of the Federal Deposit Insurance (FDI) Act to extend to foreign banks and their affiliates requirements that they report to federal banking regulators loans secured by 25 percent or more of an insured institution's voting stock. The reporting requirements include any "credit outstanding" and clarify that loans by one organization to a group of persons acting together to gain control of a U.S. bank must be reported.[6]

Consumer laws. In addition, the FBSEA placed the enforcement of foreign banks' compliance with consumer laws with the appropriate federal banking agencies, thus placing foreign banks in a position comparable to that of domestic banks.

Criteria for continued operations. Under the FBSEA the FRB is required, in consultation with the Secretary of the Treasury, to develop and to publish criteria for evaluating the operation of any foreign bank that was established in the United States prior to enactment of the FBSEA and that the FRB determines is not subject to comprehensive supervision or regulation on a consolidated basis. These criteria are for evaluative purposes and provide a framework for the continued operation in appropriate circumstances of foreign offices established in the United States before the FBSEA was enacted, even in the absence of CCS.

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[6] The statute defines "credit outstanding" to include: (1) any loan or extension of credit; (2) issuance of a guarantee, acceptance or letter of credit (including an endorsement or standby letter of credit); and (3) any other type of transaction that extends credit or financing.

The final regulations, which became effective in March 1996, provide that, after determining that a foreign bank is not subject to CCS, the FRB shall consider the following criteria in determining whether the foreign bank's U.S. operations should be permitted to continue, and if so, whether any supervisory constraints should be placed upon the bank in connection with those operations:

1. the proportion of the foreign bank's total assets and total liabilities that are located or booked in its home country, as well as the distribution and location of its assets and liabilities that are located or booked elsewhere;

2. the extent to which the operations and assets of the foreign bank and any affiliates are subject to supervision by its home country supervisors;

3. whether the appropriate authorities in the home country of such foreign bank are actively working to establish arrangements for the CCS of such bank and whether demonstrable progress is being made;

4. whether the foreign bank has effective and reliable systems of internal controls and management information and reporting that enable its management properly to oversee its worldwide operations;

5. whether the foreign bank's home country supervisor has any objection to the bank continuing to operate in the United States;

6. whether the foreign bank's home country supervisor and the home country supervisor of any parent of the foreign bank share material information regarding the operations of the foreign bank with other supervisory authorities;

7. the relationship of the U.S. operations to the other operations of the foreign bank, including whether the foreign bank maintains funds in its U.S. offices that are in excess of amounts due to its U.S. officers from the foreign bank's non-U.S. offices;

8. the soundness of the foreign bank's overall financial condition;

9. the managerial resources of the foreign bank, including the competence, experience, and integrity of the officers and directors and the integrity of its principal shareholders;

10. the scope and frequency of external audits of the foreign bank;

11. the operating record of the foreign bank generally and its role in the banking system of its home country;

12. the foreign bank's record of compliance with relevant laws, as well as the adequacy of its money laundering controls and procedures, with respect to its worldwide operations;

13. the operating record of the U.S. offices of the foreign bank;

14. the views and recommendations of the OCC or the state banking regulators in those states in which the foreign bank has operations, as appropriate;

15. whether the foreign bank, if requested, has provided the FRB with adequate assurances that such information will be made available on the operations or activities of the foreign bank and any of its affiliates as the FRB deems necessary to determine and to enforce compliance with the IBA, the BHC Act, and other applicable federal banking statutes; and

16. any other information relevant to the safety and soundness of the U.S. operations of the foreign bank.

Any foreign bank that the FRB determines is not subject to CCS may be required to enter into an agreement to conduct its U.S. operations subject to such restrictions as the FRB, having considered the above criteria, determines to be appropriate in order to assure the safety and soundness of its U.S. operations. A foreign bank that fails to comply with such restrictions may be subject to enforcement action.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 in response to the widespread bank and thrift failures of the middle and late 1980s. These failures strained the resources of the existing statutory deposit insurance fund. The primary purposes of FDICIA were to: provide a means to recapitalize the Bank Insurance Fund (BIF), improve supervision and examination of insured depository institutions, require the least-cost resolution of insured depository institutions, and reform both the financial services industry and the federal deposit insurance system. Although title II of FDICIA, FBSEA, was directed specifically at the regulation of foreign banks in the United States, other provisions of FDICIA also affect the supervision of these banks, as well as that of U.S.-owned banking organizations.

Annual audits. FDICIA amended section 36 of the FDI Act to add new requirements for annual independent audits and reports that apply both to domestic banks and to the insured U.S. branches of foreign banks with assets of more than US$150 million. One of these requirements is that each institution have an independent audit committee comprised of outside directors. In its final rule implementing the statute, the FDIC exempted insured (foreign bank) branches from this requirement because such branches do not have a separate board of directors. However, such branches are encouraged to make reasonable good faith efforts to see that similar duties are performed by persons whose qualifications are consistent with the requirements of the rule as applicable to the particular branch.

In 1996, Congress authorized the federal banking agencies to permit the independent audit committee to be made up of less than all, but no fewer than a majority of, outside directors if the agency determines that the institution has encountered hardships in recruiting and retaining a sufficient number of competent outside directors to serve on the committee. Congress also eliminated the independent auditor attestation requirement for compliance with safety and soundness laws.

Prompt corrective action. FDICIA added section 38 to the FDI Act authorizing or requiring the bank regulatory agencies to take certain supervisory actions when an insured depository institution falls within the lower range of five specifically enumerated capital categories. These categories are, in turn, based on capital maintenance regulations.

Insured branches of foreign banks are required, in lieu of capital, to maintain a pledge of assets and a certain volume of eligible assets, which is analogous to a domestic bank's required capital.[7] Therefore, for purposes of prompt corrective action, the levels of capitalization for insured foreign bank branches that may trigger supervisory actions are based on the asset pledge and volume of eligible assets.[8] As of March 31, 1998, there were 27 insured branches of foreign banks in the United States, all of which were established before enactment of the FBSEA.

Risk-based assessments. FDICIA also amended section 7 of the FDI Act to require the FDIC to establish a system of risk-based deposit insurance assessments. For domestic banks, one of the criteria for determining assessments is the adequacy of capitalization maintained by those banks. Again, because insured branches of foreign banks are required to maintain a pledge of assets and a certain volume of eligible assets in lieu of the capital required for domestic banks, the risk-based assessments for such branches refer to the branches' positions against those requirements.[9]

Crime Control Act of 1990

Section 2597 of the Crime Control Act of 1990 brings branches and agencies of foreign banks and Edge and Agreement Corporations within the scope of the federal criminal code with respect to financial crimes. These crimes include both those committed by banks and their employees and

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[7] *See* 12 CFR § 347.210-211.

[8] *See* 12 CFR § 325.103(c).

[9] *See* 12 CFR § 327.4 (a)(1)(i)(B).

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those committed against banks.[10]

Annunzio-Wylie Anti-Money Laundering Act

The Annunzio-Wylie Anti-Money Laundering Act, enacted as title XV of the Housing and Community Development Act of 1992, provides for the termination of the charters/licenses of financial institutions that are convicted of certain money laundering crimes.[11] The provisions are generally consistent with the treatment accorded under that act to U.S. financial institutions convicted of money laundering crimes.

Government Securities Act Amendments of 1993

The Government Securities Act Amendments of 1993 (GSA Amendments)[12] amended section 3(a)(34)(G) of the Securities Exchange Act of 1934, to clarify that, for purposes of the Exchange Act, the FRB is the "appropriate regulatory agency" for *uninsured* state-licensed branches of a foreign bank that are active as brokers or dealers in U.S. government securities and the FDIC is the appropriate regulatory agency for *insured* state-licensed branches of foreign banks.[13] This authority

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[10] Section 2597 of the Crime Control Act of 1990 amends the definition of "financial institution" in title 18 of the U.S. Code to include branches and agencies of foreign banks and Edge and Agreement corporations and amends certain sections of title 18 to cover branches, agencies, and Edge and Agreement corporations where they were previously omitted. Among the amended sections dealing with crimes by banks or their employees are: section 212 (offer of loan or gratuity to bank examiner); section 656 (theft, embezzlement, or misapplication of bank funds by bank officer or employee); section 1004 (certification of checks before amount has been deposited); section 1005 (making false bank entries, reports, and transactions); and section 1906 (unauthorized disclosure of information from a bank examination report). Among the amended sections of title 18 providing foreign bank offices with protection from crimes against banks are: section 655 (theft by examiner); section 1014 (making false statements in loan and credit applications); and section 2113 (bank robbery).

[11] Section 1502 of the act requires the Comptroller of the Currency to issue a notice of its intention to terminate the license of a federal branch or agency upon the Comptroller's receipt of written notice from the U.S. Attorney General of the branch's or agency's conviction of a money laundering offense under 18 U.S.C. §§ 1956 or 1957. The OCC retains final discretion over whether or not to terminate the federal branch's or agency's license. For criminal offenses of the currency transaction reporting requirements under 31 U.S.C. § 5322, the Annunzio-Wylie Act gives the OCC discretion in determining whether or not to initiate termination proceedings.

Sections 1503 and 1507 of the Annunzio-Wylie Act impose similar requirements on the FDIC, with respect to terminating the deposit insurance of insured state-licensed branches of a foreign bank, and on the FRB, with respect to terminating the activities of state agencies, uninsured state branches, and commercial lending subsidiaries of a foreign bank.

[12] *See* 15 U.S.C. § 78c(a).

[13] The FRB is also the appropriate regulatory agency for state member banks, foreign banks, state-licensed agencies of foreign banks, and commercial lending companies owned or controlled by foreign banks.

follows the general division of regulatory responsibility for supervising state-licensed branches of foreign banks. The GSA Amendments also confirmed that the FRB is the appropriate regulatory agency for Edge and Agreement Corporations acting as government securities brokers or dealers.

In addition, the GSA Amendments provided the SEC, the Treasury, and the appropriate federal banking regulatory agencies with expanded authority to monitor the government securities market, to detect and to prosecute fraudulent or manipulative activities, to permit the appropriate regulatory agencies to establish and to enforce sales practice regulations in this market, and to monitor the public availability of market information.

Interstate Banking and Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act), signed by President Clinton on September 29, 1994, established a federal framework for interstate banking and branching in the United States for both domestic and foreign banks. The Riegle-Neal Act affords foreign banks national treatment with respect to interstate banking and branching.

The Riegle-Neal Act provides three avenues of interstate expansion for foreign and domestic banks:

- interstate banking by multistate acquisition of banks;
- interstate branching by acquiring and consolidating banks or bank branches in more than one state; and
- interstate branching by establishing *de novo* branches or agencies in more than one state.

Nationwide interstate banking by acquisition. The statute permits adequately capitalized and managed bank holding companies (a term that includes foreign banks) to acquire a bank in any state subject to certain limitations. As discussed below, many states have placed minimum age requirements on the banks within their jurisdiction that may be acquired.

In addition, the Riegle-Neal Act provides a 10 percent cap on the amount of nationwide deposits that an acquirer may control following the interstate acquisition. Also, there is generally a 30 percent cap on the amount of deposits in a single state that an acquirer may control following a second, not an initial, acquisition in that state or in any other state where the acquired institution is present. Concentration limits must be nondiscriminatory, applying equally to all out-of-state acquirers.

Interstate branching by merger. The responsible banking regulators may approve a merger transaction between banks whose main offices are located in different states, subject to certain limitations. The surviving bank would then convert the merged bank's offices into branches. Concentration limits similar to those applicable to interstate banking acquisitions also apply to interstate branching by merger, except for mergers involving only affiliated banks. The individual states may require that the target bank have been in existence for a minimum period of time, but not more than five years.

As discussed below, two states have enacted laws to "opt out" of interstate branching by merger, although one of these states, Texas, subsequently reversed its position. A bank from a state that opts out may not participate in interstate branching by merger. The remaining states permit some form of interstate branching by merger.

Interstate branching by de novo establishment of branches. A bank may establish and operate a *de novo* branch in a state in which the bank does not already operate so long as the host state has expressly authorized *de novo* interstate branching by state statute. States may enact such statutes at any time.

National treatment is now afforded to foreign banks in relation to the following interstate authority:

- Opportunities for acquiring a U.S. bank located in a state other than the home state of the bank holding company or for merging with U.S. banks having different home states, are available to foreign banks to the same extent as to U.S. bank holding companies.

- A foreign bank in general may establish and operate a branch or agency in any state outside its home state to the same extent as a domestic bank with the same home state as the foreign bank.

- A U.S. bank controlled by a foreign bank may establish branches outside its home state to the same extent as other U.S. banks.

To address perceived competitive advantages of wholesale branches of foreign banks compared to domestic banks, Congress introduced four specific foreign bank provisions (all in section 107). In addition, the legislation includes a community credit provision applicable to foreign and domestic banks (section 109). These provisions of the interstate banking and branching legislation do not deviate from the principle of according national treatment to foreign banks.

Meeting community credit needs (section 107). If a foreign bank acquires an existing bank or branch in a state in which the foreign bank does not maintain a branch, the Community Reinvestment Act (CRA) shall continue to apply to each branch of the foreign bank that results from the acquisition. The CRA requirement shall not apply to any branch that receives only such deposits as are permissible for an Edge Corporation.

The foreign bank CRA requirement was narrowly drafted to apply only in the case of an initial interstate entry by a foreign bank through the *acquisition* of an existing entity that, prior to acquisition, was subject to CRA. The provision explicitly provides that the CRA requirement will not apply if the branch takes only those deposits that are permissible for an Edge Corporation (e.g., deposits from foreign governments, foreign persons, foreign banks, and International Banking Facilities and nonretail deposits related to international or foreign business). U.S. banks also acquire banks or branches subject to CRA, but the Edge type deposit alternative is not a realistic option for a U.S.-incorporated bank. The U.S. bank would have to relinquish its bank charter in order to avoid the CRA.

Review of regulations on deposit taking (section 107). The FDIC and OCC revised their regulations, effective in 1996, to restrict the amount and types of retail deposits of less than US$100,000 which can be accepted by an uninsured federal or state-licensed branch of a foreign bank.[14]

Management of shell branches (section 107). Under the IBA, a U.S. branch or agency of a foreign bank may not, through an offshore shell branch that it manages or controls, manage types of activities that a U.S. bank is not permitted to manage at a foreign branch or subsidiary. The provision is intended to help avoid any potential for a foreign bank to use its U.S. branches or agencies to manage types of activities through offshore shell branches that U.S. banks could not manage. Generally speaking, a "shell" branch is an entity having no personnel or operations in the jurisdiction where it is established and authorized to do business. The restrictions would not apply to foreign banks' non-U.S. offices that are not "managed or controlled" from a U.S. office.

Consumer protection laws (section 107). The IBA was amended to affirm that branches and agencies of foreign banks and commercial lending companies are subject to consumer protection laws. This provision reaffirms existing law and practice.

Deposit production offices (section 109). This provision is intended to ensure that the interstate branching authority provided by the Riegle-Neal Act would not result in the taking of deposits from a community without banks reasonably helping to meet the credit needs of that community. In September 1997, the OCC, FRB, and the FDIC issued a joint rule implementing section 109, which became effective in October 1997. The final rule prohibits any bank from establishing or acquiring a branch or branches outside its home state under the Riegle-Neal Act primarily for the purpose of deposit production. In addition, the rule provides guidelines for determining whether such bank is reasonably helping to meet the credit needs of the communities served by these branches.

The rule applies to any bank that established or acquired, directly or indirectly, a branch under the authority of the Riegle-Neal Act or amendments to any other provision of law made by the Riegle-

[14] *See* 12 CFR § 347.206 (FDIC); § 28.16 (OCC).

Neal Act. These branches are referred to as "covered interstate branches." The rule provides that, beginning no later than one year after a bank established or acquired a covered interstate branch, the appropriate agency will determine whether the bank satisfies a "loan-to-deposit ratio screen" based on reasonably available data.

The loan-to-deposit ratio screen compares the bank's loan-to-deposit ratio within the state where the bank's covered interstate branches are located (the bank's statewide loan-to-deposit ratio) with the loan-to-deposit ratio of banks whose home state is that state (host state loan-to-deposit ratio). If the loan-to-deposit ratio screen indicated that the bank's statewide loan-to-deposit ratio is at least 50 percent of the host state loan-to-deposit ratio, no further analysis is required. If, however, the appropriate agency determines that the bank's statewide loan-to-deposit ratio is less than 50 percent of the host state loan-to-deposit ratio, or determines that reasonably available data does not exist that permits the agency to determine the bank's statewide loan-to-deposit ratio, the agency will perform a "credit needs determination."

Under the credit needs determination, the appropriate agency reviews the loan portfolio of the bank and determines whether the bank is reasonably helping to meet the credit needs of the communities served by the bank in the host state. The agency will consider the following in making a credit needs determination: (1) whether the covered interstate branches were formerly part of a failed or failing depository institution; (2) whether the covered interstate branches were acquired under circumstances where there was a low loan-to-deposit ratio because of the nature of the acquired institution's business; (3) whether the covered interstate branches have a higher concentration of commercial or credit card lending, trust services, or other specialized activities; (4) the ratings received by the bank under the Community Reinvestment Act; (5) economic conditions, including the level of loan demand, within the communities served by the covered interstate branches; and (6) the safe and sound operation and condition of the bank. A bank that fails the loan-to-deposit ratio screen and that receives a determination that it was not reasonably helping to meet the credit needs of the communities served by the bank's interstate branches could be subject to sanctions after a hearing under section 8(h) of the FDI Act.

The final rule noted that limited branches (i.e., offices that only accept internationally-related deposits permissible for an Edge corporation) and agencies operated by foreign banks outside their home state are not subject to the provisions of section 109. In addition, the rule stated that, in making a credit needs determination for institutions not evaluated under the Community Reinvestment Act, the agencies intend to give substantial weight to the specialized activities of such institutions. As an example, the rule noted that most branches of foreign banks derive substantially all of their deposits from uninsured, wholesale deposit markets, which are generally national or international in scope, and generally are not established primarily to gather deposits in their host state.

Nonbanking Activities of Foreign Banks

Foreign banks that engage in commercial banking in the United States, whether through branches, agencies, commercial lending company subsidiaries or bank subsidiaries, are subject to the provisions of the BHC Act. The BHC Act provides that a bank holding company or foreign bank may engage in the United States only in banking activities or *activities closely related to banking.* Under this standard, a foreign bank may engage in a wide range of financial activities in the United States, such as consumer and commercial lending, trust activities, leasing, data processing, investment advisory and private placement services, foreign exchange activities, and operating thrift institutions. Foreign banks may also engage in securities underwriting and dealing activities through subsidiaries, which are described further in the next section.

Although the BHC Act generally prohibits bank holding companies from engaging in nonfinancial activities, there are two exceptions that are available only to foreign banks. First, foreign banks that became subject to the International Banking Act of 1978 were grandfathered to retain any nonbanking activities in which they were engaged at that time; 17 foreign banks were grandfathered to operate securities affiliates, even though no similar grandfathering was provided to U.S. bank holding companies. Almost half of these 17 foreign banks have subsequently relinquished their grandfather rights, either in connection with an acquisition of a U.S. bank subsidiary or through the merging of its grandfathered securities company with its Section 20 subsidiary.

Second, in order to prevent disruptions in the relationships between foreign banks and their foreign commercial and industrial affiliates, these affiliates are allowed to engage in the United States in the same nonfinancial activities that they conduct abroad. A foreign affiliate is not allowed to conduct financial activities in the United States except on the same basis as an affiliate of a U.S. bank holding company.

Securities Activities of Banking Organizations in the United States

The Glass-Steagall Act of 1933

The Glass-Steagall Act, enacted in 1933, established a separation between commercial and investment banking in the United States. Under this law and Federal Reserve and OCC regulation, banks are generally prohibited from underwriting or dealing in securities of nongovernmental issuers. The IBA extends this restriction to the U.S. branches and agencies of foreign banks.

Although banks in the United States are generally prohibited from underwriting or dealing in securities of corporate issuers, subsidiaries of bank holding companies may engage in such activities, and banks may engage in many other securities activities. A foreign bank is in the same general position as a U.S. bank or bank holding company with respect to its ability to conduct securities activities in the United States and is thus accorded national treatment. U.S. banks and bank holding companies may underwrite and deal in government securities, and they may engage directly or indirectly in the brokerage of all types of securities.

U.S. banks and subsidiaries of bank holding companies may also act as agent in the private placement of all types of securities. This activity, which is not considered underwriting because it is not offered on public markets, must be conducted within the limits of U.S. securities law and within certain prudential limits that generally prohibit an affiliated bank from purchasing for its own account or providing a credit enhancement for any security privately placed by a securities affiliate. The federal bank supervisors have approved numerous foreign banks to engage in this activity.

Section 20 Approvals

Since 1989, under the FRB's interpretation of Section 20 of the Glass-Steagall Act, the FRB has approved applications by U.S. bank holding companies and foreign banking organizations to underwrite and deal in all types of debt and equity securities subject to revenue limitations and certain additional prudential restrictions or conditions. As discussed in more detail below, these restrictions were originally implemented as conditions to the approvals, but have recently been restructured as regulatory operating standards.

Certain conditions the FRB applied to domestic bank holding companies have been adjusted to account for the status of the foreign banks and to minimize any extraterritorial impact of the framework's requirements. These adjustments included that the foreign bank meet the risk-based capital adequacy standards of its *home country* supervisor consistent with internationally accepted standards under the Basle Capital Accord.

As of September 30, 1998, the FRB had approved 50 companies to engage in underwriting and dealing in securities. Of these, 18 were owned by foreign banks.

Primary Dealers

The core participants in the U.S. government securities market are 32 primary dealers (compared with 39 in 1994), half of which are foreign-owned. A primary dealer is a firm that has established a trading relationship with the Federal Reserve Bank of New York (FRBNY). Some primary dealers are banks or bank subsidiaries, some are departments of general securities broker-dealers (including subsidiaries of bank holding companies), and others are firms specializing in government securities and other money market instruments.

Firms designated primary dealers by the Federal Reserve voluntarily report weekly to FRBNY on their volume of trading and their positions (holdings) in government and government agency issues. They also provide weekly reports on financing and periodic reports on their financial condition.

In order to be added to the list of primary dealers, a firm is expected to: (1) make markets in the full range of Treasury issues for a reasonably diverse group of customers; (2) participate meaningfully in Treasury auctions; (3) be committed to continuing as a market-maker in these securities over the long term; (4) have management depth and experience and good internal controls; and (5) have sufficient capital to support its activities and prudently manage its risk exposure. Minimum absolute levels of capital are specified (US$100 million for commercial banks and US$50 million for broker/dealers) to help ensure that primary dealers are able to enter into transactions with the Federal Reserve in sufficient size to maintain the efficiency of open market operations.

In its relations with primary dealers, the FRBNY accords foreign-owned dealers essentially the same treatment as domestically owned dealers, subject to the constraints of the Primary Dealers Act of 1988. That act requires the Federal Reserve to determine whether U.S. firms operating in the government debt markets of certain foreign countries have "the same competitive opportunities" as domestic companies operating in those markets. If a country does not offer "the same competitive opportunities" to U.S. firms, a person (including a company) from that country may not control a primary dealer in the United States. The Federal Reserve "may not designate or permit the continuation of any prior designation" of a firm from that country as a primary dealer.

Pursuant to the act, the Federal Reserve conducted extensive studies of the government debt markets in the United Kingdom, Japan, Switzerland, Germany, France, and the Netherlands. It determined that U.S. firms are accorded "the same competitive opportunities" as domestic firms in those countries. The act excludes from its coverage firms from a country with which the United States has a trade agreement or was as of January 1, 1987, negotiating to enter into a trade agreement with the United States, and firms that had been designated as primary dealers prior to July 31, 1987. As a result of these provisions, several firms either were exempt from the act or were grandfathered. As of July 20, 1998, 16 primary dealers were owned by foreign firms from six countries, compared with 19 foreign-controlled primary dealers from seven countries in 1994.

Futures, Options, and other Derivatives and Commodities Activities

Registration. Commodity futures and option transactions are governed by the Commodity Exchange Act (CEA). Any bank or bank holding company acting in the capacity of a futures commission merchant (FCM), introducing broker (IB), commodity trading adviser (CTA), or commodity pool operator (CPO) must register in the appropriate capacity with the Commodity Futures Trading Commission (CFTC).[15] Banks and bank holding companies have performed brokerage (FCM or IB)

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[15] An FCM is defined as any person who solicits or accepts orders to buy or sell futures or option contracts and who, in connection with an order, accepts any money or other property (or extends credit) to margin, guarantee, or secure the contracts resulting from the order.

An IB is any person who solicits or accepts orders to buy or sell futures or option contracts, but who does not accept and investment advisory (CTA) services and have acted as fiduciaries for pooled investment funds (CPO) in connection with a variety of futures and options contracts. Both foreign and domestic banks are subject to the same requirements with respect to their futures and commodity option activities; foreign-owned banks in the United States and foreign bank holding companies are treated the same as U.S. banks and bank holding companies.

Under the CEA, whether a person is required to register with the CFTC is generally a function of that person's location in the United States and contacts with U.S. markets and/or customers resident in the United States. The CFTC has not required persons located outside the United States who provide commodity-related brokerage and advisory services to non-U.S. persons regarding instruments traded on a U.S. futures exchange to register with the CFTC. However, other regulatory obligations such as position reporting apply as noted herein. A U.S. FCM with customers that want to trade on a foreign exchange where the U.S. FCM is not a clearing member must establish a customer omnibus account with a clearing member of such foreign exchange to execute the transactions. All funds of such customers will be channeled into the omnibus account maintained by the U.S. FCM for transactions on behalf of its U.S. customers.

Foreign banks that are permitted to act directly in a brokerage capacity in their home jurisdictions are not considered to be "located outside the United States" for purposes of relief from registration if such banks maintain branches in the United States. Although not required to register with the CFTC, any bank or bank holding company acting in the futures or commodity option markets solely for *proprietary* purposes is deemed to be a trader under rules of the CFTC and thus is subject to all CFTC regulatory requirements applicable to traders, including large trader reporting of futures and options positions. These requirements apply irrespective of the trader's location in the United States or abroad.

In an attempt to avoid duplicative regulation, the CFTC has taken cognizance of the "otherwise regulated" status of banks. Banks generally are excluded from the definition of "commodity pool operator" pursuant to CFTC Rule 4.5 with respect to their handling of the assets of any trust, custodial account or other separate unit of investment for which they act as a fiduciary and for which they are vested with investment authority.

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any money or property (or extend credit) to margin, guarantee, or secure the contracts.

A CTA is any person who, for compensation or profit, is engaged in the business of providing advisory services to others concerning futures or options contracts. The CEA specifically excludes from the definition of "commodity trading adviser" certain persons, including banks and news reporters, publishers, and editors, who provide commodity advice that is "solely incidental" to the conduct of their business or profession.

A CPO is any person who solicits funds from others for the purpose of pooling the funds for use in investing in futures or options contracts. Certain "otherwise regulated" persons and entities such as a bank, an insurance company, or an investment company may be excluded from the definition of CPO with respect to their operation of "qualifying entities."

Transactions by banking organizations. Under the CEA, a foreign bank doing business in the United States is accorded national treatment, including equality of competitive opportunity, and is treated no less advantageously than a domestic bank. Under relevant federal and state banking laws, foreign and domestic banks operating in the United States are subject to certain restrictions upon the scope of their activities related to commodity futures and options. These restrictions generally are designed to limit bank activities to banking-related functions and to protect the financial soundness of banks and the banking system. In substantially similar guidelines relating to certain derivatives activities of the banks subject to their oversight, the OCC and the FRB stress that banks' use of the specified derivatives contracts must be in accordance with "safe and sound banking practices and with levels of activity reasonably related to the bank's business needs and capacity to fulfill [its] obligations under the contracts."

Under the BHC Act and the Federal Reserve's Regulation Y, as recently revised, bank holding companies are expressly authorized to act as FCMs and CTAs for unaffiliated persons in the execution, clearance, or execution and clearance of any futures contract and option on a futures contract traded on an exchange in the United States or abroad if: (i) the activity is conducted through a separately incorporated subsidiary of the bank holding company (which may engage in activities other than FCM activities, including permissible advisory and trading activities); and (ii) the parent bank holding company does not provide a guarantee or otherwise become liable to the exchange or clearing association other than for those trades conducted by the subsidiary for its own account or for the account of any affiliate.

Under the revised regulations, a nonbanking subsidiary of a bank holding company, including a Section 20 Subsidiary, may act as an FCM regarding any exchange-traded futures contract and option on a futures contract based on a financial or nonfinancial commodity. The regulations also permit lending activities in combination with FCM activities.

The OCC has concluded that national banks and their subsidiaries may enter into derivative transactions for their *own account* where the bank may lawfully trade, deal in or purchase the underlying instrument or product for its own account.[16] The OCC has imposed prudential and supervisory conditions governing the manner in which these activities are conducted.[17] The OCC has recognized that a national bank may enter into derivative transactions for its own account to hedge risk exposure, to engage in arbitrage activities, and as part of the bank's dealer-bank trading

[16] Many states authorize state-chartered banks to engage in the same derivatives activities as national banks.

[17] OCC Banking Circular 277 provides guidance on risk management practices for national banks and federal branches and agencies engaging in financial derivatives activities, including participation as an end-user or as a financial intermediary. It specifically addresses credit, market, liquidity, operations, and legal risk management systems. Circular 277 provides that a bank should have comprehensive written policies and procedures to govern its use of financial derivatives and that senior management should establish an independent unit or individual responsible for measuring and reporting risk exposure.

activities. In connection with a bank subsidiary's derivatives activities, the OCC has also approved exchange membership, floor trading, and market making activities.

National banks may also enter into derivative transactions as *agent* for their customers. The OCC has recognized that the purchase and sale of derivative instruments as agent for customers are part of the business of banking and thus within the powers of national banks and their operating subsidiaries.[18, 19] This authority exists regardless of the underlying commodity upon which the futures (or other derivative instruments) are based, because the futures or option (or other derivative instrument) itself is a financial instrument. Accordingly, the OCC has permitted operating subsidiaries of national banks to register as FCMs and to *solicit, accept, and execute customer orders* for futures, options, options on futures and other exchange-traded and over-the-counter (OTC) instruments as an incident to the business of banking. The OCC has also approved the expansion of a national bank operating subsidiary's FCM activities to include the provision of execution, clearing, and advisory services for customer transactions in both financial and nonfinancial futures and options and to become members of exchanges and clearing associations affiliated with such exchanges.[20]

A national bank may also enter into derivatives transactions as *principal* where the bank is serving as a financial intermediary for its customers, whether or not the bank has the power to act as principal for its own account with respect to the underlying instrument or product. For example, the OCC has permitted national banks to enter into matched and unmatched commodity price index swap transactions in order to assist their customers that desire to limit certain financial risks resulting from variations in commodity prices, and to hedge such transactions on a portfolio basis. Just as with its deposit and lending activities, in matched and unmatched swap transactions a bank acts as a financial intermediary on behalf of its customers, making and receiving payments.

National banks can generally hedge the market risk associated with such commodity-based derivatives activities by entering into exchange-traded and OTC cash-settled transactions, such as exchange-traded futures and options contracts and OTC spot, forward, and option contracts. In some instances, however, both exchange-traded and OTC transactions that are cash-settled may provide less than completely accurate hedges. Accordingly, the OCC has concluded that it is legally permissible for a national bank to engage in *physical commodity transactions* in order to manage the

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[18] *See* 12 U.S.C. § 24(Seventh).

[19] The use of the word "agent" in this context is not meant to connote any characterization of the relationship between a bank or its subsidiary when acting as an FCM and its customer under the Commodity Exchange Act and rules thereunder. The CFTC views that relationship as one of principal-to-principal.

[20] With respect to customer accounts, national banks and their subsidiaries are authorized to execute transactions in option and futures contracts provided that the bank is authorized to execute transactions for the account of customers in the underlying financial product or instrument.

risks arising out of commodity derivatives transactions. Given the potential additional risks associated with physical hedging activities, however, a national bank may not engage in such activities unless it has submitted a detailed plan for such activities to the OCC, and the plan has been approved in writing by the OCC's supervisory staff.

State member banks are chartered under state law, and must have authority under state law to engage in derivatives transactions. In some states, state member banks have been permitted to use exchange-traded interest rate and foreign exchange derivatives to hedge interest rate and foreign exchange exposure.[21] In at least one state, banks are permitted to act as FCMs, engaging in trading for customers and for their own account in exchange-traded interest rate and foreign exchange derivatives. This activity generally takes place in a subsidiary.

A small number of state-chartered banks that are members of the Federal Reserve System ("member banks") engage in derivative transactions linked to equities or commodities other than interest rates or foreign currencies. Some of these transactions are related to traditional bank activities in commodities such as gold and silver, but some state member banks have obtained approval from their state regulatory authorities for activities involving a wider range of commodity-linked and equity-linked transactions. State member banks have been permitted by some state regulatory authorities to engage as a principal in OTC derivative transactions linked to commodities or equities and to use exchange-traded derivatives to hedge exposure created by OTC transactions.

The FRB has required state member banks engaging as principal in derivatives transactions linked to commodities or securities that the state member bank is not authorized to purchase and hold directly (other than transactions entered into on a perfectly matched basis) to obtain the approval of the FRB to continue such activities. State member banks that currently are not engaged in such transactions will be required to seek FRB approval to commence such activities in the future.

Banks are major participants – both as end-users and as financial intermediaries – in the large and developing swap transactions market. The CFTC has issued a rule pertaining to swaps transactions that provides greater legal certainty for the swaps market than the CFTC's earlier swaps policy statement. Swaps transactions that comply with the criteria of the rule are not generally subject to the regulatory provisions of the CEA, but they may be subject to the anti-fraud provisions of the CEA.

The marketing of "hybrid" instruments that couple elements of futures contracts with certain banking instruments such as depository obligations has raised issues concerning the treatment of such instruments by the CFTC under the CEA and CFTC regulations. The CFTC issued a rule amending its hybrid instrument exemption. The rule applies to certain hybrid instruments that combine

[21] E.g., California and New York.

characteristics of commodity futures contracts or commodity options with equity, debt, or depository instruments. Under the rule, hybrid instruments that are predominantly securities, debt, or depository instruments are exempt from CFTC regulation in deference to the primary regulator.

Insurance Activities of Banking Organizations

Banks and bank holding companies are generally not permitted to sell and underwrite insurance except in limited circumstances. National banks are permitted to sell, underwrite, and reinsure insurance that is credit-related or otherwise part of, or incidental to, the business of banking. National banks may also act as insurance agents in towns with a population of less than 5,000 where the bank is located and doing business, even if the principal office of the bank is located in a community with a larger population. National banks are also permitted to act as brokers to sell variable rate as well as fixed-rate annuities, which the OCC regards as financial investments rather than insurance. State insurance laws and regulations generally apply to national banks if their provisions do not prohibit or significantly interfere with bank insurance authorities.

Recent Developments in the United States

There have been several significant developments since 1994 in the United States regarding the national treatment accorded to foreign firms in the financial services sector. The most important development occurred in December 1997, when the United States entered into a binding agreement for financial services under the General Agreement on Trade in Services (GATS) in the World Trade Organization (WTO). Under this agreement, the United States submitted a schedule of binding commitments regarding market access and national treatment for foreign firms in the banking, securities, and insurance areas.

The U.S. banking and securities commitments provide a broad commitment of national treatment to foreign firms, with certain narrow reservations reflecting existing federal and state laws. The schedule also included a statement of the Administration's support for Glass-Steagall reform on a national treatment basis. The WTO Financial Services Agreement is discussed in Chapter 3 of this study.

In addition, there have been a number of statutory and regulatory developments since 1994 that affect foreign banks. The most important, discussed below in greater detail, are:

- legislation enacted by the various states implementing the Riegle-Neal Act;
- the Federal Reserve's initiation in 1995 of a new program for coordinating the supervision of the U.S. operations of foreign banks with U.S. offices supervised by different U.S. banking supervisory agencies;

- creation by the Conference of State Bank Supervisors (CSBS) of a working group on international bank supervision and a draft framework for streamlining supervision of foreign banks with interstate operations similar to the program developed for domestic banks;

- the FDIC's implementation of a streamlined approach to supervising banking companies with multi-chartered operations.

- the OCC's initiatives for coordinating the supervision of the U.S. banking operations of foreign banks;

- the enactment of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 that included amendments to the IBA affecting the entry of foreign banks into the United States and examination of their U.S. operations;

- the Federal Reserve's increase of the amount of total revenue that securities underwriting and dealing subsidiaries of bank holding companies (so-called "Section 20 Subsidiaries") may derive from underwriting and dealing in bank-ineligible securities pursuant to section 20 of the Glass-Steagall Act;

- the Federal Reserve's streamlining of the prudential restrictions ("firewalls") applicable to the activities of Section 20 Subsidiaries, and reformatting the restrictions as regulatory operating standards;

- the Federal Reserve's revision of its Regulation Y governing the U.S. operations of domestic and foreign banking organizations to streamline the application process and expand the range of nonbanking activities permissible for bank holding companies;

- the Federal Reserve's publication for comment of a proposed revision to its Regulation K governing the cross-border operations of U.S. and foreign banking organizations;

- the OCC's completion of a comprehensive review and revision of its international banking activities regulation and other regulations to eliminate unnecessary regulatory burden, promote competitiveness, and make the rules simpler;

- the OCC's reduction of assessment fees of foreign banks with more than one federal branch or agency, as well as of some national banks;

- the OCC's lightening of the regulatory burden on federal branches and agencies by modifying its supervisory strategy;

- the OCC's determination that additional activities are permissible for national banks and federal branches and agencies, such as mortgage reinsurance activities, insurance agency activities, and delivery of products and services to customers through electronic means, including Internet banking;

- the FDIC's revision to its Part 347, which consolidates, updates, and streamlines rules that apply to international banking to improve efficiency, reduce costs, and modernize requirements; and

- H.R. 10, a bill that would have repealed the provisions of the Glass-Steagall Act that restrict banks from affiliating with securities underwriters and would have otherwise modernized certain aspects of the financial service system.

State Implementation of the Riegle-Neal Act

As discussed above, the Riegle-Neal Act was enacted by Congress in September 1994. As of September 1995, interstate banking by acquisition was in effect in all 50 states and, as a result, any bank holding company, including foreign banking organizations, may acquire a bank subsidiary in any state without geographic restriction.

With respect to interstate branching, by July 8, 1997, 50 states, the District of Columbia, and Puerto Rico had enacted legislation on interstate branching by merger. Only Montana and Texas adopted legislation intended to prohibit interstate branching by merger, and Texas subsequently reversed its position. In the majority of states, out-of-state banks are not permitted to acquire only a portion of an in-state bank's branch network, but rather must acquire the entire bank. Most states require that an in-state bank be in existence a minimum of 3 to 5 years before being eligible for acquisition by an out-of-state bank under the Riegle-Neal Act. Legislation has been passed in 13 states (plus Puerto Rico and the District of Columbia) permitting some form of interstate *de novo* branching.

In general, a foreign bank may establish and operate a federally or state-licensed branch or agency in any state outside its home state to the same extent as a domestic bank with the same home state as the foreign bank. In addition, a U.S. bank controlled by a foreign bank may establish branches outside its home state to the same extent as other U.S. banks.

FBO Supervision Program

Consistent with economic efficiency and national treatment, foreign banking organizations (FBOs) are free to conduct their U.S. activities through a variety of forms. As a result, however, FBOs may be subject to a number of state and federal statutes, and various aspects of their operations may be supervised and regulated by both state and federal banking supervisory authorities.

In order to ensure coordination of supervisory efforts, avoid duplication and reduce burden, as well as provide a more uniform approach to FBO supervision, in 1995 a joint program to coordinate the supervision of the U.S. operations of FBOs was initiated among federal and state bank supervisors, particularly with respect to their examination plans, examination results, and, where applicable, their proposed supervisory follow-up actions (the "FBO Supervision Program"). The FBO Supervision Program encompasses all branches and agencies established by FBOs in the United States, all U.S. banks that are subsidiaries of FBOs, and all non-bank subsidiaries of FBOs authorized by the FRB to operate under section 4 of the Bank Holding Company Act.[22] As part of this program, the Federal Reserve, as the supervisor with overall responsibility for the U.S. operations of individual FBOs, also began annual assessments of the combined U.S. operations of each FBO. The OCC also prepares annual assessments. The FBO Supervision Program was revised in June 1998 to bring it into alignment with the Risk-Focused Framework for the Supervision of Large Complex Institutions applicable to domestic banks and bank holding companies. Under this framework, the appropriate bank supervisor prepares a Risk Matrix and Risk Assessment, Supervisory Plan, Examination Program, and Scope Memorandum for each FBO which are used in planning and coordinating the examination and supervision of FBOs.

Generally, each U.S. banking office of an FBO is subject to one safety and soundness examination at least every 12 months unless the office is eligible for less frequent examination. The agency responsible for the examination of an office is also responsible for completion of the examination and preparation of the examination report for that entity. In the case of joint examinations, the examining agencies will strive to issue only one report of examination for that office of the FBO.

An important component of the FBO program is the integration of individual examination findings into an assessment of an FBO's entire U.S. operations. This assessment provides the FBO, as well as the U.S. supervisory agencies, with a view of the overall condition of the U.S. operations, and helps put into context the strengths and weaknesses of individual offices.

Following the conclusion of the last examination of an FBO's U.S. operations in a given annual supervisory cycle, a Summary of Condition is prepared for the FBO. The Summary of Condition is a single-component rating for the FBO's combined U.S. operations. The evaluation includes an assessment of all risk factors, focusing on the components of the ROCA rating system. The Summary of Condition and rating of the FBO's combined U.S. operations represent important tools that are to be utilized in reaching decisions regarding the scope and frequency of future examinations and appropriate supervisory measures. The Summary of Condition is prepared as a letter to the

[22] As of October 31, 1998, FBOs operated 398 state-licensed branches or agencies, with total assets of US$855 billion, and 64 federally licensed branches or agencies, with total assets of US$74 billion. In addition, 61 state-chartered banks (total assets of US$130 billion) and 24 national banks (total assets of US$139 billion) were subsidiaries of FBOs. Finally, 680 non-bank subsidiaries of FBOs, with total assets of US$805 billion, were operating under authority of the Bank Holding Company Act.

FBO's head office management and highlights those areas of overall strength and systemic weaknesses in the FBO's U.S. operations. These results are also shared with the FBO's home country supervisor.

CSBS Initiatives for Coordination of FBO Supervision

In October 1997, the Conference of State Bank Supervisors (CSBS) formed the International Working Group, which will seek to improve the coordination and consistency of supervision of state-licensed foreign banking organizations operating in more than one state. The working group is composed of the heads of banking supervision for several states that are important international banking centers, such as New York, California, and Florida, as well as representatives from the Federal Reserve System and the FDIC.

In June 1998, the CSBS published a working draft of an agreement for coordination of examinations of foreign banking organizations with state-chartered or licensed operations in more than one state. The draft agreement, the Nationwide Foreign Banking Organization and Examination Coordination Agreement, is patterned after a similar arrangement recently developed for interstate domestic banking organizations. Under the draft agreement, the U.S. banking operations of all FBOs with multi-state operations would be subject to a supervision and examination process directed by a "State Coordinator." The state supervisors sharing responsibility for an FBO would choose a single state regulator to act as the FBO's State Coordinator. The State Coordinator for an FBO would act as the single point of contact for coordination of the supervision and examination of the FBO's state-licensed and chartered operations, and to the extent applicable, for coordination of release of supervisory information and resolution of multi-state consumer complaints related to the FBO. Each individual state supervisor would remain primarily responsible for supervising its own state-licensed or chartered foreign bank operations, and for informing the State Coordinator of any information received from the FBO or a locally licensed office. In addition, the draft agreement recognizes that any given state's law governs the operations of a state-licensed foreign bank office within that state's borders.

The State Coordinator, the responsible Federal Reserve Bank, and where applicable the FDIC would be responsible for developing a written comprehensive supervisory plan tailored to the FBO's structure and risk profile of the FBO's state-licensed operations in the United States. The comprehensive plan may include, but is not limited to, the following:

- a risk assessment and risk matrix of the FBO's U.S. operations;
- an examination plan that details the type, scope, timing, and location of on-site safety and soundness and specialty examinations;

- review and assessment of pending issues, such as the status of applications and compliance with supervisory actions;
- off-site monitoring plans; and
- such other matters as are necessary to promote the safety and soundness of the FBO's U.S. operations.

To the extent permitted under applicable law and regulation, examinations could be conducted on a joint basis or on an alternate year basis between participating state and federal bank supervisory agencies. The State Coordinator would receive copies of all examination reports or examination memoranda reflecting the findings, recommendations, and conclusions derived from the on-site examination of each office subject to examination. The State Coordinator, the responsible Federal Reserve Bank, and where applicable the FDIC, in cooperation with other participating federal and state supervisors, will use this information, together with other supervisory information deemed appropriate, in preparing an assessment of the state-licensed U.S. operations of the FBO.

In addition to examinations, the draft agreement provides for coordination of multi-state applications by FBOs. An FBO with multi-state offices filing an application for more than one office will file an application with its State Coordinator indicating activities applied for and locations at which these activities are to be conducted. The State Coordinator would copy the application to the affected state supervisors for their action and coordinate responses to the FBO. Each state supervisor would be responsible for the processing of applications regarding an FBO's offices in its state.

FDIC Initiatives for Coordination of FBO Supervision

The FDIC has reorganized its supervisory approach so that one individual is assigned responsibility for each banking company, including each FBO. This individual has continual responsibility to monitor an FBO and serves as the FDIC point of contact for FBO management. This approach simplifies the supervisory process for FBOs that operate multiple facilities in the United States.

OCC Initiatives for Coordination of FBO Supervision

At the federal level, the OCC's supervision of the federal branches and agencies of FBOs is centralized through the Northeastern District Office in New York, New York. This single point of contact helps ensure consistency in the examination process, supervisory decisions, and regulatory responses to questions and issues. This becomes even more significant when an FBO has multi-state branches. The OCC assigns responsibility for each FBO to one examiner. This examiner becomes the portfolio manager for a specified institution and is responsible for all supervisory manners regarding this institution. Through the supervisory strategies developed for each federal branch and agency, a seamless, continuous supervisory process is ensured that includes quarterly off-site reviews and on-site examinations of federal branches.

Economic Growth and Regulatory Paperwork Reduction Act of 1996

Home country supervision. The Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) was signed into law in September 1996 and contained amendments to the IBA affecting a foreign bank's entry into and operation in the U.S. market. In addition to approval from the OCC or a state supervisor, and in some cases the FDIC, the IBA requires foreign banks to obtain FRB approval prior to establishing a branch or agency office, or acquiring control of a subsidiary bank, in the United States. As discussed above, the IBA mandated that in order for the FRB to approve such an application, it must find that the applicant foreign bank is subject to "comprehensive supervision or regulation on a consolidated basis" by the appropriate authorities in its home country.

Recognizing the need for more flexibility in relation to this standard, Congress in EGRPRA amended the IBA to permit the FRB, in its discretion, to approve a branch or agency application without a determination that the foreign bank is currently subject to CCS. The amendment provides an exception to the CCS requirement in cases where the FRB is unable to find that the applicant is subject to CCS, but can find that the appropriate authorities in the applicant's home country are "actively working to establish arrangements for the consolidated supervision" of the applicant. In deciding whether to exercise its discretion to approve an application under this exception, the IBA requires the FRB to consider whether the foreign bank has adopted and implements procedures to combat money-laundering. Another factor the FRB may take into account is whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering.

Time limit for FRB action on foreign bank applications. EGRPRA also amended the IBA to impose statutory time limits on the FRB's consideration of applications submitted by foreign banks to establish a branch or agency office in the United States. Pursuant to EGRPRA's amendments, the FRB generally is required to take final action on such applications not later than 180 days after receipt of the application. The FRB may extend the review period for an additional 180 days after providing notice of the extension to the applicant and explaining the reasons for the extension. A foreign bank is permitted to waive the 180-day requirement for final action.

Examination fees. EGRPRA also amended a provision of the IBA regarding examination fees for foreign banks. Prior to EGRPRA, the IBA mandated that the cost of the Federal Reserve's examination of a foreign bank's U.S. operations be assessed against and collected from the foreign bank, while there was no similar requirement with respect to the costs of examinations of domestic banks. EGRPRA amended this provision to clarify that examination costs would be assessed by the FRB against foreign banks only to the extent that fees are collected by the FRB for examination of any state member bank.

Examination schedule. In addition, EGRPRA amended the IBA to provide that offices of foreign banks should be subject to on-site examination as frequently as domestic national and state banks. Prior to this amendment, the IBA stated that each branch and agency of a foreign bank must be examined at least once during each 12-month period in an on-site examination. Although national and state banks must be examined every 12 months, the FDI Act permits the federal banking agencies to examine national and state banks with total assets of US$250 million or less every 18 months, rather than every 12 months, provided they satisfy certain eligibility requirements. In order to extend similar treatment to U.S. offices of foreign banks, the Federal Reserve, the FDIC, and the OCC adopted regulations that make U.S. branches and agencies of foreign banks with total assets of US$250 million or less eligible to be considered for an 18-month examination cycle rather than a 12-month cycle if they meet certain qualifying criteria, which are similar to the criteria applied to domestic banks.

Increase in Section 20 Revenue Limit

In December 1996, the FRB announced an increase in the amount of revenue that a Section 20 Subsidiary could permissibly derive from underwriting and dealing in bank-ineligible securities (i.e., securities that a Federal Reserve member bank would not be permitted to underwrite or deal in) from 10 percent to 25 percent of its total revenue. The increase became effective in March 1997.

Section 20 of the Glass-Steagall Act provides that a member bank may not be affiliated with a company that is "engaged principally" in underwriting and dealing in securities. Since 1987, the FRB has permitted bank holding company subsidiaries to underwrite and deal in bank-ineligible securities. The FRB has established a revenue test to determine whether a company is "engaged principally" in underwriting and dealing for purposes of section 20. Through several interpretive steps in a series of orders, the FRB's revenue test was developed to provide that a Section 20 Subsidiary could derive <u>no more than</u> 10 percent of its total revenue from underwriting and dealing in bank-ineligible securities and still be considered <u>not</u> to be "engaged principally" in underwriting and dealing.

In July 1996, the FRB proposed to increase the revenue limit from 10 percent of total revenue to 25 percent. The FRB based this proposed increase on the experience it has gained through supervision of Section 20 Subsidiaries over the years. The FRB stated its belief that the limitation of 10 percent of total revenue it adopted in 1987, without benefit of this experience, had unduly restricted the underwriting and dealing activity of Section 20 Subsidiaries. The FRB noted that changes in the product mix that Section 20 Subsidiaries are permitted to offer and development in the securities markets had affected the relationship between revenue and activity since 1987. After receiving public comment on the proposal, the FRB concluded that a Section 20 Subsidiary will not be engaged principally in underwriting and dealing for purposes of section 20 so long as ineligible revenue does not exceed 25 percent of total revenue.

Revision of the Section 20 Firewalls

In August 1997, the FRB announced its decision to streamline or eliminate many of the Section 20 firewalls that have proven to be unduly burdensome or unnecessary in light of other laws or regulations, and consolidate the remaining restrictions in a series of eight "operating standards," which became effective on October 31, 1997. The FRB concluded that the narrower set of restrictions will be fully consistent with safety and soundness and should improve operating efficiencies at Section 20 Subsidiaries and increase options for their customers.

As discussed above, beginning in 1987, the FRB has issued a series of orders authorizing bank holding companies to establish Section 20 Subsidiaries to engage in underwriting and dealing within the limits of the Glass-Steagall Act. In those orders, the FRB established a series of prudential restrictions (the "firewalls") as conditions for approval under the Bank Holding Company Act. The firewalls were designed to prevent securities underwriting and dealing risks from being passed from a Section 20 Subsidiary to an affiliated insured depository institution, and thus to the federal safety net, and to mitigate the potential for conflicts of interest, unfair competition, and other adverse effects that may arise from the affiliation of commercial and investment banks.

In January 1997, the FRB requested comment on its proposal to rescind many of the firewalls and consolidate the remainder in operating standards to be published in the Code of Federal Regulations. The proposal was developed through the FRB's comprehensive review of its regulations and written policies that was required by section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994. That statute directs the FRB and other banking agencies to streamline their regulations to improve efficiency, reduce unnecessary costs, and eliminate unwarranted constraints on credit availability. In the proposal, the FRB stated that in its experience the risks of securities underwriting and dealing had proven to be manageable in a bank holding company framework, and that other activities posing similar risks for which no firewalls were erected had been successfully undertaken and managed. The FRB concluded that the great majority of risks of affiliation of commercial and investment banks are addressed by other provisions of law and regulations, including the securities laws and regulations of the Securities and Exchange Commission, National Association of Securities Dealers, and securities exchanges that apply to a Section 20 Subsidiary just like any other broker-dealer. In certain areas, however, the FRB determined that there are unique risks of affiliation that are not adequately addressed by other laws, and adopted the operating standards to address those risks.

The transition from firewalls to the new operating standards will result in bank holding companies being able to operate Section 20 Subsidiaries in a less costly and more efficient manner. These benefits and reduction in burden are available to U.S. and foreign banking organizations on an equal footing.

Revision of Regulation Y

In 1997, the Federal Reserve issued a revision of its Regulation Y which governs the operations of U.S. bank holding companies and foreign banking organizations that are subject to the BHC Act. The revisions were designed to eliminate unnecessary regulatory burden and operating restrictions and streamline the application/notice process for expansion of activities. The revisions include:

- a streamlined and expedited review process for bank and nonbanking proposals by bank holding companies and foreign banking organizations that qualify as "well-capitalized" and "well-managed";

- expansion of the list of nonbanking activities and removal of a number of restrictions on those activities that are outmoded, have been superceded by FRB order, or are unnecessary restrictions that would not apply to insured banks that conduct the same activity;

- amendments to the tying restrictions, including a "safe harbor" for foreign transactions; and

- other changes to eliminate unnecessary regulatory burden and to streamline and modernize Regulation Y.

Streamlined application procedures. In order to assure national treatment of foreign banking organizations under the streamlined procedures, the revision includes a number of provisions that specifically accommodate foreign banking organizations. For purposes of eligibility for the streamlined review process, the revision defines a "well-capitalized" bank holding company to require, among other things, that the organization maintain a total risk-based capital ratio of 10 percent or greater and a Tier 1 risk-based capital ratio of 6 percent or greater, on a consolidated basis both before and immediately following consummation of the proposal. The revision provides that a foreign banking organization may use the capital terms and definitions <u>of its home country</u> provided that those standards are consistent in all respects with the Basle Capital Accord. If the home country has not adopted those standards, the foreign banking organization may use the streamlined procedures if it obtains from the FRB a prior determination that its capital is equivalent to the capital that would be required of a U.S. banking organization for these purposes. For purposes of determining eligibility for the streamlined procedures, the revision states that U.S. branches and agencies of foreign banking organizations shall be deemed to have the same capital ratios as the foreign banking organization.

For purposes of determining whether a foreign banking organization meets the "well-managed" requirement for the streamlined procedures, the revision requires that: (i) the largest U.S. branch, agency, or depository institution controlled by the foreign bank have received at least a "satisfactory" composite examination rating from its U.S. banking supervisor; (ii) U.S. branches, agencies and depository institutions representing at least 80 percent of the U.S. risk-weighted assets controlled by the foreign banking organization at such offices have received at least a "satisfactory" composite examination rating from the U.S. banking supervisors; and (iii) the overall rating of the foreign banking organization's combined U.S. operations is at least "satisfactory." Further, no branch, agency, or depository institution may have received one of the two lowest composite ratings at its most recent examination. In addition, as with domestic bank holding companies, no U.S. branch, agency or insured depository institution may be subject to an asset maintenance agreement with its chartering or licensing authority.

The Federal Reserve may disqualify any banking organization, including a foreign banking organization, from using the streamlined procedure for any appropriate reason, including if information from the primary supervisor of a domestic bank or home country supervisor for a foreign bank indicates that a more in-depth review of proposals involving that organization is warranted.

Tying restrictions. In addition, the Regulation Y revision provides a "safe harbor" to the anti-tying rules created by section 106 of the Bank Holding Company Act Amendments of 1970. The revision created a safe harbor for transactions with corporate customers that are incorporated or otherwise organized, and have their principal place of business, outside the United States, or with individuals who are citizens of a foreign country and are not resident in the United States. Recognizing that U.S. legislation generally is presumed to apply only within the territorial jurisdiction of the United States, the safe harbor is intended to provide certainty for the applicability of the anti-tying rules to a defined set of transactions.

Proposed Revision of Regulation K

In December 1997, the Federal Reserve issued for public comment its proposed revision to Regulation K governing, among other things, the U.S. operations of foreign banking organizations. The FRB's proposed revisions to Regulation K would affect the U.S. nonbanking activities of certain qualifying FBOs, and the interstate banking operations of foreign banks in the United States.

QFBO activities. The FRB's proposed regulations include certain revisions to the qualifying foreign banking organization (QFBO) standard, and the permissible activities of QFBOs. Status as a QFBO is required in order for a foreign banking organization to take advantage of certain exemptions to the nonbanking restrictions contained in section 4 of the Bank Holding Company Act. In order to qualify as a QFBO, a foreign banking organization must demonstrate that: (i) more than half of its business is banking; and (ii) more than half of its banking business is conducted outside the United States. Banking business is defined to include the activities permissible for a U.S. banking organization to conduct, directly or indirectly, outside of the United States.

Under the current regulation, such activities must be conducted in the foreign bank itself or in the foreign bank's subsidiaries in order to be counted as part of the foreign bank's banking business for purposes of meeting the QFBO test. The FRB's proposed revision would permit:

- financial activities conducted by a foreign bank's holding company or sister affiliates to be counted toward the first prong of the QFBO test (that more than half of the foreign banking organization's activities be "banking"); and

- a QFBO indirectly to hold up to 10 percent (up from the current 5 percent) of the shares of a U.S. company that underwrites, sells or distributes securities in the United States in a manner that is impermissible for U.S. bank holding companies.

In addition, the FRB requested public comment on whether the list of activities that would be considered "banking" for purposes of the QFBO test should be expanded beyond the activities permissible for a U.S. banking organization abroad.

Limitations on nonbanking subsidiaries of QFBOs. The FRB also requested comment on whether it should prohibit a QFBO from using its U.S. nonbanking companies held pursuant to section 4(c)(8) of the Bank Holding Company Act to hold the shares of foreign subsidiaries that engage in activities that are impermissible for U.S. banking organizations. Regulation K currently exempts a QFBO from the nonbanking restrictions contained in section 4 of the BHC Act for any activity conducted by the QFBO outside the United States. The FRB noted that some QFBOs have interpreted the general exemption in Regulation K for non-U.S. activities as extending to the foreign subsidiaries of section 4(c)(8) subsidiaries. The FRB stated that the exemption was not intended to allow U.S. companies owned by QFBOs under section 4(c)(8) to engage in unrestricted foreign activities.

Interstate operations under the Riegle-Neal Act. The FRB's proposal also includes revisions to reflect changes to the authority of U.S. and foreign banking organizations to conduct interstate banking operations contained in the Riegle-Neal Act. The revisions basically link the ability of foreign banks to operate on an interstate basis to the ability of a U.S. bank or bank holding company with the same home state to do so. This framework is intended to advance the policy of providing national treatment to foreign banks with respect to their U.S. operations. The revisions provide for:

- a new procedure whereby a foreign bank could change its home state an unlimited number of times if it can show that a domestic bank with the same home state would be able to change its home state in a similar manner;

- upon a change in home state, retention by a foreign bank of any existing interstate branches if the foreign bank could establish such branches from its new home state under current law; and

- deletion of the home state "attribution rule," which provides that a foreign bank (or other company) and all other foreign banks which it controls must have the same home state.

Streamlined procedures for establishing U.S. offices in certain situations. The FRB's proposal also contains provisions for streamlining the approval process for additional U.S. banking offices of a foreign bank under certain circumstances. As discussed above, the Foreign Bank Supervision Enhancement Act (FBSEA) generally requires the FRB to determine that a foreign bank is subject to CCS by its home country supervisor before approving an application by that foreign bank to establish a branch or agency office in the United States. Under the FRB's proposed revisions, the general requirement for a CCS determination is retained, but foreign banks that have been approved previously by the FRB for a U.S. office under FBSEA, or are subject to FRB supervision under the BHC Act, would be permitted to establish additional U.S. direct offices under prior notice or general consent procedures, depending on the nature of the foreign bank applicant's previous FRB approvals, and the type of additional office desired. The proposed streamlined procedures provide for:

- establishment of additional U.S. branches, agencies, commercial lending company subsidiaries, and representative offices pursuant to a 45-day prior notice procedure by any foreign bank that the FRB has determined to be subject to CCS in a prior application under FBSEA;

- establishment of a representative office pursuant to a 45-day prior notice by any foreign bank that the FRB had previously approved to establish a representative office, or is subject to the BHC Act;

- general consent for the establishment of a representative office by a foreign bank that is both subject to the BHC Act, and previously has been determined by the FRB to be subject to CCS; and

- general consent for the establishment of a regional administrative office by any foreign bank that is subject to the BHC Act.

The proposed revision would also amend Regulation K to reflect the FRB's discretion to approve a branch or agency application without a determination that the foreign bank is currently subject to CCS, if the FRB finds that appropriate authorities in the applicant's home country are "actively working to establish arrangements for the consolidated supervision" of the applicant. The regulatory revision makes it clear that, in approving an application under this authority, the FRB may impose any conditions or restrictions relating to the activities or business operations of the proposed office or subsidiary, including restrictions on sources of funding.

Revision of All OCC Regulations, Including International Banking Activities Regulation

In May 1996, the OCC revised its regulations relating to international banking activities, now found in Part 28. Revised Part 28 reduces burden by removing the requirement for the two separate filings that national banks formerly had to make when they establish a foreign branch or acquire certain foreign investments. It permits national banks simply to provide notice of these transactions. This notice requirement may be satisfied by providing the OCC with a copy of the filing made with the FRB. Under the new regulation, the OCC accepts a copy of an application form, notice, or report submitted by a foreign bank or a federal branch or agency to another federal regulatory agency that covers the proposed action and contains substantially the same information that would be required by the OCC. Revised Part 28 also consolidates the substantive requirements governing international banking operations supervised by the OCC into a single, comprehensive regulation.

The OCC also revised Part 5, Rules, Policies, and Procedures for Corporate Activities, which applies to federal branches and agencies. The final rule comprehensively revises and streamlines the OCC's rules, policies, and approval process for applications and corporate filings. It also substantially revises the OCC's operating subsidiary rules, providing different levels of review and treatment for operating subsidiary applications depending on the novelty and complexity of the activities to be undertaken. The final rule establishes a procedure that national banks can use to request approval for an operating subsidiary to engage in activities that would not be permissible for the bank to conduct directly. This latter type of application is subject to a public notice and comment process, and the OCC will approve such an application only under certain, well defined conditions. The OCC has issued 22 booklets updating the Comptroller's Corporate Manual to provide more specific guidance on Part 5 and other revised regulations.

Finally, the OCC revised other significant regulations that, like Part 5, apply to federal branches and agencies as well as national banks because a federal branch or agency generally conducts its operations subject to the same authority and limitations as a national bank. The final revision to Part 7, Interpretive Rulings, modernizes and clarifies interpretive rulings in a variety of areas, including electronic money and banking, corporate governance, and the definition of "interest" for purposes of 12 U.S.C. § 85. The OCC's revision of Part 1, Investment Securities, updates the OCC's regulations to reflect certain statutory changes and codifies important OCC interpretive positions with respect to the permissibility of asset securitization and indirect investment in assets in which a national bank may invest directly. The final revision to Part 9, Fiduciary Activities, comprehensively revises the OCC's fiduciary activities regulation. The new regulation includes revisions to the rules on collective investment funds and modernizes the OCC's rules to reflect the significant changes that have taken place in the way national banks conduct these lines of business.

Reductions in Assessment Fees on National Banks and Federal Branches and Agencies

The OCC has modified its assessment regulation, Part 8, in a manner that reduced the assessment fees of foreign banks with more than one federal branch or agency. Certain federal branches and agencies are now eligible for the reduction in assessments that is available for "non-lead" national banks that are part of a holding company. If a foreign bank has more than one federal branch or agency, the largest branch will pay the full assessment, and the other branches will have their assessment reduced by 12 percent.

Reduction in Regulatory Burden on Federal Branches and Agencies

The OCC has modified its supervision of federal branches and agencies to reduce the regulatory burden by increasing focus on the foreign bank as a whole and decreasing focus on the federal branch or agency as a stand-alone operation. These changes are consistent with the OCC's supervision of national banks, which emphasizes risk management in the banking organization as a whole. Specifically, the revised policies provide that:

- The OCC discontinued its policy of requiring a branch-specific allowance for loan and lease losses (ALLL) or that the parent bank management acknowledge that an ALLL for federal branch assets is being maintained on a consolidated basis. Instead, to aid examiners in assessing the adequacy of the credit risk management processes, federal branches and agencies must be able to demonstrate the maintenance of an effective loan review system and controls in conformity with current OCC policy on the ALLL;

- The OCC eliminated the 10 percent of assets threshold currently used to identify concentrations of assets at federal branches and agencies, and examiners will instead assess the adequacy of systems and procedures at a federal branch or agency that enable the head office to monitor and evaluate asset concentrations;

- The OCC eliminated the requirement that federal branches and agencies with a Net Due From Head Office position in excess of 50 percent of assets work to reduce this position. Instead, examiners will review the adequacy of Net Due To/From Head Office positions on a case-by-case basis as part of the assessment of the parent company's strategies for funding the federal branch or agency and the overall liquidity position of the branch.

Additional Activities Permissible for National Banks or Federal Branches and Agencies

The OCC has determined that a number of additional activities or investments are permissible for national banks or federal branches and agencies. Federal branches and agencies generally may conduct the same activities, subject to the same restrictions, as national banks. Some recent OCC decisions include the following:

- A federal branch may enter into net leases of real estate to serve the home finance needs of its Muslim customers, who are prohibited by religious principles from obtaining traditional mortgages. The net leases are structured so that all of the indicia of ownership pass to the lessee and the leases meet secular accounting standards for being classified as financing transactions.

- Full participation in a multilateral clearing organization is allowed for foreign banks with federal branches and agencies. Netting and collateral agreements of the multilateral clearing organization are enforceable against participants that are uninsured federal branches or agencies in the event the OCC appoints a receiver for the federal branch or agency.

- A national bank may offer time deposits to its customers in approximately 20 different foreign currencies through the Internet and through traditional means.

- The U.S. Supreme Court upheld the OCC's determination that the National Bank Act preempts state law prohibiting most banks from selling insurance as agent. The OCC subsequently decided that a national bank's insurance agency is permitted the same marketing range and same marketing tools and facilities as are generally available for licensed insurance agencies in the state where the bank agency operates.

- A national bank may act as a finder for customers and insurance agents and split commissions with the insurance agent, but must comply with applicable state insurance laws.

- Despite state laws prohibiting banks from selling annuities, a national bank may sell as agent variable-rate as well as fixed-rate annuities, which the OCC regards as financial investments rather than insurance under the National Bank Act.

- A national bank subsidiary may underwrite and reinsure credit disability and involuntary unemployment insurance in connection with credit card loans made by the bank's affiliated credit card bank.

- In addition, a national bank may underwrite safe deposit box liability insurance for the bank and its affiliates.

- It is permissible for a national bank subsidiary to enter into reinsurance agreements with a number of unaffiliated insurance carriers that issue mortgage insurance on mortgage loans originated or purchased by the bank or its affiliates. A national bank may establish a reinsurance subsidiary that reinsures private mortgage insurance on loans originated, purchased, or serviced by a bank and its affiliates.

- A national bank operating subsidiary may, subject to special conditions, underwrite, deal and invest in municipal revenue bonds.

- A national bank may exchange portions of its portfolio of Brazilian, Mexican, and other Latin American countries' sovereign debt (held in the form of Brady bonds) for minority interests in unaffiliated investment companies formed to invest in Brazil, Mexico, and Latin America, respectively.

- A national bank subsidiary may act as a certification authority and repository for electronic "certificates" used to verify digital signatures.

- National banks, through minority investments in a limited liability company, may operate an electronic network and gateway to support home banking operations of the investing banks and other banks. A national bank may provide home banking services by means of a direct and Internet connection to the bank's home banking system.

- A national bank may make a minority investment in a company providing electronic funds transfer and electronic data interchange in a worldwide electronic commerce network.

- As part of the business of banking, a national bank may purchase a minority interest in a limited liability company engaged in the development, distribution, and maintenance of computer software for cash management applications.

- In the context of correspondent banking services, a national bank, through an operating subsidiary, may provide computer network services and related full function hardware to other financial institutions.

- National banks may invest in a company that would issue electronic stored value in an open or widely dispersed system and provide support services for the stored value system and invest in a company that would develop, install, and support "closed" stored value systems based on smart card technology.

- A national bank can acquire and lease real property provided the real estate lease transaction is incidental to a permissible lease financing of personal property.

In addition, following consultation with the State of New York and FRB, the OCC determined that a foreign bank's federal branch in the United States would be permitted to operate through a loan production office in New York.

Revision of Part 347

Effective July 1, 1998, the FDIC revised its Part 347 in order to modernize and clarify various rules for international and foreign banking activities. The new Part 347 reduces filing requirements (now in Part 303 – Subpart J) for most banks wishing to open a foreign branch or make a foreign investment. Well-run, well-capitalized institutions with no enforcement actions pending against them that meet certain other criteria may utilize FDIC's new general consent process when initiating new activities abroad. This means an eligible institution can presume to have the FDIC's approval to engage in certain activities. The institution is required to notify the FDIC after new operations begin. Alternatively, well-run, well-capitalized institutions ineligible to proceed under the presumption of general consent can now take advantage of expedited processing for their applications. Under expedited processing, applications will be acted upon within 45 days of receipt. However, general consent and expedited processing procedures do not apply if the foreign branch or investment would be located in a foreign country in which applicable law or practice would limit the FDIC's access to information for supervisory purposes. The new rule also:

- Eliminates a general limit on foreign investment of 25 percent of capital. New investment limitations are associated with specific types of activities. The regulation also includes procedures for requesting modifications to the limits.

- Permits a bank's foreign branch to underwrite, distribute and deal, invest in and trade obligations of any foreign government, rather than just the obligations of the country in which it is located. Banks may also invest directly in foreign organizations that are not banks.

- Simplifies accounting for fees on international loans. Instead of requiring specific accounting procedures, the new rule directs banks to follow generally accepted accounting principles (GAAP).

- Requires banks to either establish reserves to account for transfer risk in international assets or use an alternative method consistent with GAAP.

Part 347 was also changed to reflect statutory requirements that a FBO's retail deposit-taking activities in the United States be conducted through an insured bank subsidiary, not an insured branch. This merely implements provisions of the FBSEA, which amended the IBA to require any foreign bank intending to conduct retail deposit activities in the United States to organize an insured bank subsidiary to conduct these deposit activities.

Under the new Part 347, quarterly, not semiannual, calculations and reporting are required for pledged assets that apply to the deposit activities of insured branches. The FDIC requires an insured branch to pledge assets equal to 5 percent of the average of the insured branch's liabilities for the last 30 days of the most recent calendar quarter. Part 347 retains the FDIC's previous requirements regarding the necessity for an insured state branch to apply to the FDIC for approval to conduct or continue an activity which is otherwise not permissible for a federal branch.

H.R. 10

The U.S. Congress has been debating and considering modernization of the U.S. financial system for many years. In the 105th Congress (1997-98), financial modernization legislation made significant progress but was not enacted. On May 13, 1998, the House of Representatives passed H.R. 10, the Financial Services Act of 1998, by a vote of 214-213. On September 18, 1998, the

Senate Committee on Banking, Housing, and Urban Affairs reported H.R. 10 to the full Senate by a vote of 16-2. This legislation was not, however, considered by the Senate before the 105th Congress adjourned. Legislation that is not enacted before a Congress adjourns does not carry over into the next Congress. It is expected that the 106th Congress (1999-2000) will again consider and debate legislation relating to this issue.

H.R. 10, the bill that was under consideration in the 105th Congress, would have repealed provisions in the 1933 Glass-Steagall Act that restrict affiliations and interlocking management and employees between banks and firms engaged in securities underwriting. The bill would have allowed any bank holding company – renamed a financial holding company (FHC) – to control a securities underwriting firm, as well as companies engaged in other types of financial activities, including insurance underwriting, if, among other things, the holding company controlled only well capitalized and well managed banks. Like other bank holding companies, FHCs would have been supervised by the FRB. Securities and insurance affiliates of FHCs would have been functionally regulated under other federal and state securities and insurance laws.

Foreign banks would have been able to be deemed to be FHCs. In determining whether to treat a company as a FHC, the FRB would have been required to establish and apply comparable standards to a foreign bank that operated a branch or agency or owned or controlled a bank or commercial lending company in the United States. In establishing and applying these standards, the FRB would have been required to give due regard to the principle of national treatment and equality of competitive opportunity.

H.R. 10 also would have created a new type of depository institution called a "wholesale financial institution" (WFI). The deposits collected by a WFI would not have been insured by the FDIC and a WFI generally could not have accepted retail deposits of under US$100,000. A foreign bank operating only uninsured branches, agencies, and commercial lending companies in the United States could have requested a determination from the FRB to be treated as a WFI so long as the foreign bank met certain restrictions, including comparable capital requirements and restrictions on affiliate transactions.

Foreign banks that chose to become FHCs or are treated as WFIs under the bill would have lost their grandfather rights to engage in nonbanking activities under the IBA. However, most grandfathered activities and investments would have become generally permissible under H.R. 10 for all FHCs, and H.R. 10 would have permitted other nonconforming investments to be conformed over a certain period, or, in certain cases, held indefinitely. If a foreign bank were engaged in grandfathered activities that became generally permissible for FHCs (e.g., securities underwriting), and the foreign bank did not elect to become an FHC or be treated as a WFI within two years of enactment of the bill, the FRB would have had the authority to impose restrictions on the conduct of the grandfathered activities comparable to those applicable to FHCs.

NATIONAL TREATMENT UNDER U.S. SECURITIES LAWS

The federal securities laws generally provide national treatment to foreign brokers, dealers and investment advisers. In addition, foreign issuers are generally subject to substantially the same registration and reporting requirements as U.S. issuers. In recent years, the Securities and Exchange Commission (SEC) has taken various actions aimed at simplifying access by foreign firms and issuers to the U.S. securities markets without compromising protection of U.S. investors.

Brokers and Dealers

The Securities Exchange Act of 1934 (Exchange Act) gives the SEC broad regulatory authority over the U.S. securities markets and persons in the securities business. Under the Exchange Act, the SEC oversees the activities of broker-dealers, the national securities exchanges, the National Association of Securities Dealers (NASD), clearing organizations, and nonbank transfer agents.

A broker-dealer, other than a U.S. bank, that uses the U.S. mails, or any other means of interstate commerce, to effect transactions in securities generally must register with the SEC. In registering, a broker-dealer is not required to report to the SEC the extent to which it is owned by foreign persons, although it must disclose the identities of certain control persons, whether domestic or foreign.

The SEC's policy with respect to broker-dealers is one of equal market access: the SEC seeks to apply the same requirements to all broker-dealers, whether U.S.- or foreign-owned or U.S.- or foreign-resident. These requirements include filing a registration form with the SEC, satisfying standards of financial responsibility, operational capacity, and integrity, maintaining minimum net capital, and filing reports with the SEC and self-regulatory organizations (SROs). To ensure that it can enforce the securities laws against a nonresident foreign broker-dealer, the SEC requires such a broker-dealer to appoint the SEC as agent for service of process for securities law related to claims arising out of the conduct of its business as a registered broker-dealer in the United States.

Exchange Act Rule 15a-6 exempts from registration foreign broker-dealers that engage in certain activities involving U.S. institutional investors and U.S. securities markets. These activities include "nondirect" contacts by foreign broker-dealers with U.S. investors and markets, through execution of unsolicited securities transactions and provision of research to certain U.S. institutional investors. The exempted activities also include certain "direct" contacts, involving the execution of transactions through a registered broker-dealer intermediary with or for certain U.S. investors, and without such an intermediary with or for registered broker-dealers; banks acting in a broker or dealer capacity; certain international organizations; foreign persons temporarily present in the United States; U.S. citizens resident abroad; and foreign branches and agencies of U.S. persons.

Registered broker-dealers are required to join one or more SROs, such as the national securities exchanges and the NASD. In general, SROs are statutorily authorized and are subject to SEC oversight. An SRO is responsible for compliance by its members with rules of the SRO as well as with the federal securities laws. The Exchange Act specifically limits the ability of the national securities exchanges and the NASD to exclude registered broker-dealers from membership, ensuring that foreign ownership is not a ground for denial of membership. Foreign incorporation, or other organization, of the foreign-owned broker-dealer is not a bar to membership in the NASD and most regional exchanges, but it is a bar to membership in the New York and American Stock Exchanges. These two exchanges permit foreign-owned members, but they require those members to be organized in the United States.

Brokers and dealers whose business is solely in U.S. government securities have been, since 1987, required to register and to meet standards established by the Secretary of the Treasury concerning capital adequacy, protection of customer securities and balances, and record-keeping and reporting. The Government Securities Act of 1986, as amended in 1993, generally does not distinguish between foreign and domestic government securities brokers and dealers. Essentially, government securities brokers and dealers are required to register with the SEC and to become members of an SRO, unless the entity is already registered with the SEC as a broker or dealer or is a financial institution. Government securities brokers or dealers that are already registered with the SEC or that are financial institutions must notify the appropriate regulatory agency of their status as government securities brokers or dealers. The Department of the Treasury has provided an exemption from registration, which parallels SEC Rule 15a-6, for foreign entities that are government securities brokers or dealers.

Investment Advisers

The Investment Advisers Act of 1940 (IAA) establishes a national treatment standard, treating foreign investment advisers substantially the same as domestic advisers that are registered with the SEC. Under the IAA, an investment adviser is defined as a person who, for compensation, "engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or . . . as part of a regular business, issues or promulgates analyses or reports concerning securities. . . ."

As a result of 1996 amendments to the IAA, supervision and regulation of investment advisers is split between the states and the SEC. Certain advisers, such as foreign investment advisers, investment advisers with total assets under management of US$25 million or more, and investment advisers that advise registered investment companies, only register with the SEC. Other investment advisers are now prohibited from registering with the SEC and only register with the states in which they maintain a principal place of business.

Whether domestic or foreign, investment advisers that use the U.S. mails or any means or instrumentality of interstate commerce in connection with their business are required to register with the SEC, unless they are prohibited from registering or an exemption is available. The IAA does not specify particular qualifications for registration. Registered advisers are subject to antifraud provisions (as are unregistered advisers), limitations on advisory compensation, and disclosure and recordkeeping requirements.

The following institutions and professionals are excluded from the definition of investment adviser: U.S., but not foreign, banks and bank holding companies; lawyers, accountants, engineers, or teachers whose investment advice is solely incidental to the practice of their professions. Also excluded are: brokers or dealers whose investment advice is solely incidental to the conduct of their business as brokers or dealers and who receive no special compensation for such advice; publishers of any bona fide newspaper or financial publication of general and regular circulation; and persons giving advice only with respect to U.S. government securities.

In addition, certain types of investment advisers are exempt from the registration requirements of the IAA. These are: any adviser whose clients are all in the state in which the adviser conducts business and who does not advise with respect to securities listed, or with respect to securities having unlisted trading privileges, on a national securities exchange; any adviser whose only clients are insurance companies; and any adviser with fewer than 15 clients who does not hold itself out to the public as an investment adviser and who does not advise registered investment companies. A foreign investment adviser that has its principal place of business outside the United States must only count clients that are U.S. residents for purposes of this exemption.

As noted above, the IAA excludes U.S. banks and bank holding companies from the definition of investment adviser. The SEC also requires an investment adviser, as a prerequisite to registration, to appoint the SEC as agent for service of process for securities law claims arising out of the conduct of its business as a registered investment adviser.

Prior to 1992, the SEC staff generally took the position that once registered, domestic and foreign advisers were subject to all of the substantive provisions of the IAA with respect to both their U.S. clients and non-U.S. clients. Thus, if a foreign adviser registered to advise U.S. clients, the IAA also would apply to its relationship with clients in its own country. The IAA restricts or prohibits some conduct that may be legal in other countries. As a result, some foreign advisers registered in the United States were not able to engage in certain advisory conduct that was legal in their own countries.

Many foreign advisers avoided this result by registering a separate and independent subsidiary to provide advice to their U.S. clients, while the foreign adviser-parent would remain unregistered and would be able to advise non-U.S. clients in its home country without being subject to the IAA. To establish that the foreign parent and the subsidiary were, in fact, separate, and that the parent was not doing indirectly what it could not do directly, the SEC staff imposed a number of conditions, such as prohibiting the parent and the subsidiary from sharing personnel and investment advice. These conditions made it difficult for the U.S.-registered subsidiaries to advise U.S. clients effectively.

Based on a recommendation in its report, *Protecting Investors: A Half Century of Investment Company Regulation,* May 1992, the SEC staff has determined that the substantive provisions of the IAA generally should not govern a foreign investment adviser's relationships with its non-U.S. clients unless those relationships involve "conduct" or have "effects" in the United States. Foreign advisers must comply with certain recordkeeping requirements with respect to their non-U.S. clients, and also generally must provide the SEC access to their books, records, and personnel.

The SEC staff has issued several no-action letters that apply this approach. These no-action letters also ease the conditions under which a foreign adviser can register a U.S. advisory subsidiary, and thus provide advice to U.S. clients, without requiring the parent itself to register under the IAA. Most importantly, the letters permit the foreign adviser and the U.S. subsidiary to share personnel and investment advice as long as the SEC has access to trading and other records of each affiliate involved in the U.S. advisory activities, and to its personnel, to the extent necessary to monitor and police conduct that may harm U.S. clients or markets. The SEC staff's approach may provide even greater incentives for foreign advisers to register and provide their services to U.S. clients.

Investment Companies

The Investment Company Act of 1940 (ICA) requires registration with the SEC of all nonexempt investment companies. Investment companies required to register under the Act are subject to statutory provisions that regulate, among other things: composition of management and management's accountability to shareholders; approval of investment advisory contracts; changes in fundamental investment policies; transactions between an investment company and affiliated persons; and the capital structure of investment companies.

Under Section 7(d) of the ICA, a foreign investment company (i.e., one not "organized or otherwise created under the laws of the United States or of a State") may not, in connection with a public offering in the United States or to U.S. persons, offer for sale, sell, or deliver its securities through the mails or interstate commerce unless the SEC, by order, finds that it is both legally and practically feasible effectively to enforce the provisions of the ICA against such a company. In effect, the ICA requires the SEC to find that investors in foreign investment companies using U.S. jurisdictional means have the same protections as investors in U.S. investment companies.

Because foreign regulatory schemes differ significantly from the ICA, most foreign funds find it difficult to meet this standard. In 1954, the SEC adopted Rule 7d-1 to set forth minimum conditions and undertakings required for a Canadian company to obtain an order under Section 7(d). All of the funds that have received exemptive orders under Section 7(d), both Canadian and non-Canadian, have complied with the substantive conditions of Rule 7d-1. Only 19 foreign funds, most from Canada, have ever received Section 7(d) orders, and the SEC last issued an order of this type in 1973.

The SEC is considering proposing a rule to minimize the regulatory burdens that restrict former Canadian residents from effectively managing their assets held in certain Canadian tax-advantaged retirement plans. As part of this rulemaking process, the SEC staff is reviewing recommendations, submitted on behalf of the Investment Funds Institute of Canada, on how the SEC might address this issue by rulemaking.

Because the ICA does not prohibit foreign advisers from organizing funds in the United States, a foreign money manager may organize an investment company in the United States that invests in the same type of securities as a fund it manages in its home country. A number of publicly offered U.S. investment companies invest in foreign securities and many of these funds have advisers or sub-advisers that are located abroad.

Foreign banks (and certain other foreign entities such as foreign insurance companies) may be considered investment companies under the ICA if they are sufficiently involved in holding or trading securities. Section 3(c)(3) of the ICA expressly excepts U.S., but not foreign, banks and insurance companies from the definition of investment company. In October, 1991, however, the SEC adopted Rule 3a-6 under the ICA which excludes foreign banks and insurance companies from the definition of investment company. When the SEC adopted Rule 3a-6, it also rescinded Rule 6c-9, which had conditionally permitted foreign banks and their finance subsidiaries to sell their own debt and non-voting preferred stock in the United States. Finance subsidiaries of foreign banks and insurance companies are now excluded from the ICA under Rule 3a-6.

Issuers

The Securities Act of 1933 (Securities Act) prescribes disclosure and antifraud standards for offerings of securities in the United States, and requires registration of securities with the SEC prior to their offer or sale unless an exemption from registration is available.

Under the Exchange Act, issuers are required to register their securities with the SEC if such securities are to be listed on a national securities exchange, and issuers (other than banks and insurance companies) are required to file reports with the SEC if their securities are to be quoted on the Nasdaq Stock Market. Exchange Act registration is also required if an issuer exceeds certain asset size and shareholder number thresholds. Once its securities are registered under the Exchange Act, an issuer must file annual reports and other periodic reports with the SEC, as well as, in the case of domestic companies, proxy statements. Exchange Act reporting is also required of certain other issuers that have registered securities under the Securities Act.

Foreign Issuers

In principle, public offering and periodic reporting requirements for foreign issuers are the same as those for domestic issuers. Thus, the federal securities laws apply the concept of national treatment to foreign issuers. In practice, the SEC has adjusted its disclosure requirements to accommodate foreign issuers because of differences in legal and accounting practices between countries.

As of June 30, 1998, over 1,100 foreign issuers representing 55 countries were filing Exchange Act reports with the SEC. Over 500 new foreign companies have entered the U.S. markets since January 1994, including companies from Russia, Hungary, and Ghana.

Disclosure. Separate registration and reporting forms have been adopted under the Securities Act and the Exchange Act for use by foreign issuers. Form 20-F, which serves as both a registration statement and an annual report form under the Exchange Act, requires disclosure substantially identical to Form 10-K, the domestic issuer annual report form. As mentioned, certain accommodations have been provided to foreign issuers. These accommodations include limiting management compensation disclosure to disclosure on a group basis (unless the company otherwise discloses individual information pursuant to foreign law or practice) and requiring information on transactions by management only to the extent that such disclosure has been made pursuant to applicable foreign laws. Periodic reports need to be furnished by foreign issuers on Form 6-K only to the extent that the information in such reports is either required to be made public by applicable foreign regulations or required to be distributed to security holders. In addition, the proxy solicitation regulations and regulations pertaining to insider reporting, which are applicable to insiders of domestic issuers, generally do not apply with respect to foreign issuers.

Financial statements for foreign issuers are not required to be prepared in accordance with U.S. generally accepted accounting principles (GAAP), so long as reconciliation of significant variations from those standards is provided.[23] In most U.S. public offerings of securities by foreign issuers, a full reconciliation is required to be presented in accordance with Item 18 of Form 20-F. Item 18 requires the quantification and explanation of material differences in net income and significant balance sheet items and all other disclosures and supplemental data required by U.S. GAAP and Regulation S-X, including data about industry segments, foreign operations, pensions, and leases. In annual reports and for certain U.S. public offerings, stock exchange listings, and quotations on the Nasdaq Stock Market, the issuer need only provide a more limited reconciliation in accordance with Item 17 of Form 20-F. Item 17 requires a quantification of the difference in measurement of net income and significant balance sheet items and an explanation of the nature and financial statement effects of each material difference.

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[23] Regulation S-X contains the SEC's principal accounting requirements, which govern the form and content of financial statements filed under both the Securities Act and the Securities Exchange Act.

The foreign issuer integrated disclosure system allows a foreign issuer to abbreviate the disclosure presented in a prospectus through incorporation by reference of the business, financial and other information presented in Form 20-F. The forms for Securities Act registration by foreign private issuers (Forms F-1, F-2, F-3, and F-4), together with Exchange Act Forms 20-F and 6-K, comprise the integrated disclosure system for foreign issuers. The extent to which an issuer may incorporate information from its Exchange Act reports, rather than physically presenting it in a public offering document, varies depending on the Securities Act form the issuer is eligible to use. The foreign integrated disclosure system is comparable to the domestic integrated disclosure system. The domestic integrated disclosure system is based on Securities Act Forms S-1, S-2, S-3, and S-4, and Exchange Act Form 10-K. Form F-6 is used to register American Depositary Shares (ADSs) represented by American Depositary Receipts (ADRs), which are issued against the deposit of the underlying securities of foreign issuers.

In December 1994, the SEC adopted several amendments to Regulation S-X and Form 20-F designed to further streamline financial information and reconciliation requirements for both foreign and domestic companies.[24] These rules allow foreign issuers more flexibility in their choice of reporting currency, reduce reconciliation requirements for foreign issuers with material operations in a hyperinflationary economy when accounted for in compliance with International Accounting Standard No. 21, and lessen combinations where the method of accounting for the business combination and the amortization period of goodwill and negative goodwill is in compliance with International Accounting Standard No. 22.

In addition, these amendments eliminated the significance threshold based on relative asset size for requiring financial statements of a foreign or domestic equity investee; eliminated six financial schedules for domestic companies which already had been eliminated for foreign issuers; and eliminated two additional financial schedules for both foreign and domestic issuers.

In May 1997, the SEC adopted amendments to expand the availability of the short Forms S-3 and F-3 under the Securities Act.[25] The amendments changed the test for eligibility to include non-voting, as well as voting, common equity in the computation of the required US$75 million aggregate market value of common equity held by non-affiliates of the registrant. The SEC also adopted conforming amendments to other forms and rules.

Exemptions from registration. Exemptions from the registration requirement exist under the Securities Act both for specific types of securities and for specific categories of transactions. For example, Section 3(a)(2) of the Securities Act provides an exemption from registration for securities issued or guaranteed by certain domestic government entities. The exemption does not extend to

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[24] *See* Securities Act Release Nos. 7117, 7118, and 7119 (December 13, 1994).

[25] *See* Securities Act Release No. 7419 (May 8, 1997).

securities issued or guaranteed by a foreign government. Public offerings of such securities are registered under the Securities Act on Schedule B, which provides specialized disclosure requirements for such offerings.

Securities issued or guaranteed by a bank are also not subject to the registration requirements of the Securities Act. This exemption applies only to securities issued or guaranteed by banks, as opposed to bank holding companies or nonbank affiliates of banks. "Bank" is a term defined by the Securities Act to include U.S. banks. The SEC has deemed U.S. branches and agencies of foreign banks to be included in the exemption, provided they are subject to state or federal regulation substantially equivalent to that applicable to U.S. banks doing business in the same jurisdiction.[26]

The SEC also adopted an exemption from registration for ADRs. In July 1997, the SEC adopted the recommendation of the 1996 Task Force on Disclosure Simplification by exempting ADRs from Exchange Act registration when the ADRs are listed on a national securities exchange and registered under the Securities Act.[27] The Exchange Act registration requirements for securities listed on a national securities exchange still apply to the underlying class of securities.

In March 1998, the SEC issued an interpretative release that provides guidance on the application of the registration requirements of the U.S. securities laws to offers of securities made on the Internet by foreign issuers.[28] The release states that, for purposes of the registration requirements only, offshore Internet offers and solicitation activities would not be considered to be made "in the United States" if Internet offerors implement measures that are reasonably designed to ensure that their offshore Internet offers and solicitation activities are not targeted to the United States or to U.S. persons. The determination of whether measures reasonably designed to guard against sales to U.S. persons have been implemented depends on the facts and circumstances, and can be satisfied through different means. The release discusses examples of measures that are adequate to serve this purpose for both U.S. and foreign entities.

State Regulation

In addition to the federal regulatory scheme described above, the 50 states have securities laws, known as "blue sky" laws. Most states require that broker-dealers and non-SEC registered investment advisers active in the state register with the state. The forms used for such registration, however, generally are the same as the forms used for registration under the federal securities laws. As noted above, these forms elicit information about "control persons," and require consents to

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[26] *See* Securities Act Release No. 6661 (September 23, 1986).

[27] *See* Securities Act Release No. 7431 (July 18, 1997).

[28] *See* Securities Act Release No. 7516 (March 23, 1998).

service of process, but do not otherwise distinguish between foreign and domestic firms.

Most states also require that securities offered in the state be registered with the state. Although most states have adopted the Uniform Securities Act of 1956, there are many variations among the states. This means that if an issuer makes a public offering in the United States, it must register, or find an exemption from registration, in each state where the offering will be made. This "blue sky" process does not differ substantially, however, for domestic and foreign issuers.

The National Securities Markets Improvement Act of 1996 revised Section 18 of the Securities Act to reallocate regulatory responsibility relating to securities offerings between the federal and state governments based on the nature of the security offering. Among other things, the revised statute prevents states from directly or indirectly prohibiting, limiting, or imposing any conditions on the use of any offering document for a covered security if the offering document is prepared by or on behalf of the issuer. Section 18 defines the term "covered security," which includes securities listed on the New York Stock Exchange, the American Stock Exchange, the National Market System of the Nasdaq Stock Market, and securities issued in certain exempt offerings. The SEC adopted new rule 146 to provide a definition of the term "prepared by or on behalf of the issuer."[29] It provides that if an issuer or agent or representative authorizes an offering document's production and approves the document before its use, it is deemed prepared by or on behalf of the issuer. Revised Section 18 and new Rule 146 apply to both domestic and foreign issuers.

Summary

In the securities sector, regulators have taken a number of steps to simplify access by foreign firms and issuers to U.S. securities markets without compromising investor protection. The SEC's policy with respect to broker-dealers is one of equal market access: the SEC seeks to apply the same requirement to all broker-dealers, whether U.S.- or foreign-owned, or U.S. or foreign resident. The Investment Advisers Act of 1940 establishes a national treatment standard, treating foreign investment advisers substantially the same as domestic advisers that are registered with the SEC. The SEC has modified and simplified certain disclosure requirements that facilitate access to U.S. capital markets for foreign issuers, including accepting accounting methods relating to hyperinflationary economies and business combinations that comply with international accounting standards. Over 500 new foreign companies have entered the U.S. markets since January 1994.

[29] *See* Securities Act Release No. 33-7418 (April 30, 1997).

NATIONAL TREATMENT UNDER U.S. COMMODITIES LAWS

The CEA and implementing rules govern transactions involving futures and commodity options both on exchange and over the counter.[30] Under the CEA, the CFTC regulates transactions conducted on the 12 domestic U.S. futures exchanges (contract markets in futures and options). It also regulates futures and option transactions conducted for or on behalf of U.S. customers on both domestic and foreign markets.

Banks are major participants – both as end-users and as financial intermediaries – in the large and developing swap transactions market. The CFTC has rules (Part 35) that exempt swap agreements meeting specified criteria from the provisions of the CEA and the CFTC's rules, although they are subject to the antifraud and antimanipulation provisions of the CEA as well as Section 2(a)(1)(B) of the CEA, which delineates CFTC and SEC jurisdiction. Banks are the first listed category of eligible swap participants under Part 35 of the CFTC's rules, and domestic and foreign banks are treated equally in this context.

The marketing of "hybrid" instruments that couple elements of futures contracts with certain banking instruments such as depository obligations has raised issues concerning the treatment of such instruments by the CFTC under the CEA and CFTC rules. The CFTC has rules (Part 34) that exempt certain hybrid instruments and those transacting in and/or providing advice or other services with respect to such hybrids from all provisions of the CEA except Section 2(a)(1)(B), provided that a number of conditions are met. A hybrid instrument can be an equity or debt security, or a demand deposit, time deposit or transaction account, provided certain other criteria are met. The demand deposit, time deposit or transaction account can be offered by a domestic bank or insured credit union, as well as a branch or agency of a foreign bank.

In general, a financial intermediary engaged in transactions involving futures and option contracts regulated by the CFTC will be deemed to be subject to CFTC jurisdiction if it meets one of the following four criteria: (1) it is legally domiciled in the United States; (2) it is physically present in the United States; (3) it has consented to jurisdiction; or (4) it is conducting business in the United States by dealing with persons located in the United States. A financial intermediary conducting business in the United States need not be physically present in the United States. No distinction is made in the CEA and rules thereunder between solicited and unsolicited business.

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[30] Excluded are foreign currency options traded on a national securities exchange and options on securities and on securities indexes, which are regulated by the SEC. *See* Sections 2(a)(1)(B) and 4c of the CEA. In addition, the Treasury Amendment of the CEA states: "Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade." Section 2(a)(1)(A)(ii) of the CEA. In addition to statutory exclusions, the CFTC has the authority to grant specific exemptions under Section 4(c) of the CEA.

Under the CEA, a foreign firm doing business in the United States is accorded national treatment, including equality of competitive opportunity, and is treated no less advantageously than a domestic firm.

Transactions on U.S. Markets

The CEA generally requires that trading of commodity futures and option contracts in the United States must be conducted on or subject to the rules of a board of trade that has been designated by the CFTC as a contract market unless the transactions are otherwise exempt. In 1997, the CFTC implemented new "fast-track" procedures for processing contract market designation applications and exchange rule changes to streamline further the CFTC's review procedures. Under these procedures, many applications for designation of cash-settled and nonagricultural futures and options contracts (other than stock index futures or options thereon) may be deemed to be approved 10 days – and many other applications, 45 days – after receipt unless the exchange is notified otherwise.

The CFTC, as part of its efforts to modernize and to streamline its rules, has undertaken, in addition to the "fast-track" review procedures, the following regulatory reform initiatives over the last four years:

- Adoption of risk assessment rules for holding company systems, which require FCMs to maintain records and file reports about affiliates whose activities are likely to affect materially the FCM's operations or financial condition; these rules also require FCMs to file a statement concerning their internal control policies for handling risk originating from material affiliates.[31]

- Adoption of substantial revisions to the disclosure framework applicable to CPOs and CTAs.[32]

- Adoption of rule amendments to harmonize further financial reporting requirements of the CFTC with those of the SEC for FCMs and IBs that are also registered with the SEC.[33]

- Adoption of an amendment to the large trader reporting rules to require a large trader to file

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[31] 59 Fed. Reg. 66674 (Dec. 28, 1994).

[32] 60 Fed. Reg. 38146 (July 25, 1995).

[33] 62 Fed. Reg. 4633 (Jan. 31, 1997).

the Statement on Form 40 only when requested to do so by the CFTC, rather than annually.[34]

- Numerous initiatives designed to enable market participants to reduce costs and increase efficiency through the use of electronic media, including: (1) permitting FCMs to file required financial reports with the CFTC electronically;[35] (2) allowing CPOs and CTAs to file their required Disclosure Documents electronically;[36] (3) permitting FCMs to deliver monthly statements, trade confirmation and purchase-and-sale statements solely by electronic transmission in lieu of hard-copy delivery;[37] (4) issuing an Interpretation regarding the use of electronic media by CPOs and CTAs for delivery of Disclosure Documents and other materials;[38] and (5) proposing amendments to the recordkeeping requirements that would expand the opportunities for use of micrographic and electronic storage media for recordkeeping and eliminate the current requirement that paper records eligible for transfer to micrographic storage media be maintained in hard copy for two years.[39]

- Delegation of functions to the National Futures Association (NFA), the industry-wide SRO, including: (1) decisions relating to the registration of floor brokers (FBs)[40] and floor traders (FTs)[41] with prior disciplinary histories;[42] (2) conduct of various registration and processing functions relating to non-U.S. firms;[43] and (3) review of the Disclosure Documents that CPOs and CTAs are required to file.[44]

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[34] 62 Fed. Reg. 6112 (Feb. 11, 1997).

[35] 62 Fed. Reg. 10441 (March 7, 1997).

[36] 62 Fed. Reg. 18265 (Apr. 15, 1997).

[37] 62 Fed. Reg. 31507 (June 10, 1997).

[38] 62 Fed. Reg. 39104 (July 22, 1997).

[39] 63 Fed. Reg. 30668 (June 5, 1998).

[40] An FB is an individual who executes orders for another person for the purchase or sale of futures and commodity option contracts on the floor of a contract market. An FB can also trade for his or her own account.

[41] An FT is an individual who executes futures or commodity option orders solely for his or her own account on the floor of a contract market.

[42] 62 Fed. Reg. 36050 (July 3, 1997).

[43] 62 Fed. Reg. 47792 (Sept. 11, 1997).

[44] 62 Fed. Reg. 52088 (Oct. 6, 1997).

- Proposal of rules to establish specific procedures for filing requests for no-action, exemptive and interpretative letters.[45]

- Adoption of rule amendments whereby FCMs and IBs are no longer required to provide mandatory risk disclosure materials to certain defined categories of financially sophisticated customers.[46]

- Proposal of rules to require CPOs of public pools to issue a two-part Disclosure Document, the first part of which is limited to specific information using "plain English" principles.[47]

- Adoption of interim final rules for a three-year pilot program for trade options on enumerated agricultural commodities, which includes a delegation to NFA concerning registration functions.[48]

- Issuance of an Advisory to emphasize the importance for all CFTC registrants to take immediate action to avoid the serious disruptions that could be caused by the use of computer technology that is not year 2000 compliant.[49]

- Elimination of the capital charge for FCMs carrying short option positions for customers.[50]

- Adoption of rules that would allow exchanges to permit futures-style margining of options contracts.[51]

- Adoption of a rule to permit post-execution allocation of bunched orders of sophisticated customers where the FCM has obtained the customer's consent.[52]

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[45] 63 Fed. Reg. 3285 (Jan. 22, 1998).

[46] 63 Fed. Reg. 8566 (Feb. 20, 1998).

[47] 63 Fed. Reg. 15112 (March 30, 1998).

[48] 63 Fed. Reg. 18821 (Apr. 16, 1998).

[49] CFTC News Release No. 4140-98 (Apr. 29, 1998).

[50] 63 Fed. Reg. 32725 (June 16, 1998).

[51] 63 Fed. Reg. 32726 (June 16, 1998).

[52] 63 Fed. Reg. 45699 (Aug. 27, 1998).

- Adoption of a rule to require an FCM to notify the CFTC and the firm's designated SRO immediately whenever the firm knows or should know that it has insufficient funds in segregated accounts to meet its obligations to its customers, issued in response to the market events of October 1997.[53]

Customer and market protection. The domestic regulatory program contemplated by the CEA focuses on both market and customer protection. The CEA and rules adopted thereunder establish a comprehensive regulatory structure that is intended to prevent fraud and other wrongful conduct involving futures contracts and commodity options. The rules applicable to market protection generally address prevention of market manipulations and other price distortions in the cash and futures markets. The customer protection aspect of the regulatory regime includes:

1. *Registration requirements intended to ensure the "fitness" of all persons who deal with customers or customer funds.* The CEA and rules adopted thereunder govern registration requirements for FCMs, IBs, CPOs, CTAs, associated persons (APs) of any of the foregoing categories of firms,[54] FBs, FTs and broker associations.[55]

2. *Minimum financial requirements for FCMs and IBs.* These requirements address the financial integrity of the markets and persons transacting business on such markets. They ensure that firms have sufficient funds to operate the business and have some financial stake in their business and that, in the event of customer default on a margin obligation to an FCM, there will exist a cushion so that other customer funds will not be adversely affected.

3. *Segregation of customer funds from an FCM's proprietary funds.* A primary purpose of this requirement is to prevent the use of customer funds for purposes other than those specified by the customer and to provide protections to such funds from creditors of the carrying firm in the event of its financial failure.

4. *A comprehensive sales practice program*to prevent fraudulent and misleading sales practices in the marketing and handling of customer accounts. In addition to antifraud provisions, the CEA and rules thereunder require: (a) disclosure of material information; (b) specific customer authorization for each trade or a written authorization by the customer allowing trading without specific authorization of each trade; (c) issuance to customers of daily

[53] 63 Fed. Reg. 45711 (Aug. 27, 1998).

[54] An AP is an individual who is associated with an FCM, IB, CPO or CTA, who solicits or accepts customer orders, pool participation interests or discretionary accounts, or who supervises any person engaged in such activities.

[55] A broker association is composed of two or more exchange members who: (1) share responsibility for executing customer orders; (2) have access to each other's unfilled customer orders as a result of common employment or other types of relationships; or (3) share profits or losses associated with their brokerage or trading activity.

confirmations of transactions as well as a monthly account statement; (d) supervision of customer accounts by registrants; and (e) vicarious liability for acts and omissions of employees and agents, as well as aiding and abetting and controlling person liability.

5. *Compliance activities* undertaken by the CFTC and the futures industry SROs. The CEA and rules thereunder impose specific regulatory responsibilities on the exchanges and NFA to maintain extensive programs to assure the integrity of the markets and the participants they supervise. The CFTC oversees the operations of these SROs, which are subject to CFTC enforcement action for failure to comply with the CEA and rules thereunder.

6. *Recordkeeping and reporting requirements*. These are intended to assist in determining whether a registrant is acting in accordance with the provisions of the CEA and the rules, regulations and orders thereunder.

7. *Ethics training*. These requirements are designed to insure that registrants understand their responsibilities to observe just and equitable principles of trade, any rule or regulation of the CFTC, applicable exchanges, registered futures association (i.e., NFA) or other self-regulatory organization, or any other applicable federal or state law, rule or regulation. New registrants must attend four hours of training within six months of becoming registered, and one hour every three years thereafter.

Any person, whether domestic or foreign, who conducts business on a domestic contract market for a U.S. customer is subject to compliance with the full panoply of customer protections described above.

When a person conducts business on a domestic market for a foreign customer, however, the determination as to whether that person is subject to CFTC regulation generally is a function of where that person is deemed to be located. For example, if the person conducting business is deemed to be located within the United States, that person will be required to register and otherwise to comply with all of the CFTC's regulatory requirements applicable to registrants. If the person is located outside of the United States and is acting on U.S. markets in the capacity of, for example, a broker with respect to foreign customers, that person may be subject to reporting requirements as a "foreign broker."

"Foreign brokers" generally are defined as persons located outside of the United States that carry accounts in futures or options solely for or on behalf of non-U.S. persons on U.S. markets through a registered FCM. Foreign brokers are not required to register with the CFTC as FCMs; however, they remain subject to, among other things, large trader reporting requirements. The CFTC has also stated that a foreign broker acting in the capacity of an IB would generally not need to register as an IB. Similarly, persons located outside the United States who act in the capacity of a CPO or CTA with respect to non-U.S. persons, even if the transactions are conducted on or subject to the rules of a U.S. contract market, need not register as CPOs or CTAs.

With respect to FCMs and IBs, most foreign firms that desire to engage in such activities choose to do so by means of a U.S.-based subsidiary or affiliate which, among other things, facilitates U.S. client contact. In addition, an offshore applicant's failure either to maintain an office in the United States or to demonstrate that it has procedures to ensure CFTC and NFA access to its books and records may constitute grounds upon which registration may be denied.

Transactions on Non-U.S. Markets

Prior to 1987, the sale of most foreign futures to U.S. customers was essentially unregulated.[56] Thus, firms in the United States and overseas could offer and sell these products to U.S. customers subject only to a general antifraud provision. The offer or sale of foreign options, with minor exceptions, had been banned since 1978. In 1987, CFTC adopted comprehensive rules, which are contained in Part 30 of the CFTC's rules, to govern the offer or sale of any foreign futures or options contract to a person resident in the United States

Any person, whether located in the United States or outside of the United States, who transacts business for U.S. customers on foreign markets must register in the appropriate capacity. The Part 30 rules generally parallel the requirements applicable to persons who act in the capacity of an FCM, IB, CPO, CTA or AP in domestic markets. In general, the Part 30 rules extend existing regulatory requirements relating to intermediaries of domestic products offered in the United States to intermediaries of foreign futures and option products with respect to registration, sales practices (including disclosure), capital adequacy, protection of customer funds, compliance, recordkeeping and reporting requirements. However, there are two areas in which the Part 30 rules depart from the regulatory regime applicable to intermediaries in domestic transactions. First, under Rule 30.5, persons who act in the capacity of an IB, CPO or CTA from a location outside the United States may be exempt from the CFTC's registration requirements, provided that all of their U.S. customer accounts are carried by or through a U.S. FCM or a firm with a Rule 30.10 exemption and the customers are sophisticated. Such persons must otherwise comply with certain other requirements of the CFTC's rules (e.g., the risk disclosure requirements of CFTC Rule 30.6). Such persons also must enter into an agreement, filed with NFA, with an appropriate agent (either the FCM or Rule 30.10 firm carrying the customer accounts or NFA) for the purpose of receiving communications from the CFTC, the Department of Justice, relevant SROs and customers who do business with such persons and must provide to the CFTC and the Department of Justice access to their books and

[56] However, a foreign exchange-traded futures contract based on a stock index could not be offered or sold to U.S. customers unless the CFTC's Office of the General Counsel issued a no-action letter with respect thereto. Similarly, before a futures contract or an option thereon involving a foreign sovereign debt obligation could be offered or sold in the United States, the SEC had to designate the obligation as an "exempted security" under § 240.3a12-8 of the SEC's rules.

records within 72 hours of the request. As of May 1998, 18 firms operated under this exemption. The other area in which the CFTC's regulatory regime for intermediaries of foreign transactions differs from that applicable to intermediaries of domestic transactions relates to persons acting in the capacity of an FCM. Specifically, under Rule 30.10, such persons may apply for an exemption from the FCM registration requirement by virtue of the "comparability" of the rules in effect in the person's home country jurisdiction.

Comparability

Under CFTC Rule 30.10, persons located outside the United States, who solicit or accept orders and related funds from U.S. customers for foreign futures or options transactions and who are subject to a *comparable regulatory scheme* in their home country jurisdiction, may apply for an exemption from the application of certain of the Part 30 rules. To accommodate the increasing internationalization of futures markets and the CFTC's desire to facilitate cross-border transactions, the comparability approach permits substituted compliance with the regulatory system of another jurisdiction in lieu of compliance with the Part 30 rules. It is an effort both to avoid duplicative regulation of a foreign person and to avoid regulatory gaps.

The CFTC's comparability program consists of a two-tiered analysis. First, the CFTC reviews the rules of the applicable foreign regulator or SRO and will grant exemptive relief based upon an assessment that the rules serve as an adequate substitute for compliance with the Part 30 rules.[57] The CFTC has broad discretion to determine that the purposes of any program element generally are met, notwithstanding the fact that the offshore program does not contain an element identical to that of the CFTC's regulatory program. The CFTC also may determine to provide an exemption for certain portions of another jurisdiction's regulatory program but not for other portions. In considering each petition, the CFTC has consulted extensively with foreign regulators and SROs in assessing the comparability of the foreign regulatory regime.

Second, as a condition of granting comparability relief to a specific firm, the CFTC requires that each firm requesting exemptive relief must be sponsored by its regulator or SRO and must provide certain consents and representations.[58] The firm must be regulated fully by the country whose

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[57] The minimum elements of a comparable regulatory program include: (a) registration, authorization or other form of licensing, fitness review or qualification of persons through whom customer orders are solicited and accepted; (b) minimum financial requirements for those persons who accept customer funds; (c) protection of customer funds from misapplication; (d) recordkeeping and reporting requirements; (e) minimum sales practice standards, including disclosure of the risks of futures and option transactions, in particular the risk of transactions undertaken outside the jurisdiction of domestic law; and (f) compliance mechanisms.

[58] These consents and representations include, among other things: (a) consent to jurisdiction in the United States by filing an appointment of an agent for service of process; (b) consent to provide immediate access to its books and records (which may be effected through a foreign regulator); (c) consent to participate in an arbitration program

regulatory scheme was reviewed for comparability with that of the United States prior to granting the orders.[59]

To date, the CFTC has approved the petitions submitted by exchanges, SROs, and governmental entities in eight jurisdictions: Australia – Sydney Futures Exchange (SFE); Canada – the Montreal Exchange and the Toronto Futures Exchange; France – the Commission des Opérations de Bourse on behalf of the Marché à Terme International de France (MATIF); Japan – the Tokyo Grain Exchange; New Zealand – New Zealand Futures and Options Exchange, Ltd. (NZFOE); Singapore – the Singapore International Monetary Exchange (SIMEX); Spain – MEFF RENTA FIJA (MEFF Sociedad Rectora de Productos Financieros Derivados de Renta Fija, S.A.) and MEFF RENTA VARIABLE (MEFF Sociedad Rectora de Productos Financieros Derivados de Renta Variable, S.A); and the United Kingdom – the Securities and Investment Board (SIB), the Securities and Futures Authority (SFA), and the Investment Management Regulatory Organisation (IMRO). As of May 1998, as detailed below, CFTC and NFA had confirmed comparability relief for 179 firms under these orders.

CFTC staff is currently reviewing petitions for relief under Rule 30.10 submitted by Canada's Winnipeg Commodity Exchange and Malaysia's Kuala Lumpur Commodity Exchange.

The CFTC has issued orders permitting foreign firms that have comparability relief under Rule 30.10 to engage in limited marketing activities of foreign futures and options products from locations within the United States. Prior to issuance of these orders in 1992 and 1994, Rule 30.10 relief was available only to qualified firms that solicited customers from a foreign location. The CFTC orders permit Rule 30.10 firms and their employees or other representatives to market foreign futures and option products to qualified customers from a U.S. location, under certain circumstances.

Relief under these orders is limited to firms with Rule 30.10 relief whose:

- regulator or SRO agrees to supervise such firms' conduct in the United States;

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implemented by NFA for nonmember firms in connection with customer disputes involving foreign futures and options; (d) consent that all futures or options transactions will be made on or subject to the rules of an exchange located outside the United States; (e) representation that no principal of the firm would be disqualified from doing business under the CEA; and (f) disclosure of the identity of any U.S. affiliate or subsidiary that is engaged in a related business.

[59] *See*, e.g., CFTC Interpretative Letter No. 98-12 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,263 (Dec. 30, 1997) (foreign firm not granted Rule 30.10 relief where, among other things, the firm was doing business in, but was not domiciled in, the country whose regulatory framework was reviewed for comparability ("host" country) and the firm would be regulated in part by its "home" country rather than solely by the host country as contemplated under the CFTC's orders).

- marketing activities in the United States do not in the aggregate exceed 30 business days in any calendar year; and

- U.S. customers are persons who have a high degree of sophistication and/or substantial financial resources as specifically provided in the orders.

The CFTC has determined that this further relief is applicable to members of the Montreal Exchange, France's MATIF, the United Kingdom's SIB, SFA, and IMRO, and Australia's SFE.

In 1996 and 1997, the CFTC issued orders under Part 30 to clarify that Rule 30.10 firms in certain countries are permitted to trade for U.S. customers on all non-U.S. exchanges where such firms are permitted under the laws of their home country to engage in such futures and options transactions. In particular, these orders clarify that funds provided by U.S. customers will receive equivalent protection at all intermediaries, exchanges and clearing organizations.[60]

Other International Activities

On March 12, 1996, the CFTC amended Rule 30.3(a) to eliminate the requirement that the CFTC issue an order authorizing the offer or sale of a particular foreign exchange-traded commodity option before it can be offered or sold in the United States However, this rule change did not affect existing CEA product restrictions related to stock indexes and foreign government debt. Therefore, the rule amendment provides that if the underlying foreign exchange-traded futures product (including futures on stock indexes and on foreign government debt) may be offered or sold in the United States, the foreign option based on that futures contract may be offered or sold in the United States as well as without further action.[61]

The CFTC has worked with regulators in other countries to establish international principles of regulation and information sharing. At the CFTC's prompting, international regulators of commodity markets recently adopted best practices standards for market surveillance of commodity futures markets, for information sharing relating to the regulation of such markets, and for contract design and approval.[62] These are the first internationally agreed standards of regulation for these markets, and their adoption is a significant step towards harmonizing international regulation. The

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[60] *See* CFTC Orders for firms designated by the: (1) NZFOE, 61 Fed. Reg. 64985 (Dec. 10, 1996); (2) the Montreal Exchange, 62 Fed. Reg. 8875 (Feb. 27, 1997); (3) SFE, 62 Fed. Reg. 10445 (March 7, 1997); (4) SFA, 62 Fed. Reg. 10447 (March 7, 1997); and (5) IMRO, 62 Fed. Reg. 10449 (March 7, 1997).

[61] 61 Fed. Reg. 10891 (March 18, 1996).

[62] Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts and Guidance on Components of Market Surveillance and Information Sharing, Endorsed by 16 Regulatory Authorities on October 31, 1997, adopted in the Tokyo Communiqué on Supervision of Commodity Futures Markets, October 31, 1997.

CFTC is working through IOSCO to extend these standards to financial derivatives generally and to clarify that the guidance in the Tokyo Communiqué should apply to products other than futures contracts settled by physical delivery for which the underlying commodity is of finite supply. The CFTC has also participated in IOSCO's project on Core Principles of Securities Regulation, which resulted in production of a consultative document in May 1998. The CFTC also helped to organize the Windsor Meeting in London in 1995, which resulted in an agreed action plan by 16 futures market regulators from around the world concerning protection of customer funds, default procedures, surveillance of large exposures, cooperation during market emergencies, and contingency planning.

Electronic Trading Systems

Currently, four electronic trading systems are in operation at U.S. futures exchanges: the Chicago Board of Trade's (CBT) Project A; the Chicago Mercantile Exchange's (CME) Globex; the New York Mercantile Exchange's ACCESS; and the Cantor Financial Futures Exchange (CFFE), which was established pursuant to an agreement between the New York Cotton Exchange, a wholly-owned subsidiary of the New York Board of Trade, and CFFE, LLC, a subsidiary of Cantor Fitzgerald, LP. Since the inception of Globex and Project A trading in 1992 and ACCESS trading in 1993, the volume of trading on these systems has continued to grow. However, because these systems operate almost exclusively after the close of regular floor trading hours, and thus complement rather than compete with traditional open outcry pit trading, electronically traded volume remains a small percentage of overall futures trading. For example, during 1997 approximately 243 million contracts were executed on the CBT floor, and approximately six million contracts were executed using Project A. Although Globex originally was intended as an after-hours system for trading products otherwise traded on the floor of the CME, the CME now trades E-mini Standard and Poor's 500 contracts both on Globex and on the floor of the CME, depending upon the size of the order, during regular trading hours. The CME launched a new electronic system, "GLOBEX2," in September 1998 in a joint venture with MATIF. GLOBEX2 uses a new system architecture that replaces that previously used by the Globex system and rules related to the new system are subject to CFTC approval. CFFE is a computer-based trading system for futures on U.S. government securities, whereby exchange members transmit orders by telephone to terminal operators acting as agents for CFFE, who enter orders into the system for execution. The CFTC designated CFFE as a contract market on September 4, 1998, and trading began on September 8, 1998.

Memoranda of Understanding

The CFTC has cooperated with many foreign regulatory authorities through formal and informal arrangements to combat fraudulent and other prohibited practices that could harm customers or threaten market integrity. As of March 1998, the CFTC had entered into 44 such bilateral arrangements, consisting of regulatory and enforcement MOUs, cooperative arrangements and financial information-sharing agreements (FISMOUs) with regulators in 21 jurisdictions, including

Canada, the United Kingdom, France, the Netherlands, New Zealand, Switzerland, Spain, Brazil, Australia, Singapore, Taiwan, Japan, Italy, Argentina and Mexico. In 1997, arrangements for cooperative enforcement were concluded with South African and German authorities. The CFTC also exchanges information and cooperates in enforcement and regulatory matters on a case-by-case basis with foreign regulatory, law enforcement, and self-regulatory authorities in many countries. The CFTC also participates in a multilateral arrangement including 25 jurisdictions related to sharing information on large exposures and information necessary to deter and to detect manipulative and other abusive practices.

The CFTC views information sharing and other cooperative arrangements as vehicles to permit the CFTC better to protect the integrity of the markets and their participants by addressing cross-border fraud and manipulation and assessing more accurately the financial risks of market participants, including the potential cross-border effect of within-border financial problems. For example, the CFTC's MOUs typically provide for access to official documents and information already in the possession of the authorities. Enforcement arrangements also provide the ability to obtain documents and to take testimony of, or statements from, witnesses.

Summary

As noted above, the CFTC has undertaken a wide-ranging regulatory reform agenda in recent years so that U.S. markets continue to remain competitive in the world while maintaining essential customer and market protections. The CFTC has also been a leader in international forums such as IOSCO in the pursuit of harmonized regulatory standards on a global basis, while at the same time pursuing multilateral and bilateral MOUs. The CFTC continues to permit U.S. customers to participate in global markets through innovative programs such as comparability relief, which also permits non-U.S. firms access to U.S. customers.

CONCLUSION

This chapter has examined key developments in the treatment accorded to foreign financial institutions and products in the U.S. market since the 1994 report was published. In banking, the supervision of the operations of foreign banks in the United States has been improved and streamlined, most individual states have enacted legislation that enhances the ability of both domestic and foreign banking organizations to expand geographically in the United States, the ability of banking organizations to engage in securities activities has been expanded, and several regulatory initiatives have been introduced to reduce regulatory burden on banking organizations, both domestic and foreign, in the United States.

In the securities sector, regulators have taken a number of steps to simplify access by foreign firms and issuers to the U.S. securities markets without compromising protection of U.S. investors.

U.S. LAWS AND REGULATIONS

Disclosure requirements have been modified to facilitate access to U. S. capital markets, resales of certain restricted securities have been exempted from SEC registration requirements, and the SEC has issued no-action letters which ease the conditions under which investment advisers can register in the United States and provide advice to U.S. clients, thus providing further incentives for foreign advisers to provide services to U.S. clients.

The CFTC continued to facilitate access by U.S. customers to foreign risk management instruments, enhanced the legal certainty of certain novel derivatives instruments, and implemented measures to facilitate 24-hour trading of U.S. and foreign exchange-traded products on approved electronic trade execution systems.

Developments in U.S. law and regulation generally have been consistent with the principle of according national treatment to foreign financial institutions and have improved the access of foreign financial services providers to U.S. financial markets.

OPERATIONS OF FOREIGN FINANCIAL INSTITUTIONS IN THE UNITED STATES

FOREIGN BANKS

Activities of Foreign Banks in the United States

Foreign banks initially entered U.S. markets to serve primarily the banking needs of U.S. affiliates of their home country customers, much the same reason for the initial expansion overseas by U.S. banks. Foreign banks also have been attracted to the United States because of the depth and liquidity of U.S. money and capital markets and because of the role of the U.S. dollar in international trade. The presence of foreign banks has contributed importantly to the depth and liquidity of U.S. financial markets. In times of constraints on lending by U.S. banks, active participation by foreign banks in the United States has improved the supply of credit to U.S. companies.

Foreign banks have a wide range of choices of the institutional form in which they may operate in the U.S. market. As of March 31, 1998, 271 foreign banks from 59 countries operated 469 agencies and branches, 108 U.S. banking subsidiaries, 21 Edge Corporations, and three New York State Investment Companies. Agencies and branches are the preferred form of operation, accounting for over 58 percent of the assets of the banking offices operated by the foreign banks. In addition to operating through vehicles with banking powers, foreign banks also operate a total of 144 representative offices in the United States. Under U.S. law, foreign banks also are permitted to participate in a variety of nonbanking financial activities. For example, foreign banks can participate in leasing and finance companies, investment advisers, and limited purpose trust companies. Foreign banks that had securities broker-dealer subsidiaries prior to passage of the International Banking Act of 1978 had these operations grandfathered.

Foreign bank activity is concentrated in the major U.S. financial centers. New York accounts for 71 percent of the U.S. assets of foreign banks, Chicago for 8 percent, and San Francisco and Los Angeles (combined) for 5 percent. The remaining foreign bank assets at U.S. offices are concentrated primarily in Miami, Houston, and Atlanta.

There also is considerable diversity in the business orientation of the foreign banks with a U.S. banking presence. Some banks are involved primarily in U.S. money markets, either as net investors, net borrowers, or in managing a portion of their parent banks' liquidity. In recent years, foreign banks have become more active in lending to U.S. business, often purchasing loans originated by U.S. banks. This has improved liquidity in the banking market.

Banks headquartered in industrial countries account for the predominant share of foreign bank activity in the United States. As of March 31, 1998, the reported assets of banks headquartered in the G-10 countries and Switzerland accounted for nearly nine-tenths of all foreign bank assets in the

United States.

Relatively large assets also are reported at U.S. offices of banks based in large middle-income countries such as Korea, Ireland, Spain, and Taiwan. In addition, banks from the four largest Latin American countries (Argentina, Brazil, Mexico, and Venezuela) had U.S. office assets in excess of US$1 billion per country.

Agencies and branches, with assets of over US$919 billion as of March 31, 1998, are the most common form of operation by foreign banks. These banking offices are involved primarily in wholesale banking. They have only a small presence in retail banking. Approximately 40 percent of agency and branch office assets are accounted for by claims on other banks or other offices of their parent bank. Approximately 30 percent of their assets are loans to businesses or real estate loans and approximately 12 percent of their assets are investments in securities. By contrast, less than 1 percent of their assets are consumer loans or mortgages that might be considered retail business.

On the liability side, interbank deposits and borrowings from banks account for one-half of the total liabilities of agencies and branches. About 40 percent of the interbank business of agencies and branches of foreign banks are transactions with U.S. agencies and branches of other foreign banks. Deposits, of all kinds, from nonbank U.S. residents represent only about 20 percent of agency and branch funding. (Under federal law and regulation, a federal agency cannot accept deposits; some state laws permit state agencies to accept deposits from non-U.S. residents or citizens.)

U.S. offices of foreign banks also have tended to rely on borrowings from foreign sources. As of March 31, 1998, U.S. offices of foreign banks were net borrowers of over US$320 billion from foreign sources, including net borrowings of nearly US$146 billion from their related offices outside the United States.

Scale of Foreign Bank Operations

From year-end 1973, the first year the Federal Reserve collected comprehensive data, through March 31, 1998, the reported assets of U.S. offices of foreign banks increased from US$32 billion to US$2.1 trillion.

Foreign banks currently account for about one-fifth of the assets of all banking offices in the United States, and they have booked about 28 percent of all loans to U.S. businesses at these banking offices.

Since 1993, the Federal Reserve has collected quarterly data on offshore licensed offices of non-U.S. banks that were managed or controlled by a U.S.-domiciled office of the same parent banking organization. The reporting system for offshore branches of foreign banks indicated that as of March

31, 1998, these offshore branches of foreign banks had assets (excluding claims on their related U.S. offices) of US$320 billion and loans to U.S. businesses of US$59 billion. The new data on offshore lending by foreign banks increased the estimated share of foreign banks in all bank lending to U.S. businesses almost five percentage points.

Foreign Bank Lending to U.S. Business by Agencies, Branches, and Offshore Branches
March 31, 1998

Country of Parent Bank	U.S. Business Lending (percent)
Japan	38.7
France	12.9
Canada	11.9
Netherlands	9.0
Switzerland	5.2
Germany	3.7
Italy	2.6
United Kingdom	2.2
Korea (South)	1.8
Australia	1.6
Israel	1.5
All Others	8.9

Source: Federal Reserve

Foreign Bank Activity in the United States
March 31, 1998

Country	Total Assets (US$ millions)	Operating Offices	Bank Families
Japan	418,331	265	43
Germany	307,707	77	12
Switzerland	295,079	64	7
Canada	208,628	148	7
Netherlands	202,656	123	3
France	201,837	139	12
United Kingdom	149,909	93	11
Gibraltar	53,974	16	1
Italy	31,810	33	12
Australia	25,382	20	4
Ireland	24,593	40	2
Spain	19,702	25	7
Belgium	15,723	15	4
Sweden	14,689	10	3
Israel	12,397	22	4
Austria	11,996	31	3
China (Taiwan)	11,266	24	12
Korea (South)	11,177	38	13
Denmark	8,004	8	2
Hong Kong	5,253	24	8
Mexico	4,779	16	5
Finland	3,991	6	2
Brazil	3,682	25	12
Singapore	2,872	14	5
Venezuela	2,406	13	7

OPERATIONS OF FOREIGN FINANCIAL INSTITUTIONS

Country	Total Assets (US$ millions)	Operating Offices	Bank Families
Argentina	2,220	4	3
Portugal	2,179	7	3
China (Mainland)	2,107	5	2
India	1,657	10	3
Indonesia	1,558	14	9
Greece	1,375	6	1
Malaysia	1,329	2	2
Chile	1,136	2	1
Norway	1,075	4	2
Bahrain	883	5	2
Thailand	841	8	4
Colombia	703	6	4
Philippines	643	12	5
Uruguay	583	1	1
Ecuador	548	4	3
Turkey	524	2	2
Panama	509	2	2
Jordan	487	1	1
Poland	392	2	1
Slovenia	286	2	1
Pakistan	220	7	3
Kuwait	217	2	2
Other	*1018*	*18*	*13*
TOTAL	2,070,333	1,415	271

Source: Federal Reserve

Non-U.S. Assets and Liabilities of
U.S. Branches and Agencies of Foreign Banks
(US$ billions)

Year-End	Claims on Non-U.S. Residents	Liabilities to Non-U.S. Residents
1987	278.8	310.8
1988	305.1	340.4
1989	328.0	317.7
1990	326.7	384.9
1991	350.4	402.3
1992	328.9	426.1
1993 (revised)	293.5	424.7
1994	294.4	454.4
1995	323.3	496.7
1996	340.8	498.9
1997	427.1	553.4

Source: Treasury International Capital Reports. Data exclude negotiable CDS.

U.S. Offices of Foreign-Controlled Banks
March 31, 1998

Type of Organization	Number	Total Assets (US$ billions)
Agencies	173	120
Branches	296	799
Subsidiaries	108	300
Investment Companies	3	0.01
Edge/Agreement Corporations	21	3
Nonbanks	651	497
Section 20	18	352
Representative Offices	144	n/a
Total	1,415	2,070
Total U.S. Commercial Bank Assets		5,111
Percent Foreign-Controlled		40.5

Source: Federal Reserve

An ***Agency*** is a direct U.S. office of a foreign bank that may make loans and maintain credit balances, but generally may not accept deposits from U.S. citizens or residents.

A ***Section 20 Subsidiary*** is a nonbank subsidiary of a bank holding company that, with prior FRB approval, may engage in securities underwriting and dealing to a limited extent consistent with Section 20 of the Glass-Steagall Act.

Edge and Agreement Corporations are federally and state-chartered corporations that are permitted to engage in a range of banking and investment activities outside the United States, but whose U.S. activities are limited to activities that are incidental to its international or foreign business.

Ten U.S. Cities with the Most Foreign Banking Offices
March 31, 1998

Cities	Agencies	Branches	Bank Sub.	Investment Companies	Edge/ Agreement	Nonbanks	Section 20	Rep. Offices	Total Offices	Total Assets (US$ billions)
New York	43	193	34	3	5	323	15	11	627	1,476
Los Angeles	39	29	11	0	1	19	0	15	114	47
Chicago	0	36	5	0	3	50	2	15	111	167
Miami	39	0	1	0	8	3	0	8	59	21
San Francisco	14	11	7	0	1	15	0	11	59	62
Wilmington	0	0	0	0	1	54	0	0	55	34
Houston	12	0	0	0	0	10	0	20	42	17
Atlanta	16	0	0	0	0	5	0	5	26	10
Boston	0	3	1	0	0	18	0	4	26	8
Baltimore	0	0	1	0	1	13	0	2	17	11
Ten Cities	163	272	60	3	20	510	17	91	1,136	1,853
Total Foreign U.S. Offices	173	296	108	3	21	651	19	144	1,415	2,070

Source: Federal Reserve

Selected Assets and Liabilities of New York Offices of Foreign Banks [1]
March 1998

Amount (US$ billions)				Share of the Market [2] (Percent)			
Total Assets	Total Loans	Business Loans	Total Deposits	Total Assets	Total Loans	Business Loans	Total Deposits
712.8	245.5	133.2	389.9	58.5	48.1	47.3	58.7

[1] Data include agencies, branches, subsidiary commercial banks and New York investment companies, but not Edge or Agreement Corporations. New York offices of Puerto Rican banks are not included. Assets and liabilities include those on the books of International Banking Facilities (IBFs).

[2] Includes "domestically owned" commercial banks, U.S. agencies and branches of foreign banks, and commercial banks and New York investment companies with more than 25 percent foreign bank ownership, but not Edge or Agreement Corporations. New York offices of Puerto Rican banks are not included.

Sources: FFIEC 002, FFIEC 03 1, FFIEC 032, FFIEC 033, FFIEC 034, FR 886a, and FR 105.

Selected Assets and Liabilities of California Offices of Foreign Banks [1]
March 1998

Amount (US$ billions)				Share of the Market [2] (Percent)			
Total Assets	Total Loans	Business Loans	Total Deposits	Total Assets	Total Loans	Business Loans	Total Deposits
288.9	169.2	106.5	162.4	23.7	33.1	37.8	24.5

[1] Data include agencies, branches, subsidiary commercial banks but not Edge or Agreement Corporations. California offices of Puerto Rican banks are not included. Assets and liabilities include those on the books of International Banking Facilities (IBFs).

[2] Includes "domestically owned" commercial banks, U.S. agencies and branches of foreign banks, and commercial banks and New York investment companies with more than 25 percent foreign bank ownership, but not Edge or Agreement Corporations. California offices of Puerto Rican banks are not included.

Sources: FFIEC 002, FFIEC 03 1, FFIEC 032, FFIEC 033, FFIEC 034, FR 886a, and FR 105.

Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks
March 31, 1998
US$ billions

	Total Including IBFs
Total Assets	*920.4*
Cash & balances due from depository institutions	88.0
Total Securities	118.0
Federal Funds sold	64.7
Total loans, gross	362.7
Less: Unearned income	0.2
Loans, net:	362.4
Real estate loans	23.9
Depository institutions	33.8
Other financial institutions	53.7
Commercial and Industrial:	224.8
U.S. domicile	185.2
Non-U.S. domicile	39.6
Other	26.8
Trading Assets	98.6
Customers liabilities on acceptances	5.0
Other Assets	26.7
Net due from related depository institutions	157.0

	Total Including IBFs
Total Liabilities	*920.4*
Total deposits and credit balances	466.5
Individuals, partnerships, corporations:	225.7
U.S. domicile	197.0
Non-U.S. domicile	28.7
Commercial banks in U.S.:	80.2
U.S. branches & agencies of foreign banks.	43.1
Other banks	37.1
Banks in foreign countries	96.0
Foreign official institutions	51.2
Other	13.3
Federal Funds purchased	130.5
Other borrowed money	87.4
Branch of agency liability on acceptances	5.2
Trading Liabilities	60.3
All Other Liabilities	24.1
Net to due related depository institutions	146.4

Source: Federal Reserve

FOREIGN SECURITIES FIRMS

Brokers and Dealers

A broker-dealer (other than a U.S. bank) that uses the U.S. mail or any means or instrumentality of interstate commerce to effect transactions in nonexempted securities generally must register with the Securities and Exchange Commission (SEC) under the Securities Exchange Act. The SEC's policy is one of equal market access by applying the same requirements to all broker-dealers, whether U.S.- or foreign-owned, or U.S.- or foreign-resident. Registered broker-dealers are not required to report to the SEC the extent to which they are owned by foreigners.

Issuers

The Securities Act of 1933 (Securities Act) prescribes disclosure and antifraud standards for offerings of securities in the United States, and requires registration of securities with the SEC prior to their offer or sale unless an exemption from registration is available.

As of June 30, 1998, over 1,100 foreign issuers representing 55 countries were filing Exchange Act reports with the SEC. Over 500 new foreign companies have entered the U.S. markets since January 1994, including companies from Russia, Hungary, and Ghana.

As of June 30, 1998, over 800 foreign issuers were listed on U.S. stock exchanges.

Investment Advisers

Under the Investment Advisers Act of 1940 (IAA), foreign investment advisers that use the U.S. mail system or any means or instrument of interstate commerce in connection with their businesses are required to register with the SEC unless an exemption is available. No particular qualifications are required for registration, and the SEC generally seeks to apply the same requirements to foreign and domestic investment advisers.

As of June 30, 1998, approximately 420 (an increase of approximately 35 percent from 1994) foreign investment advisers, with foreign business addresses, were registered with the SEC, out of a total of about 7,500 SEC-registered investment advisers.[63] In addition, the SEC believes that there are

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[63] Recent amendments to the IAA have split supervision and regulation of investment advisers between the states and the SEC. Certain advisers, such as foreign investment advisers, larger investment advisers, and investment advisers that advise registered investment companies, only register with the SEC. Other investment advisers are now prohibited from registering with the SEC and only register with the states in which they maintain a principal place of business. As a result of these amendments, there has been a decline in the number of investment advisers registered with the SEC.

a small number of foreign investment advisers who use addresses in the United States when registering.

Based on their registration forms, it appears that a substantial majority of the 420 foreign advisers – approximately 269 – have 50 or fewer clients, and that 19 of these have more than 500 clients. These 420 advisers have reported an aggregate market value of approximately US$1,257.4 billion of client securities managed on a discretionary basis (compared to US$628.1 billion in 1994), and US$732.5 billion managed or supervised on a nondiscretionary basis (compared to US$427.8 billion in 1994). These advisers report giving advice to a broad range of clients, including individuals, banks and thrifts, investment companies, pension and profit sharing plans, and corporations. Approximately 29 percent (compared to 5 percent in 1994) of these advisers have reported that their principal business (or the principal business of their principal executive officers) involves something other than providing investment advice.

The business addresses of the 420 registered foreign investment advisers with foreign business addresses are in the following countries:

Business Address	Number of Investment Advisers
Argentina	2
Australia	9
Austria	3
Bahamas	5
Barbados	1
Belgium	2
Bermuda (UK)	12
Bolivia	1
Brazil	7
British Virgin Islands (UK)	2
Canada	45
Cayman Islands (UK)	2
Channel Islands (UK)	8
Chile	1
Republic of China	1

OPERATIONS OF FOREIGN FINANCIAL INSTITUTIONS

Business Address	Number of Investment Advisers
Colombia	1
Costa Rica	3
England (UK)	108
France	11
Germany	11
Ghana	1
Gibraltar (UK)	2
Greece	1
Hong Kong	30
Hungary	1
India	3
Ireland	3
Isle of Mann (UK)	1
Israel	4
Italy	4
Japan	30
Korea (Seoul)	24
Luxembourg	2
Malaysia	1
Mauritius	1
Mexico	7
Morocco	1
Netherlands	7
Norway	1
Pakistan	1
Philippines	2
Portugal	1

Business Address	Number of Investment Advisers
Russia	1
Scotland (UK)	18
Singapore	9
South Africa	4
Spain	6
Switzerland	11
Taiwan	4
Thailand	1
Turkey	2
United Arab Emirates	1

Source: SEC

Investment Companies

Under Section 7(d) of the Investment Company Act of 1940 (ICA), no foreign-domiciled investment company may make a public offering of its securities in the United States unless it has applied for and received an order from the SEC permitting it to register under the ICA. To issue a Section 7(d) order, the SEC must affirmatively find that it is both legally and practically feasible effectively to enforce the provisions of the ICA against such company and that issuance of such order is otherwise consistent with the public interest and protection of investors. Only 19 foreign funds, most of which are from Canada, have ever received orders from the commission under Section 7(d). The SEC last issued such an order in 1973.

A foreign money manager that is registered under the ICA may organize an investment company in the United States on the same basis as domestic money managers. Foreign advisers also can establish funds in the United States that invest in the same types of securities as funds they manage in their home countries.

As of June 1998, the most recent date for which data are available, there were approximately 1,337 U.S. investment companies whose portfolios consisted primarily of foreign securities. Assets of these funds totaled approximately US$471 billion. Of these funds, approximately 1,226 were open-end (funds that have a floating number of outstanding shares and stand prepared to sell or redeem shares at all times). Approximately 111 were closed-end (funds that have a fixed number of outstanding shares that are traded either on an exchange or in the over-the-counter market). Assets of open-end funds with portfolios of primarily foreign securities totalled approximately US$437.7 billion; assets of these types of closed-end funds totalled approximately US$33.6 billion.

Foreign Futures Businesses

The Commodity Exchange Act (CEA) and the regulations thereunder govern all transactions involving futures and certain option contracts. Under the CEA, a foreign firm considered to be doing business in the United States is treated no less advantageously than a domestic firm. Any person who acts in the capacity of a futures commission merchant (FCM), introducing broker (IB), commodity trading advisor (CTA), commodity pool operator (CPO), or as an associated person (AP) of the foregoing must register in the appropriate capacity with the Commodity Futures Trading Commission (CFTC) or have appropriate exemptive relief.

In general, a financial intermediary will be subject to CFTC regulation if it is legally domiciled in the United States, is physically present in the United States, has consented to jurisdiction, or is conducting business in the United States by dealing with persons located in the United States. A financial intermediary that is deemed to be conducting business in the United States need not be physically present in the United States.

CFTC data, as of May 1998, indicate that the numbers of registrants who are foreign-based are as follows: 206 CTAs (8 percent of registrants); 73 CPOs (5 percent of registrants); 1,882 APs (4 percent of registrants); 6 IBs (less than one-half of 1 percent of registrants); and 0 FCMs. The countries of origin for these registrants are as follows:

	CTA	CPO	IB	AP
Albania				1
Argentina				43
Australia	4		1	20
Austria				4
Bahamas		4		4
Bahrain				3
Belgium	3			22
Bermuda	4	18	1	8
Botswana				2
Brazil	1			15

	CTA	CPO	IB	AP
British Virgin Islands	2			2
Canada	21	6	1	46
Cayman Islands	2	3		1
Chile				8
China	5	2		152
Czech Republic				1
Denmark				3
Falkland Islands				1
France	14	1		72
Germany	17	1		178
Guadeloupe	1			2
Guatemala				1
Haiti				1
Honduras				1
Indonesia				1
Ireland	8	7		16
Israel				3
Italy	2			3
Japan	51	2		205
Korea (South)				1
Kuwait	1			
Luxembourg				9
Malta	1			
Martinique				1
Mexico	1			2
Monaco	3	1		11
Netherlands	4	1		28

	CTA	CPO	IB	AP
Netherlands Antilles	1			2
New Hebrides				1
Nicaragua				1
Philippines				2
Portugal				1
Russia				1
Scotland				1
Senegal				3
Singapore	1	1		113
Spain	1			25
Surinam				1
Sweden	1			6
Switzerland	11	3		111
Taiwan	2			4
United Arab Emirates				2
United Kingdom	41	18	3	725
Uruguay				4
Venezuela				5
West Indies	3	5		1
Yemen				1
Zimbabwe				1
TOTAL	206	73	6	1,882

Source: CFTC

CFTC rules also provide special treatment for firms engaging in the offer or sale of foreign futures and commodity option products to persons in the United States. Specifically, CFTC rules provide a mechanism for exempting foreign firms, upon application by relevant parties, from compliance with some CFTC rules, such as registration, based upon the CFTC's determination of comparability between the foreign jurisdiction's regulatory structure and that of the CFTC. This approach of substituted compliance is an effort to avoid duplicative regulation without having regulatory gaps. The countries of origin of these exempted firms are as follows:

**Foreign Firms Granted Relief from Registration as FCMs
Based upon Comparability of Foreign Regulation**
as of May 1998

Australia	27
Canada	10
France	19
Japan	8
Singapore	9
Spain	21
United Kingdom	85
TOTAL	179

Source: CFTC

When firms apply for confirmation of comparability relief, the CFTC requires disclosure of affiliates in the United States that act in the capacity of a bank, a broker-dealer, or a dealer in the cash commodity. The CFTC's records indicate that the majority of the foreign firms granted relief are affiliated with such firms in the United States.

Part II

International Financial Services Discussions

FINANCIAL SERVICES NEGOTIATIONS IN THE WORLD TRADE ORGANIZATION

INTRODUCTION

In December 1997, World Trade Organization (WTO) Members concluded multilateral negotiations to assure more open and transparent markets for banking, securities, insurance, and other financial services. These negotiations, which were held under the overall framework of the General Agreement on Trade in Services (GATS), encompassed all financial services and sectors, most notably: insurance and insurance related services; traditional banking services, such as acceptance of deposits and lending of all types; securities and derivative related services; asset management; provision and transfer of financial information; and advisory services. The resulting agreement involved a significantly broader range of countries and included substantially improved market access and national treatment commitments compared to those in an interim agreement reached in 1995. Much of the importance of the accord lies in its making this treatment legally enforceable through the WTO's dispute settlement procedures.

The 1997 agreement included improved commitments from 70 members, including entirely new offers from five members. This will bring to a total of 102 the number of WTO members with financial services commitments, accounting for over 95 percent of world trade in financial services as measured by revenues. Commitments made by WTO members in 1997 also include significant improvements in terms of (1) foreign firms' right to establish, (2) foreign firms' right to full majority ownership of financial institutions, (3) guarantees that the existing rights of foreign firms in these markets will be preserved ("grandfathering"), and (4) the right to participate fully in domestic markets on the basis of substantially full national treatment. Under the agreement, several WTO members also either withdrew their broad MFN exemptions based on reciprocity or reduced the scope of limited MFN exemptions.

THE GENERAL AGREEMENT ON TRADE IN SERVICES

The General Agreement on Trade in Services (GATS) is one of the most significant accomplishments of the Uruguay Round of Multilateral Trade Negotiations that concluded in December 1993. The GATS is the first multilateral, agreement governing international trade in services that has an effective enforcement mechanism. It covers every possible means of supplying a service, including the right to establish commercial presence in an export market.

The GATS is composed of four principal parts: the main text containing general principles and obligations; annexes that deal with rules for specific sectors; "schedules" that list positively by sector individual countries' specific market access and national treatment commitments; and, if applicable, individual countries' lists of exemptions describing measures which the country is temporarily not applying on a "most favored nation" basis. The GATS is grounded on several fundamental disciplines:

- *National treatment:* Countries should treat foreign and domestic services and service suppliers equally. This ensures a level playing field in the domestic market between local and foreign services and service suppliers.

- *Market access:* Unless a member takes an exemption to this obligation a member may not impose any of six specified measures limiting market access in sectors in which the member has undertaken a national treatment obligation.

- *Full coverage:* In principle, the GATS covers all services sectors except for those provided "in the exercise of government authority," although countries are not obliged to make national treatment or market access commitments in all sectors.

- *Additional disciplines:* Additional disciplines are imposed with respect to such matters as transparency, monopolies, transfers, and domestic regulation.

The GATS provides several means by which countries can take exceptions to certain of these principles. Most favored nation treatment is a general obligation of the GATS and is applicable in all sectors, scheduled or unscheduled. However, countries may take exceptions from the MFN obligation, but only, in principle, for up to ten years.

With respect to national treatment and market access, WTO members make commitments to open markets in specific sectors through negotiations with other members. WTO members "bind" these in a schedule that lists the sectors for which commitments are made, specifying the extent of market access and national treatment being given in those sectors. These schedules use a "positive" list approach, meaning that countries must list a sector in order to have market access and national treatment commitments in it. In so doing, however, it can identify restrictions, qualifications, exceptions, and, where appropriate, the time-frame for phasing-out restrictions in given sectors. If a country schedules a sector, but does not list any restrictions or exceptions, it is effectively binding the full range of GATS market access and national treatment obligations for that sector. Countries can in general only modify or withdraw these commitments after negotiations with other affected countries, but this would be rare since it could lead to compensation for other countries negatively affected by the change.

The Uruguay Round was only the beginning of an ambitious process to liberalize global trade in services. The GATS requires more negotiations, the first to begin by 2000, to move members toward higher degrees of market openness.

FINANCIAL SERVICES NEGOTIATIONS UNDER THE GATS

At the end of the Uruguay Round negotiations in 1993, negotiations in four sectors, including financial services, remained unfinished. Specific commitments to provide market access and national treatment in financial services were made, but the United States and some other WTO members did not consider these commitments adequate to conclude an agreement. The Second Annex on Financial Services to the General Agreement on Trade in Services (GATS) and the Decision on Financial Services adopted at the end of the Uruguay Round provided for extended negotiations in this sector. WTO members agreed to hold the next round of negotiations during the first half of 1995.

These negotiations concluded in July 1995 with only an "interim" agreement, because, again, negotiators from some members, in particular the United States, decided that the results were not satisfactory. During this round of negotiations, only 43 WTO members had improved their schedules of specific commitments or removed, or narrowed their MFN exemption in financial services.

The United States remained a full participant in the 1995 interim arrangement, with market access and national treatment commitments and entitled to all commitments scheduled by other participants. In its own schedule, in force from June 30, 1995, the United States committed to protect the existing investments of foreign financial services providers in the United States. However, the United States stopped short of guaranteeing full market access, national treatment or MFN treatment in the future by reserving the right to provide differential levels of treatment to both new foreign entrants to the U.S. financial market and to existing foreign firms seeking to expand or undertake new activities.

BUILDING MORE OPEN AND RESILIENT FINANCIAL MARKETS

In the past, a multilateral undertaking in financial services set in the context of trade law would have been inconceivable to many, particularly for a number of emerging market countries. That negotiators were able to reach a comprehensive agreement on trade in financial services in 1997 – a year of significant financial market turbulence – makes the 1997 agreement even more of an achievement. WTO members' success in concluding an agreement, despite a difficult environment, is a reflection of the international community's increasing recognition that financial sector opening is an essential part of financial system strengthening. Indeed, the WTO GATS negotiations on financial services need to be viewed as part of a broader strategy to achieve both a greater degree of global financial system integration and strengthening at both the domestic and global levels.

Financial market opening can contribute to financial system strengthening in a number of important ways. First, opening of the financial system generally introduces a greater degree of competition to domestic financial services markets, which usually leads to lower cost financial intermediation and higher quality financial services. Furthermore, foreign financial service suppliers contribute to financial market strengthening, particularly in emerging market economies, through the introduction of new financial techniques and products, improvements in human capital and transfer of skills, and improvements in financial market practices and infrastructure. Foreign financial services companies can also play a critical role in helping economies recover from financial crises through the provision of funding for bank recapitalization and new techniques for managing distressed assets. All of these factors contribute to greater economic efficiency and thus greater overall economic output and welfare.

Financial system strengthening, however, entails much more than financial liberalization alone. As the Asia crisis has shown, the creation and enforcement of a robust regime of prudential regulation are indispensable for maintaining financial sector stability. WTO negotiators were mindful of this during the Uruguay Round, when they crafted the Financial Services Annex to the GATS. An important provision of the Financial Services Annex allows WTO members to develop and maintain a strong prudential regime to enable them to prevent developments that threaten the stability of the financial system and respond to them when they occur. This includes the ability to implement measures to protect investors and depositors and to ensure the integrity and stability of the financial system. (This provision is often referred to as "the prudential carve-out.")

Since the Mexico crisis of 1994 and the Asia crisis that began in 1997, many emerging market economies also have needed, and will continue to need, to implement difficult and wide-ranging financial sector reforms to ensure greater financial system stability. Necessary reforms include: strengthening prudential regulation, disposal of high volumes of problem assets, orderly closure or recapitalization of weak or insolvent banks, and reforms to increase system-wide efficiency, including opening to external competition. The United States and the international financial institutions, particularly the International Monetary Fund and the World Bank, have dedicated great resources and attention to assist countries in their efforts to strengthen their financial systems through program lending and technical assistance. Furthermore, during the WTO GATS negotiations, U.S. negotiators worked flexibly with emerging market countries, including encouraging them to phase in further liberalization and reform over an agreed time-frame.

At the global level, the international community has also been working toward reforming the global financial architecture to reduce the frequency and severity of financial instability in the future and, when instability occurs, to deal with it more effectively. This effort dates from the 1994 G-7 Leaders Meeting in Naples, at which President Clinton and other G-7 Leaders recognized that the world needs a global financial architecture commensurate with today's challenges and called for a review of the existing system. The first set of reforms from this process were adopted at the 1995 G-7 Leaders' Meeting and have been referred to as the Halifax initiatives. Recognizing the need to expand on this effort, in April 1988, Treasury Secretary Rubin and Federal Reserve Chairman Greenspan invited finance ministers and central bank governors from 22 countries (the G-7 countries and fifteen other countries) to meet and discuss broader and deeper measures. Reflecting the important role of emerging market economies in the global economy, fourteen emerging market economies were invited to participate in this process for the first time. This process launched a work program that focused on three primary issues: (1) transparency and accountability; (2) strengthening of financial systems; and (3) managing international financial crises.

Three working groups addressed each of these issues and presented interim or final reports to ministers and central bank governors on October 5, 1998. Some of the more important recommendations in these reports include the following.

- Enhancing transparency and accountability:
  - That countries improve standards for private sector information disclosure and enforce high-quality accounting standards;
  - That countries improve the coverage, frequency, and timeliness of data on foreign exchange reserves, external debt, and financial sector soundness; and
  - That the international financial institutions improve their disclosure practices.
- Strengthening financial systems:
  - The development of agreed principles and best practices in several areas, including corporate governance, risk management, and financial safety net arrangements.
  - That national financial supervisors and regulators enhance their cooperation and coordination, through a variety of mechanisms or institutional arrangements still under consideration.
- Preventing future crises and managing those that do occur better:
  - That governments promote better risk management by limiting the scope and clarifying the design of guarantees they extend to private firms.
  - That countries implement and enforce effective insolvency and debtor-creditor regimes to promote better private sector risk management and more efficient restructuring of distressed financial assets.
  - That countries consider using "collective action clauses" in sovereign and quasi-sovereign bonds issued in foreign offerings to facilitate cooperation and orderly crisis resolution.

- That the IMF consider extending its 1989 policy of lending into arrears in appropriate circumstances to reflect the evolution of modern markets.

1997 FINANCIAL SERVICES NEGOTIATIONS AND AGREEMENT

The United States approached the 1997 round of negotiations by seeking a comprehensive agreement that would provide substantially full market access and national treatment for U.S. financial service providers in foreign markets. U.S. negotiators consulted frequently with U.S. financial services representatives to gain their insight. These institutions were also extremely active during the negotiations in engaging foreign governments and foreign financial services companies and identifying areas of common interest. Formal negotiations began in April 1997, and concluded December 12, 1997. During the negotiations, members again had an opportunity to improve, modify or withdraw their commitments in financial services.

Entering into the negotiations, the United States submitted a conditional offer that included comprehensive commitments covering insurance, banking, securities, and other financial services which would guarantee market access and national treatment to foreign service suppliers in the U.S. market on an MFN basis subject to existing state and federal laws. This offer was conditioned, however, on other countries making comprehensive commitments to provide fair and adequate treatment to U.S. financial service providers.

The end result of the 1997 negotiations, embodied in countries' individual offers as attached to the *Fifth Protocol to the General Agreement on Trade in Services*, is significantly broader in scope than the 1995 agreement and includes substantially improved market access and national treatment commitments. A total of 70 WTO members made commitments in the *Fifth Protocol*, of which five WTO members (Bolivia, Costa Rica, Mauritius, Senegal, and Sri Lanka) made commitments in financial services for the first time.

The 1997 agreement encompasses the full range of financial services and covers over 95 percent of world trade in financial services as measured by revenue. Financial services covered under the Agreement are defined in a comprehensive, nonexclusive fashion in the Financial Services Annex. For banks, they include the traditional services provided by banks, such as acceptance of deposits, lending of all types, financial leasing, and money transmission services. The agreement also covers trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money brokering, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services.

Some foreign countries offered new commitments to eliminate or relax limitations on: (1) foreign ownership of local financial institutions; (2) the juridical form of commercial presence (branches, subsidiaries, agencies, representative offices, etc.); and (3) the expansion of existing operations.

These commitments will translate into significant improvements in the ability of foreign financial service to establish and compete in these markets. Several WTO Members withdrew broad MFN exemptions based on reciprocity or reduced the scope of their MFN exemptions. The United States, for example, replaced a broad MFN exemption, taken in the face of earlier unsatisfactory offers from other countries, with a limited exemption targeted at countries that maintain policies of forced divestiture in their insurance sectors. Important progress was also made in "grandfathering" the operations and rights of existing branches and subsidiaries of foreign financial institutions that are wholly or majority owned by foreigners in overseas markets.

The 1997 financial services agreement is a significant achievement for several reasons. Commitments in the agreement are legally binding, which guarantees a level of market access and national treatment to foreign financial services providers and makes their operating environment more predictable. In making these commitments, several countries sent an important signal to global markets that they would not close their markets to foreign financial firms. Having established basic principles and negotiating mechanisms as well as a foundation of specific commitments from which to build, the agreement also provides significant traction for future multilateral negotiations.

SPECIFIC IMPROVEMENTS IN THE 1997 FINANCIAL SERVICES COMMITMENTS

During the 1997 round of the WTO Financial Services Negotiations, both developed and emerging markets made important improvements in their market access and national treatment commitments. Among developed economies, some notable improvements include:

- Japan provided a WTO guarantee for extensive market access for foreign financial firms by binding on an MFN basis in its additional commitments section certain bilateral financial services agreements that it had reached with the United States.

- Canada, for the first time, committed to change its regime governing establishment of foreign banks to allow foreign banks to establish via direct branches.

- Members of the European Communities (EC) made significant improvements over their 1995 commitments that include the elimination of a large number of country-specific market access restrictions. Some examples are:

  - Austria eliminated an economic interest test for the licensing of foreign bank branches and subsidiaries.

  - Belgium eliminated a measure that required financial institutions to engage in securities trading only through stock exchange firms incorporated in Belgium.

  - Italy eliminated a local incorporation requirement for securities dealers and for fund management companies.

- For its part, the United States removed its prior broad MFN exemption and agreed that it would continue to maintain the substantial degree of market access and national treatment afforded under current laws, both federal and state. The United States also included a commitment to national treatment for foreign firms under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

Substandard commitments by many key emerging markets had been a major stumbling block in the 1995 negotiations. By contrast, the 1997 round of financial services negotiations made significant advances in opening markets for financial service providers in many important emerging markets in terms of rights of establishment, national treatment, improved guarantees of the right to maintain existing ownership and activities, and new commitments to allow full majority ownership of domestic financial firms by foreign investors.

Asian emerging market economies made some of the most notable improvements in their commitments during the 1997 negotiations.

- Indonesia grandfathered foreign participation in existing joint ventures, eliminated its ceiling on equity portfolio investment, relaxed discriminatory capital requirements, expanded the geographic scope of operations, and bound new entry for nonbanks and securities.

- Korea, among other things, relaxed foreign portfolio investment ceilings, eliminated ceilings on individual foreign equity participation in securities and asset management companies, allowed the establishment of branches and joint ventures of foreign asset management firms, and eliminated approval requirements on the establishment of representative offices of foreign securities companies.

- Thailand fully grandfathered existing foreign bank branches. It relaxed for a period of ten years its 25 percent foreign equity limit for locally-incorporated banks and similar limits for finance companies. It bound that it would guarantee the absolute amount of equity holdings of the foreign shareholders that enter Thailand during this ten-year period.

- The Philippines grandfathered existing foreign equity levels in banks, increased guaranteed rights of foreign ownership of domestic banks and securities houses to full majority ownership, and increased the number of branches banks are allowed to establish.

- Malaysia bound itself to permit 51 percent ownership in existing joint venture insurance companies by existing foreign shareholders and allowed the establishment of majority-or wholly-foreign owned fund management companies.

Emerging market economies in other regions also made substantial improvements in their commitments.

- Peru and Bolivia made their first commitments to open banking and securities markets.

- Brazil confirmed and significantly expanded the scope of foreign firm establishment in its market and bound current practice for the entry of securities firms.

- Mexico extended national treatment to foreign pension fund managers and raised the allowable aggregate foreign participation level in the domestic financial sector.

- Egypt allowed up to 100 percent foreign ownership of bank subsidiaries.

- Many Eastern European countries removed significant barriers to new establishment, acquisition, and full majority ownership of banks and securities firms. For example, Poland committed to market access through licensed branches for foreign insurance companies, banks, and securities companies and advisors. The Czech Republic eliminated an "economic usefulness" criterion for authorization of banking activities by domestic banks or branches of foreign banks.

As a result of these accomplishments, U.S. securities firms are now guaranteed the right to enter foreign financial markets in virtually every participating WTO member country. Industrialized countries and most emerging markets also provide rights for new establishment and all industrialized countries and most emerging markets allow foreign securities companies to hold 100 percent of the equity of local subsidiaries.

NEXT STEPS

Countries have until January 29, 1999, to ratify the Agreements concluded in December 1997. If ratified as anticipated, the agreement will enter into effect on March 1, 1999. In addition, there are a number of active WTO accession negotiations underway, including with key countries such as Russia and China. The United States will continue negotiating with these countries to ensure that they make commitments that meet the standards set by the WTO Financial Services Agreement. The next services negotiations in the WTO are scheduled to begin by the year 2000.

Part III

Treatment of United States Financial Services Firms in Overseas Markets

ARGENTINA

BANKING

SUMMARY

The Argentine banking sector has undergone a significant transformation in the past four years. Following the contagion effects of the Mexican financial crisis of late 1994, Argentina's banking system has been substantially strengthened by economic recovery, consolidation, enlarged foreign bank participation, and increased liquidity and capitalization. Mergers, privatization, acquisitions and liquidations reduced the number of financial institutions in Argentina from close to 300 in 1990 to 138 at the end of 1997. In late 1997, the Argentine government announced its intent to privatize Banco de la Nación – Argentina's largest commercial bank. However, the privatization of Banco de la Nación faces strong political opposition in the Argentine Congress (which must approve the privatization) and is unlikely to occur in 1998 or 1999. It is possible, however, that the bank will be "corporatized" (converted into a socieded anonima with private management) as a step toward incorporating private capital into the institution.

Thus far, adverse effects of the Asian crisis on the Argentine banking sector have been contained with deposits increasing somewhat during the crisis. Deposits in the Argentine banking system were over US$70 billion at the end of 1997 – 40 percent higher than in December 1994. Government-owned banks held 30 percent of total deposits in 1997 (down from 46 percent in 1993), and continue to have a virtual monopoly on public deposits. Total bank deposits represent only about 20 percent of Argentina's gross domestic product – a much lower ratio than in Chile, Mexico or Brazil. The 10 largest banks in Argentina controlled approximately 60 percent of banking sector loans and deposits at year-end 1997. Foreign banks controlled approximately 40 percent of banking sector deposits, up from 16.5 percent in 1994.

Two U.S. banks – Citibank and BankBoston – have extensive wholesale and retail operations. They are among the most prominent banks in Argentina. Six other U.S. banks – Chase Manhattan, Morgan Guaranty, Bank of America, Republic Bank of New York, Bank of New York, and American Express Bank – focus on wholesale and investment banking activities, and have played an important role in introducing new technology and better management techniques to the Argentine banking sector.

Eight U.S. banks operated in Argentina during the period 1994-98 through joint stock banks. Prudential limits for branches are still based on local capital of the branch rather than the consolidated parent, in effect removing the rationale for entry of the Argentine banking market through branches. Merger and acquisition opportunities have been available to U.S. banks on par with other institutions. In addition, and there are no restrictions on foreign banks establishing or expanding their presence in Argentina.

DESCRIPTION OF THE MARKET

Structure of the Market

The Argentine banking system is bimonetary. Under the April 1991 Convertibility Law, the Argentine peso is tied to the U.S. dollar at par value. Deposits and lending are in U.S. dollars and pesos. Total deposits were about US$70 billion in December 1997. In March 1998, peso deposits represented 47 percent of total deposits and U.S. dollar deposits were 53 percent. In terms of banking sector loans to the private sector, peso loans were 38 percent of total loans and U.S. dollar loans were 62 percent.

Structure of the Argentine Banking System
December 1997

	Assets	Deposits	Number of Banks
Private National Banks	53,953	28606	58
Public Banks	40,301	23,532	19
Cooperative Banks	4,100	2,666	6
All Foreign Banks	32,452	15,347	29
U.S. Banks	16,906	8,012	8
TOTAL	130,792	70,151	112

Source: Banco Central de la República Argentina, http://www.bcra.gov.ar

Argentine Banking Indicators
December 1997

	Deposits (US$ billions)	Banks	Offices	ATMs
U.S. Banks in Argentina	6.8	8	109	173
All Banks in Argentina	70.5	138	4165	2917

Source: Banco Central de la República Argentina, http://www.bcra.gov.ar

The financial system has been strengthened considerably since 1995 through mergers, acquisitions, and privatization. The number of financial institutions in Argentina dropped from close to 300 in 1990 to 138 at the end of 1997. In June 1998, there were 132 financial institutions in Argentina.

In spite of this consolidation, the Argentine banking sector remains one of the least concentrated in Latin America. The ten largest banks in Argentina held around 60 percent of total banking sector deposits and assets at year-end 1997. Public sector banks continue to have a monopoly on public sector deposit-taking and the administration of public sector funds. The Argentine federal, provincial and local governments, and some state enterprises, carry out financial operations using designated public banks.

Share of Total Deposits Controlled by the Ten Largest Argentine Banks
(percentage, end of year)

1994	50.2
1995	58.2
1996	59.2
1997	60.5

Source: Banco Central de la República Argentina, http://www.bcra.gov.ar

Privatization of the banking sector continues, with several foreign banks acquiring stakes in Argentine banks. Growing foreign participation in the Argentine banking system, particularly since 1996, has led to better management and efficiency. In 1995, with World Bank and Inter-American Development Bank assistance, the government of Argentina created a Trust Fund for Provincial Development to assist local governments to privatize their government-controlled banks. By year-end 1997, fifteen state-controlled institutions had been privatized. A few others are in advanced stages of the privatization process. Bank privatization has resulted in considerable expansion of credit to businesses in the interior of Argentina. Several foreign banks, including Banco Santander, Banco Bilbao Vizcaya, Scotiabank and Hong Kong and Shanghai Banking Corp. (HSBC), have made large investments in the Argentine banking system since 1994. The share of total deposits in foreign banks increased from 16.5 percent in 1994 to 40 percent at the end of 1997.

The central bank of Argentina (BCRA) also issued regulations to strengthen bank capitalization, liquidity requirements, and anti-money laundering efforts. All Argentine banks must meet a minimum total risk based capital ratio (calculated along BIS guidelines) of 11.5 percent. Central bank sources note that the actual capital held by the banks is higher than the minimum requirements.

Asset quality has improved considerably since the peak of the liquidity crisis in 1995, largely because of the growth in assets and improved credit risk evaluation by private banks. A reduction in the number of large corporate borrowers has improved the quality of borrowers. Still, increased retail lending to consumers and small and medium-sized firms may cause problems in the event of an economic downturn. The proportion of problem loans has decreased from 16 percent, on average, at the peak of the 1995 liquidity crisis to below 10 percent, on average, at the end of 1997. A few Argentine banks, however, still have very large irregular loan portfolios.

Bank minimum liquidity requirements, which replaced legal mandatory reserve requirements in 1995, have been increased gradually from 16 percent to 21 percent. In 1996, the BCRA negotiated a contingency repurchase agreement with a consortium of multinational banks to cover 10 percent of total deposits in the banking system in the event of a systemic run on deposits. This safety net, originally for US$6.1 billion, was increased to over US$7 billion in 1997. Under Argentina's currency board system which was implemented by the 1991 convertibility law, the BCRA uses its foreign currency reserves (about US$21 billion at the end of 1997) to back Argentina's monetary base.

The BCRA has also taken measures to strengthen the role of market discipline and promote transparency in the banking system. For example, the BCRA has eliminated all directed credit schemes, as well as restrictions on remittances by foreign banks. Detailed monthly financial information is now publicly available on each financial institution. Accountability over the adequacy of the work of external auditors has been substantially increased, and all Argentine banks are required to be rated publicly using international risk qualifications. The BCRA also requires Argentine banks to issue debt equivalent to at least 2 percent of their deposits.

Argentina's banking system profitability is still extremely low by international standards. During 1997, the Argentine banking system registered a return of only 5.98 percent on invested capital – up from 4.21 percent in 1996 and -0.2 percent in 1995. Nevertheless, some banks are much more profitable than the average. The ATM network in Argentina is expanding rapidly – at the end of 1997 Argentina had fewer than 1,900 ATMs, and at the end of 1997, the number of ATMs reached nearly 3,000.

Depositors have maintained confidence in the Argentine banking system since 1995. Unlike the dramatic outflow of deposits in the aftermath of Mexico's peso devaluation, Argentine deposits and lending have increased steadily despite the Asian financial crisis during the last quarter of 1997.

Regulatory Structure

The BCRA, created in 1935, has as its primary mission the preservation of the value of the Argentine peso. The BCRA issues currency, administers reserves, manages financial system liquidity, and acts as the government of Argentina's financial agent. It is prohibited from lending to the government or to individuals. The BCRA is governed by a board, composed of a President, a Vice President and eight directors, nominated for six-year terms by the Executive with the consent of the Senate. The central bank's Superintendency of Financial and Exchange institutions, headed by one of the Bank's directors, supervises the financial system. The Superintendency evaluates banks' capital, assets, management, earnings and liquidity (CAMEL) and enforces banking regulations.

The BCRA has strictly adhered to the requirement that it limit assistance to the banking sector by only offering assistance for temporary liquidity problems on a fully secured basis. With regard to deposit insurance, the GOA provided no explicit deposit insurance from 1991-95. The current limited system of deposit insurance was introduced in April 1995 in response to the Tequila effect (i.e., the backwash of Mexico's 1994-95 financial crisis that affected several neighboring countries). The BCRA implemented deposit insurance through establishment of a privately-managed deposit guarantee fund. The deposit guarantee fund is growing by about US$22 million per month. The deposit guarantee fund insures deposits of less than 90 days for amounts up to US$10,000, and deposits for longer than 90 days for amounts up to US$30,000. The amounts guaranteed are on a per person basis rather than per account. All types of accounts are covered, except those accounts on which the rate of interest paid exceeds a rate set by the central bank. The guarantee fund was recently used to cover two small bank failures, and its capitalization was US$130 million in June 1998. Local bankers consider it adequate to cover small bank failures, but it would be hard pressed to cover losses stemming from a large bank failure. In 1996, the BCRA negotiated a contingency repurchase agreement with a consortium of multinational banks to cover 10 percent of total deposits in the banking system in the event of a systemic run on deposits. This safety net, originally for US$6.1 billion, was increased to over US$7 billion in 1997.

Bank minimum liquidity requirements are calculated on the basis of all bank liabilities and apply equally to foreign and Argentine banks. The rate of the requirement varies according to the residual maturity of the liability (not according to the type of liability), with a higher rate applied to liabilities with maturities of less than 90 days. There are no requirements for liabilities with maturities of longer than 365 days. The shift from reserve requirements to minimum liquidity requirements started in 1995 and reflects the BCRA's explicit recognition that reserve requirements in Argentina are a prudential regulatory tool, not an instrument of monetary policy. The liquidity requirements are remunerated.

U.S. PRESENCE IN THE MARKET

At the end of 1997, the 27 foreign banks operating in Argentina held 45 percent of deposits (US$31.3 billion). The eight U.S. banks with Argentine operations held nearly 10 percent (US$6.8 billion) of bank deposits.

Two U.S. banks – Citibank and BankBoston – have extensive retail banking networks and are two of the most prominent banks in Argentina. The six other U.S. banks – Chase Manhattan, Morgan Guaranty, Bank of America, Republic Bank of New York, Bank of New York, and American Express Bank – have offices in Buenos Aires and do not have retail banking operations. These banks are involved in corporate finance activities and investment banking. In general, U.S. and other foreign banks do not fill a particular niche in the banking system. They have played an important role, however, in introducing new technology and better management techniques. They also have deeper financial pockets, thereby providing greater stability in the banking system.

The main foreign bank competitors of U.S. banks in Argentina are from Spain and Holland. U.S. bankers anticipate greater competition from Brazilian banks in the future.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks may establish in branch and subsidiary form in Argentina, or by acquiring shares in Argentine banks. In January 1994, the BCRA announced it was lifting the ban on the issuance of new banking licenses that had been in effect since 1984. In addition, a decree was promulgated in early 1994 to formally remove the legal distinction between foreign and locally-incorporated banks. The effect was to remove any legal constraints on the establishment of a foreign bank either as a branch or subsidiary bank. However, prudential lending limits for foreign bank branches in Argentina are based on local paid-in capital, not the parent bank's capital, effectively removing much of the rationale for establishing a branch. There are no additional restrictions on foreign banks establishing or expanding their presence in Argentina. Merger and acquisition opportunities have been available to U.S. banks on par with other financial institutions.

U.S. banking operations in Argentina have indicated that the rules and regulations governing banking activities are transparent, and there is sufficient opportunity for U.S. banks to comment on proposed changes to bank regulations and receive timely notification of impending changes.

As noted above, there are differences in treatment between state-owned banks and their private counterparts. In general, public sector banks continue to have a monopoly on public sector deposit-taking and the administration of public sector funds. Since January 1998, direct bank deposit of salaries has been mandatory for all Argentine companies with more than 100 employees. Foreign banks are allowed to participate in a nondiscriminatory fashion in the direct bank deposit of salaries (including public sector salaries), and many foreign banks do so.

Argentina imposes no market access restrictions or capital controls. There are no foreign investment registration requirements in Argentina. The central bank has eliminated restrictions on remittances by foreign banks. U.S. foreign direct investments in Argentina, including those in banking, are protected by the U.S.-Argentina bilateral investment treaty, which entered into force in 1994. With the exception of cross-border supply of services, Argentina's GATS schedule of commitments reflects current levels of openness. Argentina is currently discussing financial services liberalization within Mercosur with Brazil, Paraguay and Uruguay. It is unlikely, however, that any such regional commitments will exceed Argentina's GATS commitments.

There are no Mercosur regulations or laws affecting U.S. banks' operations. Financial services liberalization is on Mercosur agenda, but to date nothing has occurred. Central bank officials say that given Argentina's already open banking environment, the Mercosur discussions are unlikely to disadvantage U.S. or other foreign banks.

ARGENTINA

SECURITIES

SUMMARY

Argentina's securities market is relatively small compared to its banking sector as Argentine corporations tend to raise capital primarily through bank loans. The number of local corporations whose shares are listed on the Bolsa de Comercio de Buenos Aires – Argentina's principal exchange – decreased from 147 in 1996 to 136 in 1997. The bond market is dominated by public sector issues. However, the mutual fund and private capital pension fund markets are growing quickly.

There are no market access restrictions or capital controls in Argentina. Argentine laws and regulations do not discriminate based on domestic or foreign ownership. U.S. banks and securities firms participate in the market either as branches or subsidiaries. There are no restrictions on Argentine access to foreign markets or foreign access to Argentine markets.

At the end of 1997, there were 163 licensed stockbrokers and brokerage houses in Argentina, including six affiliated with U.S. financial institutions.

DESCRIPTION OF THE MARKET

The Bolsa de Comercio de Buenos Aires, Argentina's principal exchange, is a not-for-profit association established in 1854. It sets listing requirements; approves, suspends, or revokes listings; and establishes guidelines to ensure accuracy of financial statements and disclosure of material information.

The Mercado de Valores de Buenos Aires, or securities market, is a for-profit corporation established in 1929. It is a self-regulating body that sets and enforces standards for individual stockbrokers and stock brokerages, regulates trading rules, and clears and settles transactions.

The two organizations are majority shareholders in the Caja de Valores S.A., the central securities depository. The Mercado Abierto Electrónico S.A. (MAE), the electronic exchange, started operations in 1989 to conduct over-the-counter transactions. Argentine and foreign financial institutions participate in the securities markets as brokers and dealers in the securities markets.

Argentina's securities markets are very small and highly concentrated by world standards. Trading is thin and prices are sometimes volatile. Trading totaled US$111.4 billion in 1997, down from over US$166 billion in 1996. (Public bond trading was unusually high in 1996 in the aftermath of the Mexican financial crisis. The "Tequila Effect" caused Argentine interest rates to soar.) Trading in corporate stocks and bonds rose 21 percent during 1997, but government bond trading decreased. The general average daily trading volume in 1997 was merely US$445.5 million, down from over US$600 million in 1994.

Market Capitalization
(US$ billions)

	December 1996	December 1997
Common Stocks	44.7	59.2
Government Bonds	39.5	42.7
Corporate Bonds	3.5	3.8

Sources: Comisión Nacional de Valores and Bolsa de Comercio de Buenos Aires at http://www.merval.sba.com.ar, Instituto Argentino de Mercade de Capitales.

Argentina's capital markets were affected by the Asian crisis of mid-October 1997, and at year-end prices began to increase but had not recovered to pre-crisis levels. Market capitalization for common stocks peaked at US$66.3 billion in October 1997, but closed below US$60 billion at the end of 1997 – up more than 30 percent from 1996. Nevertheless, market capitalization is still less than 20 percent of Argentina's GDP. Thirteen company listings were withdrawn from the Bolsa de Comercio de Buenos Aires in 1997, and two equity listings were added. Only 136 companies listed at the end of the year – down from 147 in 1996. (Some small- and medium-sized enterprises quit the exchange after an experimental period, either because they found it difficult to meet requirements or because they found financing through the exchange to be relatively expensive.)

The Buenos Aires market is highly concentrated. The 20 most actively traded stocks account for 95 percent of total trading. The five corporations with the largest market value account for 60 percent of total market capitalization of listed common shares. Small futures and options markets for commodities (wheat, corn, soybeans, and sunflower seeds) operate in Rosario and Buenos Aires. The Bolsa de Comercio de Buenos Aires also operates a market for stock and bond options. The Bolsa de Comercio de Buenos Aires and the Chicago Board of Trade are discussing a joint venture to develop futures and options markets. The joint venture is expected to start in 1999.

The number of bond issues on the Bolsa de Comercio de Buenos Aires rose to 160 in 1997. Twenty-six were government bonds and the remaining 134 were corporate issues. There are no restrictions on the types of bonds sold or underwritten in Argentina.

The Argentine Securities Commission (Comisión Nacional de Valores or CNV) was created in 1968 to regulate public offerings, ensure transparency, and to oversee the development and organization of financial markets in Argentina. Improving access of small companies to capital markets is one of the CNV's primary objectives. The CNV participates in the International Organization of Securities Commissions and the Council of Securities Regulators of the Americas.

A joint commission consisting of representatives of the CNV and the Secretariat of Agriculture is the futures regulatory authority. However, the Secretariat is the dominant voice in the commission.

At the end of 1997, 18 companies managed private capital retirement and pension fund portfolios, which had grown to nearly US$9 billion – up from US$5.3 billion in 1996. Contributions are increasing by nearly US$300 million per month. By 2010, according to industry estimates, Argentine private retirement and pension fund administrators will manage over US$110 billion in assets. Over 6.4 million Argentines have opted for private retirement and pension funds, but for various reasons only about 3.5 million made contributions at the end of 1997. Banks, securities firms, life insurers, and other financial institutions participate in management – including many U.S. firms. Stocks account for over 20 percent of these portfolios.

The Argentine mutual fund market has grown spectacularly since 1994, when 86 funds were available with total value of just US$390 million. At the end of 1997, a diversified range of 198 funds was available with total value of over US$5 billion – which is less than 2 percent of GDP and only 8 percent of total bank deposits. Fixed income and money market funds represent a large share of total mutual fund holdings. Conditions for continued growth of Argentina's mutual fund market are in place.

Argentina's Mutual Fund Market

	12/31/96	12/31/97
Number of funds	151	198
Value (US$ billions)	1.87	5.38

Sources: Comisión Nacional de Valores and Argentine Chamber of Mutual Funds.

U.S. PRESENCE IN THE MARKET

Of the 163 brokers and brokerage houses licensed in Argentina at the end of 1997, six are from the United States: Bankers Trust, BankBoston, Chase, Citicorp, J.P. Morgan and Merrill Lynch. Other U.S. firms (such as Prudential, Goldman, and others) use intermediary agents. U.S. firms are among the leaders in securities, mutual funds, and private capital pension administration in Argentina. Fidelity Investments arrived in Argentina in 1997 and is developing a corporate and institutional client base. According to data from the Argentine Chamber of Mutual Funds, BankBoston is the leading mutual fund institution in Argentina with a market share of 22 percent.

Argentina's Mutual Fund Market Shares
(percent, year-end 1997)

BankBoston	22
Banco Río-Santander	16
Banco Francés	14
Banco Galicia	7
HSBC Banco Roberts	6
Fidelity Investments	2
Others	33

Source: Argentine Chamber of Mutual Funds.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no laws or regulations that discriminate between foreign and domestic firms in the Argentine financial market. There is no requirement to obtain government approval for or to register foreign investments. Exchange markets, repatriation of capital and profit remittances are completely open and unrestricted.

One hundred percent foreign ownership of branches and subsidiaries is permitted. Foreign and Argentine firms have equal access to stock exchange seats. Registered foreign firms underwrite securities instruments, broker and trade domestic and foreign securities, and manage mutual and pension funds through licensed subsidiaries.

The Argentine government is discussing financial services liberalization within Mercosur with Brazil, Uruguay, and Paraguay. The Montevideo Protocol signed in December 1997 commits all Mercosur members to negotiate the liberalization of services, including financial services, over a ten-year period. Given Argentina's liberal treatment of financial services, it is unlikely such regional commitments will exceed Argentina's commitments under GATS. Argentina's GATS commitments reflect current levels of openness.

BRAZIL

BANKING

SUMMARY

Foreign participation in Brazil's financial sector is regulated by the Brazilian Constitution. Under transitional provisions in effect since 1988, the establishment of new branches and bank subsidiaries of foreign banking institutions is prohibited. This includes a freeze on increases in the percentage of foreign participation in the capital stock of Brazilian institutions. In addition, the number of branches (including automated teller machines) of a foreign bank cannot exceed the total existing on October 5, 1988. However, the government has in practice allowed substantial foreign entry and expansion to occur in recent years. Since March 1995, transitional rules have permitted exceptions on the basis of obligations under international agreements, reciprocity, or national interest as determined by the President of the Republic. The government will, in general, levy a toll on foreign banks that are newly entering the Brazilian banking system. This varies from an outright payment to acceptance of doubtful assets from troubled institutions subject to central bank intervention.

The Brazilian banking sector underwent a period of painful adjustment following the introduction of the "Real Plan" economic stabilization program in July 1994. Banks had successfully adjusted to the country's formerly high inflation (averaging 1,000 percent per year in the decade prior to 1994) by extending branch networks and emphasizing treasury operations instead of lending and fee-based services. In particular, banks have been able to earn favorable rates of return compared to other sectors of the economy by using float, especially on non-interest-bearing deposits. It has been estimated that banks enjoyed some US$9 billion in "float income" in 1993, the year inflation peaked at almost 2,500 percent. Following the sharp drop in inflation beginning in the second half of 1994, Brazilian banks were forced to reduce administrative overhead and to increase income from other sources including credit operations. Due to high real interest rates and lack of experience in credit operations, banks began to face rising defaults in 1995. A period of bank consolidation commenced in that year which continues to the present.

The government acted quickly to restore stability to the banking system in 1995, intervening and facilitating the orderly exit of two major private banks and other smaller financial institutions. Beginning in March, it passed regulations permitting the entry or expansion of foreign capital in the banking system on a case by case basis. In November 1995, the government instituted a program to facilitate the restructuring of the private banking sector known as PROER. Up until November 1997, PROER provided some US$19 billion in financing to six banks. Some 40 private institutions were liquidated, sold, or subjected to central bank intervention during the period. Of 248 commercial, multiple, and savings banks in June 1994, only 211 remain.

The major task remaining is to restructure the country's public sector banking system. Two state banks and one federal bank have already been privatized. Fully two-thirds of existing state banking institutions are to be privatized, wound up, or converted into development agencies under the public bank financial restructuring program known as PROES.

Several trends are evident in the evolution of Brazil's banking system since 1994: the share of private sector banks in total assets is increasing; there is a movement toward greater concentration among private sector banks; and the share of foreign bank ownership is growing. Correspondingly, the share of publicly owned banking assets has declined, in large part reflecting the exit of a few state-owned banks from the system and the operational limitations imposed by the central bank on some of the state-owned banks.

Public sector banks play an important role in the Brazilian banking system. The top two banks in the country are owned or controlled by the federal government and the third by the most important state. The last has been under central bank intervention since December 1994 and is slated for privatization. Public sector banks profited greatly from the high inflation environment due to their large branch networks and access to official deposits, but they have also been required to support administration policies and often have been subject to political pressures. As a consequence, both federal and state banks have had greater problems with non-performing loans in the last several years. The second largest public sector bank had massive losses in both 1996 and 1997 and required recapitalization by the federal government. State banks have reported a string of losses in the years since the Real Plan.

Foreign owned or controlled banks accounted for 18 percent of total bank assets in December 1997, up from 13 percent in December 1995. In most cases, foreign investment is approved in connection with the sale of a troubled private or public bank and includes payment of a premium to the government that may be either cash or assumption of problem assets. The most notable case of foreign entry into the domestic market took place in March 1997 when the fourth largest private bank was sold to a London-based global bank.

The U.S. banking presence in Brazil is growing. According to U.S. government statistics, U.S. foreign direct investment (FDI) in the banking sector (depository institutions only) increased by 78 percent to US$1.5 billion by the end of 1997. Much of this expansion reflects acquisition activity, particularly since 1996. Expansion into investment banking has been a notable trend in recent years.

DESCRIPTION OF THE MARKET

Brazil's financial sector is the largest in Latin America with bank assets totaling US$697 billion. The banking industry has 240 banking institutions operating 16,300 branches. Banks remain the primary purchasers of Brazilian government debt, both for their own account and on behalf of investment funds that they manage.

Public Sector Banks

Public sector banks play an important role in the Brazilian banking system, and accounted for 51 percent of total assets and 58 percent of deposits as of December 1997. The government-controlled Banco do Brasil, which performed many central bank functions prior to the 1964 establishment of the Banco Central do Brasil (central bank), is the largest commercial bank in the country and the second largest of all banking institutions in terms of total assets. Banco do Brasil acts as the government's agent in many transactions, including provision of export credit via the official PROEX program, and is the depository for federal government receipts. It operates throughout the country via its over 3,000 branches, has the largest deposit base in the country, and is frequently the only bank in town in the country's interior. Banco do Brasil is also the primary lender to the rural sector and is frequently called upon to make loans to support Brazilian development projects. As a result, it also has the largest bad debt portfolio (56 percent of credit operations and 31 percent of assets) of any bank in Brazil with the exception of troubled Sao Paulo state banking institution Banespa.

The Federal Savings Bank (CEF) is the largest bank in the country and the primary source of housing finance in the country. A 1997 real estate law made it possible for more private sector banks to engage in mortgage lending as it simplified the foreclosure process but has not yet been fully implemented. CEF administers funds derived from a number of taxes, accepts deposits, and offers checking accounts. It is second only to the Banco do Brasil in terms of its branch operations around the country. It is less competitive with private banks than the Banco do Brasil because of its narrower mandate. However, CEF accounts for 25 percent of all savings accounts and 35 percent of long-term deposits in the country.

The National Economic and Social Development Bank (BNDES) finances infrastructure and industrial projects and has been particularly active in providing long-term funding in connection with Brazil's ongoing privatization program. BNDES makes loans to companies with financial problems and has on occasion acted on behalf of the government to bolster stock market activity. Through BNDES, the Brazilian government is a shareholder in a number of domestic companies. One of the few sources of long-term finance in the country, BNDES derives much of its funding from international financial institutions as well as from earmarked tax collections. BNDES does not engage in ordinary commercial banking and currently is not considered a competitor of private banks.

Public banks have traditionally enjoyed certain advantages over private banks with respect to the capture of government resources such as tax collections. Due in part to their extensive branch networks, public banks also benefitted most during the high inflation period and were among the hardest hit when it ended in 1994. However, public banks were also subject to statutory mandates and political pressures to make poor quality loans or to accept and continue to roll over state debt instruments. For these reasons, the bad debt portfolio of the public banks is considerably higher than that of the private banking sector. In addition, public banks have higher administrative costs both due to their generally larger branch networks and to the difficulty of reducing bloated payrolls.

With the sale of private banking institution Bamerindus to the Hongkong & Shanghai Banking Corporation in March 1997, Brazil largely completed the restructuring of its private banking system following the introduction of the Real Plan. Thereafter, the main attention of the government turned to the public banking sector, especially state banking institutions. The objective of the PROES program, approved in mid-1996, is to liquidate, privatize, restructure, or convert to development agency status troubled state and federal banks. From July 1994 to December 1997, 35 private banks and eight public banks were either liquidated or subject to central bank intervention. Of the 33 state banking institutions existing in July 1994, fully two-thirds are to be reorganized. Rio de Janeiro state bank Banerj, Minas Gerais state bank Credireal, and federal bank Meridional have already been privatized. The next major step is the privatization of Sao Paulo state bank Banespa.

Private Banks

Brazil's largest private banks began as family operations and have become diversified financial institutions. Family interests continue to be important in terms of ownership and sometimes management. Due to increased competition and globalization, small and medium-sized family-owned banks are increasingly likely to be acquired by larger banks unless they are able to exploit a market niche. The fifth largest bank in the country is privately owned Bradesco.

Multiple Bank Licenses

Private and public banks with multiple bank licenses dominate the market. Multiple banks not only provide traditional commercial banking services, but also offer investment banking, consumer credit (financing) real estate lending, and leasing. The advantage of a multiple bank license is mainly lower cost, both in terms of lower supervision cost and compliance capital. With special departments, such banks can carry out activities of two or more financial institutions without the need to incorporate separate entities. Many institutions, including foreign financial companies, have taken advantage of the greater flexibility afforded to multiple banks and have transformed their operations into multiple banks. As a result, multiple banks include both government and privately owned banks. Multiple banks currently constitute 176 of the 240 commercial, multiple, savings, investment, and development banks operating in Brazil.

Creation of a multiple bank requires prior central bank approval and can be accomplished by various means including mergers, acquisitions, or incorporation of new institutions. Multiple banks cannot issue debentures. Only the domestic subsidiaries of foreign banks may hold such a license, not the overseas bank itself.

Financial Institutions (percent of total assets) December 31, 1997	
Multiple Banks	51.5
Federal Savings Bank*	14.0
Banco do Brasil*	12.2
National Development Bank*	7.3
Commercial Banks	4.5
Leasing Companies	4.2
Investment Banks	1.6
Stock Distributors	1.4
Brokerage Houses	1.1
Real Estate Finance	1.1
State Development Banks*	0.6
Finance Companies	0.5
State Savings Banks*	0.2

* indicates public sector institutions Source: Central Bank

Supervision

The National Monetary Council establishes overall general policies for the financial system. Members of the Council include the Ministers of Finance and Planning and the President of the central bank. The central bank has broad discretion to issue administrative rulings in order to execute policies set out by the Council. It oversees the banking system and conducts on-site inspections as well as off-site monitoring and surveillance, both domestically and overseas. The Central Bank's supervisory activities are mainly carried out by inspectors, many of which are newly hired. Since August 1996, the central bank has been in the process of replacing a number of experienced personnel who left its employ due to a change in the retirement system.

A number of steps have been taken since 1994 to improve bank supervision and regulation. The central bank has received additional powers to act preventively such as the power to recommend changes including merger or acquisition prior to formal intervention or liquidation. Since 1996, outside auditors have been personally liable for the accuracy of their reports. Some Brazilian banks have begun using U.S. accounting standards (GAAP) in preparing annual reports. A deposit insurance system was instituted in 1995 that offers protection of up to R20,000 (US$18,000) per person per institution. This limit covers 95 percent of credit holders and about 50 percent of the total value of demand and savings deposits, certificates of deposit, and other bank liabilities such as mortgage bills, and consumer credit bills. The measure is temporary in that the Constitution of 1988 requires that the congress pass new legislation governing the entire financial system including a fund or insurance to guarantee credits against financial institutions.

A Credit Risk Center instituted in May 1997 is a database of information regarding loans of more than R50,000 in value. Over 400 financial Institutions currently provide information regarding credit operations more than R50,000 (US$43,000) in value based on company or individual name.

In December 1994, all banks were required to meet the 8 percent BIS capital-adequacy ratio. This minimum was subsequently raised to 10 percent and will be set at 11 percent in 1999. Capital adequacy requirements for branches of foreign banks are based on the local capital of the branch. Foreign banks are subject to the same BIS standards and operational and lending limits as domestic banks.

Impact of Lower Inflation

A major factor affecting the Brazilian banking sector during the past few years has been the rapid drop in inflation and the consequent disappearance of "float income" derived from very short-term lending of idle balances and delays in monetary correction of deposits. During the decade prior to 1994, inflation averaged 1,000 percent per year. In this environment, banking profits rose with inflation and the emphasis was on expanding the number of branch offices, treasury operations, and greater efficiency in areas such as check clearing. As a result of inflation-derived income, the share of the financial sector in GDP peaked at almost 16 percent in 1993 before falling back sharply to under 7 percent by 1995.

With the reduction in inflation, banks were forced to reorganize their asset portfolios, reduce operating costs, and rely more on income from loans and service charges. Banks initially expanded credit operations rapidly following the introduction of the Real Plan. However, high real interest rates and lack of experience with credit operations led to a rising default rate beginning in late 1995. The default rate began to fall by mid-1997 as lending policies became more conservative. The Brazilian banking system continues to have one of the lowest credit/GDP ratios in the world at about 30 percent. In spite of considerable reorganization, Brazilian retail banks have a long way to go to attain international efficiency levels. In a recent study, consulting firm McKinsey concluded that labor productivity in Brazilian retail banks was only 40 percent that of the United States. The increasing number of banks (some of them major) encountering difficulties led to the creation of the PROER and PROES private and public bank restructuring programs. Since 1994, the industry has undergone a wave of mergers and acquisitions and it has been predicted that the number of banks could halve in the next decade.

Total Assets of the Brazilian Banking System
(US$ billions)

	December 1996	December 1997
Total Banks (218)	559.7	646.5
Largest Banks (20)	170.0	244.9
Foreign Banks (68)	79.7	123.2
U.S. Banks (9)	13.2	11.8

Net Worth of the Brazilian Banking System
(US$ billions)

	December 1996	December 1997
Total Banks (218)	55.2	55.3
Largest Banks (20)	20.3	21.3
Foreign Banks (70)	7.8	11.6
U.S. Banks (9)	1.2	1.2

Source: Central Bank

U.S. PRESENCE IN THE MARKET

The U.S. banking industry has a significant and growing presence in Brazil. Five banks – BankBoston, Citibank, Chase Manhattan, J.P. Morgan, and GM – are among the top 50 banking groups in the country and the first two are among the top 20. BankBoston and Citibank are active in retail banking with 35 and 21 branches, respectively, as of December 1997. BankBoston increased its number of banking branches by six during 1997. Chase and J.P. Morgan focus on investment banking. Since 1995, a number of U.S. institutions have entered the banking sector for the first time or expanded their presence.

Citibank and BankBoston entered Brazil prior to 1940 as branches of their U.S. parent banks with full commercial banking rights. They retain this status as a grandfather privilege. Since the Second World War, foreign banks have not been permitted to enter as branches. Citibank, BankBoston, and

American Express have transformed their financial operations into multiple banks. General Motors and Ford hold multiple bank licenses but engage primarily in consumer lending to finance the purchase of company products. Merrill Lynch also holds a multiple bank license but functions mainly as an investment bank. During the last two years, the United States has increased its presence in investment banking, in particular with the addition of Mellon Bank, American Express, and NationsBank.

In addition to nine banks from the United States, 60 other banks with foreign participation currently operate in Brazil. A wide variety of countries are represented with Great Britain, Japan, and, most recently, Spain and Portugal playing prominent roles. As a group, foreign banks account for 18 percent of banking sector assets, up sharply from 13 percent in 1995. In all, 70 wholly or partly owned foreign banks operated in Brazil as of December 1997.

Total Assets of U.S. Banks in Brazil
(US$ millions)

	1996	1997
BankBoston Bco Multiplo S.A.	5,427.5	4,914.8
Bco Chase Manhattan S.A.	2,972.4	2,328.7
Citibank N.A.	2,945.2	1,623.5
Bco General Motors S.A.	1,411.0	1,040.1
Bco J.P. Morgan S.A.	420.4	791.0
Bco Ford S.A.	628.7	719.9
Republic National Bank NY S.A.	39.7	304.5
Wachovia S.A.	152.3	79.3
Bco Merrill-Lynch S.A.	164.5	36.7

Net Worth of U.S. Banks in Brazil
(US$ millions)

	1996	1997
BankBoston Bco Multiplo S.A	276.7	336.4
Bco Chase Manhattan S.A.	244.6	264.6
Citibank N.A.	314.5	243.0
Bco General Motors S.A.	128.5	170.6
Bco J.P. Morgan	49.2	68.8
Bco Ford S.A.	55.4	77.9
Republic National Bank NY S.A.	34.8	38.7
Wachovia S.A.	41.5	23.4
Bco Merrill-Lynch S.A.	21.1	17.4

Source: Central Bank

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Brazil's Constitution of 1988 charged the Brazilian congress with drafting an omnibus law governing virtually all aspects of the financial system from the making of monetary policy to the regulation of banks, securities firms, and the insurance sector. In particular, Article 192 of the Constitution requires a so-called Complementary Law to define the conditions for new or increased participation of foreign capital in the financial sector. Work on implementing legislation has progressed slowly, but there is a good chance that proposed legislation could be voted into law by 1999. In the meantime, Article 52 (a transitional provision) prohibits the expansion of foreign bank ownership and freezes the number of bank branches at the October 1988 level. However, the provision has ceased to have practical meaning in that new entry or expansion of foreign bank branches have generally been approved on a case by case basis. In 1995, the government decided that the Executive Branch could make exceptions to this rule on the basis of international obligation, reciprocity, or national interest. Another important criterion is the degree of financial innovation the foreign bank will bring to the market. The transitional provision has been applied liberally and U.S. banks have not expressed dissatisfaction with its workings in practice. Establishment and expansion of ATM networks, though legally restricted, in practice has also been permitted.

Methods of entry into commercial and investment banking have varied from acquisition of sound or failing banks, with or without payment of a premium to the government, to the establishment of new operations. A primary criterion for entry is the national interest, particularly in the case of troubled institutions. Another important consideration is the degree of technical or financial innovation the new firm will bring to the market. Related considerations include improved export competitiveness and access to new markets. The government will, in general, levy a toll (pedagio) to foreign banks that are newly entering the Brazilian banking system. This varies from an outright payment to acceptance of doubtful assets from troubled institutions subject to central bank intervention. Although entry must be approved on a case-by-case basis due to Constitutional restrictions, this has not proved a hindrance in practice.

In WTO Financial Services negotiations held in December 1997, Brazil offered to provide national treatment in banking, pending approval of the Complementary Law and subject to the provision that all members of senior management of financial service suppliers must be permanent residents of Brazil. While there has been some discussion of harmonizing banking standards within Mercosur, the trading block that includes Argentina, Brazil, Uruguay and Paraguay, there have been no concrete decisions to date.

BRAZIL

SECURITIES

SUMMARY

The Brazilian Securities and Exchange Commission (Comissao de Valores Mobiliários, or CVM) and the Central Bank of Brazil regulate Brazil's securities markets.

The Sao Paulo Stock Exchange (BOVESPA), the largest of Brazil's nine exchanges, has registered impressive gains in both volume and share appreciation in recent years, but market capitalization as a percentage of GDP remains low. Nonetheless, the total value of shares traded on the BOVESPA market is equal to approximately 60 percent of market capitalization for all of South America as of March 1998. Market valuation and volume almost doubled in the first half of 1997 before the initial onset of the Asian financial crisis began to affect prices.

The market for new domestic issues remains thin as few corporations choose to raise capital through the Brazilian bourse. Having obtained permission to offer securities and place commercial paper abroad, larger Brazilian firms have gravitated toward international markets in order to raise capital as they have been able to obtain funding more cheaply and flexibly than is possible in the domestic financial market. In particular, the number of American Depositary Receipt (ADR) offerings has increased significantly in recent years.

Free from forced separation of the banking and securities businesses, the primary participants in the Brazilian securities market are multiple or universal banks, followed by large public and private pension funds and mutual funds. Other types of banks may conduct securities business through a subsidiary after obtaining pro forma approval from the CVM's National Monetary Council. With respect to foreign participants, Article 192 of the Constitution of 1988 barred all new entry of foreign securities and brokerage firms, but foreign firms established prior to that time were permitted to remain. A transitional rule provides for exceptions on the basis of national interest, obligations under international agreements, and reciprocity. It is expected that passage of a so-called Complementary Law to the article will clearly provide for new foreign entrants and the increase of existing investments. Foreign firms established here prior to 1988 may underwrite, broker, and trade in domestic securities and may also hold seats on Brazilian stock exchanges. They face no other impediments to doing business in Brazil. New foreign firms have entered the Brazilian securities market primarily as minority partners in joint ventures with Brazilian companies.

Since 1991, the government has been changing regulations to facilitate foreign portfolio investment in Brazil. Particularly important was approval in that year of Annex IV, which opened Brazil's stock market significantly by permitting foreign institutional investors to invest directly via managed portfolios and eliminating diversification requirements and the minimum holding period before repatriation. Since implementation of Annex IV, the net inflow of foreign portfolio investment rose from US$1,704 million in 1992 to US$6,415 billion in 1997. From 1992 to 1997, cumulative net portfolio investment inflow totaled US$31 billion.

DESCRIPTION OF THE MARKET

Regulation

Brazil's National Monetary Council, which is formally chaired by the Minister of Finance and also includes the chair of the Central Bank and the Minister of Planning, is the highest federal government regulatory body overseeing the securities markets. The Central Bank is the primary executing authority for all Council decisions and the President of the Central Bank is a member of the Council. The Council sets guidelines for the securities industry that are implemented by the Brazilian Securities and Exchange Commission (Comissao de Valores Mobiliários, or CVM), the equivalent of the U.S. Securities and Exchange Commission. The CVM has a staff of 380, is administered by a chair and four commissioners, and is linked to the Finance Minister. The CVM also regulates futures trading in stocks and stock indices.

Law 6385, enacted in 1976, empowers the CVM to supervise the activities and services of the securities markets and to impose fines as punishment for infractions. The CVM regulates stock exchanges, brokers, and equity mutual funds and also supervises pension fund and leasing company activities in the stock market. CVM authorization is required before securities exchanges can start operations. Foreigners may purchase domestic shares via both direct investment and portfolio investment made by institutional investors through the managers of the respective portfolios (Annex IV). Depositary Receipts such as ADRs are another method of acquiring shares via foreign stock exchanges and provide a mechanism for the placement of Brazilian shares in international markets. Portfolio investment by foreign investors in fixed-income instruments is restricted to two classes of fixed-income funds.

The Central Bank of Brazil regulates bond mutual funds, commodity, interest rate, and foreign currency futures, pension funds, leasing companies, and investment abroad by Brazilian individuals and firms.

Capital Formation: Instruments and Exchanges

High inflation prior to the 1994 Real Plan and persistent government budget deficits since have left a large supply of Brazilian government paper in the hands of the private sector. As a result, Brazilian government paper remains the primary instrument traded by financial institutions, especially after the doubling of reference interest rates in October 1997. Most of this paper is short-term in nature and is therefore popular both for its high liquidity and positive real rates of return. Investors participate through government-certified dealers (primarily banks, both domestic and foreign) in the Central Bank primary government paper market. The most important public debt instruments are National Treasury Notes (NTN), Central Bank Bonds (BBC), National Treasury Financial Letters (LFT), and National Treasury Letters (LTN).

Debt instruments vary by maturity, purpose (debt finance or monetary policy), and indexation to exchange or interest rates. The percentage of inflation-indexed bonds declined dramatically with the success of the Real Plan stabilization. Both the Treasury and the Central Bank issue domestic currency bonds indexed to the real/dollar exchange rate: National Treasury Notes-Dollar (NTN-D) and Central Bank Notes-Exchange (NBC-E), respectively. As of December 1997, the stock of federal securities outside of the Central Bank stood at US$229 billion and those of states and municipalities in private hands at just over US$10 billion.

Brazil has nine stock exchanges, listing a total of 590 companies. (Dual listing is permitted.) The largest, representing over 90 percent of total trading volume, is the Sao Paulo Stock Exchange, BOVESPA, which trades in stocks, including stock options and futures. The Rio de Janeiro Stock Exchange (BVRJ) accounts for about five percent of volume. The seven other regional exchanges have a negligible presence and are linked electronically with the Rio exchange.

BOVESPA's relative importance is explained in part by the shift in economic activity, particularly industrial, from Rio de Janeiro to Sao Paulo in recent years. Recently, other states have been increasing industrial activity as well by offering fiscal incentives to foreign companies, especially in the automotive sector.

BOVESPA listed 536 companies in December 1997, down from 552 in 1993. Nationally, the trend has been to delist on stock exchanges: 618 in 1980 to 582 in 1993 to 590 in 1997. Some companies choose to delist (or "close capital") because of balance sheet publishing costs ("custo de divulgação"). For example, a company may choose to raise funds through loans instead of stocks or debentures to free itself from the mandatory requirement of publishing its balance sheets.

Daily turnover provides a rough comparison of the relative sizes of Brazil's exchanges.

Brazilian Stock Exchanges
(Volume in US$ thousands, cash market, 1997)

Sao Paulo	154,879,924
Rio de Janeiro	9,138,338
Minas-Espirito Santo-Brasilia	960,194
Pernambuco and Paraiba	473,676

Brazilian Stock Exchanges (Volume in US$ thousands, cash market, 1997)	
Parana	227,948
Regional	144,922
Extremo-Sul	3,940
Bahia-Sergipe-Alagoas	2,604
Santos	1,037

Source: National Commission of Stock Exchanges

The increase in market capitalization on the BOVESPA bourse has been remarkable in the last few years, rising from US$99 billion in December 1993 to US$255 billion in December 1997. However, market capitalization as a percentage of GDP remains relatively low at 32 percent. Furthermore, while overall performance has been impressive, year-to-year changes have been erratic. The BOVESPA stock index rose 60 percent in 1994, fell 14 percent in 1995, rose 53 percent in 1996, and was up 34 percent in 1997 in U.S. dollar terms. After rising 20 percent in the first four months of 1998, the market had lost all of its gains in the next two months. An important reason for recent volatility is the high degree of liquidity in the Brazilian stock market compared to other emerging market exchanges. When investors become nervous about emerging markets, as has occurred since July 1997, the Brazilian exchange is often the first to be tapped in order to increase portfolio liquidity.

Few corporations raise capital through the Brazilian exchanges due to the considerable expense involved. In 1993, only US$841 million was raised in the primary market, generated through 24 new issues. In 1997, comparable figures were US$3.5 billion and 23 new issues. Efforts to expand opportunities for capital formation are ongoing. In particular, privatization of state enterprises has been increasing activity in the market due to share offerings by the new owners and to the creation of new issues via the breakup of public enterprises, especially in the power and telecommunications sectors. Brazilian firms are allowed to offer securities on international capital markets via Depositary Receipts and obtained permission to place commercial paper internationally in mid-1990. The latter funding mechanism has been widely used by larger firms as it is a much cheaper source of finance in view of the high real interest rates and short maturities which characterize domestic lending.

Trading volume in the secondary market in 1997 was US$216 billion. Equity trading on Brazilian exchanges is highly concentrated in a handful of stocks, mainly public sector firms. Although 590 companies were listed on all Brazilian exchanges as of December 1997, telecommunications parastatal Telebras accounted for almost 60 percent of volume and electric utility parastatal Electrobras for almost 4 percent. Government petroleum monopoly Petrobras accounted for another four percent.

The Commodities and Futures Exchange (Bolsa de Mercadorias & Futuros, or BM&F) came into being as a result of the May 1991 merger of the traditional Bolsa de Mercadorias de Sao Paolo (SP Commodities Exchange) dating back to 1917 and the Bolsa de Mercadorias & Futuros created in 1986 which had a greater number of financial operations in derivatives. On June 30, 1997, BM&F merged with Rio de Janeiro's BBF (Bolsa Brasileira de Futuros, created in 1983), resulting in the principal derivatives negotiation floor within Mercosur.

BM&F's clearinghouse is to operate electronically as a division. According to BM&F, this model appears more suitable for the Brazilian derivatives market than hiring an independent company to provide the service. In addition, there is a comprehensive guarantee system composed of funds for liquidating operations, reducing delinquency, etc.

A large number of items can be traded in the BM&F via its various markets as futures, puts, calls, swaps, spot, and term. Among these products are the BOVESPA index, C bonds (Brazilian Brady bonds), the U.S. dollar, the overnight interest rate, and commodities, such as gold, soy, crystal sugar, cotton, "fat ox," arabica coffee, and corn.

Participants

In contrast to the United States, Brazil has not traditionally segregated participation in the banking and securities markets. A new "Chinese Wall" regulation due to take full effect as of July 1998 would require banks to segregate management of third party funds from bank treasury operations, however. In fact, the primary players in the Brazilian securities markets are the so-called multiple banks, both domestic and foreign, which account for 40 percent of trading volume. Multiple banks are authorized to provide a broad variety of financial services including investment and commercial banking, stockbroking, and leasing. Other major participants include the large public and private pension funds and mutual funds. Foreign investors as a group account for some 26 percent of trading volume. While more individual investors have been entering the market via mutual funds, particularly since the beginning of 1997, individual investing remains relatively insignificant.

Securities Held by the Public
(US$ billions, as of June 1998)

Government Paper	229.0
of which: Central Bank	*58.4*
Treasury Notes	*170.6*
Certificates of Deposits (balance)	105.6

Securities Held by the Public (US$ billions, as of June 1998)	
Government Paper	229.0
Savings (balance)	174.0
Mutual Funds (fixed income, net worth)	113.9
Mutual Funds (foreign capital, net worth)	4.2
Social Development Funds (net worth)	0.4

Source: Central Bank and ANDIMA (estimates)

Brazil has two classes of stockbrokers: corretoras and distribuidoras. Corretoras are securities firms that hold seats on the exchanges. Distribuidoras accept trading orders from investors and deal indirectly with the exchanges through the corretoras. A seat on an exchange must be purchased in order to establish a brokerage firm. Both foreign and domestic firms may function as either corretora or distribuitora. For firms established prior to 1988, no restrictions are imposed in opening a corretora or distribuidora. Firms which entered the Brazilian market after 1998 can also purchase a seat on a stock exchange through an exemption to Article 52 of the Transitory Constitutional Provisions Act. The top 40 brokers accounted for four-fifths of total trading in December 1997.

Brazilian Mutual Funds
May 1998

Type	Number
Stock Funds	106
"Carteira Livre" Funds	453
Foreign Capital Investment Funds	13
Foreign Capital Conversion Funds	21
Foreign Capital Fixed Income	105
Fixed Income Funds: Short-Term	92
Fixed Income Funds: 30-day	109
Fixed Income Funds: 60-day	1,057
Fixed Income Funds: 90-day	100
TOTAL	2,056

Source: Central Bank of Brazil

Capital Controls and Foreign Investment

Foreign portfolio investment is subject to the exchange control system established by the Foreign Capital Law. As of December 1997, the government had authorized nine vehicles for foreign portfolio investment:

Annex I: Investment Companies
Annex II: Open-end Funds
Annex III: Closed-end Funds
Annex IV: Institutional Investment
Annex V: American Depositary Receipts
Foreign Capital Privatization Mutual Funds
Foreign Capital Conversion Mutual Funds
Foreign Capital Emerging Companies Mutual Funds
Foreign Capital Fixed Income Mutual Funds

(Individual portfolio investment is also possible via so-called "CC-5 nonresident accounts.")

Brazil's regime of capital controls has been significantly liberalized in the 1990s. Starting in 1991, a number of regulations were changed to facilitate foreign portfolio investment in Brazil. In order to provide additional investment vehicles for foreign investors, beginning in 1991 the Brazilian authorities permitted foreign investors to invest in the country via American and Global Depositary Receipts (ADRs and GDRs), securities issued abroad based upon Brazilian shares deposited with a fiduciary institution.

Also in 1991, the National Monetary Council approved Annex IV, which significantly opened up investment in the stock market by permitting foreign institutional investors to invest directly through managed portfolios and eliminating the minimum holding period before repatriation. (Individual foreign investors and companies domiciled abroad can enter Brazilian stock markets through Annex II, but are ineligible for the capital gains tax exemption granted to Annex IV investors.) In addition, Annex IV permitted establishment of omnibus accounts to incorporate sub-accounts of other institutional investors. Omnibus accounts permit foreign investors to set up individual accounts, thus circumventing restrictions on foreign individual investors directly investing in the Brazilian securities market.

Rules allowing swaps were established in 1994. Foreign capital fixed-income funds may conduct operations in organized derivatives markets, including futures operations carried out in markets managed by stock exchanges or commodities and futures exchanges. Subject to certain conditions and Central Bank oversight, Brazilian private sector entities may engage in hedging operations with financial institutions or stock exchanges abroad to protect themselves against the risk of variations in interest rates, exchange rates, and commodities prices.

BRAZIL – SECURITIES

Brazilian firms may hold equity shares in foreign companies, subject to regulation by the Central Bank. Companies or individuals may make investments through the purchase on Brazilian stock exchanges of custody certificates representing issued shares. Brazilian firms may send up to US$5 million per year abroad to related companies to pay for offices, service centers, and representatives without previous Central Bank approval. However, the transaction must be reported to the Central Bank. Firms may also send more than US$1 million abroad provided that the bank carrying out the transaction consults with a Central Bank regional office 30 days in advance and the Central Bank has no objection. Upon closing down business activity abroad, a Brazilian firm is required to repatriate capital and any receipts.

Foreign investors may make indirect portfolio investments in Brazilian equities by acquiring shares in an Annex I Brazilian investment company (not quoted on exchanges) or an Annex III Brazilian investment company (quoted on the New York Stock Exchange).

Since implementation of Annex IV, annual net foreign investment in the Brazilian market increased from US$386 million in 1991 to US$5.5 billion in 1993 before dropping to US$1.6 billion in 1997 due to the Asian financial crisis. For the first quarter of 1998, net inflow was US$2.2 billion. According to BOVESPA, foreign investors account for some 26 percent of trading volume. As of December 1997, the CVM had registered two foreign investment companies, 15 open-end investment funds, one closed-end fund, and 455 Annex IV foreign investors. The last category included 217 banks, 87 brokers, seven pension funds and 144 other investors. By origin, Annex IV investment was 31 percent North American, 36 percent Central American, 22 percent European, 9 percent South American, and 2 percent Asian as of December 1997. Of some US$32 billion in Annex IV investment in December 1997, 96 percent was in stocks and the remainder in securities: derivatives, debentures and privatization bonds.

Foreign investment other than portfolio investment in Brazil is classified for purposes of registration as direct investment or a loan. If the foreign capital does not constitute part of the corporation's capital directly subject to operational risk, it is considered a loan.

Foreign Participation in Financial Markets
(US$ millions)

		1994	1995	1996	1997	1Q 1998
Investments		27,214	28,010	35,152	56,719	13,319
of which:	*Portfolio*	*21,600*	*22,559*	*24,684*	*37,190*	*8,519*
	Direct	*2,241*	*3,285*	*9,580*	*17,864*	*3,171*
	Mutual Funds	*3,373*	*2,166*	*888*	*1,665*	*1,629*
Loans		8,756	15,883	28,078	35,535	19,218
of which:	*Relending*	*1,254*	*4,054*	*8,504*	*14,403*	*10,951*
	Commercial Paper	*182*	*381*	*633*	*451*	*508*
	Bonds and Notes	*5,961*	*9,650*	*18,046*	*20,448*	*7,615*
	Export Securities	*261*	*494*	*297*	*58*	*144*
	Renewals	*1,098*	*1,304*	*598*	*175*	*0*
Financing		4,353	4,576	6,828	24,192	5,10
of which:	*Registered*	*630*	*1,074*	*1,422*	*12,131*	*4,488*
	Authorized	*3,723*	*3,502*	*5,406*	*12,061*	*613*
Leasing		842	1,143	1,868	4,002	365
Export Pre-pay		1,908	4,273	7,073	8,536	1,705
TOTAL		43,073	53,885	78,999	128,984	39,708

Source: Central Bank of Brazil

U.S. PRESENCE IN THE MARKET

Due to continuing high real interest rates domestically, Brazilian firms have sought increased access to foreign capital markets and U.S. securities and brokerage firms have played a leading role in assisting and advising them.

Several U.S. securities firms have minority interests in joint ventures with Brazilian companies. Salomon Brothers has been permitted by the Central Bank and CVM to gain a majority interest in a Brazilian securities firm by buying the shares of its Brazilian partners.

With respect to accessing foreign capital, U.S. securities firms have been very active in underwriting international issues by local firms. In an effort to lengthen maturities of private sector debt, the government has provided a fiscal incentive for maturities longer than eight years. The government has steadily increased its presence in the overseas debt market since 1994, mainly seeking to establish tenor and rate benchmarks for Brazilian private sector debt.

U.S. and other foreign banks have also been active in Brazil's securities markets. Citibank has its own brokerage operation and has a majority interest in the country's ninth largest brokerage house. U.S. and other foreign banks are well represented among foreign investment stock funds in Brazil.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Article 192 of the Constitution of 1988 effectively prohibited the entry or expansion of foreign banks and securities firms. Only those foreign securities firms already established in Brazil may underwrite, broker, and trade in domestic securities or hold seats on Brazilian exchanges. Despite these restrictions, foreign securities firms have been entering Brazil in recent years as partners of Brazilian firms.

Although no foreign or domestic firm had previously been permitted to deal in foreign securities, in September 1994, the Central Bank authorized Brazilians, via foreign and domestic banks, to invest in securities traded in international markets, with the proviso that 60 percent of the investment must be in Brazilian external debt.

Foreign firms may engage in fund management activities, although they may not sell foreign mutual funds to local investors. Foreign capital investment in Brazil remains subject to a number of exchange controls and other limitations on access, although repatriation is not restricted.

In WTO Financial Services negotiations held in December 1997, Brazil offered to provide national treatment in the financial services area, pending approval of the Complementary Law to Article 192. This law is currently awaiting congressional action and will liberalize entry into both the banking and securities sectors. In addition, further liberalization is subject to the provision that all members of senior management of financial services suppliers must be permanent residents in Brazil.

CANADA

BANKING

SUMMARY

Canada has a large and highly-developed banking industry that included over 8,140 branches at the end of 1997. However, the industry continues to be dominated by the six largest "Schedule I" banks which are widely-held and Canadian-owned institutions with aggregate assets in excess of C$1.2 trillion. These six banks controlled over 90 percent of total banking assets at year-end 1997.

In December 1996, the government created a Task Force on the Future of the Canadian Financial Services Sector to develop a framework for the sector in the 21st century. The Task Force, chaired by Harold MacKay, reported its findings in September 1998. Early in 1998, two proposed mergers of major Canadian banks were announced. If approved and completed, these mergers will increase the level of concentration in the Canadian banking industry.

At year-end 1997, 10 U.S. bank subsidiaries were operating in Canada compared to 16 in 1990. The decline was due to bank mergers in the United States and to strategic business decisions by some institutions to withdraw from the Canadian market. Most U.S. banks in Canada concentrate on the corporate sector, capital market transactions, and cross-border financial activities. They generally have not attempted to compete with Canadian financial institutions in the retail market.

The Bank Act and other financial services laws in Canada are mandated for review every five years. Amendments to the Bank Act in 1992 and 1997 removed some obstacles to doing business in Canada for U.S. and other foreign banks. Foreign banks can now “opt out” of the Canada Deposit Insurance Corporation, and the federal government has agreed to allow direct foreign-bank branching. Legislation to implement branching has been postponed, but Canada has committed to modify its GATS offer in the WTO financial services negotiations by June 30, 1999, to incorporate results of implementing a new direct branching regime for foreign banks.

The financial services chapter of the NAFTA, which entered into force on January 1, 1994, established a comprehensive set of rules to govern trade and investment in financial services among the three signatory countries (U.S., Canada, and Mexico). As a result, U.S. banks now enjoy a right of establishment and a guarantee of national treatment in Canada.

DESCRIPTION OF THE MARKET

Commercial Banking Market Structure

At the end of 1997, the Canadian banking industry included 54 commercial banks employing more than 221,400 people and managing over C$1.3 trillion in assets. However, the industry is highly concentrated and is dominated by the six largest "Schedule I" banks. In descending order of asset size, these banks are the Royal Bank of Canada, Canadian Imperial Bank of Commerce (CIBC), Bank of Montreal, Bank of Nova Scotia (Scotiabank), Toronto-Dominion Bank, and National Bank of Canada. These institutions accounted for over 90 percent of total banking system assets at the end of 1997. The remaining 48 banks are "Schedule II" banks which are closely-held institutions with capital not exceeding C$750 million. The Schedule II banks include five Canadian institutions and 43 foreign-bank subsidiaries, of which 10 are U.S. bank subsidiaries.[1]

Total bank assets increased 62 percent between 1993 and 1997. Strong business investment, recovery in the housing market, and growing consumption fueled loan demand. The assets of Canada's domestic banks increased 63 percent, while asset growth of foreign-bank subsidiaries was 51 percent. U.S. bank subsidiaries achieved an 81 percent increase in assets between 1993 and 1997.

Balance Sheet Data for the Canadian Banking Industry
(C$ billions, year-end)
1993

	Shareholders' Equity	Liabilities	Assets
All Banks	39.2	716.8	756.0
Domestic Banks	35.4	659.7	695.2
Foreign Banks	3.8	57.0	60.8
U.S. Banks	*1.1*	*11.1*	*12.2*

Balance Sheet Data for the Canadian Banking Industry
(C$ billions, year-end)
1997

	Shareholders' Equity	Liabilities	Assets
All Banks	54.7	1169.6	1224.3
Domestic Banks	49.8	1082.7	1132.4
Foreign Banks	4.9	86.9	91.9
U.S. Banks	*1.6*	*22.1*	*23.7*

Source: Chartered Bank Assets & Liabilities, Canada Gazette, Part I. www.canada.gc.ca

[1]Schedule I banks are publicly-traded, majority-owned Canadian institutions with capital in excess of C$750 million. Schedule II banks are closely-held institutions with capital not exceeding C$750 million.

In the first half of the period 1993-1997, interest rates were volatile due in part to the Mexican financial crisis. Short-term rates declined from over 8 percent in early 1995 to a little over 3 percent by mid-1997 and climbed back to near 5 percent by the end of 1997. Given this interest-rate environment and the overall growth of the Canadian economy, the period of 1993-1997 was very good for the financial services sector and the banking industry in Canada. The six largest Canadian banks recorded net income of C$7.5 billion in FY97 (ending October 31, 1997), compared with C$2.9 billion in FY93. Return on common shareholders' equity increased to 15.3 percent in FY97 from 9 percent in FY93. Income from the securities subsidiaries of Schedule I banks played a major role in this rise in earnings. Non-interest income of the top six banks contributed 47.5 percent of the total net interest and non-interest income in FY97, up from 38 percent two years earlier.

Canadian banks are federally-chartered and regulated. They may operate in all ten Canadian provinces and two territories, as well as overseas. At the end of 1997, about 8,140 branches were located throughout Canada. The Schedule I banks operated the majority of the branches and employed the majority of the 221,400 employees working in the banking sector at year-end 1997. Schedule II banks had 157 branches at year-end 1997, of which 99 belonged to the Hongkong Bank of Canada, a subsidiary of Hongkong Shanghai Bank Corporation. NAFTA-country Schedule II bank subsidiaries can establish inter-provincial branches under the same terms as Schedule I banks. However, non-NAFTA country Schedule II bank subsidiaries must secure approval from the Minister of Finance to open more than one branch. As part of its WTO financial services offer, Canada has committed to removing this requirement by June 30, 1999.

Canadian banks, both Schedule I and Schedule II, can engage in a wide range of financial activities in addition to traditional banking services. A bank may provide financial services (including financial planning), investment counseling and portfolio management services, and merchandise promotion and payment services to credit and charge-card holders. In addition, a bank may create subsidiaries to undertake other financial activities, including securities dealing, mortgage lending, trust services, insurance, mutual fund sales and management, merchant banking, venture capital, real estate brokerage and investment, leasing (except automobile leasing), and factoring.

A number of "near-banks" in Canada compete for the deposit and lending business of the commercial banks. These include trust and loan companies (similar to U.S. savings and loans), credit unions, consumer loan and finance companies, and several public-sector housing and financial agencies (i.e., Canada Mortgage and Housing Corporation, Export Development Corporation, various provincial savings banks, and the federal Farm Credit Corporation). Other types of financial institutions include life and health insurance companies, property and casualty insurance companies, investment dealers, and merchant banks.

Foreign banks were not permitted to operate in Canada until 1980. After that, foreign-bank operations were authorized as separately-capitalized subsidiaries. Generally, foreign banks have concentrated on wholesale banking and capital markets activities; this approach reflects the significant investment in facilities and marketing needed to compete in the retail sector. However, Hongkong Bank of Canada is an exception. It is the largest Schedule II bank and the seventh-largest bank in Canada in terms of assets, and it is the only Schedule II bank with an extensive retail branch network. Hongkong Bank's growth results from its acquisition of several other institutions and its cultivation of Canada's rapidly-growing Chinese community. (Foreign Schedule II banks can undertake the same banking activities as domestic banks.)

In December 1996, the government created a Task Force on the Future of the Canadian Financial Services Sector to develop a framework for the sector in the 21st century. The Task Force, chaired by Harold Mac Kay, issued its report on September 15, 1998. The report addressed banking, leasing, and insurance financial services in the context of increasing globalization and mergers. Overall, the report concluded that the government has a role to play in supervising the financial services sector, but recognizes that the sector must be shaped by market forces. Priority was given to consumer interest as the criteria by which to judge government policy in the sector. To this end, the Task Force Report recommended passing legislation to permit foreign bank branching (not ruling out mergers among Canada's largest banks) and liberalizing the insurance and leasing markets. As of November 1, 1998, the government of Canada is undertaking hearings in further consideration of these recommendations.

Early in 1998, two proposed mergers of major Canadian banks were announced. In January the Royal Bank of Canada and the Bank of Montreal announced that they planned to merge and, a few months later, the Canadian Imperial Bank of Commerce and Toronto-Dominion Bank announced that they intended to merge. Both of these mergers require approval from shareholders, regulators, and the Minister of Finance. If approved and completed, these mergers will increase the high level of concentration in the Canadian banking industry.

Bank Supervision and Regulation

Banks are regulated by the Office of the Superintendent of Financial Institutions (OSFI), which also regulates federally-chartered trust and loan companies and insurance companies. OSFI is an independent regulatory agency of the Canadian federal government. The Superintendent is appointed by the Finance Minister and confirmed by the Cabinet for a seven-year term. On matters requiring the attention of the Cabinet, the Finance Minister represents OSFI. Federal government policy regarding financial institutions is established by the Department of Finance.

Banks are required to join the Canada Deposit Insurance Corporation (CDIC), a federal entity (a Crown corporation) that insures depositors up to C$60,000. Banks and trust and loan companies currently pay a CDIC insurance premium set at 0.167 percent of assets. Due to failures of insured institutions since the mid-1980s, the CDIC had a cumulative deficit of C$1.5 billion at the end of 1993. These failures prompted new legislation in 1996 to strengthen the regulatory regime for financial institutions. Since 1993, the CDIC has steadily reduced its deficit and plans to eliminate it entirely by March 1999. A 1997 revision of the Bank Act includes an "opt out" clause for foreign banks with respect to membership in CDIC, since it is oriented toward the protection of retail depositors and most foreign-bank subsidiaries do not accept retail deposits. Those banks opting out are effectively limited to taking deposits over C$150,000 (the level below which the retail banking regulations apply).

Since 1987, banks have been allowed to own securities firms in Canada. Each of the six largest Schedule I banks has either acquired a securities firm or started one *de novo* since then. Consequently, bank-owned securities firms dominate the Canadian securities market. Banks may also own trust and loan companies and insurance companies. They may set up "networking" arrangements with other financial institutions and distribute those institutions' products and services in their branches to their customers. Banks also have the right to own "specialized financing corporations," which allow them to undertake broad venture capital and merchant banking activities.

Banks may offer investment counseling and portfolio management services directly or through securities subsidiaries, and financial planning services are also permitted as part of the business of banking. Banks may offer real estate services (property development, management and brokerage), and they are also allowed to offer some non-financial services such as information management. Over the past few years, banks' movement into the trust area has been significant; however, banks' movement into the insurance area has been cautious largely because of a restriction on their ability to network most traditional insurance products within their branches to their customers.

Payments and Electronic Banking

Payments in the Canadian banking system are transacted through the Canadian Payments Association (CPA), created by the Canadian Payments Association Act. The CPA is chaired by the Bank of Canada, the central bank, and representatives of banks and other deposit-taking financial institutions sit on its board of directors. The CPA had 145 members at year-end 1997. Clearing is handled through regional settlement points of the CPA located in seven major cities across Canada. The Bank of Canada, unlike the U.S. Federal Reserve System, does not have a direct role in the clearing process. Although the CPA cleared 3.2 billion items worth C$16 trillion by year-end 1997, the smaller number of financial institutions in Canada reduces the complexity of the clearing process as compared to the United States.

Canada has an extensive network of automated teller machines (ATMs), with 14,484 bank-owned ATMs at year-end 1997, compared to 12,000 in 1994 and 6,000 in 1990. Additional ATMs owned by other financial institutions are connected through the electronic banking network run by the "Interac" association, a consortium of Canada's "big six" banks, Canada Trustco, and credit unions. This network brings total ATMs to about 19,200. Most Canadian ATMs allow access to the U.S.-based Cirrus and Plus ATM networks. The CPA requires that transactions between member institutions in Canada on any ATM network be routed and settled entirely within Canada. All the major deposit-taking institutions now provide telephone banking services, as well as some type of computer-based banking. Citizens Bank, owned by the Canadian VanCity Savings Credit Union, and ING Direct, a subsidiary of the Dutch financial group ING, began operating in 1997 as branchless "virtual banks" in the retail sector.

U.S. PRESENCE IN THE MARKET

At year-end 1997, 10 U.S. bank subsidiaries were operating in Canada, two fewer than at the end of 1993. The decline in the number of U.S. bank subsidiaries in Canada is due both to the mergers of U.S. parent banks and to strategic business decisions by U.S. organizations to withdraw from the Canadian market. U.S. banks had C$23.7 billion in total assets at year-end 1997, up from C$12.2 billion at the end of 1993. They accounted for 1.9 percent of banking assets and 1.0 percent of loans at the end of 1997, compared with 1.6 and 1.3 percent respectively in 1993, and 2.2 and 2.1 percent respectively at the end of 1990.

U.S. banks in Canada focus on the corporate sector and capital market activities. Generally, they have not attempted to compete with Canadian financial institutions in the retail market. (Only two U.S. banks have retail branches in more than one Canadian city.) Given their small capital base relative to their much larger Canadian competitors, U.S. banks have been successful in Canada by emphasizing their expertise in capital markets activity. They offer specific off-balance sheet products, foreign exchange swaps, and other financial services through which the U.S. bank can serve clients on both sides of the border.

Among the non-lending activities currently conducted by U.S. banks in Canada are cash management, investment banking, government bond sales and trading, and dealing in derivative products. Since 1989, three U.S. banks have been authorized by the Department of Finance to function as primary distributors of Canadian government securities. One of the U.S. banks is the second largest dealer in the government bond market in Canada. Although it is permitted, only one U.S. bank has entered into a joint venture with a Canadian trust company to form a limited-purpose trust company that engages in stock transfer and corporate trust services.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Until 1980, foreign banks were permitted to operate in Canada only as representative offices. An amendment to the Bank Act in that year authorized the establishment of foreign-bank subsidiaries, but foreign-bank operations were subjected to administrative controls on their growth in the form of rules regarding "deemed authorized capital" and market share limits. The U.S.-Canada Free Trade Agreement (FTA), which entered into force on January 1, 1989, exempted U.S. banks from the system of deemed authorized capital and market share limits. In addition, U.S. bank subsidiaries were exempted from the requirement to obtain approval from the Finance Minister prior to opening branches and from the regulatory constraints on loan transfers to their parent banks. All U.S. investors were exempted from the 25 percent limit on aggregate foreign ownership of widely-held (Schedule I) Canadian banks.

The financial services chapter of the NAFTA, which entered into force on January 1, 1994, established a comprehensive set of rules to govern trade and investment in financial services among the three signatory countries (U.S., Canada, and Mexico). As a result, U.S. banks now enjoy a right of establishment and a guarantee of national treatment in Canada. NAFTA also established a Financial Services Committee to supervise implementation of the chapter and to address financial services issues that are referred to it by any of the three countries. If differences of interpretation cannot be resolved by this committee, formal dispute settlement mechanisms are available.

In early 1997 the government announced that it would "make public" legislation to allow direct foreign-bank branching in Canada by the end of 1997. This legislation has been delayed both by the discussion of two proposed mergers among the largest Canadian banks and by the government's desire to review the Task Force Report on the Financial Services Sector. Until a law is enacted to amend the Bank Act, foreign banks in Canada will continue to be prohibited from operating as direct branches of their parent institutions. Therefore, these banks remain at a competitive disadvantage with respect to Canadian banks. Due to their relatively small capitalization and legal lending limits, U.S. and foreign-bank subsidiaries are precluded from competing for large corporate loans. (They are prohibited from extending loans to a single borrower in excess of 100 percent of the subsidiary's capital. Furthermore, bank subsidiaries may only reach the 100 percent limit in exceptional cases, and they must notify OSFI when they exceed the 50 percent level.) Foreign-bank subsidiaries also face the added expense of maintaining a separate board of directors, half of whom must be Canadian residents.

U.S. and other foreign banks are also disadvantaged by Canada's Income Tax Act, which imposes a nonresident withholding tax on funds borrowed by the foreign-bank subsidiary from its nonresident parent bank and nonresident related companies. Although 1995 amendments to the U.S.-Canada tax treaty reduced the rate of withholding from 15 percent to 10 percent, this tax provision makes it uneconomical for foreign-bank subsidiaries in Canada to lower their funding costs by borrowing from their parent banks.

The conditions for foreign-bank branching that the Canadian government has proposed thus far (and which may be part of the final legislation) would remove some disadvantages that foreign institutions face due to the subsidiary requirement, but other restrictions would continue. For example, the ability to operate branches in Canada would generally apply to foreign banks with at least C$25 billion in assets on a worldwide basis; however, the branches of foreign banks would not be allowed to take retail deposits (defined as under C$150,000). According to the Department of

Finance, most foreign banks operating subsidiaries in Canada at present would be able to operate branches in the future. However, the ability of regional and/or special-purpose U.S. banks to set up branches would be limited.

Bank Act revisions in 1992 loosened the previous requirement that banks operating in Canada must maintain and process all their customer data in Canada. Banks must request approval from OSFI for offshore data processing, but reportedly all such requests by U.S. banks have been approved. A prohibition precluding banks from offering data processing services to outside parties is still in effect. However, exemptions from the prohibition can be requested and all banks (both Schedule I and Schedule II) may apply to OSFI for an exemption. To date, no U.S. bank that has applied for an exemption has been turned down.

In addition to the CDIC opt-out provision for foreign banks noted above, a few other changes to the Bank Act in 1997 improved the treatment of U.S. financial services companies in Canada. Regulated foreign banks that own a Schedule II bank will no longer be required to own other financial services subsidiaries through the Schedule II bank. This change means that a U.S. bank with a Schedule II bank in Canada could operate its other Canadian subsidiaries, performing nonbank operations such as securities brokerage and investment banking, directly under the U.S. parent.

In addition to wholesale banking operations, U.S. banks and financial services companies engage in a range of activities in Canada, including consumer finance, leasing, credit-card issuance, and mortgage insurance. The government has distinguished between two types of foreign companies that offer limited financial services in Canada, or "near banks," depending on how they are regulated in their home jurisdiction. In general, both types are defined as entities that do not take deposits, that provide one or more banking-type services, and that have received approval under the Bank Act to enter the Canadian market.

The 1997 banking legislation specifies regulations for near banks that are not regulated as banks in their home jurisdiction, such as GE Capital, the "big three" auto company finance subsidiaries, and key U.S. consumer finance companies. However, the government places in a separate category, and treats differently, those foreign providers of limited financial services that are regulated as banks in their home jurisdiction. The government proposed in 1996 that these companies be required to become bank subsidiaries to operate in Canada. This requirement would have created a significant burden for U.S. companies already in operation, and it met with opposition in Parliament. The government, therefore, decided to address these foreign companies when it issues the foreign branching legislation. Until then, those foreign companies offering a limited range of financial services and now operating unregulated in Canada, as well as new entrants that meet certain criteria, will be allowed to conduct their activities without being regulated as financial institutions.

Exchange Rates:

1994 period average	1.37 C$/US$
1995 period average	1.37 C$/US$
1996 period average	1.36 C$/US$
1997 period average	1.38 C$/US$

CHILE

BANKING

SUMMARY

As of year-end 1997, 29 banks and three consumer finance companies were operating in Chile. The Banco Santiago (the result of the merger of two banks in 1997) is Chile's largest bank, accounting for 17 percent of loans and almost 14 percent of deposits. However, Chile's one state-owned bank, the Banco del Estado, continued to hold the largest share of deposits, almost 16 percent of the total. Private banks handle nearly all corporate business within the banking sector. Three "financieras," roughly equivalent to consumer finance companies, concentrate on consumer business and are not permitted to offer checking accounts or handle international business.

Continued vigorous economic growth in recent years has strengthened bank profits. Loans and deposits both doubled in the four years through December 1997, and banking system assets grew in nominal terms by 25 percent in 1997.

A new banking law, passed in November 1997, stipulates objective parameters for allowing new banks to enter the Chilean market. The law also substantially expands the types of activities in which banks may engage: Chilean and foreign banks may establish subsidiaries for securities and insurance brokerage, leasing, and factoring. With the exception of the regulation regarding the maximum conventional interest rate, all of the regulations for effecting the changes embodied in the new law have been promulgated

The banking sector is regulated by the Superintendency of Banks and Financial Institutions, an agency that reports to the Finance Minister. The Central Bank, in conducting monetary and exchange rate policy, also regulates bank operations.

As of year-end 1997, six U.S. banks had 35 branches in Chile. The six banks with branches accounted for around 4 percent of deposits and slightly less than 5 percent of loans in the banking system. U.S. banks generally focus on corporate rather than retail business.

Foreign banks are allowed to establish either as branches or subsidiaries, although the Bank Superintendency appears to prefer that foreign banks set up branches. Foreign banks operating in Chile are guaranteed nondiscriminatory treatment by a 1960 law and Chile's foreign investment law (Decree Law 600). Foreign banks can engage in the same range of activities permitted domestic banks. Lending limits are based on a foreign branch's local capitalization, rather than the worldwide capital of its parent.

As of year-end 1997, one private Chilean bank, the Banco de Chile, had a branch office in New York, a state agency in Miami, and a representative office in Frankfurt. Banco de Santiago has applied to establish a federal branch and a state agency in the United States. Other private Chilean banks had representative offices in Buenos Aires, Sao Paulo, Caracas, Mexico City, and Hong Kong.

DESCRIPTION OF THE MARKET

Structure of the Market

As of year-end 1997, 29 banks and three finance companies were operating in Chile; total banking system assets were US$105.2 billion.[1] Domestic Chilean banks have varying patterns of ownership. The one state-owned bank, the Banco del Estado, accounted for 12 percent of loans and 15.6 percent of deposits. Some of the 11 private Chilean banks are controlled by Chilean families with other commercial and industrial interests. Others are owned in part by banks or firms from the United Kingdom, France, Italy, the Netherlands, Canada, and Spain. Shares of most private Chilean banks are traded on Chilean stock exchanges, and four are traded on the New York Stock Exchange. The 17 foreign banks operating in Chile include six U.S. banks (35 branches) and branches or subsidiaries of banks from Spain, Brazil, Argentina, the Netherlands, France, Japan, and Hong Kong.

The Banco del Estado concentrates on providing services to the public sector and savings accounts to small individual savers. It is not seen as a major direct competitor to the commercial banking system. Private banks handle nearly all corporate business within the banking sector. Three "financieras," roughly equivalent to consumer finance companies, concentrate on consumer business and are not allowed to offer checking accounts or handle international business.

Corporate lending is focused on medium-sized businesses. Until early 1994, banks were prohibited from lending more than 5 percent of their assets on an unsecured basis to a single customer, so firms wanting to borrow larger amounts resorted to international sources of finance. A new banking law passed in late-1997 established a variety of specific collateral criteria for lending in excess of this general limit, such as for export and public works projects.

Chile's rapid economic growth throughout this decade has permitted increased financial activity and healthy bank profits – the volume of loans and deposits both doubled in the four years through December 1997, and banking system assets grew in nominal terms by 25 percent in 1997. Loan quality has improved as a result and at the end of 1997, delinquent loans were near the historic low point and stood at 1.0 percent of total loans. However, higher interest rates may increase the amount of non-performing loans.

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[1] Asset figure not adjusted for futures operations, checks in clearance, and adjustment/control accounts.

A new banking law, passed in November 1997, substantially enhanced the prospects for new banking activity in Chile. Since the financial crisis of the early 1980s, Chilean authorities had considered Chile "overbanked" and allowed no new banks, foreign or domestic, to enter the market except through the purchase of existing banks; several foreign banks entered the Chilean market in this manner. In addition to stipulating objective parameters for allowing new banks to enter the Chilean market, the new law also substantially expands the types of activities in which banks may engage. Under this law, Chilean and foreign banks may establish subsidiaries for securities and insurance brokerage, leasing, and factoring. (Branches may also engage in leasing and factoring.) Chilean banks also are now permitted to engage in banking business overseas, through cross-border lending, the establishment of branches and by directly investing in foreign affiliates. Many of the regulations for effecting the changes embodied in the new law were still pending as of mid-1998.

Automatic teller machines are provided by a network of 17 private banks. As U.S. banks concentrate on corporate lending, there are only two U.S. banks that participate in the network. However, foreign banks are afforded the same treatment for offering ATM services as domestic institutions. As of mid-1998, the number of ATM cards in use was estimated at almost 2.8 million and there were almost 1,600 machines operating in the country; in 1997, the number of transactions recorded on the system totaled 101.4 million.

Bank credit cards are managed by a separate network of 13 private banks. At the end of 1997, over 2.2 million credit cards were being used in Chile; the number of cards in use had almost doubled in a period of four years. In the final quarter of 1997, spending using bank credit cards totaled almost US$450 million. Retail stores make up a significant part of the credit card business, and a department store is actually Chile's largest issuer of credit cards (by number of cards). Debit cards were introduced into the Chilean market in 1995; in 1997, transactions using this type of instrument amounted to US$11 million.

Banks trade foreign exchange in the official foreign exchange market. Since mid-1992, banks and other local firms have been allowed to trade currency and interest rate futures. The volume of these transactions on the Santiago Stock Exchange is small; the off-exchange trading volume is not known.

Regulatory Structure

The banking sector is regulated by the Superintendency of Banks and Financial Institutions, an agency that reports to the Finance Minister. The Central Bank, in conducting monetary and exchange rate policy, also regulates bank operations. The new banking legislation passed in 1997 implemented Basle capital adequacy standards in Chile. The Superintendency establishes a differentiated maximum lending rate, the "tasa maxima convencional," for various categories of loans made by financial institutions. The Central Bank and the Superintendency both regulate derivatives trading.

Under the new banking law, 100 percent of sight deposits and long-term savings accounts for both domestic and foreign banks are guaranteed. Ninety percent of the value of bank time deposits are also guaranteed, for both domestic and foreign banks, up to a limit of approximately US$3,400 per individual depositor.

In April 1998, the Federal Reserve Board of the United States, the U.S. Comptroller of the Currency, and the Chilean Superintendency of Banks and Financial Institutions entered into a cooperation arrangement. The regulatory authorities agreed to exchange information concerning applications filed for establishing banking business in Chile and the United States, as well as material information relevant to banking supervision, subject to each country's disclosure restrictions.

U.S. PRESENCE IN THE MARKET

Six U.S. banks operate in Chile through 35 branches. Most U.S. banks have concentrated on corporate lending, although a few U.S. banks have significant retail banking businesses. Several have established securities subsidiaries that have no formal connection to their Chilean banking branches.

Chilean branches of U.S. banks in general have not been highly profitable compared to private Chilean banks. U.S. banks generally show more dollar assets than obligations and more peso obligations than assets which, due to the real peso appreciation that has taken place over the past several years, led to losses as most head offices require that local capital be hedged in dollars. These losses of Chilean branches are balanced by corresponding gains of U.S. parent firms, which have balancing surpluses of dollar obligations and peso assets. This phenomenon appeared to reverse in early 1998 as U.S. banks substantially outperformed Chilean banks due largely to a lack of market liquidity and subsequent dollar appreciation.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks are allowed to establish either as branches or subsidiaries, but the Bank Superintendency appears to prefer branches because the legal liability of a foreign branch extends to the parent institution. All U.S. banks in Chile are considered branches by their home offices and Chilean law. However, they have the subsidiary-like characteristic of being subject to lending limits based on local capital.

Foreign banks are permitted the same range of activities as domestic banks, including issuance of credit cards and the offering of ATM services, and may fund themselves through deposits as do domestic banks. Foreign banks also can establish securities subsidiaries that have no formal connection to their Chilean banking operations to carry out these activities.

Foreign banks can trade foreign exchange through the official exchange market. However, Chile retains some controls on international movement of capital. One measure discouraging inward flows, particularly of short-term capital, is a reserve requirement on all credit inflows except direct supplier credits. Under this measure, firms are required to deposit an established percentage of the inflow in a non-interest-bearing reserve account for one year, or pay the Central Bank a tax equivalent to the interest that would be foregone. (However, the percentage rate was lowered from 10 percent to zero in September 1998.) These capital restrictions apply to domestic and foreign firms equally under the law, but their removal probably would benefit foreign, including U.S., banks disproportionately because foreign banks' international networks are stronger than those of Chilean banks. Foreign banks can fund themselves through deposits.

Chilean regulatory practices are generally transparent. U.S. bankers contacted for this report did not express any complaints about regulatory transparency.

Chilean Banking System
(Shares of Deposits and Loans by Type of Institution)

Type of Institution	Number of Firms	Number of Branches	Percent of Deposits	Percent of Assets
Domestic Private Banks	11	742	62.1	54.8
Banco del Estado	1	204	15.6	10.9
Foreign Banks*	17	220	18.3	32.5
of which: U.S. Banks	*6*	*35*	*4.2*	*16.2*
Consumer Finance	3	159	4.0	1.8
TOTAL	32	1325	100.0	100.0

*At least 51 percent foreign ownership. Figures are as of December 1997.

Source: Superintendency of Banks and Financial Institutions.

U.S. Commercial Banks' Share of the Chilean Market as of December 31, 1997

Bank	Percent of Deposits	Percent of Assets
Citibank	2.6	3.8
Bank Boston	0.7	5.0
Republic National Bank	0.5	0.6
Chase Manhattan	0.3	3.5
American Express	0.2	0.8
Bank of America	0.0	2.4
TOTAL	4.3	16.1

Source: Superintendency of Banks and Financial Institutions

CHILE

SECURITIES

SUMMARY

Chile has three securities exchanges, with the Santiago-based Electronic Exchange (Bolsa Electrónica) and the Santiago Trading Exchange (Bolsa de Comercio) accounting for nearly all of the transactions. The exchanges trade equities, corporate debt, government debt, and Central Bank debt. Despite rapid growth in equity prices and an associated rise in new stock issues through the mid-1990s, the market remains relatively concentrated and illiquid. The bulk of trading is focused on the shares of only a few companies and daily trading volumes tend to be small. The number of Chilean companies offering shares on the New York Stock Exchange (NYSE) through American Depositary Receipts (ADRs) now totals 25, and much of the trading of shares of Chilean companies now takes place in New York.

There is no legal discrimination or restrictions against foreign securities firms wishing to operate in Chile's securities markets. However, foreign brokerage firms must establish Chilean subsidiaries. At the end of 1997, eight foreign firms, including several from the United States, participated as brokers through their Chilean subsidiaries. U.S. firms can manage pension funds and mutual funds as well as operate insurance companies in Chile.

The most important institutional investors in both the stock and the bond markets are Chile's rapidly growing private pension funds, which at the end of 1997 had US$31 billion in assets (39 percent of GDP).

Direct purchases of Chilean equities by U.S. investors are permitted, but economically discouraged by requirements that foreign investors maintain their Chilean investments for at least one year and deposit some percentage of their capital in a non-interest-bearing account with the Central Bank. (The reserve requirement rate was reduced to zero in September 1998.) Foreign investors are also liable for Chilean capital gains taxes. Chilean institutions and individuals face a variety of limitations in undertaking investments in foreign securities.

U.S. firms have participated in underwriting Chilean offshore securities issues (bonds and ADR issues).

DESCRIPTION OF THE MARKET

Chile has three stock exchanges. The Bolsa de Comercio accounts for almost three-quarters of equities trading in the country and slightly more than 48 percent of total value of transactions. At the end of 1997, it was owned by 40 brokerage houses, including five subsidiaries of foreign firms.

The Bolsa Electrónica, founded in 1989, is the largest exchange in terms of total value of transactions. At the end of 1997, this exchange had 18 brokers and traded the shares of some 324 companies with a total market share of 51 percent. The nation's oldest exchange, the Bolsa de Corredores, based in the port city of Valparaíso, handles less than one percent of total value of transactions.

Market Capitalization
Bolsa de Comercio, Bolsa Electrónica, and Valparaíso

Year	Chilean pesos	US$ billions
1993	19,233,969	45.2
1994	27,349,445	69.0
1995	28,978,489	70.9
1996	27,981,726	66.2
1997	31,592,248	72.1

Source: Superintendency of Securities and Insurance

At the end of 1997, there were 53 full service brokerage houses. An additional nine securities dealers traded fixed-income debt instruments only. Affiliates of Chilean banks had a market share of almost 40 percent through nine securities brokers. About 34 percent of the market was being conducted by seven foreign securities firms; the largest single broker was an affiliate of a U.S. bank.

Securities houses can be either "corredores de bolsa" or "agentes de bolsa." The former must belong to a stock exchange, while the latter cannot trade on the exchanges.

The three exchanges trade primarily equities, corporate bonds, government debt, nominal and inflation-adjusted Central Bank debt, and mortgage debt issued by banks. Interest rates on Central Bank and corporate bonds with maturities of over 30 days are adjusted for consumer price inflation, but 30-day Central Bank paper is expressed in nominal interest rates. Despite past market specialization, both the Bolsa de Comercio and the Bolsa Electrónica handle stock activity, fixed-real-rate bonds, and short-term Central Bank paper. The Bolsa de Comercio runs a small futures market where futures on dollars and the blue-chip stock index are traded. New financial products must be approved by the Central Bank and/or the appropriate superintendency (of banks and financial institutions, or of securities and insurance). In addition, new products to be traded on securities exchanges must be approved by those exchanges.

Rapid economic growth over the past decade and rising investor confidence led to a dramatic increase in stock market activity in terms of volume, market capitalization, share value, and listed companies through the middle of the decade. Share prices increased substantially and new equity offerings far outpaced new issues of corporate bonds. Chile's return to international creditworthiness led several firms to sell bonds on international markets.

In 1996 and 1997, however, local stock exchange trading volume in equities was adversely affected by a general weakening of the Chilean peso vis-à-vis the U.S. dollar and a transfer of market activity to the NYSE. The fact that the most heavily traded Chilean shares are now offered as ADRs on the NYSE is a contributing factor to this development.

Chile's stock market still remains relatively concentrated and illiquid. Shares of the 10 most heavily traded companies on the Bolsa de Comercio, four of which were utility firms, accounted for some 35 percent of the market's capitalization at the end of 1997. Trading in those shares accounted for 60 percent of total 1997 trading volume. In December 1997, average daily trading activity on the Bolsa de Comercio was US$28 million. The low rate of turnover makes prices highly volatile, especially when outside factors suddenly change a company's earnings prospects.

Foreign investment in Chilean shares contributed to the increase in share prices and to the increase in blue-chip stock price/earnings ratios through the mid-1990s. Most of the foreign share purchases have been targeted at the 25 Chilean firms whose shares are traded in the United States via ADRs. (The total number of ADRs traded on the NYSE is 26 as one Chilean firm, Andina, has issued two ADRs.) The shares traded via ADRs include many of the market's most important companies. There are also 26 foreign investment funds that purchase shares in a variety of Chilean companies.

Institutional Investors

By far the largest institutional investors in Chile are Chile's private pension funds managed by Administradores de Fondos de Pension (also known as AFPs). The AFPs were created in 1981 when the government-run pension system was privatized. Most working adults switched to the private system, and all of those entering the labor force since that time have been required to contribute a fixed percentage of their wages to an AFP of their choice. As the economy has grown, and as new workers have entered the labor force, AFP assets have risen rapidly. At the end of 1997, AFP assets totaled about US$31 billion. These funds are invested primarily in long-term bonds and the stock market.

Other institutional investors include insurance companies, mutual funds, and foreign investment capital funds. Insurance companies had assets of some US$8.3 billion as of April 1998, invested primarily in long-term Central Bank bonds. At the end of 1997, mutual fund assets totaled US$4.2 billion. Of the 92 mutual funds, 33 invest exclusively in securities and 59 in bonds. The number of investors participating in mutual funds virtually tripled from 1993 and stood at roughly 210,000 at the end of 1997.

The 26 foreign investment funds allow foreign buyers to invest in Chilean stocks other than through ADRs. (U.S. investors are not prohibited from purchasing Chilean stocks directly, but foreign capital invested in Chile must be kept in the country for a minimum of one year.) The funds are registered under Chile's foreign investment law, Decree Law 600. The foreign investment funds allow U.S. investors to purchase shares in the United States in funds that trade Chilean stocks in the Chilean market. The funds are not limited to U.S. investors. At the end of 1997, assets of foreign investment funds totaled just US$1.4 billion; at the end of 1994, such assets stood at roughly US$2.4 billion (indexed to December 1997).

Regulation

Chile's securities markets are regulated by the Superintendency of Securities and Insurance (SVS). The SVS supervises corporations and other entities offering securities publicly, the stock exchanges, brokers, over-the-counter dealers, insurance companies, and mutual and investment funds. It requires quarterly reports and notification of any material facts by all entities offering securities. The Superintendency of Banks and Financial Institutions supervises domestic banks, including trading in their stock. AFPs are regulated by the Superintendency of Pension Fund Administrators. The legal basis for formation and administration of joint stock corporations is Law 18,046 of 1981. Capital markets reforms passed in early 1994 increased the variety of investment options available to the AFPs and tightened conflict-of-interest restrictions.

U.S. PRESENCE IN THE MARKET

U.S. firms, particularly affiliates of U.S. commercial banks, have a growing presence as stock and bond traders. As of December 1997, four U.S.-owned securities firms had nearly 38 percent of all stock broker assets in the combined market and several other U.S. firms owned partial stakes in, or were affiliated with, other brokers. Most of the U.S.-owned brokers are on the Bolsa Electrónica, and only two are on the Bolsa de Comercio. None are on the smaller Valparaíso-based Bolsa de Corredores.

Among the institutional investors, a number of pension fund management companies, insurance companies, and foreign investment fund management companies are owned by U.S. firms. Seven of the 92 mutual funds, representing some nine percent of the total value, are operated by Citicorp.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

U.S. brokerage firms can establish and operate in Chile according to the procedures of the foreign investment law, Decree Law 600, which is based on the principle of nondiscrimination. Nondiscriminatory treatment is also guaranteed in the Chilean constitution's Article 19. U.S. securities firms may be present in Chile, but only as subsidiaries.

There are no requirements concerning the employment of Chilean nationals or limits on the employment of foreign nationals. However, U.S. and other foreign securities firms wanting to trade stock on an exchange must purchase a seat.

There is no obstacle to a U.S. firm establishing an AFP, as long as the AFP is a Chilean corporation (100 percent foreign ownership is allowed) and is registered with the Chilean AFP superintendency.

Purchases of foreign securities by Chilean residents (banks, pension funds, mutual funds, and insurance firms) are limited according to regulations for each type of institution. The share of assets of pension funds that can be invested abroad in foreign securities was increased to 12 percent in 1997; most new equity purchases by the pension funds in fact have been in overseas markets. Individuals may buy foreign securities, but they are not guaranteed authorization to buy dollars at the official interbank exchange rate (Central Bank authorization is required for foreign currency purchases on the interbank market for operations abroad, although a blanket authorization for certain types of operations is possible). Chilean individuals and firms wishing to make equity investments abroad must register their investments with the Central Bank. Also, the Central Bank has placed limits that allow only relatively large and credit-worthy companies to issue stock in the United States via ADRs. Banks must have a minimum BBB- rating, and other companies a minimum BB rating, to be able to issue ADRs.

As for inward portfolio investment, government policies tend to discourage short-term portfolio investments in two ways. First, investors must keep their capital in Chile for a minimum of one year. Second, a set percentage of all foreign capital inflows (except supplier credits) must be placed in a non-interest-bearing reserve account with the Central Bank for one year. (This requirement may be waived when the capital finances capacity expansion or technological improvement.) In June 1998, the Central Bank lowered the reserve requirement rate from 30 to 10 percent. In September 1998, the rate was reduced to zero. As a general result of these policies, most U.S. investment in Chilean stocks is made either through ADRs traded on Wall Street or through U.S.-based foreign investment funds.

U.S. firms operating in the domestic market have not expressed concern over discriminatory treatment, although some have described the information requirements for beginning operations in Chile as onerous. Neither U.S. nor Chilean firms are typically invited to comment on proposed rule changes. While many foreign firms are satisfied that Chilean regulators take their viewpoints into account when considering rule changes, the degree to which this is true appears to be a function of how actively the particular industry association pursues its interests with the authorities.

One area in which current Chilean practice is more favorable than that bound in its GATS schedule concerns the two-year limit on repatriating capital. Current practice is to require that foreign-sourced capital remain in the country one year before repatriation.

In addition, Chile made no commitments in asset management in its GATS schedule. While foreign firms have been permitted to own AFPs and Chilean mutual fund management companies, Chile has made no GATS commitments to continue to permit them to do so.

Trading Volume in Chilean Markets
(billions of pesos indexed to December 1997)

	1996	1997
Equities	3,822	3,221
Fixed Real Rate Instruments	35,687	38,409
Short-Term Nominal Instruments	50,227	61,350
Currency	5,629	9,110
Futures/Other	35	33
Total (US$ billions)	95,401 (231)	112,125 (267)

Source: Superintendency of Securities and Insurance

Combined Exchange Activity
Bolsa de Comercio and Bolsa Electrónica
(billions of pesos, indexed to December 1997)

	1994	1995	1996	1997
Yearly Trading Volume	47,569	76,055	95,401	112,125
Market Capitalization	33,458	33,627	29,672	31,592
General Stock Index Increase	27.2	-2.2	-19.9	-7.8
Number of Firms Listed	335	323	326	330
Number of Brokerage Houses	75	67	62	53

Source: Superintendency of Securities and Insurance, Bolsa de Comercio, and Bolsa Electrónica

CHINA

BANKING

SUMMARY

China has made impressive strides over the past 20 years toward establishing a more market-based economy, but its domestic banking system is still heavily influenced by the legacy of the old planned economy. The banking system continues to channel the bulk of private savings to the state-owned sector through loans that are often politically directed. In 1994, the Chinese government converted four "specialized" banks that had dominated the domestic banking system into "commercial" banks by transferring their responsibilities for making noncommercial loans to three newly established "policy" banks. The Chinese government also passed the People's Republic of China's (PRC's) first central and commercial banking laws and has allowed new, non-state-owned banks to set up business. Creating a modern commercial banking system in China, however, will require a number of years to complete. A number of banking sector reforms have yet to be fully implemented.

All aspects of the Chinese banking system are heavily regulated. The People's Bank of China (PBOC), the central bank, sets interest rates and deposit rates, and, until January 1998, overall bank lending was controlled administratively through the credit plan. Because a large share of lending by Chinese banks has traditionally been based on noncommercial criteria, these banks have little experience with credit analysis, and their balance sheets contain many large problem loans, especially to unprofitable state-owned enterprises. Even with the abolition of the credit plan, state-owned banks will still be under considerable political pressure to extend loans to favored enterprises or industries.

China's treatment of foreign financial institutions is highly restrictive. Foreign banks are not permitted to conduct local currency (renminbi, or RMB) business except at tightly controlled levels in limited geographical areas in Shanghai and Shenzhen. They otherwise may only participate in wholesale banking in such areas as letters of credit, export credits, and commercial loan syndicates. Foreign banks may open branches and subsidiaries (joint ventures and wholly-foreign-owned), but only in 24 selected cities and special economic zones. Foreign banks are subject to several licensing restrictions. For example, the parent foreign bank applicant is required to have a minimum of US$20 billion in total assets to open a branch. The foreign branch is required to have RMB 100 million (US$12.1 million) in capital, of which 30 percent must be deposited at the PBOC. U.S. bankers complain that this substantially restricts the branch's liquidity. Banks must have had a representative office in China for at least two years to be eligible to open a branch. To open a bank subsidiary, the parent must have US$10 billion in assets. The necessary registered capital is RMB 300 million (US$36 million). U.S. bankers also note that other *de facto* conditions for issuing a license, such as a track record of "contributions to China," lack transparency and are politically motivated. The regulations of the State Administration of Foreign Exchange (SAFE) impose further burdens on U.S. banks.

DESCRIPTION OF THE MARKET

The Chinese financial system consists of policy banks, state-owned commercial banks, shareholding commercial banks, cooperative banks, finance companies, and financial trust and investment companies. The four largest state-owned banks dominate the banking sector, with about 70 percent of the assets of the banking system as of year-end 1997. A major problem in the banking sector is the large amount of nonperforming loans resulting from a legacy of directed lending to inefficient state-owned companies. Estimates by industry analysts place nonperforming loans at about 30 percent of total loans in the banking system, rendering the banking sector technically insolvent. To address this issue, three policy banks were established in 1994 to assume policy lending from the state-owned banks. The shareholding commercial banks and cooperative banks account for 7 percent and 15 percent of banking sector assets, respectively.

State-owned Commercial Banks

Each of the four major state-owned commercial banks originally concentrated on providing financial services to a specific economic sector, but in recent years these distinctions have diminished as they have broadened the scope of their business activities. Nevertheless, the Industrial and Commercial Bank of China (ICBC), the largest of these banks, still extends working capital loans primarily to state enterprises and loans to the state sector for fixed asset investment. The Agricultural Bank of China (ABC) provides financial services in rural areas. The China Construction Bank (CCB) offers medium- and long-term financing to capital construction projects, and the Bank of China (BOC) remains the PRC's main international and foreign exchange bank.

The concentration of China's financial resources in the state-owned banks has ensured that state-owned enterprises have enjoyed preferential access to formal credit. As subsidies and other government expenditures were moved off budget in the late 1980s and early 1990s, the banking system has become an increasingly important conduit for quasi-fiscal financing to the state sector. Though non-state enterprises are generally more efficient, official policies have discouraged state banks from providing them with credit in proportion to their increasing weight in the economy. For example, state bank lending to the non-state sector represented only about 35 percent of total lending by all financial institutions at the end of 1996, even though they accounted for 57 percent of total industrial output. The situation has, however, been improving as state-owned banks have been encouraged to use prudential criteria and some state-owned enterprises have been partially privatized.

Policy Banks

China established three new "policy banks" in 1994. The Import-Export Bank helps finance major trade deals, the State Development Bank funds infrastructure projects, and the Agricultural Development Bank of China funds agricultural procurement and rural development. While the establishment of these new banks is an important reform, the large, state-owned commercial banks remain responsible for providing "working capital" loans to financially troubled state enterprises. Furthermore, a large percentage of their policy loans have not yet been transferred to the policy banks.

Shareholding Commercial Banks

There are fourteen shareholding commercial banks, of which the Bank of Communications, China Investment Bank, the CITIC Industrial Bank, and China Everbright Bank are by far the most important. The total assets of these commercial banks, some of which are collectively owned or are joint-stock enterprises, was over RMB 700 billion (US$84 billion) at the end of 1996.

Assets, Liabilities, Deposits, and Loans of Major Chinese Commercial Banks, Year-End 1996
(In billions of RMB)

	Total Assets	Total Loans	Total Liabilities	Total Deposits
ICBC	3,629.6	1,787.5	3,343.9	1,900.9
BOC	2,107.0	1,062.3	2,002.9	673.8
CCB	2,125.3	995.5	1,515.5	1,166.5
ABC	1,466.9	898.5	1,424.8	951.5
BoComm	433.5	213.4	376.2	344.4
CITIC IB	108.7	50.9	103.2	67.9
CIB	61.1	31.2	58.5	33.1
Everbright	47.1	22.6	44.9	28.7

Sources: Industrial and Commercial Bank of China (ICBC); Bank of China (BOC); China Construction Bank (CCB); Agricultural Bank of China (ABC); Bank of Communications (BoComm); China International Trust and Investment Corporation Industrial Bank (CITIC IB); China Investment Bank (CIB); and China Everbright Bank (Everbright).

Rural and Urban Credit Cooperatives

China's financial system includes a vast network of rural credit cooperatives (RCCs). There were more than 51,000 credit cooperatives as of year-end 1997, including more than 48,000 rural credit cooperatives and around 3,500 urban credit cooperatives. Rural credit cooperatives are in principle owned collectively by their depositors, but in practice they are under the guidance of the Agricultural Development Bank of China and enjoy little autonomy in management and lending decisions. RCCs extend credit to individuals and are an important source of financing for rural township and village enterprises. China's RCCs had total assets of RMB 1.5 trillion (US$181 billion)and total liabilities of RMB 1.4 trillion (US$169 billion) as of year-end 1997. Urban cooperatives play a smaller role, with total assets of around RMB 327 billion (US$39.5 billion) and liabilities of RMB 317 billion (US$38.3 billion) as of year-end 1997. In 1997, China began to restructure the UCCs into commercial banks in some localities and into more tightly regulated cooperatives, in others. There are 34 city cooperative banks.

Nonbank Financial Institutions

Although the number of nonbank financial institutions has expanded in China in recent years, there has been an official reassessment of international trust and investment companies in 1998, and several have been closed. In 1979, the China International Trust and Investment Corporation was established to raise foreign currency funding for projects in China. With RMB 191 billion (US$23 billion) in assets at the end of 1996, it was by far the largest. Many other trust and investment companies (TICs) were set up in the years that followed at national and local levels. Their main business has been to receive government agency and enterprise trust deposits and entrusted deposits for lending to long-term government projects.

Finance companies have been formed by industrial and commercial conglomerates to facilitate intragroup financing. Leasing companies have been primarily engaged in leasing imported capital goods to export-oriented enterprises. At the end of 1997, there were 244 trust and investment companies (with assets of RMB 434 billion or US$52.4 billion), 90 securities companies (RMB 206 billion or US$24.9 billion), 72 finance companies (RMB 149 billion or US$18.0 billion), nine leasing companies, and three insurance companies in China. The nonbank financial institutions are more autonomous and profit-driven and have introduced a limited degree of competition into the financial sector.

In 1997, the PBOC authorized the licensing of group holding companies, established by foreign companies, to finance the sale of group products in local currency. However, due to a restrictive and time-consuming approval process, only one such license has been approved to date. In addition, group finance companies are required to fund their operations from deposits held by member firms, substantially limiting their ability to support sales. Chinese firms, by contrast, can create large cash balances to support their finance companies.

Market Regulation

The PBOC is the only government agency with authority to supervise, regulate, and inspect China's banks and insurance companies. The PBOC has units responsible for bank supervision at each of its branch offices at the provincial and city level, as well as at many of its county level branches. As part of its planned central bank reforms, China hopes to strengthen the PBOC's auditing staff, especially at the headquarters level, and to enact comprehensive central and commercial banking laws that will provide a clearer legal basis for the PBOC's supervisory activities.

Under China's traditional planned economic system, the main purpose of bank regulation was to ensure that loans were made to priority sectors and bank branches adhered to the credit plan. Chinese regulators have therefore place little emphasis on prudential regulation intended to control risks and maintain the overall soundness of the financial system. Most supervisory activity is still directed at regulating the local branches of the large commercial banks, rather than at a more centralized level where systemic risks are likely to be greater. China has begun, however, to implement reforms aimed at strengthening the PBOC's ability to supervise the banking system. However, many of the new regulations have not yet been fully implemented. In 1994, the PBOC issued new supervisory guidelines requiring all banks to apply new credit control procedures designed to bring China in line with the risk-weighted capital adequacy established in the Basle Agreement. The PBOC has received National People's Congress (NPC) approval to undertake a special US$32 billion bond issue in late 1998 to re-capitalize the state-owned commercial banks and, according to the PBOC, enable them to meet the 8-percent capital-adequacy ratio of the Basle Agreement. Few outside observers, however, expect this one-time bond issue to resolve the outstanding bad debt problem.

The Chinese authorities have never allowed a bank failure and there has been only one run on deposits (a branch of China Construction Bank experienced a run on its deposits in the fourth quarter of 1997). In June 1998, the PBOC dissolved the Hainan Development Bank, a small regional bank that had accumulated large losses during a real estate development boom in the early part of the decade. ICBC was designated to carry out the liquidation of the bank. The government has also closed China Venturetech and Guangdong International Investment and Trust Company. Other such closures are anticipated over the next few years, with speculation abounding about the possible reorganization of the larger state owned banks.

All interest rates on deposits and loans are set administratively by the central government, with preferential lending rates being set to encourage various sectors of the economy. During the period of reform since 1979, real interest rates on savings deposits have generally been kept positive, encouraging a high rate of financial saving. In addition, Chinese savers have few options but to deposit their savings in Chinese banks. The result has been a significant deepening in China's financial sector. Broad money (M2) increased from just 37 percent of China's GDP in 1979 to over 122 percent in 1997.

During periods of high inflation the PBOC has introduced indexing on long-term savings deposits. From mid-1993 until early 1995, real interest rates were negative, but private savings deposits nonetheless increased at a rapid rate. Since January 1995, real interest rates have turned positive as inflation has been squeezed out of the economy. By early 1998, disinflation had set in while real lending rates hovered at 8-10 percent. The government has set small adjustment ranges for some categories of interest rates and has pledged to widen these ranges gradually over time. Banks also use compensating balances and creative fee structures to make up for the lack of interest rate flexibility.

U.S. PRESENCE IN THE MARKET

Foreign commercial banks have established a banking presence in China through direct branches, wholly owned foreign bank subsidiaries, Sino-foreign joint venture banks, and representative offices. Chinese-owned banks based in Hong Kong (e.g., Bank of Kwangtung, Nanyang Commercial Bank) were the first foreign-registered banks to set up branches in the Shenzhen Special Economic Zone. By the end of 1997, there were 142 direct foreign branches and 275 representative offices. With assets totaling US$37.9 billion, foreign banks including a few small joint ventures, granted US$27.5 billion of loans (24.6 percent of foreign-currency and 2.7 percent of aggregate loans, respectively). They received US$4.5 billion in savings deposits, according to official Chinese statistics, some 5.5 percent of foreign currency and 0.4 percent of aggregate deposits.

Bank of America has branches in Shanghai, Guangzhou, and Beijing; Citibank has branches in Shanghai, Shenzhen, Guangzhou, and Beijing; Chase Manhattan has branches in Tianjin and Shanghai; and First National Bank of Chicago has a branch in Beijing. Bank of the Orient has a branch in Xiamen. In October 1998, Chase Manhattan filed an application to upgrade its Beijing Representative Office to a full Branch. It has been suggested that other U.S. banks may have delayed such applications for conversion, primarily because of the restrictions on local currency business. In addition, the PBOC did not seem to encourage banks to open new representative offices or branches in major markets.

Wholesale banking and trade finance are the market staples for foreign banks in China. Primarily through their branches located outside of China, U.S. banks handle letters of credit and funds transfers, arrange or participate in U.S. or other export credit programs, participate in joint ventures in commercial banking and leasing, provide financial advice for major projects, trade currency and bonds with Chinese banks, manage foreign currency funds for Chinese entities, and arrange and participate in commercial loan syndications.

Foreign currency activities permitted foreign bank branches within China include loans, deposits, discount bills, investment, remittances, guarantees, import and export settlements, transactions between foreign currencies, agency for payments against credit cards, safe deposit boxes, and credit investigation. Foreign banks generally may only accept deposits from other foreign-invested firms (e.g., joint ventures) and foreign individuals. Chinese enterprises are not allowed to make deposits at a foreign bank from which they have not received a loan. Foreign currency loans made to Chinese firms are subject to the approval of the PBOC and the State Administration of Foreign Exchange (SAFE – previously known as the State Administration of Exchange Control). Representative offices may be established in any Chinese city open to foreigners, but may not engage in profit-making activities but often help facilitate these activities on behalf of the banks.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks in China face substantial restrictions on the scope of their business activities. The most fundamental are: their inability to conduct business in local currency (except in the Pudong district of Shanghai), geographical restrictions on where they can establish, and restrictions that prevent Chinese firms from opening accounts at foreign banks. The general lack of regulatory transparency, common to almost all sectors of the Chinese economy, also plagues the foreign banking industry.

In 1992, China liberalized its rules regarding permissible locations for foreign branch banking. In early 1994, China agreed to expand the number of areas that would be open to foreign branch banking and to permit foreign banks to engage in renminbi business on an experimental basis. While these commitments represented welcome progress, Chinese authorities have so far only taken gradual steps to implement them. Branch openings are still heavily controlled. Nineteen cities – Shanghai, Dalian, Tianjin, Qingdao, Nanjing, Fuzhou, Guangzhou, Ningbo, Beijing, Shijiazhuang, Xi'an, Hefei, Hangzhou, Suzhou, Wuhan, Chongqing, Chengdu, Shenyang, and Kunming – and five special economic zones – Shenzhen, Zhuhai, Hainan, Xiamen, and Shantou – are now open to foreign commercial bank branches. Most foreign bank branches are in Beijing, Shanghai, Guangzhou, and Shenzhen. Investment banks are still restricted from opening branches.

Nine foreign banks, including Citibank, have qualified to engage in renminbi business in the newly developed Pudong District of Shanghai. These banks, however, are allowed to make renminbi loans in an amount not exceeding 35 percent of their total renminbi deposits, which are limited to firms registered in Shanghai and approved by SAFE. Total deposits at those banks reached only RMB 763 million (US$92 million) in mid-1998 with loans of RMB 603 million (US$73 million).

In early 1998, PBOC announced that banks authorized to engage in renminbi business in Pudong and Shenzhen would also have access to the "first tier" interbank market for renminbi. Loans in this narrow market, however, are transacted at such large lots and high spreads that they are unattractive sources of funding for U.S. banks, which are restricted from engaging in significant renminbi lending. U.S. banks report that they can meet their meager needs for renminbi funds through secondary interbank markets.

Foreign banks are subject to several licensing restrictions. To open a branch, the parent foreign bank applicant is required to have a minimum of US$20 billion in total assets. A minimum of US$10 billion in total assets is required to open a bank subsidiary. The foreign branch is required to have RMB 100 million (US$12.1 million) in capital, of which 30 percent must be deposited in an interest-bearing account with the PBOC. U.S. bankers complain that this substantially restricts the branch's liquidity. Foreign banks must have had a representative office in China for at least two years to be eligible to open a branch. U.S. bankers complain that other *de facto* conditions for issuing a license, such as a track record of "contributions to China," lack transparency and are politically motivated.

To obtain approval for a local currency license in the Pudong section of Shanghai, a foreign bank branch must have been a branch for three years and have been profitable for two successive years. In addition, it must have maintained a minimum average month-end balance of at least US$150 million in outstanding foreign exchange loans (US$100 million for a joint venture or wholly foreign-owned bank). A successful applicant must increase its capital by a minimum of RMB 30 million (US$3.6 million). Local currency liabilities, however, may not exceed 35 percent of total foreign exchange liabilities.

Staffing is another critical issue, especially for the representative office of U.S. banks. While branch offices can recruit directly, representative offices must hire through a Chinese government agency, FESCO, that retains 55 percent of the annual gross salary paid to a Chinese employee as a fee. This inhibits the recruiting of highly qualified employees and increases the salary cost of representative offices, because they routinely have to provide additional compensation to employees.

The regulations of the SAFE impose further burdens on U.S. banks. Since U.S. banks' business scope in China is restricted to foreign exchange business, the SAFE approval is required for almost all of their activities. Particularly troublesome is that the SAFE informs joint ventures that their accounts with foreign banks are initially approved for only two years on a renewable basis. While renewals never seem to be a problem, the uncertainty may lead many joint ventures to open accounts instead with Chinese commercial banks, whose SAFE approvals seem not to require renewal. Once a joint venture obtains approval from the SAFE, it is free to open as many foreign exchange accounts with Chinese banks as it chooses, but it must receive a specific SAFE approval for each account opened at any foreign bank. Beginning in mid-1998, the Asian financial crisis prompted the Chinese government to tighten SAFE regulations and make it difficult to issue stand-by letters of credit or other guarantees to support local currency loans from Chinese banks. Finance officers from U.S. firms complain that these regulations restrict their ability to adjust to market conditions.

Recent tightening of enforcement of foreign exchange control regulations has resulted in an increase of late payments by Chinese banks under their letters of credit in violation of UCC 500 rules. New requirements that Chinese companies financing imports through letters of credit deal only with a bank in the city where they are domiciled in order to facilitate SAFE's efforts to fight fraud seriously disadvantage the trade finance business of foreign bank branches, which typically serve a wide geographic area.

Foreign banks may become members of China's Foreign Exchange Trading Centers. While they may buy and sell foreign exchange on behalf of joint ventures, they are prevented from selling foreign exchange to Chinese customers, placing them at a considerable competitive disadvantage.

Financial Policy Discussions

The U.S. Treasury Department is actively seeking an expanded role for foreign financial institutions in China, in the context of an ongoing bilateral dialogue and in the context of China's bid to join the WTO, the successor to the GATT. As described above, the scope of permissible activities for foreign bank branches in China is very limited. The U.S. Treasury Department has been pressing the Chinese government to allow foreign financial institutions to establish in additional cities, to engage in local currency business, and to serve Chinese clients and to expand the number of areas open to foreign branch banking and to permit foreign banks to engage in renminbi business on an experimental basis. Yet, the Chinese authorities have taken only incremental steps toward market opening. The total assets of foreign banks in China have quintupled from the end of 1993 to the end of 1997, but much of this expansion could have been achieved without the presence of full-fledged bank branches in China. Indeed, many banks service their operations in China from offshore.

In 1998, China's application to enter the WTO and its financial services offer came under intense review. The U.S. Treasury Department asked China to make commitments to provide substantially full market access and national treatment for foreign financial institutions. These objectives could be achieved in accordance with a timetable for implementation of specific liberalizing measures, including previous commitments made as early as January 1994 and reiterated in meetings of the Joint Economic Committee with Secretary Rubin in 1997 and 1998.

The single most important area for improvement in national treatment is in the expansion of local currency or renminbi business. The U.S. Treasury Department has recommended that China designate an overall cap on assets or market share for foreign financial institutions rather than geographical limitations having little practical significance. The U.S. Treasury Department has also argued, unsuccessfully to date, that allowing foreign financial institutions to compete equally for local currency loans and deposits could be accomplished without opening China's borders to the kinds of capital flows that have marked the current regional financial crisis.

Exchange Rates Used:

June 1998	8.28 RMB/US$
1997 end-of-period	8.28 RMB/US$
1996 end-of-period	8.30 RMB/US$

CHINA

SECURITIES

SUMMARY

Although still in their infancy, the reestablishment of securities markets in China has been one of the most dramatic aspects of China's financial reforms. After a hiatus of more than 40 years, the Shanghai Securities Exchange reopened on November 26, 1990, and on July 3, 1991, Shenzhen, in China's southeastern Guangdong province, opened the country's second exchange.

Partly because the equity market is so new, China's regulatory structure is still in flux. Overlapping agencies with ill-defined responsibilities make the regulatory process unclear. At present, interim regulations issued by the State Council in May 1993 govern the activities of domestic investors, but there is still no law explicitly covering the presence or activities of foreign firms. Foreign firms comment that this lack of transparency of regulations represents a significant problem.

Foreign securities firms may establish representative offices, but they cannot establish local branches or subsidiaries. Foreign firms may purchase seats on both the Shanghai and Shenzhen exchanges to broker "B" shares (explained below), but they must work with domestic brokers for all of their transactions on the basis of a shared commission. Foreign firms cannot underwrite local securities issues or act as dealers or brokers in renminbi (RMB) denominated securities. U.S. firms' major involvement in China is in underwriting offshore equity and bond issues for domestic companies. However, each offshore issue must receive prior approval from the government.

Publicly offered stocks are segregated into two types of shares: "A" shares and "B" shares. "A" shares are issued by Chinese companies for sale exclusively to Chinese individuals and Chinese legal persons. "B" shares, which are denominated in RMB but must be purchased with foreign currency, are issued by Chinese companies for sale exclusively to non-Chinese. The combined aggregate capitalization of equity securities on both markets as of end-1997 was approximately RMB 1,753 billion (US$212 billion). Aggregate market capitalization of shares available for purchase by non-Chinese was approximately US$4 billion as of end-1997.

DESCRIPTION OF THE MARKET

China's equity market has grown rapidly since its reopening in November 1990. The Shanghai Exchange opened with 46 seats and two trading counters. At the end of its first full year of operation, total trading turnover on the Shanghai Exchange was RMB 11 billion (US$2.1 billion). By the end of 1992, there were 73 listed securities and turnover was RMB 65 billion (US$11.8 billion). As of May 1998, there were 407 listed shares traded in Shanghai and 467 seats on the exchange.

Similar growth has occurred on the Shenzhen Exchange. At the end of 1992, 33 listed securities were traded and total trading volume on the exchange amounted to RMB 43.8 billion (US$7.9 billion). As of May 1998, 384 listed securities were traded in Shenzhen, with 397 seats on the exchange.

Chinese companies seeking to issue shares must undergo different levels of review by the China Securities Regulatory Commission (CSRC). Companies seeking to issue "B" shares must be limited liability shareholding companies that have been profitable for at least two consecutive years, possess sufficient foreign exchange revenues to pay dividends and cash bonuses, and provide financial statements and earnings forecasts for three consecutive years. The price to earnings ratio must be below 15 at the time of listing.

Foreign investors seeking to purchase "B" shares must open an account with a foreign clearing house through an approved foreign broker. The overseas broker can then pass customers' orders to traders on the exchange floors or to a related local broker. In Shanghai, all qualified domestic brokers can now trade "B" shares. Eighty or so "franchise B share brokers" currently trade in Shenzhen, of which 10 are foreign firms. All orders are executed in the central order matching system in either market. In Shenzhen, settlement takes place three days after the day of trade. In Shanghai, to increase market liquidity, the exchange replaced the T+3 rule with a T+0 rule. Off-market trading and short selling are not allowed in either market.

In addition to the two officially recognized exchanges, there are "securities exchange centers" in 19 of China's larger cities and two electronic trading systems, the National Electronic Trading system (NET) and the Securities Trading Automatic Quotation system (STAQ). Trading at "securities exchange centers," in Wuhan, Shenyang, Tianjin, and other cities, is limited to government and corporate debt securities only. In late 1997, however, these markets were virtually shut down by the CSRC due to suspicion of fraud, and there were indications that they would be abolished altogether. (NET and STAQ provide secondary markets for a small number of "legal person shares" – corporate shares that can be traded by China's "registered legal persons," mostly government agencies and state-owned enterprises.)

China's "A" share market has remained volatile. Shanghai's "A" share index tumbled to a low of 328.85 at the end of July 1994, prompting the CSRC to announce several measures to boost public confidence in the stock market. The measures included: (1) canceling all "A" share listings scheduled for 1994 until the end of the year; (2) announcing the authorities' intention to gradually allow foreign institutional investors to buy "A" shares; (3) encouraging the development of mutual funds; and (4) tightening control over rights issues. However, the authorities appear to have backed away from opening the stock market to foreign investors in the near term as the "A" share index has rebounded. The measures announced by the CSRC do not address other underlying problems in the stock markets, including a lack of standard accounting practices, shortage of information, and the perception of poor management.

Initial reaction to the opening of China's securities markets to foreign investors in the form of "B" shares in 1991 was frenzied buying. In the first half of 1992, 20 China funds were launched, raising more that US$1 billion for investment in both listed and unlisted companies. Most of the initial "B" share issues were many times oversubscribed. In mid-May 1992, after share prices reached more than 200 percent above their initial listing price, the market plunged. Since then, "B" shares have generally performed worse than "A" shares, generally tracking the Hong Kong market.

Prices of Shenzhen "B" shares have generally outpaced those in Shanghai, but both markets have been volatile. The relatively weak demand for "B" shares is attributable to China's nonstandard accounting practices, the shortage of information on listed companies, and the variety of alternative China investment strategies available to foreign investors. In an attempt to address the former concerns, the CSRC issued provisional regulations in 1993 requiring all "B" share companies to issue annual reports audited by certified accountants. This was followed in 1994 with a requirement for all listed companies to file semiannual reports.

Many foreign interests have chosen to invest in China indirectly through Hong Kong and other Asian companies with major investment and trading interests in China, through more than two dozen Hong Kong-listed "red chips" – companies primarily owned by mainland interests, or through "H" shares – Hong Kong listings of mainland companies. In 1993, nine Chinese state enterprises were selected to float "H" shares in Hong Kong, 22 others were selected to list in 1994. Other investors chose to buy American Depositary Receipts (ADRs) of five Chinese companies listed on the New York Stock Exchange. The number of overseas listings reached 42 firms by the end of 1997.

One feature of the domestic securities market is that companies are only allowed to issue once at the time of the initial listing. Companies know that they cannot go back to the market and therefore have little incentive to consider shareholder interests or to manage the firm in a way that will increase shareholder value and the stock price. China is thus not receiving the benefit of market discipline, and many companies seem to believe that equity is "free."

China has 14 futures exchanges, including Shanghai and Shenzhen. Physical deliveries amounted to only RMB 17.4 billion (US$2.1 billion) in 1996, down sharply from 1995, and continued to plummet in 1997 as the government struggled to clean up abuses in the market. In mid-1998, there were rumors that the government would move to shut down completely all of the futures exchanges and only gradually move to reopen them under a new set of strict regulations.

Fund Management

China began a fledgling domestic mutual funds market in early 1998, in accordance with "interim procedures" published in October 1997. Each of the four closed-end funds announced as of mid-1998 was capped at a total issue volume of RMB 2 billion (US$242 million) and did not include foreign partners. Reports have circulated that foreign firms may soon be allowed to jointly manage at least some of these funds.

The overwhelming majority of investors, however, trade on their own accounts. Foreign banks may not sell foreign mutual funds or any other form of foreign securities to Chinese citizens or institutions.

Pension fund development is moving forward in China. Foreign banks might be allowed to manage domestic pension funds in the future, but at present all pension funds remain under government control.

Regulatory Structure

The CSRC, an executive agency of the State Council, has become the supreme regulatory authority over all domestic securities markets. With offices in Beijing, Shanghai, and Shenzhen, the CSRC designates firms for listing and licenses brokerage companies. It also controls commodity futures markets.

In early 1998, the designation of the CSRC as the sole regulator initiated a new phase in the development of a regulatory system that had lacked clarity and had been plagued by overlapping responsibilities between competing agencies. According to the reform, the CSRC will take over from the People's Bank of China (PBOC) and other agencies all responsibility for regulating markets. The State Administration of Exchange Control (SAFE), now an independent agency, retains some oversight responsibility for transactions involving foreign exchange, including dividend payments on "B" shares.

The Financial and Economic Committee of the National People's Congress (NPC) has drafted national regulations for China's securities markets. But differences over key provisions of the law, including the responsibilities of national and local regulatory bodies, have delayed final passage of this important legislation. Chinese officials are hopeful that the CSRC will be able to re-draft the Securities Law in the second half of 1998, but until then securities markets will continue to be regulated by interim rules issued in May 1993. The interim regulations govern only the activities of domestic investors in securities.

U.S. PRESENCE IN THE MARKET

U.S. securities firms active in both Shanghai and Beijing include J.P. Morgan, Merrill Lynch, Morgan Stanley Dean Witter, and Bear Stearns. Prudential Securities is active in Shanghai, as are Goldman Sachs and Salomon Smith Barney in Beijing.

Securities firms in Shanghai may only conduct trades in "B" shares through domestic brokers on shared commission. There are 15 foreign seats on the Shenzhen stock exchange at a cost per seat of HK$1 million (US$128,000). However, clearance and settlement still must go through a local sponsoring broker. The membership fee for a special seat is RMB 1 million (about US$121,000), the same fee paid by local brokers.

The primary involvement of U.S. securities firms in China has been through the preparation and underwriting of international offerings of both equity and debt. On October 9, 1992, China Brilliance Automotive Holding (CBA), a Chinese bus maker, made its debut on the New York Stock Exchange, becoming the first Chinese-based enterprise to list abroad. The CBA issue was lead-managed by CS First Boston, and U.S. legal and accounting firms were heavily involved in its preparation. Since then, U.S. securities firms have secured many international underwriting deals involving Chinese debt or equities. For example, CS First Boston lead-managed or co-managed equity issues totaling over US$1.9 billion in 1997.

Introduction of new domestic financial products is prohibited, but offshore derivatives is an attractive business for foreign banks operating in China.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Although U.S. firms have competed successfully for many of China's overseas underwriting deals, within China their business continues to be severely restricted by discriminatory regulations and lack of market transparency. Foreign securities firms cannot establish local branches or subsidiaries. They may establish only representative offices. Representative offices are limited to offshore activities and, for stock exchange members, to transactions in "B" shares only.

Foreign firms are required by Chinese regulations to hire their Chinese staff through an "approved labor supplier." Subsidiaries, branches, and joint ventures are not governed by the same rules and may recruit employees directly.

Establishment of representative offices of all foreign financial institutions, including investment banks, is subject to the Regulations Governing Representative Offices by Foreign Financial Institutions, which was promulgated by the PBOC in 1990. A firm seeking to open a representative office applies to the CSRC (not the PBOC), which then must consult with other interested agencies and local government offices before issuing its approval. Opening a representative office, as opposed to a branch or subsidiary, is generally a relatively straightforward process, and apparently there are no current significant problems.

Even though foreign securities firms may open only representative offices in China, they can participate in "B" share brokerage business and have seats on exchanges. However, they cannot underwrite "A" shares, government securities, or nongovernment bond issues, nor can they purchase or act as dealers in the secondary markets for any form of RMB denominated security. In Shenzhen, a limited number of foreign firms have been permitted to purchase seats on the exchange, but their trades must still be cleared and settled through a sponsoring local broker. In Shanghai, foreign firms also may purchase exchange seats, but they must enlist domestic brokers to conduct "B" share trades, and they must share commissions.

Foreign firms may underwrite international equity and bond issues, but approval by the State Council and relevant ministries is required before any domestic enterprise may list securities in an overseas market. Residents may not invest onshore dollars overseas without government approval, which eliminates an area of securities business in which U.S. securities firms are traditionally strong. For capital account purposes, the Chinese currency is not convertible.

China still has not passed a national securities law. Official press commentary on the law regularly espouses reform of the securities sector, particularly opening "B" share sales to domestic investors or eliminating the "B" share market entirely. There is no indication that such moves are imminent.

China's existing securities and accounting regulations lack transparency, although timeliness of notification of changes has improved. Lack of enforcement of settlement payment procedures and insufficient requirements on disclosure of information by listing companies also increase the risk of foreign investors and brokers. Regulations mandating capital gains tax on investment income have been promulgated, but enforcement is spotty. A stamp tax on share transactions has been implemented instead.

Repatriation of profits requires government approval, but this is generally a formality. Dividend payments on "B" shares do not require special approval.

Despite these restrictions, and the still relatively underdeveloped state of the Chinese securities market, most U.S. securities firms remain optimistic about the longer-term prospects for the Chinese market. They note that progress has been made both with regard to domestic exchanges and the introduction of companies to overseas markets, and they remain hopeful that conditions for doing business will improve significantly as further securities market reforms are introduced.

Financial Policy Discussions

In numerous bilateral and multilateral discussions, including in the context of China's application to enter the WTO, Treasury has sought significant liberalization of China's securities market including permission for foreign financial institutions to participate in the underwriting and trading of renminbi-denominated securities. China has been reluctant to make meaningful commitments and, despite the optimism noted above, there are no indications that China will soon allow an expanded role for foreign securities firms beyond setting up joint ventures in tightly restricted markets. Much work remains to be done, especially as commitments in the securities area would make a positive contribution to China's WTO accession commitments.

The major barriers to national treatment remain the strict separation of the "A" and "B" share markets and the lack of clear-cut prudential criteria for licensing foreign securities firms. Passage of the Securities Law currently under final revision is unlikely to remedy these deficiencies but would be a step toward greater transparency in the market.

Exchange Rates Used:

June 1998	8.28 RMB/US$
1997 end-of-period	8.28 RMB/US$
1996 end-of-period	8.30 RMB/US$
1992 period average	5.51 RMB/US$
1991 period average	5.32 RMB/US$

CZECH REPUBLIC

BANKING

SUMMARY

As of September 30, 1998, 47 banks operated in the Czech Republic, including 14 foreign banks and nine branches of foreign banks. The largest five locally incorporated banks dominate the market, with 66 percent of the banking sector's overall assets. Foreign banks and their branches accounted for 22 percent of banking sector assets as of year-end 1997, a substantial increase from only 6 percent as of year-end 1993.

The Czech government continues to hold near majority stakes in three large banks. The privatization process only recently evidenced any notable progress, beginning with the sale of the government's stake in the Investment and Postal Bank to Nomura in 1998. The banking sector remains weak, with domestic banks burdened by large volumes of delinquent loans. The Czech government is looking to improve the sector's performance through further bank privatization, stricter bank oversight and simplified bankruptcy laws.

The Czech National Bank (CNB) regulates banking operations. In response to the weakness of the sector and the financial irregularities which characterized the banking sector in the early 1990s, the CNB, in coordination with the government, has tightened prudential requirements, introduced legislation to separate banks' investment and banking operations, and increased bank supervisory staff. Further regulatory changes are expected in the runup toward EU accession.

There are 14 foreign banks and nine branches of foreign banks. Currently two U.S. banks conduct commercial banking operations (other than representative offices) in the Czech Republic. Citibank is one of the most prominent foreign banks in the Czech Republic, and operates through a wholly-owned bank subsidiary. GE Capital recently purchased Agrobanka, a medium-sized Czech bank forced into receivership. To date, U.S. banks have not entered the retail banking sector, though the recent purchase of Agrobanka by GE Capital is expected to bring a U.S. presence to the retail banking sector. As of July 31, 1998, U.S. banks controlled less than 5 percent of total banking sector assets.

The CNB issued no new bank licenses in 1997, and only two banks received licenses in 1996, following an informal moratorium on new bank licenses from 1994-1995, as the central bank attempted to clean up the troubled sector. The central bank has stated that it will grant new licenses to those banks, foreign or domestic, which will improve the overall quality and competitiveness of the banking sector. Foreign banks are generally permitted to engage in the same range of financial activities as domestic banks. The one exception is a restriction on the issuance of mortgage-backed debt securities by branches of foreign banks. U.S. banks have not reported any instances of discriminatory treatment.

DESCRIPTION OF THE MARKET

Structure of the Market

As of December 31, 1997, 50 banks were operating in the Czech Republic, including 14 foreign banks and nine branches of foreign banks. Total banking sector assets equaled US$67.4 billion in 1997, with the lion's share of recent increases attributable to foreign banks and foreign bank branches. The banking sector is dominated by the five largest locally-incorporated banks, consisting of Komercni Banka (Commercial Bank), Ceska Sporitelna (The Czech Savings Bank, which dominates the household sector), Konsolidacni Banka (The Consolidation Bank), Investicni-Postovni Banka (IPB, or The Investment and Postal Bank), and Cesko-Slovenska Obchodni Banka (CSOB, or The Czechoslovak Trade Bank). All five banks have universal banking licenses. They accounted for a combined 66 percent share of banking sector assets as of year-end 1997, compared with 84 percent at the beginning of 1994. The decline in their market share is, in large part, attributed to the entry of foreign banks into the system. Foreign banks and their branches accounted for 22 percent of banking sector assets as of year-end 1997, a substantial increase from only 6 percent as of year-end 1993.

As of year-end 1997, the government held major stakes in four large locally incorporated banks: Komercni Banka (49 percent), Ceska Sporitelna (45 percent, but with 53 percent of the voting rights), Konsolidacni Banka (100 percent), and CSOB (40 percent by the Czech government, 27 percent by the Czech central bank, and 25 percent by the Slovak central bank). The government also retains a 49 percent stake in the Czechmoravian Development Bank, with additional shares held by the Ceska Sporitelna (13 percent), Komercni Banka (13 percent), Investicni-Postovni Banka (13 percent), CSOB (2 percent) and Agrobanka (11 percent).

Komercni Banka and Investicni Banka were established in 1990, when the commercial banking functions of the Czechoslovak National Bank were separated from central banking functions. Long-term investment assets were transferred to Investicni Banka, and the assets of the remaining commercial activities were transferred to Komercni Banka. The liability side of both banks consisted primarily of short- to medium-term funds from Ceska Sporitelna. Komercni Banka is the largest commercial bank in the Czech Republic. In 1993, Investicni Banka merged with Postovni Banka (a bank specializing in bill payment and funds transfers through Czech post offices) to build up its retail business. The merged entity, now known as Investicni-Postovni Banka, is the fourth largest bank. Ceska Sporitelna, also established in 1990 and presently the second largest bank, is the successor organization of the Czechoslovak State Savings Bank, the country's only savings bank in the Communist era. Ceska Sporitelna recently expanded its activities to include lending to small- and medium-sized companies, and investment banking and treasury activities. Prior to 1989, virtually all Czechoslovak foreign trade and major projects were financed by CSOB, which still holds an estimated 70 percent share of the foreign financing market.

Konsolidacni Banka, the third largest and only majority government owned bank, was established by the Czechoslovak government in 1991 to administer US$3.7 billion of non-performing loans of the major banks. Konsolidacni Banka also evolved to serve as a government development bank, and has even provided credits to ailing firms in a few cases. The remaining smaller, locally incorporated banks have varied ownership structures. Shares of three of the larger banks – Komercni Banka, Ceska Sporitelna, and IPB – are traded on the Czech Stock Exchange.

The Tosovsky government, which concluded its term in June 1998, began implementation of long-promised privatization of the banks, with the sale of the government's minority stake in IPB to longtime suitor Nomura in March 1998. It also set in motion the process to privatize Komercni, the Czech Savings Bank and the CSOB by the year 2000. At this time it is unclear whether the new Social Democratic government, while generally supportive of continued bank privatization, will adhere to its predecessor's timetable or proceed at a slower pace. The IFC approved in July a ceiling of US$75 million to purchase a stake of between 10 percent and 15 percent in CSOB. In addition, the European Bank for Reconstruction and Development gained a 10 percent stake in Ceska Sporitelna in 1998.

The weakness of the financial sector, including the banks, is one of the most serious problems afflicting the Czech economy. During the early 1990s, privatization of companies through the issuance of "voucher" shares to citizens rapidly created a voluminous and largely unregulated equity market. Investment funds promising to deliver high returns for management of individual vouchers quickly formed. Banks owned many of the funds which bought up these voucher certificates issued during the privatization process. As the remaining shares in these industrial concerns were held by individuals, the banks ended up owning the largest blocks of shares in many nonfinancial companies. The banks and firms exploited this relationship: Firms sought loans instead of raising capital by other means, and banks forced these firms to take on noncompetitive loans. The linkages between the banks, the funds and corporations, combined with weak regulation of capital markets and poor oversight of the banks, led to the issuance of questionable loans to many corporations, and a subsequent rise in the banks' classified loans. This situation was further complicated by the banks' inability to foreclose on collateral due to outdated and inadequate bankruptcy and commercial codes.

Burdened by bad debt, total banking sector losses began to mount. As of June 30, 1998, 28.9 percent of bank credits were classified as non-performing (more than 30 days past due), not including loans held by the Konsolidacni Banka and Ceska Financni programs. This share is expected to rise due to stricter provisioning requirements and oversight by the central bank, and the recent sluggishness of the economy. The weakness of the banks has limited the extension of new credits, acting as a further drag on economic growth.

Due to budgetary pressures, commitment to continued economic reform, and unsuccessful past attempts with government intervention, the Czech government continues to reject a broad bailout plan for the troubled banking sector, looking to bank privatization, stricter oversight, tightened provisioning requirements and simplified bankruptcy laws to improve the sector's performance. In 1996, as part of an overall "small bank" stabilization plan following the failure of two small banks and the forced administration of a third, the CNB established Ceska Financni to shore up the smaller domestic banks. Under this program, small banks transferred US$405 million in bad loans to Ceska Financni with the understanding the loans would be repurchased in seven years. As of June 30, 1998, only one of the original seven banks in this program remained in receivership. The Tosovsky government announced its intentions to spend as much as US$330 million to cover losses stemming from the transfer of nonperforming loans from locally-incorporated banks to Konsolidacni Banka. It is unclear whether the new government will follow up on this.

Electronic banking has started to penetrate the Czech market. The level of services offered by Czech banks varies widely. Presently, electronic banking is oriented exclusively toward current account transactions, including payments abroad. There are two ATM networks operating in the Czech Republic: one operated by Ceska Sporitelna and the second by a group of 18 banks sharing a common network. Ceska Sporitelna has issued almost 1.2 million ATM cards and has 825 ATM machines. The other network has issued 600,000 cards and operates 532 ATMs.

Regulatory Structure

The CNB is an independent monetary and regulatory authority that has responsibility for licensing and regulating banking activity. The CNB has come under fire in recent years for inadequate bank supervision, that in turn has been attributed to the current weak state of the banking sector and high level of non-performing loans.

In response, the central bank more than doubled the number of bank supervisory staff and tightened provisions and reserves for non-performing loans, and prudential requirements in general. Mandatory deposit insurance now covers 90 percent of deposits valued at approximately US$12,000 in a single bank, except for foreign currency deposits. Banks are restricted in lending of no more than 25 percent of regular capital to a single client. New amendments to the banking act implemented in February 1998 prohibit banks from holding controlling stakes in companies other than banks, financial institutions, and companies providing banking support services. The total amount of banks' stakes in all non-financial companies will be limited to a maximum of 60 percent of a bank's equity, with a single investment totaling no more than 15 percent. The amendment also requires banks to separate commercial and investment banking divisions.

Other recent amendments boost the central bank's supervisory powers by enhancing its capability to enforce stricter reporting requirements. Additionally, the CNB issued new regulations in 1998 requiring the creation of provisions to cover the spread between the purchase and market price of securities in banks' portfolios. With a view toward accession to the European Union, the central bank plans to revise further regulations governing the sector in order to harmonize with EU norms.

U.S. PRESENCE IN THE MARKET

There are currently 14 foreign banks and 9 branches of foreign banks. Foreign banks can establish bank subsidiaries, direct branches, joint ventures, offshore branches, and representative offices. Foreign banks can also acquire locally incorporated banks. However, the CNB issued no new bank licenses in 1997, and only two banks received licenses in 1996, following an informal moratorium on new bank licenses from 1994-1995, as the central bank attempted to clean up the troubled sector. European banks dominate the foreign banking sector.

There are two U.S. banks with banking operations other than representative offices in the Czech Republic, which controlled less than 5 percent of total banking sector assets as of July 31, 1998. Citibank is one of the most prominent foreign banks in the Czech Republic, and operates through a wholly-owned bank subsidiary. GE Capital recently purchased Agrobanka, a small Czech bank forced into receivership. Chase Manhattan, Bankers Trust and J.P. Morgan also have representative offices, operating in the investment banking sphere. To date, U.S. banks have not entered the retail banking sector, though the recent purchase of Agrobanka by GE Capital is expected to bring a U.S. presence to the retail banking sector.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign bank participation in the Czech banking sector remains an important element in the successful transition of the Czech economy and efforts to enhance the competitiveness and stability of the banking sector. The central bank has stated that it will grant new licenses to those banks, foreign or domestic, which will improve the overall quality and competitiveness of the banking sector. Foreign banks are generally permitted to engage in the same range of financial activities as domestic banks. The one exception is a restriction on the issuance of mortgage-backed debt securities by branches of foreign banks. U.S. banks have not reported any instances of discriminatory treatment.

The Czech Republic's GATS commitments of December 1997 accurately reflects current practice.

CZECH REPUBLIC

SECURITIES

SUMMARY

The Czech Republic has three active stock markets – the Prague Stock Exchange (PSE), the RM-System (RMS), and the over-the-counter (OTC) market. Trading activity among the markets is fragmented, with prices of shares varying across markets. In 1997, market capitalization of the PSE stood at US$15.6 billion, but trading volumes are low. The short-term bond market has grown significantly in recent years and the derivatives market is developing rapidly. Most equity shares are held by investment and share funds created following coupon privatization in the early 1990s.

Foreign investment represents a relatively small and declining share of overall investment but influences the direction of the markets. Fragmentation of markets, lack of transparency, financial fraud, and bottlenecks in trading have sharply reduced investor confidence in the Czech equity markets in recent years.

Capital markets are regulated by the newly established Czech Securities Commission (SECOM). Unlike counterpart regulators in most other OECD countries, SECOM possesses no rule-making authority and depends on the state budget for funding. A proven track record of independence to investigate allegations of fraud and impose appropriate penalties will likely be needed before investor confidence is restored. The government is also strengthening regulations and laws governing the capital markets, such as recent amendments to the law on investment companies.

U.S. firms are present in the Czech Republic, though no U.S. firm is a member of the PSE. Most U.S. firms deal in cross-border transactions or government securities and derivatives trading, rather than the equities or corporate bond markets. The Czech government places no restriction on the establishment of foreign securities firms in the Czech Republic and foreign investors may purchase Czech equities through brokers. There are no restrictions on foreign ownership of publicly-traded securities. U.S. firms operating in the Czech Republic have not reported any instances of discriminatory treatment.

DESCRIPTION OF MARKET

The Czech Republic has three active stock markets: the PSE, the RMS, and an OTC market. The PSE has 78 members, 60 of which are shareholders. In 1996, it subdivided into three markets: an unlisted or "open" market, an intermediate market with moderate capital requirements, and the main or "central" market, the most liquid of the three markets and home to the Czech Republic's "blue chip" companies. At year-end 1997, market capitalization of shares and share certificates equaled US$15.6 billion, an 8 percent decline from a year earlier. Capitalization of bonds traded in 1997 reached US$5.5 billion. Average daily trading volume on the PSE in 1997 was US$85 million. The RMS is a network of trading "shops" where institutional or individual investors can place orders. Transactions are only completed when a counterpart is found in the same trading system. OTC trades may be made directly between firms or individuals and registered with the Ministry of Finance's Securities Center. Terms of some OTC deals are private, although many are reported to the PSE as direct trades. A fourth market, RTP, has received a license from the Ministry of Finance but has yet to begin operations. It will be based on electronic auction.

Activity among the markets is fragmented. According to published statistics, in 1997, 48 percent of shares and 19 percent of share certificates were traded on the PSE, with 24 percent and 50 percent respectively of shares and share certificates traded on the RMS, and 28 percent and 31 percent respectively by OTC trades registered with the Securities Center. Prices of shares of the same company often vary substantially across markets. The PSE more heavily dominates bond trading with a 63 percent share. Until 1996, trading in equities dominated overall trading, but in 1997 faster growth in bond trading led to a shift in the structure of the market. Demand for fixed-income funds is on the rise. Money markets are also quite active. The interbank deposit market is the most developed and liquid of these markets. The volume of transactions on the short-term bond market grew significantly in 1997. Rapid development of a derivatives market is being driven by the growing volume of crown-denominated Eurobonds.

As of July 31, 1998, there were 424 securities traders and 1,528 registered brokers operating in the Czech Republic. There is no breakdown available on the number of foreign-owned or affiliated firms. As of June 30, 1998, 103 investment funds, 150 open-end share funds, and 75 closed-end share funds operated on the markets. (An investment fund is a legal person under Czech law, unlike open-end or closed-end funds administered by investment companies.) Officials at the PSE estimate that its members are responsible for 95 percent of transactions on all markets. Individual investors are less significant in the Czech Republic than in many other markets, with most equity shares held by investment or share funds. In the recent past, shares were often traded artificially among these funds to boost equity prices and increase brokerage fee receipts by firms. An improved regulatory environment and impending bank privatization appear to have lessened this practice.

Czech equity markets in recent years have suffered from a lack of investor confidence, both domestic and foreign. The proliferation of separate markets, lack of transparency, numerous cases of financial fraud, and bottlenecks in trading have resulted in foreign and new domestic investors limiting their exposure to the Czech market. Since 1997, there have been few new issues, no new domestic bond issues, and no initial public offerings. Nevertheless, capitalization statistics are high compared to neighboring countries, given the market's initial boost from the voucher privatization process.

Trading volumes are generally much lower than in neighboring countries. Foreign investment represents a relatively small and declining share of overall investment, but often influences the direction of the market. The general weakness of the Czech equity markets has led to a shortage of capital for already highly-leveraged Czech firms, in turn hurting their competitiveness, and the growth potential of the Czech economy.

Market Regulators

SECOM opened its doors in April 1998, taking over the role of capital market watchdog from the Ministry of Finance. The new body is charged with enforcing regulations and charging fines for violations; overseeing information and disclosure requirements for issuers, investors, and brokers; and collecting data on trading. SECOM's self-proclaimed goal is to establish transparency as the norm in Czech capital markets. It has already prepared procedures for relicensing of securities dealers which are expected to improve the quality of trading on Czech capital markets. Unlike counterpart regulators in many other OECD countries, SECOM possesses no rule-making authority and depends on the state budget for funding. Its commissioners are appointed by the President, and it must cooperate with the Ministry of Finance and Czech National Bank in preparing and interpreting laws. The new authority presently suffers from severe staffing gaps.

Market fragmentation and a weak regulatory framework allowed high levels of fraudulent activity in the past. Existing statutes to enforce fiduciary responsibility and other protective measures for shareholders were widely circumvented and violations rarely prosecuted. The investment funds spawned by coupon privatization gained disproportionate influence on the incentive structure of the economy as wide dispersion of ownership led to unclear corporate governance structures. Managers (often the owners through bank-financed management buyouts) continue to face weak performance incentives, given unhealthy links among banks, investments funds, and firms. Effective policing of capital markets remains a critical issue. Many are looking to the newly-created SECOM as the first step in getting this troubled sector of the economy back on track, but SECOM's success is also highly dependent on the government's ability to introduce effective disclosure rules and prohibitions on secret and insider-trading common in other market economies. A proven track record of independence to investigate and impose appropriate penalties is needed before investor confidence can be restored.

In June 1998, the government strengthened the law on investment companies. The new amendments require closed-end funds to open within six months of the amendment's passage if the fund's shares are valued at a 40 percent or higher discount to net-asset-value. This threshold falls to 25 percent after one year. This change is expected to lead to a wide redemption of shares and consequent shrinkage in market capitalization, but should make funds more accountable to shareholders. In an effort to protect further minority shareholders, the amendments limit a fund's holdings in a single company to 11 percent of the company's assets and set new rules for transformation of investment funds into holding companies. This change could have the unintended side effect of further loosening performance incentives for some corporate managers.

Foreign Portfolio Investment

The unethical practices of brokers, lack of transparency, and ineffective regulation have reduced foreign investor confidence in the Czech stock market in recent years. Foreign investors who had been bullish on the Czech markets in the early 1990s gradually pulled out starting in 1995. Most foreign investment comes from funds structured to include Czech equities. While foreign investment comprises a relatively small share of the market, foreign investors often drive the market. Recently, foreign investors have invested heavily in short-term fixed income instruments attracted by high interest rate spreads and a positive view of future developments as the Czech currency converges toward the euro as the Czech Republic's EU accession approaches.

Czech nationals may invest directly in offshore securities markets, but must obtain a prior permit from the Czech National Bank. Restrictions on investment in offshore instruments exist for Czech investment funds, pension funds, and insurance companies.

U.S. PRESENCE IN THE MARKET

U.S. financial firms, including Merrill Lynch and several affiliates of U.S. investment banks, are widely represented in the Czech Republic. No U.S. firm, however, is a member of the PSE, though a wholly Czech Citibank subsidiary, Citibank Securities, is a member. Foreign-owned and affiliated firms represent approximately a third of the PSE's membership. U.S. securities firms established in the Czech Republic deal primarily in cross-border transactions, rather than in the domestic market. They support strategic investments, corporate privatization, and underwriting bonds for Czech companies on other international markets. U.S. securities firms participate to a limited extent in government securities, foreign exchange, and derivatives trading in the Czech Republic.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The Czech government places no restriction on the establishment of foreign securities firms in the Czech Republic. Foreign investors may purchase Czech stocks through a broker on the PSE, through the RMS, or on the OTC market.

The Czech government has actively encouraged foreign participation in its capital markets, and U.S. and foreign financial institutions are accorded the same treatment as corresponding Czech firms. There are no discriminatory restrictions on foreign ownership of publicly-traded shares or debt instruments, nor are there any limitations on non-Czech ownership of government securities.

U.S. firms operating in the domestic market have reported no instances of discriminatory treatment.

CZECH REPUBLIC – SECURITIES

The Czech Republic is committed to liberalize its financial sector in accordance with its OECD membership obligations. The Czech Republic's GATS commitments reflect current levels of openness, and there are no limitations on national treatment regarding securities services. Market-access restrictions remain in some areas, including cross-border securities issuance and asset management.

Exchange Rates Used:

1991 (average)	29.47 CZK/US$
1996 (average)	27.14 CZK/US$
1996 (year-end)	27.33 CZK/US$
1997 (average)	31.71 CZK/US$
1997 (year-end)	34.64 CZK/US$

EUROPEAN UNION

BANKING

SUMMARY

The banking market in the European Union (EU) is one of the world's largest and most sophisticated, although it remains in many ways a work in progress. The member states of the EU (the "EU-15" consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom) decided over a decade ago to attempt to create a single market for financial services and have completed much of the legal framework to support a single market. As a result, any bank established in any member country gains a "passport" to provide banking services through local branches or across borders throughout the EU. Each bank is regulated by the authorities of its home country and may provide financial products that are permitted by those home-country regulators throughout the EU (subject to the minimum standards set forth in EC directives). This rule also applies to separately-capitalized subsidiaries of foreign banks, which are subject to all of the standards set forth in EC directives, but it does not apply to direct branches.

Several hurdles remain to the completion of a truly unified market. Different tax structures and differences in tax treatment across borders constitute major obstacles to the single market. National rules adopted to protect the "general good" may also create hurdles to cross-border provision of financial services.

U.S. bank subsidiaries established in any EU member state receive national treatment. This treatment was reinforced by the EU's commitment under GATS negotiations in the WTO to provide market access and national treatment to the banks of its trading partners. Direct branches of non-EU member banks are now governed by this commitment. As a result, the concerns of U.S. banks operating in the EU are for the most part quite similar to those of their European counterparts. The European Commission has recently adopted a plan to improve the way the European Union's financial services markets function. The plan focuses on the adaptation of the existing legal framework; improving the retail market in financial services; and enhancing regulatory and supervisory cooperation at EU and international levels. The paper will be presented to the European Union Heads of State and Government at the Vienna European Council in December and will likely guide the agenda for financial reform in coming years.

DESCRIPTION OF THE MARKET

Market Structure

The EU banking market is large and diverse. Aggregate data for the EU-15 are limited, although the availability of data will improve soon as the new European System of Central Banks (ESCB) begins to implement Economic and Monetary Union (EMU). According to the European Monetary Institute (EMI), total bank assets of the EU-15 countries were US$13.8 trillion compared to US$9.9 trillion for the EMU-11 countries and US$5.0 trillion for the United States (year-end 1997 data). The number of banks in the EU-15 countries was about 9,500 in 1997.

The corporate finance market in the EU has traditionally been characterized by a relatively high degree of bank lending compared to securities issuance, though the volumes vary greatly across member states. Total bank credit amounts to 89 percent of total indebtedness of non-financial companies in Germany, 82 percent in France, 68 percent in Italy, and 63 percent in the UK. Commercial paper markets exist in six EU countries (Belgium, Germany, Spain, France, the Netherlands, and the UK), but they play a sizeable role only in France and Spain.

In 1997, the EMI conducted a wide-ranging survey of the EU banking sector in preparation for EMU. The survey identified medium and long-term trends of importance to the stability of the EU banking system. In its 1997 Annual Report, while cautioning against over-generalization, the EMI stated that four main trends could be discerned over the past four years:

1. A decline in banks' profitability;
2. A narrowing of interest rate margins;
3. A rise in non-interest income; and
4. A reduction in staff costs and the number of staff.

The EMI viewed these trends as the result of the combined effect of several factors – financial liberalization, disintermediation, internationalization, and technological change – which have emerged in recent years.

Major Developments in the EU Banking Market

The most significant developments in the EU banking market in the past few years have been the decision to introduce a single currency in eleven member states beginning January 1, 1999, and several developments related to completion of the internal market for banking. (The WTO multilateral financial services negotiations, and their impact on the EU banking market and U.S. banks operating therein, are discussed in the final section of this chapter.)

Economic and Monetary Union (EMU). As of January 1, 1999, the official currency of eleven of the fifteen EU member states (Denmark, Greece, Sweden, and the United Kingdom will not participate initially) will become the "euro." The national currencies of these member states will be phased-out over three years, during which time the national bank notes will continue to circulate as "non-decimal denominations" of the euro. All international transactions, wholesale financial transactions, interbank transactions, and public finances will be conducted in euros from January 1, 1999. Also, all outstanding stocks of government debt will be re-denominated into euros on that date. Banks will have the option of offering consumer accounts and various services denominated in euros starting on that date, and most of the large banks are preparing to do so.

EMU is expected to have substantial and far-reaching effects on the banking sector of the EU. Although opinions vary considerably and a thorough discussion of all of these effects is beyond the scope of this report, many experts agree on the following major effects: increased cross-border competition and continuing consolidation within the euro zone, the elimination of intra-European currency trading and corresponding business adjustments, further development of the European corporate bond market and possible reductions in bank lending, and increased "policy" competition among European governments and possible reduced demand for some governments' bonds.

The euro zone will have a single monetary policy, which will be set and implemented by the European System of Central Banks (ESCB). The ESCB will consist of the European Central Bank (ECB), located in Frankfurt, and the national central banks of the EU-15 countries. The decision-making authority of the ECB will reside in the Executive Board (the President and Vice President of the ECB and four other members appointed by the European Council), the Governing Council (the Executive Board of the ECB and the governors of the participating national central banks), and the General Council (the President and Vice President of the ECB and the governors of all the national central banks).

Although the ECB officially opened its doors on June 1, 1998, the precise nature of its approach to implementing monetary policy is still evolving. For example, on July 7, 1998, the ECB announced that it would impose minimum reserve requirements and it laid out some key parameters of the policy; however, it said a final decision on the exact specifications of the reserve requirements would come in November 1998. The Maastricht Treaty which established the ECB makes clear that the primary objective of the ECB is to maintain price stability, and it is only secondarily to support the economic policies of the EU.

Refining the Second Banking Directive. The EU is in the process of attempting to combine the fifteen distinct financial services markets of its member states into a single unified market. This process began in earnest with the liberalization of capital movements within the European Community in July 1990. With the removal by Greece of the final derogation to this decision in May 1994, capital movements within the European Community became essentially unrestricted. Member states must also endeavor to apply the same degree of liberalization to capital movements to and from third countries. (In the case of serious disturbances arising from such capital movements, member states are required to consult one another.)

The freedom to provide banking services across borders, creating a "single market" for banking, was provided by the Second Banking Directive (2BD) in January 1993. This directive established the principles of a single license or "passport" and control by home-country regulators under a regime of common rules on admission and supervision. In July 1997, the European Commission published an "Interpretive Communication" on the functioning of the 2BD. This communication attempted to address what the Commission saw as key deficiencies in the 2BD that were hindering the development of a true, single market for banking. Despite this clarification from the Commission regarding member states' use of the "general good" exclusion to prohibit some banking services, some U.S. banks remain concerned that differing interpretations may continue at the member state level. In the absence of clear guidance at the EU level and a more precise definition of the "general good," some uncertainty remains about which banking services will be permitted.

Proposal on Taxation of Cross-Border Savings Income. In May 1998, the European Commission proposed a new directive "to ensure minimum effective taxation" of savings income in the EU. In the Commission's proposal, each member state would be required to apply either a withholding tax of at least 20 percent or provide information to other member states on interest income from savings. To avoid double taxation, each state would be obliged to credit withholding tax paid in another member state. Banks, or any other entities that pay interest income, would be responsible for implementing the withholding tax or the reporting requirement.

U.S. participants in the EU market have expressed concerns about this proposal. They argue that the system would add significant costs to financial transactions in the EU, impairing the competitiveness of European financial centers and creating incentives for the development of offshore financing structures. They also assert that this requirement would be counter to the international trend of reducing or eliminating withholding tax on interest income and that it would be a significant imposition on financial institutions already strained by the information technology demands of the euro transition and the Year 2000 problem.

Enhancing Consumer Confidence. In May 1996, the European Commission published a Green Paper on "Financial Services: Meeting Consumers' Expectations." The Green Paper drew attention to a number of particular consumer problems that the Commission thought required action. These problems included the refusal by some institutions to sell financial services to nonresidents, poor quality of service, lack of consumer information, and the activities of unregulated intermediaries.

After a series of consultations were held, a Communication from the Commission presented a work plan in June 1997. The work plan included four steps: 1) a proposal for a new directive on "distance selling" of financial services, 2) a call for a "clear commitment" from the industry to voluntarily improve the information provided to consumers, 3) a review by the Commission of the 1987 directive on consumer credit to consider updating the directive to current market conditions, and 4) a series of measures to facilitate development and acceptance of electronic commerce.

Simplifying the Legislative Structure for Banking. In December 1997, the European Commission proposed replacing 19 separate directives governing the banking industry (7 basic and 12 amending) with a single Directive, without changing their substance. The basic directives to be consolidated include the 1977 First Coordinating Directive, the directives on own funds of credit institutions and on the solvency ratio for credit institutions, the 1989 Second Coordinating Directive (2BD), the directive on large exposures, and the directive on supervision on a consolidated basis. The directives on deposit-guarantee schemes, the prohibition of money-laundering, capital adequacy, and the accounting directives on the banking industry would be beyond the scope of this proposed consolidation.

The EU Directive on Data Protection (sometimes referred to as the Privacy Directive), approved in 1996 and due to take effect in October 1998, may cause problems for U.S. banks operating in the EU. (Indeed, implementation with respect to the United States has been delayed, pending the outcome of negotiations between the Commerce Department and the EU. The objective is to reach agreement on a set of "safe harbor" principles to which U.S. corporations could adhere voluntarily, providing such corporations with a presumption of an adequate level of privacy protection.) This directive is intended to protect the personal information of consumers by placing restrictions on the manner in which corporations can collect, use, store and transmit any data related to an identifiable individual. Under the directive, corporations will generally be required to collect such data only with permission, use it only for stated purposes, maintain its accuracy, and make it available to individuals upon request.

Most importantly for U.S. corporations and other multinational corporations, including European ones, businesses will be allowed to transmit such data across borders only to countries that have been deemed to provide "an adequate level of protection," as determined by the EU. If the United States was found not to provide adequate protection of personal data, this restriction could handicap many types of businesses (e.g., banks and credit-card companies) by preventing them from sharing data on EU customers with home office operations.

Regulatory Structure

Although EMU will transfer the control of monetary policy from member-state central banks to the ECB, the responsibility for bank supervision and regulation will remain at the member-state level. As described above, the Second Banking Directive established the principle of "home-country" supervision under which a financial institution is subject to the authority of the bank regulator in its country of incorporation. This principle applies even for services provided cross-border in the jurisdiction of another regulator. In the case of some services, "home-country" regulators must be notified of an institution's plans to provide the service. (The Commission has indicated that it intends to submit a proposal to abolish the notification requirement.)

Bank Supervisory Agencies in EU Member States

Country	Supervisory Agency
Austria	Federal Ministry of Finance
Belgium	Banking and Finance Commission
Denmark	Danish Financial Supervisory Authority
Finland	Financial Supervision Authority
France	French Banking Commission
Germany	Federal Banking Supervisory Office
Greece	Bank of Greece
Ireland	Central Bank of Ireland
Italy	Bank of Italy
Luxembourg	Luxembourg Monetary Institute
Netherlands	Central Bank of the Netherlands
Portugal	Bank of Portugal
Spain	Bank of Spain
Sweden	Financial Supervisory Authority
United Kingdom	Financial Services Authority (as of June 1998)

U. S. PRESENCE IN THE MARKET

In 1997, approximately 150 subsidiaries and branches of U.S. banks and other financial institutions were operating in the EU-15 countries. This total included 33 in the United Kingdom, 29 in France, 20 in Germany, 13 in Italy, and 11 in Spain. U.S. institutions are located primarily in major financial centers, and they concentrate on wholesale banking operations. However, a few U.S. institutions have pursued a broader strategy, with more locations and a full array of retail products.

TREATMENT OF U. S. FINANCIAL INSTITUTIONS

In the WTO multilateral financial services negotiations, the EU committed to provide access to its banking market on a "most-favored nation" (MFN) basis, including the right to establish branches. The EU's commitment also removed several remaining restrictions on the operations of foreign banks, including the application of "economic-needs testing" in the banking sector in Austria. The reciprocity provisions in the various EU financial services directives (i.e. banking, investment services, and insurance) are automatically superseded by the WTO commitments because of specific clauses in the EU directives. For example, the reciprocity article of the Second Banking Directive provides that "Measures taken pursuant to this Article shall comply with the Community's obligations under any international agreements, bilateral or multilateral, governing the taking-up and pursuit of the business of credit institutions."

As a result of these WTO commitments, very few strictly "national treatment" issues remain for U.S. banks operating in the EU. As mentioned above, the EU offers market access to foreign financial institutions on a MFN basis. The concerns of U.S. financial service companies in the EU market are generally concerns that are shared by all institutions in that market, both foreign and domestic. For example, the cross-border provision of services in the EU is an increasingly sensitive issue for U.S. institutions as they continue to centralize their global activities. Several large U.S. institutions are developing systems in which foreign exchange transactions – whether they are initiated in London, Paris, Rome, or Athens – will be executed from a single location. If this business practice is restricted or hindered by EU member-state application of "general good" provisions, these U.S. institutions will be commercially disadvantaged. However, an EU bank pursuing the same strategy could be equally disadvantaged.

EUROPEAN UNION

SECURITIES

SUMMARY

The European Union (EU) is attempting to create a single market for securities services among its fifteen member states, similar to the single market for banking discussed in the previous chapter. A series of EU "directives" have established the parameters of this single market, though implementation of some of the directives has been delayed, inconsistent or incomplete. The cornerstone of the system is the "single passport" to provide investment services throughout the EU, provided by the Investment Services Directive.

If taken as a whole, the EU market for transferable securities is larger than Japan's, but smaller than that of the United States, with total stock market capitalization in the EU-15 of US$3.8 trillion (45 percent of GDP) and total debt securities outstanding of US$8.7 trillion (103 percent of GDP). The potential for equity growth in Europe is considered to be tremendous, with huge unfunded (pay-as-you-go) pension liabilities, an aging population, low interest rates, improving economies, and undeveloped equity markets. The equity market capitalization of the euro-zone countries represents less than 50 percent of GDP compared to 140 percent for the US.

In the context of the GATS negotiations in the WTO, the EU committed to provide market access and national treatment to foreign financial services firms with reservations for certain member state laws inconsistent with these commitments. The concerns that U.S. firms have in the market are generally consistent with those of their EU competitors.

DESCRIPTION OF THE MARKET

As part of its program to develop a true single market for goods and services throughout its fifteen member states, the European Union is in the process of attempting to consolidate the securities markets of the member states. While some harmonization and consolidation have taken place, the market remains quite segmented, with some countries hosting modern, deep and globally active financial markets, and others much less so.

Stock and Bond Markets

The table below, based on IMF data, summarizes the size of the various national financial markets, and compares them to the markets of the United States and Japan. It shows that the largest EU equity market is found, not unexpectedly, in the U.K., with the deepest bond markets in Germany, France, and Italy. In 1996, 76 percent of all equity market turnover in domestic EU companies occurred in the UK and Germany. The EU-15 stock markets total about 55 percent of the U.S.

equity markets, and total bonds in the EU are nearly 80 percent of the U.S. total. This reflects the much greater historical reliance on debt, and commercial bank financing in particular, for financing throughout the European corporate sector.

European Union Securities Markets, 1995
(US$ billions)

	Stock Market Capitalization	Public and Private Debt Securities	Bonds and Stock Market (as a % of GDP)
Austria	33	211	105
Belgium	105	470	214
Denmark	56	329	223
Finland	44	144	151
France	522	1,485	131
Germany	577	2,179	114
Greece	17	105	108
Ireland	26	45	116
Italy	210	1,618	168
Luxembourg	30	17	248
Netherlands	357	388	188
Portugal	18	72	88
Spain	198	362	100
Sweden	178	419	261
United Kingdom	1,408	826	202
EU-15	3,779	8,673	148
United States	6,858	11,008	246
Japan	3,667	5,326	176

EUROPEAN UNION – SECURITIES

The London and Frankfurt stock exchanges have announced plans for an alliance that will eventually provide a single electronic trading platform for the 300 largest European companies. Officials also indicated that they will pursue alliances with additional European exchanges in the future. However, Paris stock exchange officials stated they would seek alliances with other European exchanges. Other exchanges to date have expressed more interest in the London/ Frankfurt alliance as these are the top two equity markets in Europe.

Most EU stock markets still basically trade domestic securities. Only the Stock Exchange Automated Quotations system (SEAQ) in London has a sizeable amount of trading in foreign shares (around two thirds of total trading in London, 95 percent of total EU foreign share trading). While a large number of foreign shares are listed in Germany, trading is quite thin. Nevertheless, financial integration has over recent years translated into closer relations among national stock markets. Cross-border securities transactions (within the EU) have markedly increased and portfolios, particularly of institutional investors, have become more international.

The largest EU bond markets are by far in Germany and Italy, with together nearly half of all EU outstanding bonds. In most EU member states, the bond market is heavily weighted with public sector issues, and bonds do not provide a feasible alternative for company funding. Germany has the largest private sector bond market, mostly driven by mortgage-backed or other bank bonds. The main issuers on European bond markets are governments and financial institutions. Other corporate bonds are found in significant number only in France, the Netherlands, and Spain. Public issuers particularly dominant in Italy, Belgium and Greece.

EU derivatives markets are less developed than those of the United States, despite increased demand for hedging by institutional investors. At present, liquid interest rate derivative markets exist only for the currencies of Germany, Spain, France, and the United Kingdom, though the Deutschemark market serves as an adequate proxy for those currencies to which it is closely linked. All these markets have developed in the last six or seven years. Initially, only long-term contracts were offered, but short-term contracts (three-month contracts) have recently been extremely successful. Other financial derivatives contracts are based on European currencies and government bonds. Commodity derivatives contracts are available on such items as sugar, potatoes, wheat, and metals. The London International Financial Futures and Options Exchange (LIFFE), the Deutsche Terminbörse (DTB), the Marché à Terme International de France (MATIF), and the London Metal Exchange (LME) are the principal derivatives exchanges in the Community.

Small and medium-sized companies have traditionally had no alternative to commercial bank financing, typically short-term, throughout most of the EU. In the past few years, though, two alternative systems of stock exchanges for smaller European companies have been started. EASDAQ started in September 1996, but did not immediately attract many listers. The Euro-NM (for "new market") is a joint enterprise of organizations based in Paris, Brussels, Amsterdam and Frankfurt, with "New Markets" based in each city. The Paris NM opened in February 1996 and the fourth (Frankfurt) in March 1997. The exchanges have struggled with listings still limited to a few dozen companies.

The universal banking model prevalent throughout the EU means that the large commercial banks remain important actors in EU securities markets. Most are developing more sophisticated retail marketing programs, commensurate with the deepening and harmonization of equity markets in particular, as well as a greatly increased demand for portfolio diversification among individual investors.

Single Market Legislation

The EU attempt to legislate a single market in the securities field is centered on two pieces of Community legislation: the Investment Services Directive (ISD) and the Capital Adequacy Directive (CAD). The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive governs the provision of mutual funds. These directives, like the Second Banking Directive, are based on the principle of mutual recognition of home country regulation. In 1997, the EU approved the Investor Compensation Directive (ICD) to protect consumers from losses stemming from investment firm failures.

The ISD provides the single passport for investment firms. It spells out requirements for the authorization and supervision of investment firms, and lists covered services (brokerage, dealing, underwriting, and portfolio management) and instruments (transferable securities, money market instruments, futures, forward interest rate agreements, swaps, and options). The home country licensing authorities must ensure that investment firms meet minimum initial capital requirements, observe certain prudential rules, and adhere to capital adequacy standards with respect to market risk spelled out in the CAD.

On this basis, investment firms authorized in any member state may provide the covered services in the covered instruments in any other member state, under the supervision of the home state and without any additional authorization, although the home country must notify the host country of these activities. Services may be provided through branches or cross-border sales, and firms may advertise their services freely, subject to rules adopted "in the general good." Host member states must permit investment firms to become members of, or have access to, regulated markets and local clearing and settlement systems. Investment firms are subject to host country rules of conduct, and transparency and reporting requirements.

The CAD is one of the most technically complex of EU financial services legislation. The CAD serves the purpose of four directives in the banking area, namely the Own Funds, Solvency Ratio, Large Exposures and Consolidated Supervision Directives. A stated objective of the CAD is to achieve equality in the treatment of banks and investment firms with respect to investment services and activities. The CAD draws heavily on the provisions of the banking directives.

The CAD specifies minimum initial capital requirements for different types of investment firms, as well as rules governing capital standards for market risk for both investment firms and the securities activities of banks. In particular, the CAD establishes the concept of a "trading book." Detailed annexes in the CAD devise a system for measuring market risk in the trading book and the amount of capital to be held against this risk. Market risk is divided into four basic components: position risk (general and specific risks associated with debt and equity instruments, and underwriting risk); settlement and counterparty risk; foreign exchange risk, and "other" risks.

The CAD also sets forth requirements concerning the proprietary funds of investment firms, the monitoring and control of large exposures, the valuation of positions for reporting purposes, consolidated supervision and reporting requirements. The directive, however, does leave home country regulators considerable scope for interpreting or applying their provisions.

Originally inconsistent with international standards of capital adequacy (Basle conventions), the CAD in the process of being amended as this report was written. The intent was to bring CAD in line with Basle, though this has not been entirely successful, as there remain areas where even CAD II is inconsistent with current Basle standards. There is discussion underway in the Commission about amending the CAD yet again (CAD III).

The UCITS Directive, adopted in 1985, created a single market for UCITS (similar to mutual funds in the United States), effective October 1, 1989. The directive established minimum essential rules governing the authorization of UCITS, their structure and capitalization, the choice of depository, investment and borrowing policies and information to be provided to investors. These rules then allow for mutual recognition, permitting a UCITS authorized in one member state to market its shares in other EU countries without further authorization.

On July 17, 1998, the European Commission proposed several amendments to the UCITS Directive, aimed at promoting investor confidence and a pan-European market for UCITS. Under the proposal, UCITS would be permitted to invest in bank deposits (cash), money markets, standardized options and futures contracts dealt on regulated exchanges, and in shares of other funds.

In February 1997, the European Parliament and European Council approved the Investor Compensation Directive. The ICD requires that minimum safeguards be put in place to compensate investors (essentially small investors) in the case of failure of an investment firm, where the firm proves unable to refund to investors the money or securities belonging to them. Member states are required to ensure that at least 90 percent of each investor's claims are met by the compensation scheme. The "top-up" clause gives branches of investment firms established in a host country the right to join the host country's scheme if it provides a higher level of compensation than the home country's scheme.

EMU and EU Securities Markets

On January 1, 1999, eleven of the fifteen EU member states will abandon their individual currencies in favor of a single multinational currency call the "euro". The monetary policy of the euro will be managed by the European Central Bank, headquartered in Frankfurt, at the head of the European System of Central Banks, which is composed of the national central banks of the participating member states. On the changeover date, all outstanding sovereign debt will be redenominated in euros, all wholesale banking will be conducted in euros, and all new issues of securities will be in euros.

This monumental changeover will have deeply significant effects on all European markets, factor and product, goods and services. A detailed examination of these changes is beyond the scope of this report, but a brief summary of a few of the changes likely to occur in EU financial markets cannot be avoided.

First, the euro will eliminate the foreign exchange risk in long-term contracts between entities in EMU countries, and the relative importance of other types of risk will increase. Credit risk is likely to become the most important determinant of securities prices, but other factors (liquidity, settlement, legal and event risks) will also influence pricing. This will create an incentive for member states to improve their financial infrastructure.

Second, the elimination of multiple currencies will reduce the cost of cross-border spot transactions, reducing but not eliminating barriers to intra-EU financial transactions.

Third, some intra-EMU foreign exchange and investment restrictions that now apply to pools of capital such as pension funds will become irrelevant. The size and diversification of portfolios managed by EU institutional investors could increase rapidly as a result.

Fourth, as credit risk gets more attention, cross-border competition is likely to increase between financial intermediaries in bringing new issues to market, rating new credit, and allocating investment funds across national markets. There is also likely to be increased "policy competition" among sovereign borrowers who will be less able to rely on their "home-currency" market for captive investors.

U. S. PRESENCE IN THE MARKET

There exists no authoritative source for data on the presence of U.S. securities firms in the EU. Information from European regulators, the National Association of Securities Dealers, The EU Committee of the American Chamber of Commerce in Belgium, and an informal survey by the Treasury Financial Attache to the EU supports the following conclusions.

There are at least 50 U.S. firms involved in some aspect of the securities business in the EU, operating upwards of 100 separate branches, including multiple branches of a single firm in some countries. More than half of the branches were in the United Kingdom, with Germany, France and Italy following behind. These numbers are lower than the comparable figures in the last National Treatment Study, reflecting primarily consolidation in the industry.

Many U.S. securities firms are planning or are already involved in significant expansions in the EU, in preparation for EMU. One large firm that already has 7,700 employees in 11 countries has put more than 100 full-time employees, in 56 working groups, into its effort to prepare for EMU. Many U.S. firms are expecting EU securities business to grow very rapidly, both due to EMU (see above) and to other market trends including the growing need for securitization of pension fund assets. U.S. asset management firms are also engaged in mutual fund business in the EU, including Fidelity (with 1996 European assets of US$11.0 billion), Mercury (US$4.9 billion), and Citicorp (US$2.4 billion).

TREATMENT OF U. S. FINANCIAL INSTITUTIONS

In the context of the WTO multilateral financial services negotiations, the EU committed to provide access to its financial services market on an MFN basis, including the freedom to establish branches. The reciprocity provisions in the various EU financial services directives (banking, investment services, and insurance) are automatically superseded by the GATS commitments because of specific clauses in the EU directives. For example, the reciprocity article of the Second Banking Directive provides that "Measures taken pursuant to this Article shall comply with the Community's obligations under any international agreements, bilateral or multilateral, governing the taking-up and pursuit of the business of credit institutions."

As a result of these GATS commitments, there are very few strictly "national treatment" issues for U.S. financial services firms operating in the EU. To the extent that U.S. financial service companies have concerns in the EU market, they are usually concerns that are shared by all institutions in the market, both foreign and domestic.

For example, the issue of cross-border provision of services in the EU is increasingly sensitive for U.S. institutions, as they move to centralize their global activities. Several large U.S. institutions, for instance, are moving toward a system in which foreign exchange transactions – whether they are initiated in Paris, Rome or Athens – will be executed from a single location. If this business practice is restricted or hindered by member state application of "general good" provisions, these U.S. institutions will be commercially disadvantaged. But, this disadvantage is most strictly related to the choice to centralize, and not to the non-EU nature of the institution. An EU firm pursuing the same strategy might be equally disadvantaged.

HONG KONG

BANKING

SUMMARY

Since the 1994 National Treatment Study, Hong Kong has reverted from United Kingdom to Chinese sovereignty. Under guarantees provided by the Basic Law, promulgated by China in 1990, and the 1984 Sino-British Joint Declaration, Hong Kong's monetary and financial regulatory structure has remained autonomous following Hong Kong's reversion to Chinese sovereignty on July 1, 1997, after which it became a Special Administrative Region of China.

Until recently, sustained regional prosperity, the attendant accumulation of wealth, and China's rapidly expanding need for capital to finance its fast-growing economy contributed to the robust development of Hong Kong's financial sector during the 1990s. Hong Kong serves as a gateway to China and as a regional center for foreign financial institutions. As of January 1998, 55 percent of the assets and liabilities in the banking sector were derived from external sources.

Although the territory has no central bank, the Hong Kong Monetary Authority (HKMA) assumes many of the normal central banking functions. It is responsible for maintaining stability of the financial system and managing the Exchange Fund backing Hong Kong's currency, as well as ensuring the safety and soundness of the financial banking system, including regulating banks.

Hong Kong has a three-tier system of deposit-taking institutions, collectively known as authorized institutions. These include (full) licensed banks, restricted license banks, and deposit-taking companies. Only licensed banks can offer current (checking) or savings accounts. Restricted license banks are not permitted to conduct retail operations, and engage primarily in merchant banking and capital market activities. Deposit taking companies are restricted to taking large deposits with an original maturity of at least three months. Along with banks, they are increasingly diversifying into other financial services, including securities, fund management and providing investment advice. The Hongkong and Shanghai Banking Corporation (HSBC) is the territory's largest banking group. It is estimated that the group, with its majority-owned subsidiary Hang Seng Bank and 365 branches, controls more than 40 percent of Hong Kong dollar deposits.

At year-end 1997, there were 361 authorized institutions (32 U.S.) and 159 local representative offices (11 U.S.) in Hong Kong. The U.S. authorized institutions included 14 of 180 licensed banks, 13 of 66 restricted license banks, and 5 of 115 deposit-taking companies. U.S. authorized institutions held 6.2 percent of total assets of US$1,077 billion, 4.8 percent of total loans of US$528 billion, and 5.8 percent of total deposits of US$342 billion. Foreign banks granted banking licenses in Hong Kong after 1978 may maintain offices in only one building. In September 1994, this limitation was modified to permit foreign banks to set up a regional office and back office operation at buildings separate from the branch office. Automated teller machines for banks granted licenses after 1978 also are subject to the regulation. In addition, foreign banks that want to establish a fully licensed bank are subject to a requirement that the banking group must have US$16 billion in assets. Full licensed banks can establish only in branch form. They cannot establish as wholly owned bank subsidiaries due to the licensing criteria that the applicant should be closely associated and identified with Hong Kong. They can, however, establish bank subsidiaries as restricted license banks or deposit-taking subsidiaries. Foreign banks may acquire a controlling interest in a local bank which has unlimited branching rights. U.S. banks indicate they generally view Hong Kong as one of the most open, transparent, and fair markets in which to do business in Asia, and have not identified any national treatment concerns beyond the inconvenience posed by the bank branch limitation.

DESCRIPTION OF THE MARKET

Hong Kong is the world's ninth largest merchandise exporter and the principal conduit for trade and capital flows to and from China. As of 1996, services account for 84 percent of GDP. Laissez-faire economic policies, complete freedom of capital movement, low taxes, modern infrastructure, and a well-understood regulatory and legal environment have propelled Hong Kong's entrepot economy. Eighty-two of the world's top 100 banks operate in the territory. There were also 159 local representative offices of overseas banks at year-end 1997. Foreign exchange turnover was the fifth largest in the world, with daily turnover exceeding US$90 billion.

Hong Kong is a primary gateway to China. Geographic proximity, plus cultural and linguistic ties, particularly with neighboring Guangdong Province, have a synergistic effect on the development of the two economies. Hong Kong is China's "front-office" service center, supplying PRC enterprises with financial resources and expertise, shipping services and marketing. The territory is the most important source of external direct investment in China, accounting for an estimated 56 percent of the total. According to Chinese sources, Hong Kong-based businesspeople invested US$97 billion in China during 1979-96. Hong Kong manufacturers have taken full advantage of China's lower cost of land and labor resources in shifting their manufacturing operations to China.

The Hong Kong Stock Exchange's role in raising equity capital for China's enterprises has attracted a large foreign investment banking presence, and the territory has become an important center for loan syndications and international fund management. Over the 14-year period from 1982 to 1995, the gross output and value added of the financial sector at current prices grew from US$2.4 billion and US$1.7 billion, respectively, to US$17.3 billion and US$12.2 billion in 1995. More recent figures are not available.

Since 1983, the Hong Kong dollar has been linked to the U.S. dollar at a rate of HK$7.8 = US$1. Bank notes are issued by the HSBC, Standard Chartered Bank and, beginning May 1, 1994, the Bank of China. Note-issuing banks are required to deposit U.S. dollars at the fixed exchange rate in an amount equivalent to the value of Hong Kong currency notes issued, receiving non-interest-bearing certificates of indebtedness from the Exchange Fund in return.

China's Basic Law on Hong Kong guarantees continuation of the rights and freedoms that Hong Kong long enjoyed, including the continuation of the rule of law and the maintenance of Hong Kong's capitalist system for 50 years. Defense and foreign affairs are now under the direct control of Beijing, but the free flow of capital is retained. Hong Kong continues to formulate its own monetary and financial policies, and has independent finances using revenues exclusively for its own purposes. The Hong Kong dollar continues to circulate as the legal tender of the region and remains freely convertible. Markets for foreign exchange, gold, securities, futures, and the like continue to operate, along with related regulatory and supervisory structures.

Structure of the Market

Hong Kong maintains a three-tier system of deposit-taking institutions, collectively known as authorized institutions. These include licensed banks, restricted licensed banks, and deposit taking companies. Total deposit liabilities of all authorized institutions at the end of 1997 were HK$2,666 billion (US$342 billion), total assets were HK$8,401 billion (US$1,077 billion), and total loans for use in Hong Kong were HK$1,743 billion (US$224 billion). All banks are required to become members of the Hong Kong Association of Banks and observe rules made by the association.

According to Hong Kong's Banking Ordinance, licensed banks can perform all banking services, and have the exclusive right to offer current (checking) accounts and savings accounts. At the end of 1997, Hong Kong had 180 licensed banks (including banks incorporated both in Hong Kong and overseas) operating 1,511 branches, for a total of 1,691 offices. Thirty-one were locally incorporated, operating roughly two-thirds of the total branches. Deposit liabilities of licensed banks to customers at year-end 1997 totaled HK$2,599 billion (US$333 million).

Restricted license banks engage primarily in merchant banking and capital market activities. They are not permitted to conduct retail operations. Restricted license banks may use the word "bank" to describe their business, but this must be qualified by adjectives such as "restricted license," "merchant," or "investment." The minimum paid-up capital requirement is HK$100 million (US$12.8 million). These institutions also must meet criteria regarding ownership, general standing, and quality of management. They can accept deposits of any maturity of sums not less than HK$500,000 (US$64,100). At the end of 1997, there were 66 restricted license banks with total deposit liabilities to customers of HK$52 billion (US$6.7 billion).

Deposit taking companies have a minimum capital requirement of HK$25 million (US$3.2 million). They are restricted to taking deposits of HK$100,000 (US$12,800) or more with an original maturity of at least three months. At the end of 1997, there were 115 deposit taking corporations with total liabilities to customers of HK$15 billion (US$1.9 billion). Along with banks, they are increasingly diversifying into other financial services, including securities, fund management and providing investment advice.

The Hongkong and Shanghai Banking Corporation (HSBC), including its 62 percent-owned subsidiary Hang Seng Bank, remains the largest bank group in Hong Kong, with a combined network or 365 branches. It controls an approximately 40 percent of Hong Kong dollar deposits. The Bank of China Group is the second-largest bank group. At the end of 1997, the group's 13 member banks had a network of 386 branches in Hong Kong and controlled an estimated 23 percent of Hong Kong dollar deposits. Standard Chartered Bank is also active in Hong Kong's retail market, with 84 branches at year-end 1997. The Bank of Communications separated from the Bank of China Group on April 14, 1998. The Bank is now operating on its own as an independent bank under the direction of its Head Office in Shanghai.

Bank loans for use in Hong Kong have been expanding at an average rate of 17.5 percent per year over the past five years from 1993-97. Offshore lending to customers represented 45 percent of loans to customers and totaled HK$1,843 billion (US$236 billion) in 1997. Foreign currency lending totaled US$305 billion or 58 percent of total loans to all customers. The share of HK$ deposits in total deposits increased from 52.2 percent in 1994 to 57.7 percent in 1997. Industry analysts indicate that during this period, good opportunities for investment gains resulting from strong growth in the local economy encouraged the holding of liquidity in HK dollar deposits for investments in HK dollar-based assets, in particular, investments in the stock and property markets. In 1997, foreign currency interbank borrowing accounted for 72 percent of total foreign currency liabilities of HK$5,476 billion (US$702 billion). Interbank borrowing, including both foreign currency and Hong Kong dollars, represented 57 percent of total liabilities of the banking system of HK$8,401 billion (US$1,077 billion).

Regulatory Structure

Hong Kong has made steady progress in strengthening its banking regulatory framework. After a series of bank failures in the early 1980s, the Hong Kong government enacted the Banking Ordinance of 1986. It updated the previous bank legislation and gave the then-Commissioner of Banking enhanced regulatory powers, set minimum capital standards, and placed limitations on loans to individual customers, directors, and employees. Since year-end 1989, Hong Kong's banking sector has been required to conform to Basle Committee standards on capital adequacy.

At year-end 1997, the consolidated capital adequacy for all locally incorporated institutions remained stable at 17.5 percent, compared to 17.8 percent in 1996. Supervisory responsibility for branches of foreign banks is shared with overseas banking supervisory authorities in accordance with guidelines of the Basle Committee on Banking Supervision.

Although the territory has no central bank, the HKMA has statutory responsibility for the stability and integrity of Hong Kong's financial system and for management of reserves backing Hong Kong's currency, which has been linked since 1983 to the U.S. dollar at HK$7.8 = US$1. The HKMA also insures the safety and soundness of the financial system, including exercising prudential supervision and regulation of the banking system. The HKMA was formed in April 1993 by merging the Office of the Exchange Fund and the Commissioner of Banking. The *de facto* management board of the HKMA is the Exchange Fund Advisory Committee. Members of this committee are appointed in their personal capacity. One of its members is the Chief Executive of the Hong Kong branch of the Chase Manhattan Bank.

The Banking Advisory Committee (BAC) advises the Chief Executive of the Hong Kong Special Administrative region on matters relating to the Banking Ordinance and banking business generally. The Financial Secretary chairs the Advisory Committee; its members appointed by the Chief Executive. The Chief Executive of the Hong Kong Branch of Bank of America NT & SA is a member of the committee. The Bank of China, HSBC, and Standard Chartered are members of the Banking Advisory Committee and officials from all three institutions are on the Exchange Fund Advisory Committee.

Hong Kong does not have deposit insurance, though financial turmoil in late 1997 and early 1998 has increased discussion of this issue. A scheme giving priority to claims of small depositors was enacted under the Hong Kong Companies Ordinance, effective in August 1995. It was modeled on a scheme of arrangement approved by creditors in the Bank of Credit and Commerce (BCCHK, which is related to BCCI) liquidation. In 1996, an amendment of the Hong Kong Companies Ordinance gave priority to small depositors up to HK$100,000 each in the event of a bank liquidation. Specifically, the scheme provides that in the event of bank liquidation eligible depositors (i.e., all depositors except persons connected with the bank being liquidated, the HKMA, and other authorized institutions) will receive payment in priority over other unsecured debts except employees' compensation for the first HK$100,000 of their deposits. The scheme applies to all licensed banks, including branches of foreign banks.

Prior to 1994, banks in Kong Hong disclosed very little financial information. Since 1994, with the establishment of a working party on financial disclosure by the HKMA, the amount of financial information disclosed by banks in Hong Kong has steadily increased. Banks now disclose their full profit and loss accounts and detailed analysis of all on and off-balance sheet items in their annual financial statements. Locally incorporated Hong Kong banks are required to publish information relating to loan quality, level of bad debt provisions, the amount of nonperforming loans, and inner reserves. The previous practice of maintaining undisclosed "inner reserves" has been abolished. Inner reserves provide a pool of funds that a bank can draw from in order to smooth out performance.

Each year, the HKMA reviews and recommends additional requirements to ensure that the level of financial disclosure is maintained at a high standard which they believe is comparable with major international financial centers. Financial disclosure standards of banks in Hong Kong are now among the best in Asia. For 1998, the HKMA is considering proposals to standardize banks' policy on interest recognition, increase the amount of disclosure made on non-performing loans, require foreign banks to make disclosure on their activities in Hong Kong, and require listed authorized institutions to disclose more information in their interim reports.

All licensed banks are required to be members of the Hong Kong Association of Banks (HKAB). Two U.S. banks (Morgan Guaranty Trust and Chase Manhattan) sit on the Association's main committee and, in turn, represent constituent North American banks. HSBC alternates the chair of the HKAB with Standard Chartered Bank, and the Bank of China Group (since 1995). The Association can discipline members to the point of expulsion for breaching its rules. The Association suggests the maximum rates of interest payable on deposits or the minimum deposit charge that must be levied by its members on Hong Kong dollar deposits. Until 1995, this "interest rate agreement" covered deposits of up to HK$500,000 with maturities of less than 15 months, though the government has since relaxed this rule to cover deposits of seven days or less. The remaining interest rate rules continue to govern interest rates offered by licensed banks on deposits less than HK$500,000 with maturities of less than seven days, including 24-hour deposits, savings and current/or checking accounts. Since 1995, over 99 percent of the previously regulated deposits had become unregulated in terms of interest rates. As of June 30, 1998, the amount of HK$ deposits still governed by the interest rate rules totaled HK$1,041 million.

In December 1996, Hong Kong's interbank payment system moved to Real Time Gross Settlement under which settlement risks in the banking system have been considerably reduced. The Hong Kong Interbank Clearing Limited, jointly and equally owned by the HKMA and the Hong Kong Association of Banks (HKAB), was set up in May 1995 to take over in phases the Hong Kong dollar clearing facilities from HSBC as management bank of the HKAB Clearing House.

U.S. PRESENCE IN THE MARKET

Foreign banks, including U.S. banks, may establish a banking presence in Hong Kong as a "licensed bank," "restricted licensed bank," or a "deposit-taking company." A foreign applicant seeking a full banking license can establish only in branch form. A restricted licensed bank can be in the form if either a branch or bank subsidiary. Since 1977, the practice is not to grant a "deposit taking" license in branch form to a locally incorporated or foreign bank. U.S. banks that have established branches since 1978 have tended to concentrate in wholesale banking, money market operations, trade finance, and the securities business.

As of the end of 1997, U.S. financial institutions operated a total of 32 authorized institutions, i.e., licensed banks, restricted license banks, or deposit-taking companies - and eleven local representative offices. There were 14 full licensed banks, 13 restricted license banks, and 5 deposit taking companies. Restricted license banks engage mainly in merchant banking and trade finance. Activities of five U.S. deposit-taking companies, span deposit-taking, vehicle finance, trade finance, and securities and brokerage operations. Eight U.S. banks maintained 11 representative offices.

U.S. authorized institutions accounted for 6.2 percent of total assets, 4.8 percent of total loans, and 5.8 percent of total deposits in the Hong Kong Banking sector at year-end 1997. The market share of U.S. authorized institutions total assets, loans, and deposits remained stable since 1994. In contrast, Japanese institutions, while accounting for only 3.1 percent of HK$ deposits in 1997, held 39 percent of total assets, down from 53 percent in 1994. Although Japanese institutions were the largest players in offshore lending, their market share of loans for use in Hong Kong declined 14 percent in 1997 from 21 percent in 1994. Chinese institutions accounted for 28 percent of Hong Kong dollar deposits, 11 percent of total assets, and 18 percent of loans for use in Hong Kong in 1997. European institutions accounted for 12 percent of Hong Kong dollar deposits, 17 percent of total assets, and 18 percent of loans for use in Hong Kong.

According to Hong Kong government records, three U.S. banks held stakes in excess of 10 percent in two local banks. Bank of New York International Financing Corporation, a subsidiary of the Bank of New York Company, Inc., held a 25 percent stake in Wing Hang Bank. Wells Fargo Bank, N.A., held a 20 percent stake in Shanghai Commercial Bank Ltd. Bank of America's stake in Bank of America Asia Limited (formerly the Bank of Canton) effectively approaches 100 percent.

Market Share of U.S. Authorized Institutions as of December 31, 1997
(HK$ billions)

	Total Assets	Total Loans	Loans in HK$	Total Deposits	Deposits in HK$ (a)
All	8401	4122	1743	2666	1495
U.S.	524	197	123	154	38
Percent of Total	6.2	4.8	7.1	5.8	2.5
U.S. Banks	444	160	89	146	37
Percent of Total	5.3	3.9	5.1	5.5	2.5

HK$7.8 = US$1
(a) Excludes swap deposits

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Banks incorporated outside Hong Kong that wish to establish a licensed bank branch in Hong Kong generally must satisfy the following major criteria: (1) have assets of US$16 billion (net of contra items); (2) be incorporated in countries in which the home supervisor can meet the minimum standards of supervision of international banks recommended by the Basle Committee on Banking Supervision, and the home supervisor has given its consent for the establishment of a branch in Hong Kong; (3) the bank's country of incorporation must provide an acceptable form of reciprocity to Hong Kong banks (this requirement does not apply to banking applications from companies incorporated in a place which is, or is part of the territory of, a member of the WTO); (4) senior management of the branch is fit and proper; and (5) the branch has adequate financial resources to support its business, adequate accounting systems, and adequate systems of internal control. Foreign banks are expected to first establish a representative office prior to upgrading to a licensed branch. Foreign branches are also subject to a one-building condition. Foreign banks that want to establish a "restricted license" branch are not subject to the requirement that the banking group must have US$16 billion in assets.

A foreign bank applying for a full banking license cannot, in practice, establish in bank subsidiary form, due to the licensing criterion that the applicant should be closely associated and identified with Hong Kong. This criterion takes into account such factors as the historical association of the institution with Hong Kong, and the extent to which its shares are locally held. Additionally, there is a licensing requirement that the subsidiary bank must have been authorized as a restricted licensed bank or deposit taking company for not less than 10 years in order to obtain a full banking license.

Foreign banks may acquire an interest, including a controlling interest (more than 50 percent of the voting shares) in a locally-incorporated bank, which has unlimited branching rights. Both foreign and locally-incorporated banks must obtain central bank approval to acquire a 10 percent or greater interest in the voting share capital of a locally-incorporated bank.

Foreign banks granted licenses after 1978 may maintain offices that conduct banking business in only one building. The word "office" includes any automated teller machine or similar terminal device that provides facilities to the customers of the bank. This restriction took effect when the Hong Kong government lifted a moratorium on new banking licenses that had been in place since 1965. The government argued that it was concerned about overcrowding in the retail banking market and that unrestrained entry might undermine the stability of the banking system. On September 30, 1994, this rule was modified to permit foreign banks to establish a regional office and one back office in a building or buildings separate from its branch office in Hong Kong.

U.S. financial institutions generally give authorities high marks for fairness and transparency, and generally express the view that Hong Kong does not discriminate in terms of competitive opportunities. They have a voice in the policies that affect their industry, though some U.S. banks have called for consideration of rotating the chair of the Hong Kong Banking Association among a wider group of banks.

In the financial services sector, in general, Hong Kong has relatively few limitations on market access or on national treatment, but Hong Kong's existing regime is more liberal than its binding GATS commitments. However, Hong Kong's revised offer on financial services in December 1997 did include additional commitments in financial leasing, guarantees and commitments, and cross border supply of advisory and auxiliary financial services. An informal survey of U.S. financial firms already in the market and a handful of firms "passing through or visiting" Hong Kong suggests minor irritants remain, such as the branch limitation, as opposed to major barriers.

Exhibit 1 - 1997 Balance Sheet of All Authorized Institutions
Assets
(HK$ billions)

	HK$	Foreign Currency	Total
Loans to Customers	1,743	2,379	4,122
Inside HK	1,702	508	2,210
Outside HK	30	1,813	1,843
Others	11	57	68
Interbank Lending	713	2,368	3,081
Inside HK	517	254	771
Outside HK	196	2,114	2,310
Negotiable CDS	122	50	172
Bank Acceptances and Bills of Exchange	4	98	102
FRN and Commercial Paper	26	167	193
Securities and Investments	236	187	423
Other Assets	96	213	309
TOTAL ASSETS	2,939	5,462	8,401

Liabilities

	HK$	Foreign Currency	Total
Deposits from Customers	1,538	1,128	2,666
Interbank Borrowing	881	3,942	4,753
Inside HK	521	251	772
Outside HK	290	3,691	3,981
Negotiable CDS	172	48	220
Other Liabilities	404	358	762
TOTAL LIABILITIES	2,925	5,476	8,401

Source: HKMA Annual Report 1997

Exhibit 2 - Loans and Deposits in 1997 by Category of Authorized Institution
Loans and Advance
(HK$ billions)

	HK$	Foreign Currency	Total
Licensed Banks	1,557	2,319	3,876
Restricted License Banks	127	36	163
Deposit-Taking Companies	59	24	83
TOTAL	1,743	2,379	4,122

Deposits from Customers

	HK$	Foreign Currency	Total
Licensed Banks	1,522	1,077	2,599
Restricted License Banks	9	43	52
Deposit Taking Companies	7	8	15
TOTAL	1,538	1,128	2,666

Source: HKMA Annual Report 1997

Exhibit 3 - U.S. Authorized Institutions and Local Representative Offices in Hong Kong
Licensed Banks

Name/Year Licensed	Offices	Major Activities
Citibank, N.A. (1965)	18	Wholesale/Retail/Private Banking, Money Market Operations
Chase Manhattan Bank (1965)	7	Consumer Banking/Mortgage, Corporate Finance/Private Banking
Bank of America NT & SA (1965)	1	Wholesale/Retail Bank, Commercial Loan Syndication
Bank of America (Asia) Ltd. (1965)	17	Retail Banking, Property & Consumer Lending, Trade Finance
American Express Bank Ltd. (1965)	3	Private Banking, Corporate Finance
Morgan Guaranty Trust Co. of NY (1978)	1	Corporate Finance, Capital Markets, Debt/Equity Finance, Direct Investment, Project Finance, Underwriting, Private Banking
First National Bank of Chicago (1979)	1	Treasury Operations, Capital Markets and Derivatives
Bankers Trust Co. (1981)	1	Corporate Finance, Capital Markets
Republic National Bank of NY (1979)	1	Banknotes Trading, Treasury Operations, and Private Banking
State Street Bank and Trust Co. (1994)	1	Trade Finance and Custodian Services
The Bank of NY (1983)	1	Trade Finance
Bank of Boston, N.A. (1978)	1	Trade Finance
Norwest Bank Minnesota (1989)	1	Trade Finance
NationsBank, N.A. (1995)	1	Trade Finance

Restricted License Banks

Name/Year Licensed	Offices	Major Activities
Citicorp Commercial Finance (HK) Ltd. (1994)	1	Vehicle Finance, Leasing, and Machinery Finance
Chase Manhattan Asia Ltd. (1984)	1	Merchant Banking
Manhattan Card Co. Ltd. (1993)	1	Credit Card Business
BA Asia Ltd. (1982)	1	Merchant Banking and Underwriting of Capital Market Instruments
Lehman Brothers Finance Ltd. (1983)	1	Share Margin Financing
Corestates Bank, N.A. (1990)	1	Trade Finance
Pacific Bank, N.A. (1990)	1	Trade Finance
Citibank International (1997)	1	Credit Card Business
Bank of Hawaii (1994)	1	Trade Finance
SPC Credit Ltd. (1997)	12	Personal Loans, Auto Finance, Mortgage
Bankers Trust Australia Ltd. (1994)	1	Treasury, Capital Markets
GE Capital Finance Ltd. (1982)	16	Personal Lending, Auto/Equipment Loans, Mortgages
Citicorp International Ltd. (1978)	1	Merchant Banking

Deposit Taking Companies

Name/Year Licensed	Offices	Major Activities
BA Finance (HK) Ltd. (1976)	1	Deposit Taking
Inchroy Credit Corporation Ltd. (1976)	4	Auto Financing, Leasing
BT Asia Ltd. (1987)	1	Securities Trading and Financial Advisory Services
Avco Financial Services (Asia) Ltd. (1994)	7	Auto Finance
Orient First Capital Ltd. (1981)	1	Personal Loan, Trade Finance

Local Representative Offices		
Name/Year Licensed	Offices	Major Activities
Cathay Bank (1984)	1	Research and Liaison
Republic National Bank of NY (Suisse) S.A. (1992)	1	Research and Liaison
Republic National Bank of NY (Luxembourg) (1992)	1	Research and Liaison
Wells Fargo Bank N.A.	1	Research and Liaison
Offitbank (1994)	1	Research and Liaison
Fiduciary Trust Co. International (1989)	1	Research and Liaison
Merrill Lynch Bank (Suisse) S.A. (1990)	1	Research and Liaison
Merrill Lynch International Bank Ltd. (1989)	1	Research and Liaison
Morgan Stanley Trust Company (1995)	1	Research and Liaison
First Union National Bank (1996)	1	Research and Liaison
Comercia Bank (1997)	1	Research and Liaison

Source: Hong Kong Government Financial Services Branch, Authorized Institutions.

Note: Business activities of several listed U.S. institutions pre-date granting of license. e.g., Citibank established in Hong Kong in 1902, Chase Manhattan in 1930.

Exhibit 4 - Market Share of Total Assets for Institutions by Origin of Ownership (percent)

Region	1994	1995	1996	1997
China	10	10	11	11
Europe	13	13	15	17
Japan	53	51	44	39
USA	5	5	5	6
Other	19	21	25	27
TOTAL	100	100	100	100

Source: Hong Kong Monetary Authority Annual Report 1997

Exhibit 5 - Market Share of Loans for Use in Hong Kong by Origin of Ownership (percent)

Region	1994	1995	1996	1997
China	16	17	17	18
Europe	16	17	17	18
Japan	21	19	17	14
USA	8	8	8	8
Other (1)	39	39	41	42
TOTAL	100	100	100	100

(1) Includes trade finance loans but excludes loans to finance trade not touching Hong Kong.
Source: Hong Kong Monetary Authority Annual Report 1997

Exhibit 6 - Market Share of HK Dollar Deposits by Origin of Ownership (percent)

Region	1994	1995	1996	1997
China	28	28	28	28
Europe	10	11	11	12
Japan	4	4	3	3
USA	4	4	4	4
Other (1)	53	53	54	54
Total	100	100	100	100

(1) Adjusted to include swap deposits.
Source: Hong Kong Monetary Authority Annual Report 1997

HONG KONG

SECURITIES

SUMMARY

The Stock Exchange of Hong Kong (SEHK) ranked ninth largest in the world in market capitalization in 1997, down from sixth largest in 1993, largely due to regional financial turmoil in late 1997. The exchange is playing a significant and growing role in raising equity capital for China's state-owned enterprises. From 1994 through 1997, market capitalization increased 54 percent, while the number of listed firms grew from 529 to 658. U.S. firms hold 13 of the 102 foreign corporate memberships of the SEHK, out of a total exchange membership of 555 (382 corporate, 173 individual).

The Hong Kong Futures Exchange (HKFE) offers stock index and sub-index futures, stock index options, stock futures, foreign exchange ("Rolling Forex") derivatives, and one- and three-month Hong Kong Interbank Offered Rate (HIBOR) futures. As of March 31, 1998, 36 percent of HKFE members were foreign companies, of which 19 were controlled by U.S. companies. Although fiscal surpluses have obviated the need to borrow to finance government expenditures, the Hong Kong government has taken a number of steps to develop a debt market. These include a bills and notes program with maturities currently out to ten years, tax exempt status for multilateral debt issues, and the establishment of a Central Money-markets Unit as a central depository for debt instruments.

Operation and regulation of Hong Kong's stock and futures markets have strengthened considerably in line with wide-ranging recommendations made by a Securities Review Committee appointed in the wake of the 1987 market crash. The Securities and Futures Commission (SFC) has supervisory powers to ensure the integrity of markets and protection of investors. Securities and futures intermediaries must be registered with the SFC. Besides capital and liquidity requirements, intermediaries must satisfy nondiscriminatory "fit and proper person" criteria before they can conduct business. They may be established as either branches or as subsidiaries, although in practice most firms form subsidiaries. The rules are the same irrespective of ownership – foreign or domestic. Subject to licensing and registration requirements, foreign and local institutions can engage in a full range of investment banking and brokerage activities.

U.S. financial institutions have a substantial and rapidly expanding presence in Hong Kong. As of the end of 1997, there were 35 U.S.-controlled securities dealers out of 243 foreign securities dealers. There were 19 commodities dealers (who may offer futures contracts) controlled by U.S. companies out of a total of 78 foreign-owned commodities dealers. A survey of major U.S. bank and nonbank financial institutions regarding their Hong Kong operations revealed that none observed any substantive concerns about national treatment, though a few firms sense a more restrictive immigration policy may constrain workforce choices. Respondents generally viewed Hong Kong as the most open environment in Asia within which to do business. The regulatory environment was generally viewed as fair, supportive, flexible, and transparent.

DESCRIPTION OF THE MARKET

Hong Kong became a Special Administrative Region of China (HKSAR) as of July 1, 1997. The Basic Law guarantees for 50 years the rights and freedoms Hong Kong residents now enjoy, the continued rule of law, and the maintenance of Hong Kong's capitalist system. Defense and foreign affairs of the HKSAR are now under the direct control of Beijing, but in all other areas Hong Kong is guaranteed a "high degree of autonomy." The HKSAR has retained the status of an international financial center and safeguards the free flow of capital. It has continued to formulate its own monetary and financial policies, and safeguard the free operation of business and financial markets. The HKSAR has independent finances, using revenues exclusively for its own purposes. The Hong Kong dollar continues to be freely convertible, circulating as the legal tender of the HKSAR. Markets for foreign exchange, gold, securities, and futures continue to operate, together with relevant regulatory and supervisory frameworks.

The Stock Exchange of Hong Kong

The first formal stock market in 1891 evolved into four markets, which were subsequently unified in 1986 to create the SEHK. The SEHK was ranked ninth largest in the world in terms of market capitalization at the end of 1997, down from sixth largest in 1993, due to regional financial turmoil in late 1997. In addition to ordinary and preference shares, the SEHK also lists warrants, unit trusts, and debt securities. In 1997, 82 new listings raised US$10.5 billion, up from 53 new listings that raised US$2.2 billion in 1994. The number of listed companies increased from 529 in 1994 to 658 in 1997. Market capitalization grew from US$267 billion to US$411 billion during the same period, while average daily turnover increased from US$588 million to US$1,983 million. (Tables 1, 2, and 3 at the end of this chapter contain four-year data on new listings, selected performance data, and a breakdown of market capitalization by sector.) As of April 30, 1998, 12 companies listed in Hong Kong had listing status in the United States through American Depositary Receipts (ADRs).

At the year end of 1997, the Hang Seng Index of blue chip stocks, which consists of 33 of Hong Kong's largest, most liquid equities, closed at 31 percent higher than year-end 1994. Market conditions were extremely bullish in the first three quarters of the year, with a correction in the fourth quarter because of the Asian financial crisis. The Hang Seng Index reached a new historical high of 16,673 in August 1997. Turnover also expanded dramatically before the market downturn, with a new daily turnover record of HK$46 billion (US$5.9 billion) on August 29. The October market correction reduced the market capitalization to HK$3,202 billion (US$410.5 billion) at the end of 1997. The ranking of Hong Kong as a global territorial stock market dropped to ninth but still remained the second in Asia.

The SEHK plays an increasingly important role in raising equity capital for PRC state enterprises. A memorandum of understanding (MOU) on regulatory cooperation between the PRC and Hong Kong stock market authorities signed in June 1993 provides a framework for Chinese state enterprises to raise equity in Hong Kong through the issuance of "H" Shares, provided they meet Hong Kong regulatory and accounting requirements. "H" shares are denominated in Chinese renminbi currency, but must be purchased in Hong Kong dollars. The MOU also provides for cooperation in enforcement of laws and regulations in the areas of market manipulation, insider dealing, and other fraudulent practices. At the end of April 1998, 41 H shares were listed in Hong Kong.

As of April 30, 1998, the market capitalization of the 41 listed "H" shares totaled about HK$52.3 billion (US$6.7 billion), representing 1.79 percent of the SEHK's total market capitalization of HK$2,925 billion (US$375 billion). Turnover of H shares accounted for 5 percent of the market total as of April 30, 1998.

"Red Chips," Hong Kong-registered companies in which Chinese corporations hold at least 30 percent interest were estimated to account for 5.7 percent of the SEHK's market capitalization. Turnover of red chips accounted for 12 percent of the market total as of April 30, 1998. At the end of 1997, the SEHK had 555 members, including 173 individual and 382 corporate members. Each member must hold at least one share in the SEHK, which entitles the holder to a seat on the exchange floor. There are no specific restrictions on expatriates becoming individual members. All applicants for membership are subject to uniform requirements including being of good character and having experience in dealing in securities and meeting capital adequacy requirements. An individual member is required to have been resident in Hong Kong for five out of seven years immediately preceding his/her application, though this provision has been loosely interpreted. A corporation must be incorporated in Hong Kong, be of good financial standing, and be registered by the SFC.

At the end of 1997, 101 corporate members, representing 18 percent of the SEHK's total membership, were controlled by foreign companies. Seventeen were controlled by U.S. companies. Out of 475 registered commodities dealers, 16 percent, or 78 dealers, were controlled by foreign entities, including 19 controlled by U.S. companies. Of 1,850 registered securities dealers as of March 31, 1997, 13 percent, or 243 dealers, were controlled by foreign entities, including 35 controlled by U.S. companies.

As of March 31, 1997, there were 1,579 registered businesses in Hong Kong involved in securities and commodities dealing and advising. 15,575 registered persons worked in those businesses. (Note that not all employees are required to register.) The number of securities firms from the People's Republic of China went from eight as of March 31, 1994, to 22 as of March 31, 1997. There were 37 from Japan, 16 from Singapore, 19 from Taiwan, three from Australia, six from Thailand, seven from Indonesia, 10 from Korea, and 13 from Malaysia.

Any firm in Hong Kong involved in dealing in securities, trading commodity futures contracts, or giving advice on investments in securities or commodity futures must be registered with the SFC. Among the laws with which they must comply are the Securities Ordinance, the Commodities Trading Ordinance, and the Securities and Futures Commission Ordinance. Besides net capital and liquidity margin requirements, the SFC requires that applicants satisfy "fit and proper person" criteria. These relate generally to ensuring that the applicant is fair, honest, and financially sound.

Authorized institutions, as defined under Hong Kong's Banking Ordinance, are increasingly diversifying away from deposit-taking activities into financial areas, including the securities business. Licensed banks, restricted license banks, and deposit taking companies accounted for almost 70 percent of the 225 "exempt" dealers and investment advisers registered in Hong Kong as of March 31, 1997. Generally, a firm can be declared an exempt dealer for the purpose of the Securities Ordinance if its main business is not in securities dealing, or if its main business is securities dealing only at the wholesale level, with any securities dealing at the retail level done through a registered member of the SEHK or through other authorized channels. Licensed banks and trustee companies may also be eligible for exempt dealer status even if they do not satisfy these criteria. A firm can be declared an exempt investment adviser if it gives investment advice only to people residing outside of Hong Kong.

Regulation and Oversight

A number of ordinances govern securities dealings in Hong Kong. The Securities Ordinance, the Stock Exchanges Unification Ordinance, and the Securities and Futures Commission Ordinance require registration of dealers, dealing partnerships, investment advisers, and other intermediaries. They provide for investigation of malpractice and a compensation fund for clients of defaulting brokers. Established in 1989, the SFC is an independent statutory body outside the civil service with licensing and supervisory powers to ensure the integrity of markets and protection of investors.

Among recent developments, the SFC has focused on improving minority shareholder protection and enhancing corporate governance. It is working to update and rationalize Hong Kong's securities and futures legislation. Codes of conduct for the SEHK and HKFE were finalized in 1993 and the SFC introduced a code of conduct applying to all other persons registered under the Securities Ordinance and Commodities Trading Ordinance in 1994. The SFC also has regulatory powers over certain aspects of the foreign exchange market under the Leveraged Foreign Exchange Trading Ordinance. The ordinance is designed to regulate so-called "fringe forex dealers" who are not currently regulated and who provide leveraged foreign exchange contracts to retail investors. Funding for SFC operations comes primarily from market transaction levies and SFC fees and charges. To ensure the international competitiveness of Hong Kong market, SFC completed during 1996-97 a review of the Leveraged Foreign Exchange Trading Regulatory System, Financial Rules and the Reporting System for OTC Derivatives Activities.

The SEHK introduced regulated short selling of 21 blue chip stocks in January 1994. The short selling activity was further liberalized during 1995-97. Since March 1997, member registration prior to commencing short selling activities was no longer required. By the end of 1997, the total number of stocks eligible for short selling increased to 241. Stock option trading was launched on September 8, 1995. The number of options classes increased from nine in 1995 to 15 in 1997. The total contract value grew from HK$1,941 million (US$248.7 million) in 1996 to HK$4,037 million (US$517.6 million) in 1997. Daily turnover averaged 6,730 contracts in 1997, compared with 5,100 in 1996.

The SEHK introduced a computerized Automatic Order Matching and Execution System (AMS) in late 1993. AMS provides real-time order entry and execution and near-instantaneous reporting of transactions. Traders input orders from their booths on the floor of the SEHK using computers. Exchange trading hours are from 10:00 p.m. to 12:30 p.m. and from 2:30 p.m. to 4:00 p.m., Monday through Friday.

On April 16, 1996, the SFC published a Consultation Paper on a Draft for a composite Securities and Futures Bill. The draft bill, when enacted, will repeal and replace eight of the ordinances currently administered by the SFC. It will enhance the investor protection functions of the SFC while promoting a fair, efficient, competitive, and informed market, standardize the licensing regime applicable to dealers and advisers in the securities and futures industry, and generally update and modernize Hong Kong's securities legislation. Currently, the SFC is studying proposed changes to U.S. and British legislation to see if they should be included in Hong Kong's Composite Securities and Futures bill. The SFC hopes to bring the legislation to fruition in 1999.

In 1997, the SFC reinforced its supervision of financial intermediaries through a series of special inspections of some 103 stockbrokers and their related 56 finance companies. These finance companies subsequently tightened credit. In January 1998, a joint task force (SFC, HKSE, and a consultancy) was formed to review and monitor the financial position of the finance companies, pending legislation clarifying supervisory responsibility.

Futures

The HKFE evolved from trading commodities to offering financial futures in 1986 centering on the Hang Seng Data Service's benchmark Hang Seng Index. Following the 1987 market crash, trading volumes did not significantly recover until 1993. (See table 4.) Futures based on the four Hang Seng subindices – finance, properties, utilities, and commerce and industry – were launched in 1991. As of April 30, 1998, products traded on the HKFE included eight main categories: Hang Seng Index futures, Hang Seng Index options, Hang Seng China-Affiliated Corporation Index futures (Red-Chip futures), Hang Seng China-Affiliated Corporation Index options (Red-Chip options), HKFE Taiwan Index futures, HKFE Taiwan Index options, one- and three-month HIBOR futures, and stock futures.

Trading on the HKFE is on an open outcry basis for Hang Seng Index futures and options, while all other contracts are traded on the HKFE's computerized Automated Trading System (ATS). The HKFE has announced that it will migrate all trading to the ATS by the end of 1999. A clearing system installed with assistance from the Options Clearing Corporation of Chicago provides state-of-the-art clearing and risk management capabilities. There were 136 members of the HKFE as of March 1998 and all were corporations. Forty-nine foreign companies, including 19 controlled by U.S. companies, accounted for 36 percent of HKFE members.

The Debt Market

While Hong Kong's local debt market is still small compared to the stock market, it has become a significant source of capital in recent years. Over the years, the Hong Kong government has made significant efforts to develop the market infrastructure in the local debt market, including the development of a benchmark yield curve, granting of tax-exempt status for multilateral issuers and concessionary tax schemes for eligible private sector debt issues, promotion of an efficient debt securities clearing and settlement system, and establishment of the Hong Kong Mortgage Corporation Limited (HKMC).

In March 1990, the Hong Kong Monetary Authority (HKMA) launched an Exchange Fund Bills Programme with the issuance of 91-day bills, a program which has expanded and lengthened Hong Kong's yield curve. At the end of 1995, seven-year notes were introduced and in October 1996, the first 10-year notes were issued, joining two, three, and five-year notes. In addition, four tap issues of 28-day Exchange Fund Bills were launched in 1996 to facilitate the liquidity management of banks under the Real Time Gross Settlement (RTGS) system. Some 33 recognized dealers are appointed as market makers that are obliged to quote two-way yields for Bills and Notes.

The following table gives an indication of the size of the government program:

Issues of Exchange Fund Bills, Government Bonds, and Exchange Fund Notes
(HK$ millions)

Year	New Issues	Amount Outstanding	Average Daily Turnover
1990	16,266	7,540	1,459
1991	30,700	14,640	4,963
1992	43,900	23,340	7,946
1993	67,000	31,660	15,276
1994	105,100	52,940	22,438

Year	New Issues	Amount Outstanding	Average Daily Turnover
1995	111,800	58,730	17,199
1996	142,000	91,850	16,320
1997	349,500	101,650	16,506

Source: Hong Kong Monetary Authority

Daily turnover of Exchange Fund Bills and Notes in the secondary market averaged HK$16.5 billion (US$2.1 billion), or 16 percent of the total amount of Bills and Notes outstanding at year-end 1997 of HK$101.7 billion (US$13.0 billion).

The following table provides an indication of the amount of Hong Kong dollar instruments outstanding:

Major Debt Instruments Outstanding
(HK$ millions)

Year	Exchange Fund Bills and Notes	Government Bonds	Multilaterals	Other Private Sector Debt
1989	0	0	500	358
1990	7,540	0	1,600	1,308
1991	14,040	600	2,400	4,719
1992	20,340	3,000	3,400	10,907
1993	28,060	3,600	7,650	27,714
1994	52,340	600	10,950	76,245
1995	58,730	0	13,550	124,776
1996	91,850	0	18,500	169,057
1997	101,650	0	25,950	217,908

Source: Hong Kong Monetary Authority

The World Bank was the first multilateral institution to launch a Hong Kong dollar-denominated bond issue in 1989. It is estimated that HK$26 billion (US$3.3 billion) in debt securities or 11 percent of the total Hong Kong dollar private debt outstanding at the end of 1997 was issued by multilateral agencies. A total of twelve issues involving HK$8.5 billion (US$1.1 billion) were launched by six multilateral agencies for the year 1997. The World Bank and the International Finance Corporation have tapped the Hong Kong dollar market for a total of six issues in 1997. The landmark transaction for early 1998 was the HK$3 billion (US$385 million) fixed-rate bond issued by the Asian Development Bank. To encourage supply of quality debt issues in Hong Kong, the government introduced tax exemption and concessionary schemes.

The Central Money-Markets Unit (CMU) service, originally run by the HKMA for the clearing and settlement of Exchange Bills and Notes, was extended to cover other Hong Kong dollar debt instruments in January 1994. The CMU service provides a central depository for CMU instruments and an electronic book-entry system, which eliminates the need for physical delivery of the instruments between CMU members. Since December 1995 the CMU has further enhanced its services by introducing end-of-day Delivery versus Payment (DvP) facility for CMU instruments. The HKMA together with the Hong Kong Association of Banks launched the RTGS system in December 1996 to enhance the robustness of the interbank payment system in Hong Kong. The CMU established a linkage with the central securities depositories in Australia in December 1997. The HKMA also set up a bilateral securities linkage on reciprocal basis with the central securities depository in New Zealand in April 1998. In December 1997, the CMU successfully launched a Securities Lending Programme for private sector debt securities so that long-term investors could lend securities to the more active market participants. This helps to increase liquidity in the secondary market for debt securities.

In March 1997, the HKMC was set up to promote the development of the secondary mortgage market in Hong Kong. The HKMC is 100 percent owned by the government through the Exchange Fund. The HKMC purchases residential mortgage loans for its retained portfolio then packages and resells them as mortgage-backed securities. By end of April 1998, the HKMC has issued HK$1 billion (US$128 million) worth of unsecured debt securities in the local market.

Fund Management

Securities firms, provided they obtain an investment adviser license, and foreign banks are allowed to engage in fund management activities and can manage local pension fund monies or other institutional monies. Under the Securities Ordinance, authorized institutions under the Banking Ordinance are excluded from the scope of investment adviser regulations. According to the Financial Services Branch of the Hong Kong government, authorized institutions in Hong Kong can engage in portfolio management without the need to obtain an investment adviser license. Foreign securities firms and banks can sell foreign mutual funds to local investors provided they obtain a dealer license (or obtain exempt dealer status) under the Securities Ordinance, and meet domestic mutual fund requirements.

Cross Border

Residents may freely access financial instruments offshore. There are no capital controls limiting either the amount or kinds of products in which residents may invest. Residents also can freely access offshore markets as issuers of securities or notes, and U.S. firms have participated in underwriting these issues.

U.S. PRESENCE IN THE MARKET

U.S. financial institutions have a substantial, broad-based, and growing presence in Hong Kong's securities markets. Several banks and nonbank institutions have been active for decades; other have entered the market in recent years. As of March 31, 1998, there were 37 registered, U.S.-controlled securities dealers and 19 registered, U.S.-controlled corporate commodities dealers in Hong Kong.

A number of U.S. banks, through affiliates or subsidiaries, as well as nonbank financial institutions, are involved in a broad range of investment banking and other capital market activities. These include, but are not limited to, foreign exchange trading, funds management, debt and equity underwriting, mergers and acquisitions, derivatives sales and trading, brokerage and dealing of domestic and foreign securities, commodities dealing, project finance, custody, and other fiduciary services. In some cases, they act as advisers to the Hong Kong government on infrastructure projects.

U.S.-based institutions that maintain a significant presence in Hong Kong are Bear Stearns, CS First Boston, Goldman Sachs, J.P. Morgan, Lehman Brothers, Morgan Stanley Dean Witter, Merrill Lynch, and Salomon Smith Barney. Others include Prudential Securities, Kidder Peabody, Fidelity Investments Management, and American International Assurance through AIGIC. Several U.S. banks – directly or through subsidiaries and affiliates – are active in securities and capital markets services. These include Bankers Trust, Citibank N.A., Chase Manhattan, Bank of America, First National Bank of Chicago, and Republic National Bank of New York. Mellon Asia is active in trust and investment management. No attempt is made to classify individual U.S. financial institutions by major area of activity because of the lack of a complete database on individual institutional activities.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no legal constraints per se to foreign securities firms establishing representation in Hong Kong via branching, acquisition or subsidiary operations. Under the Securities Ordinance, applicants are required to meet "fit and proper person" criteria as well as net capital and liquidity margin requirements. In practice, foreign securities firms typically establish via subsidiaries, which can be wholly or partially owned. The rules are the same irrespective of ownership – domestic or foreign. An informal survey of many major U.S. bank and nonbank U.S. financial institutions revealed the absence of any substantive concerns regarding denial of national treatment. There are no impediments to the free flow of financial resources. Foreign entities can issue securities in Hong Kong subject to protection of investor legislation and listing requirements. There are no restrictions on sales and marketing of Hong Kong issues outside of the territory. There are also no restrictions on trading Hong Kong debt and equity instruments offshore.

Respondents generally view Hong Kong as the most open environment in Asia within which to do business. While most of Hong Kong's history has seen a laissez-faire approach to securities markets, some respondents noted that there has been a decided trend toward greater supervision and regulation, though they note parallel increases internationally as well.

The Hong Kong government's response to the regional financial turmoil has varied. Both the government and the markets initially believed Hong Kong would not suffer, though downturns in October 1997 and January 1998 corrected this impression. The government reacted with wide-ranging but modest accommodations in its February budget announcement. In June, the steady decline of property prices (and fears for the banking sector) led the government to take steps to support the property market. In August, the government intervened in the stock, futures, and currency markets (spending about US$15 billion) to defend itself from market "manipulators," arguing the move was a "one-time" divergence from Hong Kong's usual adherence to non-interventionist, market-oriented policies. In the aftermath of the market intervention, some respondents are concerned that government involvement in the markets, both as regulator and participant, may increase beyond internationally expected norms. In October, the government created a holding company (Exchange Fund Investment Limited) to hold and manage its shares in order to ensure greater separation and transparency.

The legal system in Hong Kong makes no distinction between local and foreign corporations. Licensing is viewed as fair, with no significant distinctions made between local and overseas-incorporated applicants. Regulations are published in English. Institutions have access to regulatory authorities and often consult them; for example, the Hong Kong Capital Markets Association and the Hong Kong Association of Restricted License Banks and Deposit-Taking Companies meet regularly with the Hong Kong government. With the onset of the financial downturn, some firms say a restrictive immigration policy has limited the free movement of employees. Overall, the regulatory environment in Hong Kong is viewed as fair, supportive, flexible, and transparent. There appears to have been no impact on the treatment of U.S. financial institutions as a result of the July 1997 changeover.

Hong Kong's existing regime is more liberal than its binding GATS commitments, although Hong Kong's revised offer in December 1997 did include additional commitments, such as for the supply of advisory and auxiliary financial services. However, few if any U.S. financial firms had expressed concern over minor irritants much less major barriers.

Table 1 - SEHK New Listings and Total Funds Raised 1994-97

	1994	1995	1996	1997
Number of New Listings	53	26	49	82
Amount of Funds Raised (HK$ millions)	7,139	8,085	31,216	81,654
Total Funds Raised (1) (HK$ millions)	346,430	152,799	247,537	458,421
Total Funds Raised Through Means Other Than New Listings (HK$ millions)	329,291	144,714	216,321	376,767

(1) Includes offer for subscription, offer for sale, placing, rights issue, open offer, consideration issue, warrants exercised, investment companies, debt securities, derivative warrants, and others.

Sources: SEHK fact books 1994-97.

Table 2 - SEHK: Selected Indicators

	1994	1995	1996	1997
Number of Listed Companies	529	542	583	658
Number of Listed Securities	1,006	1,033	1,272	1,533
Total Market Capitalization (US$ millions)	267,331	301,065	445,637	410,594
Total Market Turnover (US$ millions)	141,582	106,000	181,057	485,764
Average Daily Turnover (US$ millions)	588	429	727	1,983

Sources: SEHK fact books, 1994-97.
HK$7.80 = US$1

Table 3 - SEHK Market Capitalization by Sector
as of February 28, 1998

Sector	Percent
Properties	20.8
Conglomerates	21.0
Finance	28.0
Utilities	18.5
Industrials	9.9
Hotels	1.4
Others	0.4
Totals	100.0

Source: SEHK Monthly Bulletin, March 1998

Table 4 - Hong Kong Futures Exchange
Average Daily Turnover (number of contracts)

	1992	1993	1994	1995	1996	1997
Hang Seng Index Futures	4,356	9,702	16,906	18,407	18,688	26,313
Hang Seng Index Options	-	1,426	2,446	2,614	4,393	4,683

Sources: HKFE Economic Research Department

Table 5 - Stock and Futures Market Intermediaries

Number of Registered Securities and Commodities Intermediates as of March 31, 1997

	Securities	Commodities	Total
Dealers	1,850	475	2,325
Dealer's Representatives	7,369	2,952	10,321
Advisers	1,648	292	1,940
Adviser's Representatives	2,405	163	2,568
TOTAL	13,272	3,882	17,154

Source: SFC Annual Report, 1996-97

HUNGARY

BANKING

SUMMARY

Until 1987, the Hungarian National Bank conducted all banking operations. In that year, the Hungarian government established a two-tiered banking system by separating the function of commercial banking from the National Bank through the creation of five state-owned commercial banks.

Hungary's biggest bank problems began in the early 1990s when macroeconomic conditions worsened and GDP dropped rapidly (18 percent from 1990-93). The state-dominated corporate sector regularly defaulted on loans, and the government borrowed tremendous sums of money from the state-owned banks to serve the debt-ridden welfare system. In 1992, operating losses at state-owned banks stood at US$4 billion or 11 percent of GDP. In 1992, approximately US$3 billion in loans were considered problematic.

The privatization process began in 1994 and has continued through 1998, with nearly all of the Hungarian banking sector assets transferred to the private sector and to foreign banks by year-end 1996. The law on commercial banking required a reduction in state ownership in all banks to less than 15 percent by the end of 1997, except for special purpose institutions and banks holding more than 25 percent of the retail banking market. Foreign participation represented more than 60 percent of the capital in the banking sector by the end of 1997. Foreign banks held more than 50 percent of total assets in the Hungarian banking system. (Included in these figures is Budapest Bank, in which General Electric Capital Corporation holds a large minority stake.) The privatization of Hungary's largest banks and the entry into the system by several foreign banks has contributed to substantial improvement in the condition of the banking system.

While other Hungarian banks began to show signs of stability in 1997, Postabank ran into problems. Established in 1988, in cooperation with the Hungarian Postal Service, the bank's problems first surfaced with a HUF 25 billion (US$125 million) run on deposits in February 1997. In July 1998 the government acquired a sufficiently large stake and removed the bank's management, to begin a final cleanup of the institution.

As of August 1998, two U.S. financial institutions (Citibank and General Motors Acceptance Corporation) operated in Hungary through three wholly-owned bank subsidiaries. In addition, General Electric Capital Corporation holds a large minority shareholding (27.62 percent) in a locally incorporated bank, and Bankers Trust established a wholly-owned financial subsidiary that operates by choice under a corporate license.

Foreign banks may establish direct branches, bank subsidiaries, and joint venture banks in Hungary. They may also acquire shares in locally incorporated banks. Hungary has relatively liberal banking entry requirements; however, foreign banks were only allowed to establish in branch form since January 1, 1998. No foreign bank has established a direct branch as of October 1998. There are no branching restrictions on foreign banks in Hungary. The requirements for merger or acquisition are the same for foreign and locally incorporated banks. There are no specified limits to foreign ownership levels in joint ventures, nor specific investment levels. The licensing requirements are the same as for the establishment of any other new credit institution. There are four sectoral exceptions to the principle of national treatment: ownership of arable land by mortgage bank branches, custodial and asset management services in relation to collective investment institutions, and asset management services in relation to pension schemes.

DESCRIPTION OF THE MARKET

Structure of the Market

Like other countries in the former Soviet bloc, Hungary's biggest bank problems began in the early 1990s when macroeconomic conditions worsened and GDP dropped rapidly (18 percent from 1990-93). The state-dominated corporate sector regularly defaulted on loans, and the government borrowed tremendous sums of money from the state-owned banks to serve the debt-ridden welfare system. In 1992, operating losses at state-owned banks stood at US$4 billion or 11 percent of GDP. In 1992, approximately US$3 billion in loans were considered problematic.

The privatization process began in 1994 with the sale of the Hungarian Foreign Trade Bank (MKB) and continued in 1995 with the sale of Budapest Bank to a U.S. investor, GE Capital, and the European Bank for Reconstruction and Development (EBRD). In 1996, another big retail bank, Hungarian Credit Bank (MHB) was sold to the Dutch firm ABN AMRO. Authorities also decided to sell Takarekbank, K&H, Mezobank, Penzintezeti Kozpont (PK Bank), and the Polgari Bank in 1997. The law on commercial banking required a reduction in state ownership in all banks to less than 15 percent by the end of 1997, except for special purpose institutions and banks holding more than 25 percent of the retail banking market. Thus, the government sold its 25 percent stake in the National Savings Bank (OTP), leaving only one golden share remaining in state hands, and the National Bank of Hungary sold its 34 percent stake in the Central European International Bank to COMIT Holding, a fully-owned subsidiary of Banca Commerciale Italiana.

A special case in the banking sector has been Postabank, created in 1988, in cooperation with the Hungarian Postal Service. Post offices throughout the country, some 3200 of them, became bank branches, immediately making Postabank Hungary's second-largest bank. It opened with a simple majority of private owners, as well as shares held by state entities such as the Hungarian Pension and Health Funds and the Hungarian Postal Service. Postabank ran into problems, which first surfaced with a HUF 25 billion (US$125 million) run on deposits in February 1997. In July 1998 the government acquired a sufficiently large stake in the troubled bank to begin a final cleanup of the institution. Most importantly, as clear majority owner, the government removed Postabank's management. Thus began what should be the last significant bank bailout in Hungary. The cost to the government is not yet known, but the consolidation may run as high as US$500 million by current estimates. Nonetheless, the rest of the Hungarian banking system remains sound, and the workout of Postabank (and several smaller associated banks) should clean up the last blight on the banking landscape.

Until the Postabank buyout, only the Hungarian Development Bank and the Hungarian Eximbank remained fully state-owned as special purpose institutions. As a consequence, the share of private ownership was almost 80 percent in the Hungarian banking sector, with foreign participation representing more than 60 percent of the capital in the banking sector by the end of 1997.

Ownership Structure of Hungarian Banks

Owners	HUF Millions	Percent
State ownership	62.4	20.7
of which:		
APV Rt (State Privatization and Holding Co.)	*47.6*	*15.8*
Domestic private ownership	49.7	16.5
of which:		
Financial institutions	*16.7*	*5.5*
Insurance firms, investment funds	*5.9*	*2.0*
Other	*27.1*	*9.0*
Total domestic ownership	112.1	37.1
Foreign ownership	184.8	61.2
of which:		
financial institutions	*147.7*	*48.9*
other	*37.1*	*12.3*

Owners	HUF Millions	Percent
Preference shares	2.9	1.0
Own shares	2.1	0.7
TOTAL	301.9	100.0

Source: National Bank of Hungary

As of July 1998, there were 44 financial institutions in Hungary, including five state-owned banks (the central bank, Hungarian Development Bank, EximBank, Postabank, and a small home mortgage bank), nine locally incorporated private banks, and 30 foreign banks. This compares to 40 financial institutions as of year-end 1993, including 17 state-owned banks, 4 locally incorporated private banks, and 19 foreign banks. The 44 banks in Hungary serve the personal and business needs of both domestic and international clients. Total assets amounted to about HUF 4,460 billion (US$22.3 billion, or 50 percent of GDP) at the end of 1997. About 64 percent of assets are concentrated in the six largest banks, about average for the region, but low in comparison with smaller EU countries. The assets-to-GDP ratio, as well as that of lending-to-GDP (around 25 percent) would seem to indicate that Hungary is relatively under-banked.

OTP, Hungary's largest bank, held about 25 percent of total assets in the banking system as of year-end 1997. The retail banking sector is dominated by OTP and Postabank, which held an additional 8 percent. OTP's position is strengthened by its majority share of the municipal banking market, while Postabank's extensive branch network makes it the leader for banking services to individuals. The asset shares of the next five largest banks average around 7 percent each. Although the total number of banks has been stable since 1994, some small domestic banks have exited the market and were replaced by new foreign banks. The corporate banking sector is more advanced than the retail sector, but efforts are being made to bring retail services up to EU standards. Banks operating in Hungary, in a legal sense, are not universal banks. They can offer investment services only with some restrictions. However, they can have 100 percent owned subsidiaries which deal with the whole range of investment services (such as Citibank does). New legislation on the Hungarian financial services sector adopts a number of EU directives to a introduce system based on the use of trading books. Thus in the near future credit institutions can obtain universal banking licenses.

Demand for electronic bank services, such as automated teller machines (ATMs) and Internet access to accounts, exploded in the mid-1990s. Hungarian banks responded to this demand by updating services and equipment. For example, there were a total of 54 ATMs in Hungary in 1992. As of December 31, 1997, there were 1,553 ATMs. Investment funds have also become more popular and Hungarian banks have responded by offering both private and corporate investment services.

However, Hungarian banks have been slow to meet the demand for other types of bank services. For example, lending is largely limited to providing financing for Hungarian and foreign blue chip firms, granting credit for vehicle purchases, and lombard loans (loans collateralized by securities portfolios). More recently banks have begun to offer housing loans and credit for purchasing consumer goods, but the need for increased lending services still exists. Competition is building for retail customers, as interest rates continue to fall with inflation, the average income in Hungary rises, and banks seek potential clients in the medium-sized enterprise sector. Several banks are actively pursuing OTP's previously captive municipal government clientele. As for the future of Postabank, the government is determined to ensure that it returns to viability as a strong retail bank. Reorganization has only just begun, and is expected to take between 18 months and two years. The decision as to whether to keep the bank in state hands or to privatize it is not likely to be made until mid- to late-1999.

In general, banking sector portfolio quality has improved steadily since 1994. At the end of 1997, the State Banking and Capital Markets Supervision (APTF) rated 92 percent of the banking sector's portfolio as problem free, 5.1 percent required special watching, 1 percent was substandard, 0.8 percent doubtful, and 1.2 percent non-performing. In 1994, nearly 13 percent of the sector's portfolio was substandard or worse.

Regulatory Structure

The 1996 Act on Credit Institutions and Financial Enterprises, effective January 1, 1997, merged the State Banking Supervision and the State Securities and Stock Exchange Supervision to create the APTF, which regulates the banking sector and reports to the Finance Minister. This step was taken as the separation of banking and securities activities will be gradually phased out and universal banking is implemented.

The law on commercial banks, effective since 1992, established capital adequacy levels along the guidelines of the Basle standards. The capital adequacy ratio averaged 18 percent at the end of 1997, and only one bank did not meet the 8 percent minimum requirement at year-end 1997.

Banking regulations stipulate a two-step licensing regime for the establishment of banks, including branches of nonresident banks, which is the same for both domestic and foreign investors. Banks may operate as joint stock companies or, as of January 1, 1998, as branches. The minimum registered capital of a bank operating in either structure is HUF 2 billion. For the establishment of a bank, the subscribed capital must be paid in cash at credit institutions with a registered seat in Hungary which are not involved in the establishment.

Capital requirements (and legal lending limits) for foreign branches are based on the local capital of the branch. To date, no foreign bank has established a branch.

Hungary provides deposit insurance for individual deposits of up to HUF 1 million per registered account. The insurance is financed through retail bank-paid fees, and supplemented if necessary from the central budget. It is administered jointly by the National Bank of Hungary, the Ministry of Finance, and the Hungarian Banking Association.

As of year-end 1997, foreign banks held more than 50 percent of total assets in the Hungarian banking system. Foreign banks held around 80 percent of corporate deposits and 30 percent of retail deposits. Included in these figures is Budapest Bank, in which General Electric Capital Corporation holds a large minority stake (27.62 percent).

Percent Market Share of Foreign Banks in Hungary as of December 31, 1997

	Domestic Banks	Foreign Banks	Total *	U.S. Banks**
Total Assets	42.9	57.1	100.0	6.3
Loans	36.8	63.2	100.0	7.1
Corporate Deposits	20.1	79.9	100.0	12.6
Retail Deposits	70.4	29.6	100.0	3.8

* With savings cooperatives
** Citibank, Budapest Bank, Opel Bank
Source: State Banking and Capital Markets Supervision (APTF)

U.S. PRESENCE IN THE MARKET

Foreign banks have increased overall market share since 1994 in total assets, loans, corporate deposits, and retail deposits. They have the dominant share in the first three categories; Hungarian banks still dominate retail deposits. As of August 1998, two U.S. financial institutions operated in Hungary through three wholly-owned bank subsidiaries – Citibank through Citibank Budapest and the European Commercial Bank; General Motors Acceptance Corporation through Opel Bank Hungary Ltd. In addition, General Electric Capital Corporation holds a large minority shareholding (28 percent) in a locally incorporated bank, and Bankers Trust established a wholly-owned financial subsidiary that operates by choice under a corporate license.

Citibank Budapest Rt. was first established in December 1985 by the Citibank Overseas Investment Corporation (80 percent) and the National Bank of Hungary (20 percent). This was the first venture of its kind in Central and Eastern Europe and it commenced operations on January 1, 1986. In 1991, the Act on the National Bank of Hungary was passed, forcing the National Bank to sell its holdings in all foreign banks, including Citibank. In 1993, the Citibank Overseas Investment Corporation purchased the remaining 20 percent of shares and became the sole owner of the bank. Citibank launched retail services in 1995 and began to focus on increasing market share in 1996. Its main services include corporate and personal deposits and lending, foreign exchange transactions, letters of credit, guarantees, prompt payment orders, bank account keeping, and custodial services. Citibank was named "the best foreign bank in Hungary" in 1996 by Central European Magazine. It operates two branches as well as its headquarters. In August 1998, Citibank completed the purchase of the formerly Italian/Austrian owned European Commercial Bank. Citibank also owns a fully licensed securities company and a leasing company.

Budapest Credit and Development Bank (Budapest Bank) was established in January 1987 as a commercial bank in Hungary's two-tiered banking system. As of June 1998, the European Bank for Reconstruction and Development held 32.4 percent of the share capital; General Electric Capital Corporation, the leading non-institutional shareholder, held 27.62 percent; and the Hungarian Ministry of Finance owned 23 percent. The remaining shares are listed on the over-the-counter market. Budapest Bank offers a wide range of services to both corporate and private clients including account keeping, securities transactions and management of investment funds (through its brokerage subsidiary), bank card services, short- and medium-term loans, and foreign exchange account keeping. Budapest Bank deals with domestic and international clients and puts special emphasis on business development and product development. Its corporate clientele continues to play a decisive role in the bank's balance sheet and income. Alongside its existing large, corporate clients, the bank intends to strengthen its position in the sphere of small- and medium-sized business. The importance of the retail sector as a focus clientele is continually growing in the bank's strategy and operation. The bank is also trying to attract new clients by upgrading facilities and offering fast and flexible services. Budapest Bank is headquartered in Budapest and operates 74 branches throughout Hungary.

Opel Bank Hungary Ltd. was established in March 31, 1996 and began operations on September 6, 1996. Opel Bank is owned entirely by the U.S.-based General Motors Acceptance Corporation (GMAC), a member of the GM Corporation. The bank's organization and activities are closely related to Opel Leasing Financial Services Ltd., founded by GMAC. Like Opel Leasing, Opel Bank exists to meet the needs of firms in the Opel Franchise and their customers. It grants investment and working capital loans to authorized Opel dealers and provides consumer credits to private individuals and corporate clients. Opel Bank intends to expand its services by increasing its activities in the used car market and extending its operations to the financing of non-Opel vehicles.

Bankers Trust, which was established as a wholly-owned subsidiary in Hungary in 1991, operates by choice under a corporate license. As a corporation (not a bank), Bankers Trust concentrates on international market placements, risk management, and advisory work. Bankers Trust has chosen not to apply for a banking license because of its corporate strategy.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks may establish direct branches, bank subsidiaries, and joint venture banks in Hungary. They may also acquire shares in locally incorporated banks. However, foreign banks were only allowed to establish in branch form since January 1, 1998, and no foreign bank had established a direct branch as of October 1998.

Nonresident investors in the banking sector are granted treatment equivalent to that given domestic financial institutions. Previous provisions requiring special prior government authorization for the establishment of banks and acquisition of shares by foreigners were abolished in 1996. No higher regulatory, material, personal requirements, or financial guarantees are imposed for the establishment and operation of branches than for domestic institutions. There are no branching restrictions on foreign banks in Hungary.

The licensing requirements for merger or acquisition and for joint ventures are the same for foreign and locally incorporated banks. Foreign banks may acquire healthy or problem banks; no preferential treatment is accorded to acquisitions of problem banks. There are no specified limits to foreign ownership levels in joint ventures, nor specific investment levels.

There are four sectoral exceptions to the principle of national treatment: ownership of arable land by mortgage bank branches, custodial and asset management services in relation to collective investment institutions, and asset management services in relation to pension schemes.

Hungary's GATS schedule of commitments, one of the most liberal offered during the GATS negotiations, is fully implemented. U.S. banks operating in Hungary state that they have received since their establishment full national treatment. It appears that the current levels of openness are fully bound in GATS. Hungary has medium term plans to eliminate three of the four sectoral exceptions to national treatment, in all likelihood by the end of the century. The most problematic, that of ownership of arable land by mortgage bank branches, is tied up in very sensitive domestic political considerations, and will not likely be relaxed except in the context of requirements for future EU membership.

HUNGARY

SECURITIES

SUMMARY

The Hungarian securities market has grown dramatically since its return to operation in 1990, and even more significantly since 1994. The Budapest Stock Exchange (BSE) has expanded from listing one security in 1990 to 149 listings in 1997. The Budapest Commodity Exchange (BCE) allows trading in eight currencies and two interest rates, as well as futures contacts on grains and livestock.

The period from late 1996 to present has been one of spectacular increase in activity, especially on the stock exchange, both in volume and in value. Volatility has also been high. Share prices have fluctuated sharply due to financial crises in Asia and Russia as well as uncertainty surrounding Hungary's national elections in May 1998. The majority of companies listed on the BSE have seen strong earnings growth and stock price appreciation. This, coupled with Hungary's strong economic fundamentals, has been both a boon and a curse for the exchange. Foreign and domestic investors have poured substantial sums into listed equities and bonds in times of calm, but appear to have liquidated their holdings of BSE shares to shore up balance sheets weakened by losses in other emerging markets.

Market regulation, while essentially well-structured, lacks some necessary investigation and enforcement powers. To date there have been no reported instances of major investor losses because of inadequate capital market supervision.

Foreign firms enjoy discrimination-free access to brokerage licenses and over half of the existing brokerages have some foreign ownership. Participation by U.S. firms is small, while Western European banks have established numerous trading subsidiaries with privileges on the BSE.

DESCRIPTION OF THE MARKET

Hungary's two exchanges, the BSE and the BCE, trade a range of financial instruments and futures contracts. The BSE lists stocks, bonds, investment trusts, and compensation coupons. The BCE lists futures contracts on grains, livestock, currencies, and interest rates.

The Budapest Stock Exchange

The BSE resumed trading on June 21, 1990, becoming the first stock exchange to reopen in the former Communist states in Central and Eastern Europe. Only one security was listed initially. By the end of 1990, there were six securities. At the end of 1997, 149 securities were listed. In

December 1994, total capitalization was HUF 883.8 billion (US$8.0 billion); at the end of 1997 it had reached HUF 5,115 billion (US$25.1 billion).

As shown in the following table, the number of listed securities is roughly split between bonds and T-bills, on the one hand, and equities and investment funds, on the other. In terms of value, however, bonds and T-bills dominate, accounting for 77 percent of the nominal value of listed securities. Compensation coupons – given to Hungarians to recompense property lost under Communist or World War II fascist regimes – accounted for only 5.7 percent of nominal value, down from 14.1 percent in 1994. Equities accounted for 16.1 percent, up from 9.3 percent in 1994. There were 20 investment funds (mutual funds), accounting for just 1.1 percent of nominal value.

Budapest Stock Exchange
end-of-year

	1994	1995	1996	1997
Number of members	51	56	57	63
of which:				
Brokerage firms	*50*	*55*	*56*	*62*
Banks	*1*	*1*	*1*	*1**
Number of listed securities	120	166	167	149
of which:				
Equities	*40*	*42*	*45*	*49*
Bonds	*28*	*37*	*38*	*35*
T-bills	*31*	*50*	*50*	*44*
Investment funds	*20*	*36*	*33*	*20*
Compensation notes	*1*	*1*	*1*	*1*

	1994	1995	1996	1997
Nominal value of securities admitted (HUF billions)	856.3	1,217.8	1,833.6	2,467.1
of which:				
Equities	*79.8*	*211.7*	*286.1*	*398.2*
Bonds	*375.8*	*420.0*	*617.4*	*940.5*
T-bills	*256.6*	*413.5*	*750.1*	*961.7*
Investment funds	*23.8*	*43.0*	*40.4*	*27.0*
Compensation notes	*120.3*	*129.7*	*139.7*	*139.7*

*National Bank of Hungary
Source: BSE

Between January 1, 1996 and June 30, 1997, record trading volume and a steep upturn in prices on the spot market made the BSE the leading exchange in East and Central Europe. Due to steadily increasing domestic and foreign interest in Hungarian shares, the BSE index gained 133.5 percent in 1996 in US$ terms, outperforming all other emerging markets. As shown in the table below, in 1997 the spot market turnover of the BSE exceeded HUF 6,736 billion (US$36.1 billion), of which 42.7 percent was attributable to the corporate equities market. This is up from 27 percent in 1994. The number of trades has exploded, indicating significant small investor participation in the market.

Budapest Stock Exchange
(HUF billions)

	1994	1995	1996	1997
Turnover (market value)	211.23	253.18	1,145.44	6,736.31
of which:				
Equities	*57.11*	*87.27*	*490.53*	*2,872.71*
Bonds	*53.90*	*77.21*	*418.78*	*1,998.57*
T-bills	*81.22*	*81.11*	*206.33*	*1,817.74*
Investment funds	*0.26*	*3.43*	*8.88*	*2.33*
Compensation notes	*18.74*	*4.16*	*20.93*	*44.97*

	1994	1995	1996	1997
Number of transactions	70,744	71,240	170,956	504,879
Average daily number of transactions	281	286	689	2,044
Average daily turnover	838.2	1,016.8	4,618.7	27,272.5
Turnover/transaction	3.0	3.6	6.7	13.3

Source: Budapest Stock Exchange

In October 1993, the BSE, together with the National Bank of Hungary and the BCE, established a Central Clearing House and Depository (KELER). The clearing house was designed to provide timely settlement of securities market and derivatives transactions completed in Hungary, and provides safekeeping for securities primarily for financial institutions.

The BSE has been extremely volatile since June 1998 due to a combination of factors. Post-election concerns over the possible economic policies of the incoming government caused a strong drop in share prices in June. Prices stabilized in late June and July, only to tumble again in August from the combined impact of the worsening Asian financial crisis and the economic turmoil in Russia, despite strong Hungarian fundamentals and favorable price/earnings ratios for most listed firms. The sell-off appears to have been driven by investors with extensive holdings in riskier markets, taking advantage of the BSE's good liquidity to shore up their financial positions. (The BSE's good liquidity has been attributed to: (1) efficient clearing operations; and (2) the strong reputations and past performance of listed companies, so that even in a bear market sellers have been able to find buyers.)

The BSE has recently decided to adjust its fluctuation limits on the spot market. Shares in the BUX basket (the share index of the BSE) will be suspended for 10 minutes if prices fluctuate more than 8 percent and trading will be suspended for the remainder of the session if the price change reaches 15 percent. These new fluctuation limits took effect in August 1998. The 10 percent and 20 percent rules will remain in effect for all other shares.

Pension reform is expected to bring significant new investment funds to the BSE. This is especially true of the pension system's "second pillar" – obligatory contributions to privately managed, government regulated pension funds. These funds will be able to invest worker contributions in registered securities. Contributions are obligatory only for new entrants to the job market, beginning in 1998. The response to these funds has been overwhelming. Over 25 percent of the total employed workforce had joined second pillar funds by June 1998.

The Budapest Commodity Exchange

The BCE was established on August 15, 1989 as the Produce Exchange Co., and began trading grains futures on October 25, 1989, six months before the first democratic election in Hungary. The BCE was the first operational futures market in the region. Established as a private commodity exchange modeled after American commodity exchanges, the BCE is a non-profit, self-governing organization. In 1990, the BCE changed its name from the Produce Exchange to its current name. Present ownership is made up of banks, foreign trade companies, brokers, grain traders, and meat processors.

BCE floor rules require an exchange seat in each market for which privileges are desired: grains, livestock, and financial (includes currencies and interest rates). The maximum number of members in each section is 50. The grains and livestock sections are at full capacity, but the financial section still has 32 places available. As with the BSE, payment and clearance is effected through KELER. Earlier BCE rules had provided membership for any company or individual, Hungarian or foreign, meeting certain financial and other criteria. Current legislation provides for closer regulation of traders by limiting membership to companies registered under Hungarian law.

The BCE offers two basic types of trades: spot and futures trades. Spot contracts are, however, only permitted in the grains and livestock sections. The proportion of spot trades in the total turnover of the BCE is becoming marginal. The main type of trade on the exchange floor is the buying and selling of futures. Turnover of these standardized contracts is increasing dynamically, mainly as a result of rising interest in currency futures and other financial instruments. The currency section is significantly stronger than the other two sections. It now accounts for 97 percent of the BCE market share. Trading is done through the open-outcry method.

Foreign currency futures were introduced in March 16, 1993, with the Hungarian forint contracts written against deutschmarks and U.S. dollars to allow hedging of currency risk. In January 1994, a Japanese yen contract was added. To date there are eight currencies and two interest rates available for trading, including: the U.S. dollar, the deutschmark, the yen, the ecu, the pound sterling, the lira, the Swiss franc, the Czech koruna, and one-month and three-month BUBOR interest rates.

Regulatory Structure

Securities trading regulations are administered and enforced by the State Banking and Capital Markets Supervision (APTF). The APTF also regulates futures trading. Although modeled after the U.S. Securities and Exchange Commission, the APTF has fewer enforcement powers. The APTF has full legal rights to oversee securities contracts and registration and to access files of broker companies. It must rely on the police, however, to investigate suspected violations.

U.S. PRESENCE IN THE MARKET

There are no prohibitions against foreign company ownership in brokerages engaged in either the stock or commodity markets. U.S. presence is limited to five companies (out of 62), but includes large firms such as Citibank Securities Co. Major Western European banks have also established trading subsidiaries with privileges on the BSE.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign firms have discrimination-free access to brokerage licenses and over half of the existing brokerages have some foreign ownership. Trading rights are limited to firms specifically established to engage in securities transactions. Banks and other financial institutions must set up dedicated, separate subsidiaries in order to trade. Brokerage licenses are issued on a non-discriminatory basis, available to those Hungarian citizens and foreigners who fulfill the necessary criteria. The criteria are:

1. The brokerage company must be a company registered in Hungary;
2. The company must meet minimum capital requirements, depending on the license sought;
3. Managers and brokers must pass an examination on Hungarian securities law in the Hungarian language, given by the APTF, and must present evidence of two years' experience in securities transactions.

Hungary's GATS schedule of commitments is one of the most liberal offered during the negotiations. To date, it has been fully implemented, both *de jure* and *de facto*.

Exchange Rates Used:

1994 end of period	110.7 HUF/US$
1997 end of period	203.5 HUF/US$
1997 period average	186.8 HUF/US$

INDIA

BANKING

SUMMARY

The State Bank of India (SBI), India's largest bank, and the other major public sector banks dominate the financial sector, but the government has allowed for the controlled entry of private sector and foreign competitors in banking and most other financial services. The public sector banks account for about 80 percent of India's banking activities. In a further move toward reform of the banking sector, government ownership in several public sector banks, including SBI, has been diluted. However, the Reserve Bank of India (RBI) still retains a majority shareholding in SBI of approximately 60 percent. In 1993, the government began to issue licenses for a limited number of private sector banks. There are currently 10 private Indian banks in operation, although these banks are still very small compared to the public sector banks.

The RBI is India's central banking institution and has sole authority for money supply management as well as administration of exchange controls and banking regulations. As the supervisory body for banking operations in India, it is also responsible for granting licenses for new banks and bank branches.

Interest rates have been largely freed from government control and banks are generally allowed to determine interest rates on domestic term deposits and lending rates independently. Cash reserve requirements for banks have been lowered progressively in recent years and now stand at 11 percent. The money market rates have been completely freed. Regulations governing loan syndication and credit for working capital purposes have been eliminated, allowing development financial institutions (FIs) and scheduled commercial banks to compete for both term and working capital loans. However, the RBI still requires that 40 percent of lending by locally-incorporated banks be directed to priority sectors of the economy.

Foreign banks face significant restrictions on entry and expansion. Foreign banks cannot establish bank subsidiaries. In addition, the number of foreign bank branches continues to be connected to the size and presence of Indian banks in the applicant's home country. The Narasimham Committee recommends that foreign banks should operate as bank subsidiaries rather than as branches, and that those foreign banks operating as branches should be encouraged to convert to bank subsidiaries. The report also recommends that foreign bank subsidiaries should have higher minimal capital requirements than locally incorporated banks.

India has introduced capital requirements based to some extent on the Basle Accord. However, branches of foreign banks must meet the capital requirements on the basis of locally held capital; parent capital is not taken into account. Additionally, legal lending limits are based on the locally held capital of the branch, in effect eliminating an important reason for establishing in branch form.

Foreign banks pay a basic corporate tax rate of 48 percent, compared to the 35 percent rate applied to local bank profits. In some respects, U.S. and other foreign banks receive better than national treatment, notably in lower directed lending requirements (32 percent for foreign banks) at concessional interest rates to priority sectors – small businesses, exporters, and the agricultural sector.

There are currently 42 foreign banks with 186 branches in India. Foreign banks control only 8 percent of total banking assets in India, of which U.S. banks hold nearly 35 percent.

DESCRIPTION OF THE MARKET

Structure of the Market

India's banking sector is dominated by the public sector banks, which accounted for approximately 82 percent of deposits and 79 percent of loans in the banking sector as of March 31, 1998. India's 27 public sector banks were all nationalized prior to 1980. One of the goals of Indian policy following the nationalization was the extension of financial services throughout the country, particularly to rural areas where branches might not be justified on a purely commercial basis. As a result, the number of public sector bank branches grew dramatically from 7,015 in 1969 (when 14 private banks were nationalized) to 56,998 by June 30, 1993 and 64,309 on September 30, 1998. Table I provides data on deposits and loans (in billions of rupees) for the locally incorporated public sector banks, locally-incorporated private sector banks, and foreign banks.

Table I – Broad Structure of the Industry
(in billions of rupees)

	Deposits		Loans	
Banks	March 31, 1997	March 31, 1998	March 31, 1997	March 31, 1998
Public Sector	4,493.29	5,046.82	2,202.51	2,595.12
State Bank of India (SBI)	*1,107.01*	*1,235.48*	*622.33*	*704.71*
SBI Associate Banks	*371.91*	*425.36*	*206.68*	*256.12*
Other Public Sector Banks	*3,014.37*	*3,385.96*	*1,373.49*	*1,634.28*
Foreign Banks	373.94	433.78	239.19	309.65
Private Banks	507.92	693.34	285.01	365.20
TOTAL	5,375.15	6,173.93	2,726.71	3,269.98

Source: RBI

The government's ownership share in public sector banks is being reduced slowly. In part due to pressure of funding requirements needed for the public sector banks to comply with India's new capital standards and to cover problem loans, the government has allowed the public sector banks to approach the capital market to sell equity to the public. The first public sector bank to take this step was India's largest bank, the State Bank of India, in which RBI ownership has been reduced to 60 percent. The Narasimham Committee has recommended that the government (RBI) holding in the SBI and other nationalized banks be reduced to 33 percent, a policy that would require amendment of the Banking, Nationalization and SBI Acts.

An important part of the liberalization process has been the government's policy of licensing new private banks and allowing additional branches of foreign banks to be established. The RBI granted "in principle" approval for 13 new private locally incorporated banks in March 1994. Two approvals were subsequently withdrawn in light of adverse circumstances. Thus far, 10 private locally incorporated banks have been granted licenses and started operations. Unit Trust of India Bank was the first of the group to begin operations in April 1994. New banks must provide paid-in capital of Rs1 billion (US$25 million), foreign banks and firms can hold up to 20 percent equity, and nonresident Indians can hold up to 40 percent of the equity in the new private banks. Multilateral institutions such as the International Finance Corporation and the Asian Development Bank can partake to the extent of the shortfall in nonresident Indian contributions. The introduction of these private banks has enhanced competition in the banking sector, especially since the new private and foreign banks have higher productivity levels based on newer technology and lower staffing levels. The private banks have generally reported higher levels of profitability than the public sector banks, due to advantages in lower overall staff costs, higher administrative efficiency and better managed asset portfolios. Although these changes represent a significant shift in government policy, the banking sector is still dominated by the public sector banks. Private banks accounted for only 11 percent of loans in the banking sector and 9 percent of deposits.

As of March 31, 1997, there were 42 foreign banks in India with 186 branches, most of which are located in metropolitan centers. These banks accounted for 9 percent of total banking sector loans and 7 percent of deposits. Since January 1992, 19 new foreign banks with a total of 47 branches have been allowed to enter the Indian market. Between April-May 1998, three more banks were permitted entry. The foreign banks are primarily involved in financing trade and extending loans to large business groups, and have a small exposure in the priority sector. Most foreign banks in the country have diversified their operations by opening merchant banking divisions, retail banking, mobilizing special deposits by nonresident Indians, security operations, and management consultant services. In addition, there were 28 representative offices of foreign banks in India as of March 1997. Foreign banks enjoy a positive reputation for customer satisfaction and innovation in the Indian market, and they continue to increase their business despite limitations on the number of branches they are allowed. They have higher productivity levels based on newer technology and lower levels of manning. The net profit ratio for foreign banks was 1.4 percent as of March 31, 1997, far above the industry average.

Indian banks still hold large amounts of nonperforming loans, in large part due to directed lending by the government to priority sectors. Nonperforming loans represented about 17.5 percent of outstanding loans in the banking system as of March 31, 1997 (US$10.2 billion) as compared with 21.9 percent as of March 31, 1994. Banks have made provisions for roughly half of that figure. Rapid asset growth may mask the banking sector's asset quality problems. Commercial banks extended loans of Rs 330 billion (US$8 billion) for the fiscal year ended March 31, 1998, up sharply from Rs 175.48 billion (US$4.4 billion) the previous year. The government established special tribunals for speedy loan recovery in late 1993 and is pressing nationalized banks to recover bad debts. However, these tribunals have yielded disappointing results and policy makers are looking for other ways of addressing the problem of debt recovery. In the recent budget the government announced measures to strengthen the debt recovery tribunals and selectively encourage banks with high nonperforming assets (NPAs) to establish Asset Reconstruction Companies to facilitate better recovery of dues.

Regulatory Structure

The RBI is India's central banking institution and has sole authority for money supply management as well as administration of exchange controls and banking regulations. As the supervisory body for banking operations in India, it is also responsible for granting licenses for new banks and bank branches.

In April 1992, the RBI followed the Basle Group's recommendations in prescribing new risk weighted capital requirements. Indian banks had to reach a minimum ratio of risk weighted assets of 8 percent by March 1994 and those with an international presence were required to do so by March 1995. Foreign banks operating in India were required to meet the minimum capital ratio requirement by March 1993. The budget for the fiscal year ended March 31, 1998, proposes to raise the minimum capital adequacy ratio requirement for banks from the present 8 percent to 9 percent by March 31, 2000, and to 10 percent by 2002.

The Narasimham Committee on Indian banking sector reforms, set up in December 1997 to make recommendations for the second phase of financial sector reforms, presented its report to the Minister of Finance in April 1998. This report follows a 1991 report issued by the first Narasimham Committee, which made many similar recommendations. The latest report makes a case for strengthening India's banking system, particularly in view of plans to move toward capital account convertibility. Some of the major recommendations include:

- The merger of some strong public sector banks and the closure of some weak ones to comply with the greater integration of global financial systems.

- Separation of the regulatory and supervisory functions from the other responsibilities of the RBI. As the formulator and implementing agency of monetary policy, the RBI should not also be the owner of a bank due to possible conflicts of interest. The government should consider granting autonomous status to the Board for Financial Supervision, now part of the RBI.

- Reduction of the average level of net NPAs for all banks to below 5 percent by the year 2000 and to 3 percent by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPAs to 5 percent and 3 percent by 2000 and 2002, respectively and net NPAs to 3 percent and 0 percent by these dates. Asset reconstruction funds should be established to tackle the problem of NPAs.

- An increase in the capital base of banks and a review of their capital adequacy ratios to improve the inherent strength of banks and their capacity to absorb risk. The minimum capital to risk-weighted assets ratio should be raised to 10 percent from the present level of 8 percent.

- Realignment of the roles of commercial banks and development financial institutions in India in favor of the concept of universal banking.

- Removal of the appointment of bank chairmen and board members from the realm of politics to encourage professionalism in bank management.

- Greater managerial autonomy for public sector banks and reduction in government ownership form the current 51 percent. The size of the work force at public sector banks should also be reduced to make them more efficient and competitive.

The Reserve Bank (RBI) has engaged in phased deregulation of interest rates over the past several years. All deposit rates have been deregulated except for savings deposits and FCNR(B) deposits. Rates for term deposits above 30 days have been deregulated and the maximum deposit rate for periods up to 30 days is linked to the "Bank Rate" established by the RBI. With regard to lending rates, banks are free to determine interest rates for loans above Rs 200,000. In the past two years, there has also been a significant reduction in the cash reserve ratio (CRR) and statutory liquidity ratio (SLR) requirements imposed by the RBI. The Cash reserve has been progressively reduced from 14 percent for the fiscal year-ended March 31, 1997, to 12 percent for the fiscal year-ended March 31, 1998, and is presently at 11 percent. Requirements of Statutory Liquidity Ratio (SLR) have been rationalized and banks must now maintain SLR at a reduced minimum of 25 percent of their entire net demand and time liabilities, compared to the 35 percent requirement for the fiscal year ended March 31, 1997.

The Indian banking sector has taken some important steps in recent years in upgrading service information technology, including the launch of an Internet banking service by Industrial Credit and Investment Corporation of India Bank. The Magnetic Ink Character Recognition (MICR) Check Processing Center, already in existence in the four metro areas (New Delhi, Mumbai, Chennai and Calcutta), has been extended to nine additional cities. Furthermore, the RBI has taken steps to set up a Very Small Aperture Terminal Network to provide reliable communication throughout the financial sector. The RBI is also encouraging greater use of the RBINet/BANKNET, a network to which all public sector banks, foreign banks and domestic private sector banks are connected. To provide extended working hours to the customers, many banks are establishing Shared Payment Network Systems (SPNS) and installing of Automated Teller Machines (ATMs) and Cash Dispensers. Other facilities that have been introduced are Electronic Funds Transfer Systems and Electronic Clearing Services for repetitive or low value transactions. Many foreign and domestic private sector banks are providing telebanking services and have become members of the Society for Worldwide Interbank Financial Telecommunications. In spite of these improvements, however, India's banking sector continues to lag behind its counterparts in Western countries and in many of its Asian neighbors in the use of technology.

U.S. PRESENCE IN THE MARKET

Citibank, Bank of America, American Express Bank, and Chase Manhattan Bank operate 17 branches in India and account for only 3 percent of total banking sector assets. The assets of these branches totaled US$4.5 billion on March 31, 1997, compared to US$3.5 billion in 1993. Morgan Guarantee Trust is in the process of opening a branch. Nations Bank is in the process of merging with Bank of America and is not seeking a branch. U.S. banks are leaders in consumer banking, retail services, custodial services, factoring, and other sophisticated banking services, and are among the most profitable banks in India. Bank of New York, Bankers Trust, Union Bank of California, Bank of Boston, and First Union National Bank have one representative office each.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks can currently operate as branches in India, but cannot establish in bank subsidiary form. However, the Narasimham Committee recommends that foreign banks should operate as bank subsidiaries and not as branches, and that those foreign banks operating as branches should be encouraged to convert to bank subsidiaries. The report also recommends that foreign bank subsidiaries should have higher minimal capital requirements than locally incorporated banks.

The entry of foreign banks is based on economic, political, and bilateral relations with the applicant bank's home country. It is not strictly on a reciprocal basis, though it is roughly comparable to the presence of Indian banks in the applicant's home country. An inter-agency committee approves applications for entry and expansion. Because Indian banks have not been major international players (98 overseas branches, 14 representative offices, 7 joint ventures, and 11 subsidiaries), not very many new foreign banks have been able to enter the Indian market since 1948. Liberalized policies since 1991 have opened the door for a number of additional foreign banks. The RBI fixes the number of branches both for new banks and existing banks taking into account WTO commitments and other factors. The RBI generally does not allow foreign banks to have both representative and branch offices at the same center.

Once approved for entry, foreign banks must capitalize their first two branches at US$10 million each; an additional US$5 million is required for a third branch. Subsequent branches do not require additional capital. The Narasimham Committee has recommended that the minimum start-up capital requirements for foreign branches must be higher than for Indian banks, and should be raised from US$10 million to US$25 million as a lump sum.

The RBI fixes the number of authorized branches upon granting an entry license, taking into account reciprocity and other factors, and does not usually allow foreign banks to have both representative and branch offices. The restriction on the number of branches applies only to foreign banks.

Foreign banks and firms can hold up to 20 percent equity in a private, locally incorporated bank, and nonresident Indians can hold up to 40 percent. Foreign banks and finance companies that do not have a presence in India are also permitted to invest up to 20 percent as a technical collaborator (within the overall 40 percent ceiling) in new private sector banks, subject to government approval. Joint ventures between foreign and domestic banks and nonbanking services are allowed in accordance with the foreign investment policy.

The RBI considers the capital base of a foreign bank as foreign funds deployed in India, including foreign currency loans extended to the branch by the parent, initial capital, and any subsequent increases in capitalization. Net funds deployed are required to be no less than 3.5 percent of aggregate liabilities, and no more than 25 percent of the capital base can be lent to any one borrower. The local capital of the foreign branch instead of the consolidated capital of the parent bank is used to compute the branch's minimum capital adequacy ratio requirement and legal lending limit.

India's 1997-98 budget reduced the basic tax rate from 43 percent to 35 percent for Indian banks and from 55 percent to 48 percent for foreign banks.

In some respects, foreign banks have advantages compared with locally incorporated banks. For instance, they are not required to open branches in rural areas, or to make loans to the agricultural sector. Locally incorporated Indian banks are required to extend 40 percent of their loans at concessional rates to the "priority sector, " consisting largely of the agricultural sector, exporters, and small businesses. Foreign banks are subject to slightly less rigorous requirements. Since July 1993, foreign banks have been required to extend 32 percent of their loans to the priority sector. Within the target of 32 percent, two sub-targets for loans to the small scale sector (minimum of 10 percent) and exports (minimum of 12 percent) have been fixed. However, they are exempt from compulsory loans to the agricultural sector. Shortfalls in meeting the target can be balanced by depositing funds with the NABARD/Small Industries Development Bank of India (SIDBI).

Under the WTO Financial Services Agreement, the government has committed to licensing at least 12 new foreign bank branches per year (up from the present commitment of 8 per year).

The current levels of openness in the banking sector are not bound under GATS and actual practice is more liberal than Indian commitments. Continued reforms are expected that are likely to go further beyond India's commitments. One issue of national treatment is taxation, where foreign banks pay higher taxes than domestic banks, though this is balanced somewhat by the fact that foreign banks have lower levels of required lending to priority sectors. The other major issue is that foreign banks face a more restrictive policy on branching than do domestic banks.

INDIA

SECURITIES

SUMMARY

While India's capital markets have a long history, it is only recently that they have grown significant in size. At present, there are 22 accredited stock exchanges in India, including the National Stock Exchange (NSE) and Over-the-Counter Exchange of India (OCTEI), serving an estimated 30 million investors. Twenty of the exchanges have computer trading systems. The market includes about 9,890 listed companies, over 8,900 brokers (27 percent are corporate brokers) supported by an estimated 100,000 sub-brokers throughout the country, close to 1,000 financial institutions offering merchant banking services, 36 mutual funds with a total corpus of over Rs 22 billion (US$56 million), and four credit rating agencies. A wide variety of equity and fixed income instruments are available to investors. The stock exchanges have become important sources of financing for Indian corporations, reducing the previously dominant role of commercial banks and state-owned financial institutions. In addition, there are market participants such as registrars, transfer agents (issue bankers that distribute and collect share applications), and securities custodians. The National Securities Depository was established in 1996 to allow for paperless trading of shares and to improve deliveries for market participants. It is expected that in the near future, trading in equity derivatives will be introduced in India.

At the end of the Indian fiscal year 1997-98 (IFY 97-98), total market capitalization of Indian stock exchanges stood at Rs 5,898 billion (US$150 billion). Capital raised through primary issues of equity securities, bonds, and other instruments increased from Rs 2 billion (US$5 million) in IFY 80-81 to Rs 276 billion (US$7 billion) in IFY 93-94, but subsequently declined to Rs 46 billion (US$1.2 billion) in IFY 97-98. The decline was partly due to the strengthening of disclosure norms for new issues, to the availability of alternative methods of raising funds, and to industrial slowdown. Mutual funds increased Rs 134 billion (US$3.4 billion) during IFY 97-98.

Much of the growth in India's markets has been driven by the economic reforms in the wider economy, which freed industry from controls on investment and expansion. These were supplemented by regulatory reforms and infrastructure development in the securities markets, many of which were initiated by the Securities and Exchange Board of India (SEBI). Companies are now allowed to issue equity at market determined prices, the issue process has been made more flexible, and India's capital markets have been opened to foreign investors. Tax concessions on long-term capital gains and dividend payments were also introduced.

Several U.S. financial institutions participate in Indian capital markets in various capacities. U.S. and other foreign financial institutions have established joint ventures with Indian financial institutions in the areas of investment banking, asset management, and consumer finance. U.S. financial institutions have also been active in underwriting offshore securities issues by Indian companies, and in managing and marketing mutual funds. In addition, institutional investors from

the United States constitute the largest number of foreign institutional investors (FIIs), accounting for approximately 60 percent of cumulative net FII investment. With the approval of the Foreign Investment Promotion Board and the Reserve Bank of India, foreign investors can also invest in domestic capital venture funds, in the form of trusts or companies, according to the Guidelines for Overseas Venture Capital.

SEBI is responsible for the development and regulation of India's securities, investor protection, and collaboration with the government and the Reserve Bank of India on securities market development.

FIIs may make portfolio investments in local stock markets, subject to registration requirements and certain investor ceilings. However, foreign individuals and foreign corporate bodies are not permitted to make portfolio investments in the shares of Indian firms. Foreign investors have been concerned by inadequate custodial facilities, lack of transparency in trading operations, and a weak clearance and settlement system. Several measures have been introduced by SEBI, the Indian government, and the stock exchanges to address these issues. The most significant measure has been the enactment of legislation facilitating the dematerialization of securities in a depository and settlement by electronic book entry.

The National Securities Depository Limited began operations in 1996. There are now over 50 participants, including all custodian banks used by foreign investors, and substantial dematerialization of share holdings of institutional investors in eligible securities has already taken place. SEBI is taking steps to make settlement through the depository of all trades on Indian stock exchanges compulsory in a phased manner.

Indian residents are not permitted to invest in foreign securities. Indian companies may raise funds overseas through issues of Global Depositary Receipts (GDRs), American Depositary Receipts (ADRs), and convertible bonds. In May 1998, these guidelines were liberalized to permit previously unlisted companies to issue GDRs and ADRs and removed some existing restrictions on the end use of funds raised through such issues.

DESCRIPTION OF THE MARKET

Capital Market Growth

The present process of economic reform, which began in 1991, has focused on increasing the output, efficiency, and competitiveness of Indian industry at home and abroad by pulling down artificial entry barriers for industry, removing restrictions on growth in the size of firms, and eliminating licensing requirements. Reform of the financial services sector, especially the securities markets, has been at the very heart of this effort. The aim has been to create a much larger role for the private sector in the economy and to allocate capital more efficiently through market mechanisms. This has led to an expansion of markets in terms of primary issues, secondary market trading, introduction of new instruments, institutionalization, and development of well-capitalized and professionally run intermediaries.

The market includes, of 9,890 listed companies, over 8,900 brokers (27 percent of which are corporate brokers) supported by an estimated 100,000 sub-brokers throughout the country, close to 1,000 financial institutions offering investment banking services, 36 mutual funds with assets of over Rs 22 billion (US$56 million), and four credit rating agencies.

Capital raised through new equity issues, bonds, and other capital market instruments totaled Rs 46 billion (US$1.2 billion at an exchange rate of Rs 39.4 equals US$1) in IFY 97-98 versus only Rs 2 billion (US$5 million) in IFY 80-81. In IFY 93-94, Rs 276 billion (US$7 billion) were raised. The decline may be due to strengthening of disclosure norms for issues and to the availability of alternative methods of raising funds. However, this was partly offset by the spurt in capital raised through the private placement route, mainly debt instruments of public sector companies and institutions.

In addition to conventional equity/preference shares and debentures, Indian securities firms are now able to offer a wide variety of securities products: triple-option convertible bonds, deep-discount bonds, zero-interest partly convertible debentures, cumulative convertible redeemable preference shares, equity shares with detachable warrants, and floating rate bonds. Indian firms no longer limit themselves to raising funds earmarked for individual projects; they use capital proceeds to retire debt, invest in subsidiaries, and provide working capital. Some foreign banks and nationalized banks offer over-the-counter trading for government bonds.

Stock Exchanges

There are presently 22 stock exchanges, including the NSE and OCTEI, serving an estimated 30 million investors. The largest stock exchanges are in Mumbai, Calcutta, Madras, Delhi, and Ahmedabad. Out of the 22 stock exchanges, Ahmedabad, Mumbai, Calcutta, Delhi, and the NSE accounted for over 90 percent of total turnover in IFY 96-97, and out of the stocks traded at the Bombay Stock Exchange (BSE, in Mumbai), less than 20 percent are traded heavily. Automated screen-based trading, which was introduced through the establishment of the OTCEI and NSE and subsequently introduced by the BSE, has brought about a qualitative improvement in the market and its transparency. Twenty stock exchanges now have screen-based trading systems. This implies that today, 98.8 percent of trading takes place on screen-based systems. The BSE has also expanded its trading network outside of Mumbai, and now covers 118 cities across the country with its computer trading system. Together, the NSE and BSE cover over 250 centers across the country through their trading networks. The smaller exchanges are also in the process of inter-connecting their trading systems to provide cross-market execution to their members. The stock exchanges are managed by their governing boards and executive directors, which establish their operating rules. They are subject to regulations by the Ministry of Finance and the SEBI.

The ratio of market capitalization of the BSE to GDP rose from 12.1 percent in IFY 89-90 to 33.9 percent in IFY 96-97. Similarly, trading volume in the BSE increased more than four times during the same period. As of March 1998, the All-India market capitalization of all companies listed on stock exchanges was Rs 5,898 billion (US$150 billion). Total turnover on the stock exchanges as of the end of March 1997 was Rs 6,461 billion (US$164 billion). Market capitalization at the BSE, as of the end of March 1997, was Rs 2,624 billion (US$66 billion). The average price/earnings (P/E) ratio (Sensex) of listed companies was 15.65 in March 1998, compared to a P/E of 14.81 a year earlier. The following table provides data on selected major stock exchanges (many of which list the same stocks), with capitalization expressed in billions of rupees, as of March 31, 1997:

Major Stock Exchanges
Composition of Market Capitalization as of March 1997

Stock Exchanges	Regional Firms Listed	Market Capitalization (Billions of rupees)
1. Mumbai	1,810	2,624.04
2. Calcutta	1,875	407.18
3. Delhi	1,744	370.33
4. Madras	664	327.27
5. Ludhiana	290	184.96
6. Uttar Pradesh	347	158.02
7. Hyderabad	619	113.10
8. Pune	173	110.85
9. Bangalore	255	96.99
10. Cochin	140	95.36
11. Ahmedabad	676	92.46
12. Vadodara	325	72.94
13. NSE	7	57.71
14. Madhya Pradesh	268	46.38
15. Jaipur	179	31.48
16. Mangalore	20	29.19

Stock Exchanges	Regional Firms Listed	Market Capitalization (Billions of rupees)
17. Saurashtra Kutch	43	26.53
18. Coimbatore	96	10.94
19. Gauhati	170	10.20
20. Bhubaneshwar	46	10.04
21. OTCEI	108	4.18
22. Magadh	35	2.76
TOTAL OF ABOVE	9,890	4,882.91

Turnover on Indian Stock Exchanges
(Billions of rupees)

	IFY 96-97	IFY 97-98
1. NSE	2,945.04	3,699.34
2. Mumbai	1,242.84	2,073.83
3. Calcutta	1,056.64	1,787.78
4. Delhi	486.31	678.40
5. Ahmedabad	205.33	307.71
6. Uttar Pradesh	160.70	153.90
7. Bangalore	43.98	86.36
8. Pune	99.03	86.24
9. Ludhiana	52.74	83.15
10. Vadodara	42.68	45.76

Source: SEBI

OTCEI, an over-the-counter electronic trading system, is for small investors and small companies. It commenced operations in September 1992 in Bombay and is similar to the National Association of Securities Dealers Automated Quotation Market in the United States. In late 1993, it began operating regional windows in Delhi and Madras, and now has representative offices in 23 major cities.

The NSE has emerged as the dominant stock exchange of the country, accounting for nearly 60 percent of the total trading turnover on all the stock exchanges. The NSE is an automated stock exchange that has introduced screen-based trading throughout the country. The NSE began on-line trading in the debt market in June 1994 and the equity segment of the NSE became operational in November 1994. It has spread its operations to 179 cities across 18 states. In addition to equities, the NSE offers a trading facility for wholesale corporate and government debt. Its central computer in Mumbai is linked to market participants around the country via a satellite network.

SEBI is responsible for the development and regulation of India's capital markets, investor protection, and advising the government on capital market development. It was constituted as a non-statutory body on April 12, 1988, and given regulatory authority on January 30, 1992. SEBI has drafted and issued a variety of regulations governing transactions by stockbrokers, investment bankers, portfolio managers, and mutual funds. SEBI has also issued regulations governing substantial acquisitions of shares and takeovers, foreign institutional investors, and venture capital funds. Prior to SEBI's establishment, functions relating to the issue of capital and its pricing were handled by the Controller of Capital Issues within the Ministry of Finance, under the authority of the Capital Issues (Control) Act, 1947 (repealed on May 29, 1992).

Securities are traded on the stock exchanges through a limited number of licensed brokers, but a large number of sub-brokers and their agents operate through the registered brokers. SEBI has imposed stricter requirements on brokers in recent years, requiring registration and stricter financial disclosure norms. It also has pushed to have brokers clearly separate trading on their own account from trades executed for customers.

A new carry forward system was introduced in October 1995 replacing the "badla" system, which was considered to be speculative and inequitable and was banned by SEBI in March 1994. The BSE implemented a new system which included: special safeguards, including margins; limits on the number of days transactions could be carried forward; and separation of carry forward trades from those for settlement.

One recent development is the formation of the Federation of Indian Stock Exchanges (FISE) by 12 regional stock exchanges. Their next step is to set up a central trading system through inter-connectivity; for this purpose they formed a body called the Indian Stock Exchanges Services Corporation (ISESC). If FISE succeeds in setting up an all-India trading system through ISESC, there will be three entities with a national stature: the NSE, the BSE, and the ISESC.

There are four credit rating agencies in operation in India: the Credit Rating Information Services of India Ltd. (CRISIL), the Investment Information and Credit Rating Agency of India Ltd. (ICRA), the Credit Analysis and Research Ltd. (CARE), and Duff and Phelps. These agencies generally rate the debt instruments of firms seeking to raise resources from the capital market. Recently, SEBI formulated a new set of tough guidelines to regulate private debt placements, which had previously not been required to obtain ratings. The new guidelines state that any issue having more than 100 investors will be considered a public issue. Ratings are mandatory for publicly issued debt instruments with maturity periods, even if the maturity period is less than 18 months.

Foreign financial institutions may act as securities custodians. Currently there are 14 securities custodians operating in the Indian market, including the Stock Holding Corporation of India, Ltd., Hongkong and Shanghai Bank, Citibank, Standard Chartered Bank, the State Bank of India, Deutsche Bank, ANZ Grindlays, and Morgan Stanley Trust Company.

There are a number of major problems facing Indian stock exchanges, including lack of transparency, inadequate custodial services, and delays in physical delivery of certificates. Delivery may take up to six months, although generally 50 percent of the total value of the transactions must be paid at the time of purchase. These problems have been addressed by the introduction of screen-based trading on most exchanges, the settlement of transactions by electronic book entry, and the establishment of a depository. Measures have also been taken by SEBI to make settlement of trades in a depository compulsory in a phased manner.

The 1997-98 budget reduced the corporate tax rate from 43 percent to 35 percent for domestic companies and from 55 percent to 48 percent for foreign companies. The tax rate for nonresident Indians on capital gains on securities sales was reduced from 20 percent to 10 percent. In addition, dividend income received from a domestic company is exempt from tax in the hands of the shareholder. Companies pay an additional tax of 10 percent on dividends declared, distributed, or paid.

The institutional infrastructure in the government securities market has been strengthened with the system of primary dealers announced in March 1995 and that of satellite dealers in December 1996. At present six primary dealers are in operation and nine companies have been registered as satellite dealers.

The U.S. Agency for International Development (USAID), in consultation with the Indian government, administers a Financial Institutions Reform and Expansion (FIRE) project. The project is designed to help India's capital markets adopt "best practices" in market regulation, oversight, and enforcement to improve market transparency. It also assists in modernizing the operating systems used in the capital markets to promote efficiency and reduce high levels of systemic risks, thereby bolstering investor confidence in the transparency and fairness of the market.

The National Securities Depository Limited (NSDL)

The Depositories Act of 1996 paved the way for the establishment of depositories in India. It permits transfer of securities through electronic book entry, leading to better investor service and protection. As a result of this Act, the NSDL was established and began operations in October 1996, sponsored by Industrial Development Bank of India, Unit Trust of India, and the NSE. NSDL carries out its operations through participating companies and the clearing corporations of the various stock exchanges. The participants act as market intermediaries through whom NSDL interacts with the investors and clearing members. Since only the NSE has a clearing corporation, the National Securities Clearing Corporation Limited (NSCCL), which guarantees performance of trade obligations and has been admitted into the depository, only the capital market segment of the National Stock Exchange has been associated with NSDL at this point. As of April 30, 1998, total market capitalization signed up for dematerialization with NSDL stood at Rs 3,298 billion (US$83 billion), which accounted for nearly 55 percent of the total market capitalization of all the listed companies in the country. In a bid to give a push to the depository system, SEBI has decided to make it compulsory for all institutional investors to settle their trades through the depository. These include banks, mutual funds, and FIIs having a minimum portfolio of Rs 100 million (US$2.5 million) as of the latest balance sheet.

Incorporation of Brokers

There were 8,867 brokers on the various stock exchanges in India as of March 1997. Until recently, brokerage houses were generally partnership firms. Consequently, the brokers were poorly capitalized with little, if any, capability to do equity research and provide comprehensive and relevant market information. There was no apparent link between a brokerage's capital base and its risk exposure. In an effort to encourage brokerages to adopt a corporate business form, the government granted in its 1997-98 budget a one-time exemption on capital gains tax for the conversion of partnerships into corporations. This exemption has been extended by the government for a second year in the 1998-99 budget.

Some of the top FIIs operating stock brokerages in India reported losses in IFY 96-97. Among the FIIs that reported losses were Morgan Stanley India Securities, Jardine Fleming India Broking, Peregrine Securities, HG (India), James Capel Batlivala & Karani Securities (now HSBC B&K), ING Baring Securities, Birla Marlin Securities, and Credit Capital Securities. The three FIIs that made profits were Crédit Lyonnais Securities India, UBS Securities, and DSP Merrill Lynch.

Stock Lending

Following changes in tax regulations in the recent budget which proposed that lending of securities would not attract capital gains tax, a proposal designed to facilitate stock lending in a regulated manner has been introduced. Stock lending can now take place through an intermediary which is registered for this purpose with SEBI and has a minimum capital of Rs 500 million (US$13 million). Lenders and borrowers of securities have to enter into agreements with the intermediary. The introduction of stock lending will facilitate the timely settlement of transactions on the stock exchanges, especially in an environment that requires physical delivery of certificates for settlement.

Derivatives

As a starting point for equity derivatives in India, SEBI has approved the phased introduction of trading stock index futures on existing stock exchanges. The exchanges have been permitted to trade derivatives subject to fulfilment of the eligibility conditions prescribed by the L.C. Gupta Committee report, including provision of adequate infrastructure, the use of an on-line trading and surveillance system, and participation of a minimum of 50 members in derivatives trading. SEBI has announced that mutual funds must make necessary disclosures in their offer documents if they intend to trade in derivatives. The NSE and the CRISIL have set up a new company for indexing and will put out various equity indices in technical collaboration with Standard and Poor's of the United States. The indices NSE 50 and CRISIL 500 will henceforth be known as S&P CNX Nifty and S&P CNX 500. The current Securities Exchange Contracts Regulations Act needs to be amended to redefine securities to include derivatives such as futures and options.

Forward markets are regulated by the Forward Markets Commission. The Forwards Markets Commission (FMC) is a statutory body set up by the government of India under the Forwards Contracts Act of 1952. The act provides for the regulation of matters relating to forward contracts, the prohibition of options on goods, and related matters. The Commission functions under the Department of Consumer Affairs, Ministry of Food and Consumer Affairs, and thus is not independent. At present, the FMC has two members. It is headquartered in Mumbai and has a regional office in Calcutta. The FMC has three functional wings: the Commodity division, the Enforcement division, and the Administration division.

A domestic futures market has operated for several years under the Spices Association in Cochin. A recently-started International Pepper Exchange has seen little activity as domestic exporters prefer to hedge in the domestic futures market and international interest has so far been small. There are plans for a cotton futures market in Mumbai.

At present, futures trading is regulated through 17 recognized associations in seven commodities: castor seeds, pepper, tumeric, potatoes, gur, hessian, and jute goods.

Mutual Funds Industry

The government has permitted mutual funds to be established both in the government and the private sector. Unit Trust of India is the dominant player in the public sector, with a market share of about 80 percent, and Life Insurance Corporation and the General Insurance Corporation also have large mutual funds.

The promulgation of SEBI's mutual fund regulations in 1993 brought about a restructuring of the mutual fund industry. An arm's length relationship was required between the fund sponsor, trustee, custodian, and asset management company. The regulations prescribed disclosure and advertising norms for mutual funds and, for the first time, permitted the entry of private mutual funds, some of which have U.S. participation in their asset management companies. These regulations were revised in 1996 to improve investor protection, to facilitate competition by removing unnecessary regulation, and to encourage innovation and flexibility. Guidelines for money market mutual funds have also been issued. Mutual funds in India are exempt from taxation; income from investment in mutual fund schemes is taxed in the hands of investors. Foreign financial institutions established in India may manage local mutual funds. Foreign asset management companies may also set up joint ventures to manage some of the domestic mutual funds, but they must be registered with the SEBI.

The mutual fund industry is still in its early stages of development in India and has not had a stellar performance record in recent years, largely due to weak capital markets. India's 33 mutual funds mobilized Rs 134 billion (US$3.4 billion) in IFY 97-98, adding to cumulative assets of Rs 979 billion (US$25 billion) at the end of IFY 96-97. The industry suffers from poor product image, lack of self–regulation and transparency, inadequate disclosure norms, and weak accounting standards. The Association of Mutual Funds has been established to bring about structural and quantitative improvement in the mutual fund industry.

Foreign Investment in Venture Capital Funds

Venture capital funds may be set up as companies or trusts. Regulations permit venture capital funds to raise money only from institutional and high net worth individuals. The minimum amount that may be raised from any investor is Rs 500,000. The only investment restriction that has been prescribed is that at least 80 percent of the funds raised by a venture capital fund or trust may be invested in unlisted companies and financially weak companies (listed or unlisted) or used to provide loan assistance to investee ventures. Venture capital funds are exempt from taxation, provided that they invest in certain sectors of the economy designated by the tax authorities and such investment, among other requirements, is for a minimum period of three years. Venture capital funds may invest up to 20 percent of their assets in the equity of any single company.

Foreign investors may invest in domestic capital venture funds, whether set up as trusts or companies. This investment is governed by the Guidelines for Overseas Venture Capital Investment. The initial investment in the domestic venture capital fund by an overseas investor requires the approval of the Foreign Investment Promotion Board (FIPB) and the Reserve Bank of India (RBI); however, approval for subsequent investment by the venture capital fund into investor ventures is not necessary.

Foreign Institutional Investment

Issuance of the guidelines for Foreign Institutional Investment in September 1992 invited FIIs to invest in Indian securities markets. In September 1995, the SEBI (Foreign Institutional Investors) Regulations, 1995 came into effect. The regulations require FIIs to register with SEBI and to obtain approval from the RBI under the Foreign Exchange Regulation Act to buy and sell securities, to open foreign currency and rupee bank accounts, and to remit and repatriate funds. Once SEBI registration has been obtained, no further permission is needed to buy or sell securities or to transfer funds in and out of the country, subject to payment of applicable taxes.

FIIs such as foreign pension funds, foreign mutual funds, and foreign investment trusts, insurance or reinsurance companies, government agencies, multilateral agencies, and endowment funds can invest in domestic Indian securities. Shares held by all FIIs combined may not exceed 24 percent of the issued capital of the Indian company. The limit can be raised to 30 percent with the approval of the board of directors of the company concerned. The ceiling on holdings by an individual FII (or its sub-accounts) is 10 percent of the total issued capital of the Indian company.

Investment in Indian securities is also possible through the purchase of Global Depositary Receipts, Foreign Currency Convertible Bonds, and Foreign Currency Bonds, which are all listed, traded, and settled overseas. These instruments are generally denominated in U.S. dollars.
Foreign investors, whether registered as FIIs or not, may also invest in Indian securities, with approval from the FIPB in the Ministry of Industry and the RBI. In some cases, only RBI approval may be necessary, depending on the size of investment and the industry in which the investment is to be made.

The government recently opened the government securities market to all FIIs. It has permitted FIIs to lend securities and eased the lock-in norms for preferential allotments. FIIs can invest in primary and secondary markets including shares, debentures, and warrants of companies which are listed (or soon to be listed) on a recognized stock exchange in India. FIIs are allowed to invest in units of instruments floated by the Unit Trust of India and other domestic mutual funds, whether listed or not. FIIs are also allowed to make equity investments in unlisted companies, but must channel transactions through authorized Indian companies. Both FIIs with a ceiling of 30 percent investment in debt instruments and those in the category of 100 percent debt funds are permitted to invest in government debt securities. The RBI has restricted FII investments to a prescribed debt ceiling in order to safeguard against a potential negative development that may result from foreign investment in short-term debt. These investments are subject to an annual cap within the overall external commercial borrowing limits, currently in the region of US$9.5 billion. The government has also recently allowed FIIs to invest in treasury bills. Proprietary funds are also permitted to make investments through the FII route subject to the condition that they are subject to their home regulators or are registered with their tax authorities.

FIIs enjoy a concessional tax rate of 10 percent on long-term capital gains (securities held for 12 months or more), and 30 percent on short-term capital gains (securities held for less than 12 months). Dividends and interest income are taxed at a rate of 20 percent. Indian firms pay 20 percent on profits earned on equity securities. The final tax incidence may be different if investors take advantage of bilateral double taxation treaties, which India has signed with 40 countries, including the United States, the United Kingdom, Japan, Germany, and France.

To meet Indian requirements, FIIs must be regulated by an appropriate foreign regulatory authority, such as a securities regulator, central bank, or other government agency. Registration with foreign authorities that are responsible for incorporation is not, by itself, enough to meet this requirement. FIIs must also have a track record of two to three years of operations.

Foreign financial service institutions have also been allowed to set up joint ventures with Indian partners in stock brokerage companies, asset management companies, investment banking, and other financial services firms. Foreign participation in financial services requires the approval of the FIPB.

The Ministry of Industry has permitted foreign investors in foreign exchange brokerage services in addition to a range of 14 nonbank financial services where foreign equity investment has already been permitted. These 14 activities include merchant banking, underwriting, portfolio management services, investment advisory services, financial consultancy, stock brokerage, asset management, venture capital, custodial services, factoring, credit reference agencies, credit rating agencies, leasing, and housing finance.

All investment proposals must be routed through the FIPB. One hundred percent foreign-owned foreign exchange brokerage firms have been allowed to act only as holding companies. Specific activities will have to be undertaken by subsidiaries with a minimum domestic equity of 25 percent. Domestic equity in the subsidiaries of 100 percent foreign-owned companies may be phased by starting with 10 percent domestic equity and increasing the percentage over a period of 24 months.

As of May 26, 1998, 502 FIIs were registered with SEBI (about 150 are active in the market) and had made cumulative net investments of US$9.1 billion. As of the same date, 17 approvals have been given for 100 percent debt investments for a total allocation of US$2.52 billion. Of these, five FIIs have become active and have made cumulative net investments of US$97 million.

International Issues

Although Indian residents are not permitted to purchase foreign securities, the RBI permits Indian firms to raise funds overseas, but only through issues of Global Depositary Receipts (GDRs) or convertible bonds that can be listed overseas and are mainly denominated in U.S. dollars. American Depositary Receipts (ADRs) are also permitted, but Indian firms find it difficult to meet SEC listing standards. Indian firms have successfully launched Euro-issues in overseas markets. Early in 1993, several large firms entered the international markets by issuing GDRs convertible bonds. Based on their success, smaller firms also entered the market to raise funds for modernization and expansion, to reduce/retire debt, and to set up overseas subsidiaries. As of June 1998, Indian issuers have placed 76 GDR issues and raised US$7,432 million in Foreign Currency Convertible Bonds.

U.S. PRESENCE IN THE MARKET

U.S. Securities Firms and Financial Institutions

Several U.S. companies have joined with Indian partners to offer financial services in India. J.P. Morgan had a 40 percent joint venture with Industrial Credit and Investment Corporation of India (ICICI) for investment banking and stock brokerage services. J.P. Morgan also had a joint venture with ICICI for asset management. They have decided to part ways and J.P. Morgan has been granted approval to set up a securities and investment banking firm with up to 75 percent held by J.P. Morgan and the remaining by an Indian partner, yet to be identified. J.P. Morgan has also been granted approval for a full bank branch.

Morgan Stanley has a 75 percent stake in an asset management company, which operates a mutual fund, as well as in two securities firms, one for investment banking and one for stock brokerage services. Morgan Stanley has announced that it will enter into joint ventures with Jamnadas Morajee, a leading domestic investment banking and securities group. Morgan Stanley Trust Company has a branch in Mumbai, which offers custodial services to FIIs. This activity is likely to be taken over by the Chase branch in Mumbai following the sale of Morgan Stanley's custody and trust businesses to Chase Manhattan Bank.

Numerous other large U.S. financial firms have affiliated with Indian firms, including Merrill Lynch, Goldman Sachs, Kemper Financial Services, and GE Capital Corporation.

Several U.S. investment banks have been lead underwriters of GDRs and foreign currency convertible bonds and have been appointed as lead managers for overseas issues in government disinvestment programs designed to reduce the government's holding in selected public sector firms.

SHCIL plans to become a global custodian and expects to diversify into the securities lending business and retail custodial services as well as operate a limited purpose bank. SHCIL has already begun negotiations with the U.S. SEC for necessary approvals for the global custodian business and will adhere to international capital adequacy norms prescribed by the SEC.

Investment by U.S.-Based FIIs

The largest number of FIIs registered with SEBI are from the United States. These companies account for about 60 percent of cumulative net investment by FIIs in India. Six financial institutions have also been granted approvals by SEBI for establishing funds to invest entirely in Indian debt securities. Planned investment totals about US$840 million.

The Banking Regulation Act was amended in 1983 to permit commercial banks to establish investment banking subsidiaries. Among the public sector banks and foreign banks active in this sector are:

- public financial institutions such as the Industrial Credit and Investment Corporation of India (ICICI) and Industrial Finance Corporation of India (IFCI);

- commercial banks such as State Bank of India, Canara Bank, Grindlays, Citibank, and Standard Chartered; and

- private nonbank finance companies such as JM Financial and Investment Consultancy Services, the Credit Capital Group, Champaklal Investment and Financial Consultancy, and DSP Financial Consultant Ltd.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There is no limit on the extent of foreign equity participation in financial subsidiaries engaged in securities activities; however, they are subject to minimum capital requirements and approval from the FIPB, RBI, and SEBI for foreign ownership. The Indian government is flexible on whether investment banks can establish 100 percent foreign-owned entities.

The RBI permits the opening of representative offices by foreign securities firms, provided that the office earns no income and all expenses are paid by remittances from abroad.

Although Indian residents are not allowed to invest in portfolio securities overseas, Indian companies are permitted to issue equity and equity-related instruments to international investors with RBI permission. U.S. investment banks may underwrite international offerings by Indian firms.

The major barriers to market access in the securities industry that have yet to be addressed by the Indian government include: (1) the removal of discriminatory restrictions on the ability of FIIs to trade for their own account or for the account of customers; and (2) the inability of foreign securities firms to operate on the Indian stock exchanges directly instead of working through registered Indian brokers to execute transactions.

India's GATS offer makes very few commitments. In general, actual practice is more liberal than commitments made in the offer. For example, the offer binds India to allow up to 51 percent foreign equity in foreign financial services companies, but in practice the government routinely approves higher levels of foreign equity, up to 100 percent. There is continued reform and liberalization in the securities sector, which goes well beyond the GATS offer.

INDONESIA

BANKING

SUMMARY

Indonesia's banking sector is currently in dire condition, and a major effort to restructure the sector is beginning to take shape. The economic crisis that swept Southeast Asia starting in July 1997 has nearly paralyzed Indonesia's financial sector. Most bank loans are not being serviced and a collapse in bank credibility has all but shut off the flow of interbank credit. Public confidence in Indonesian banks is also low.

After a decade of banking sector liberalization, the government of Indonesia has found itself forced to issue a sweeping guarantee on bank deposits and other liabilities as the economic crisis deepens. Bank Indonesia has provided a substantial amount of liquidity credits to troubled banks – in effect becoming part owner – after several potentially disastrous bank runs. The government has also established the Indonesian Bank Restructuring Agency (IBRA), charged with supervising and eventually recapitalizing the ailing banks. It is estimated that over 70 percent of banking system assets are under government control.

Against this backdrop, the conditions facing U.S. and other foreign banks in Indonesia are improving in terms of market access and national treatment. In the December 1997 WTO financial services negotiations, Indonesia submitted a far-reaching offer that, among other improvements, guaranteed the ownership rights of existing financial services firms. In addition, partly in response to the banking sector crisis, the government is preparing legislation that would allow full foreign ownership of banks.

DESCRIPTION OF THE MARKET

Structure of the Market

As of April 1998, the Indonesian banking sector consisted of seven state-owned banks, 136 private national banks, 34 joint venture banks, 27 regional development banks, and 10 foreign bank branches. There were also 2,189 Rural Credit Banks and 7,191 other rural financial institutions providing small-scale credit to farmers. In terms of reported assets, private national banks were slightly larger than state-owned banks, due to a rapid increase in the number and size of private banks that began after a deregulation package was released in 1988. Although the number of banks is large, the entire banking sector is small by international standards, with assets totaling less than US$100 billion.

Consolidated Balance Sheet of Indonesian Banks
April 1998 (US$ millions)

	State-Owned	Private National	Foreign	Joint-Venture	Regional Government	Total
Assets						
Cash in vault	308	546	15	4	72	945
Demand dep. at BI	808	920	121	30	52	1,931
Foreign assets	5,557	5,043	928	1,011	2	12,541
Claims on Govt.	49	9	0	7	7	72
Claims on State-owned enterprises	3,449	716	31	47	39	4,282
Claims on private enterprises/ individuals	24,351	25,399	4,159	5,643	828	60,380
other	5,724	8,023	1,656	500	395	16,298
TOTAL	40,246	40,656	6,910	7,242	1,395	96,449
Liabilities and Equity						
Demand deposits	2,062	4,074	591	147	319	7,194
Time/saving deposits	14,107	16,154	874	277	580	31,992
Foreign exchange accounts	3,910	4,168	3,488	1,355	5	12,926
Foreign liabilities	5,856	2,417	1,226	4,155	13	13,668
Government account	1,687	110	11	16	81	1,905
Import guarantees	157	93	13	5	1	269
Borrowings from BI	4,570	6,425	51	459	48	11,554
Capital	2,684	2,639	335	502	153	6,313

	State-Owned	Private National	Foreign	Joint-Venture	Regional Government	Total
Assets						
Cash in vault	308	546	15	4	72	945
Other	5,210	4,577	320	327	194	10,629
TOTAL	40,243	40,657	6,909	7,243	1,394	96,450

Source: Bank Indonesia
Note: Converted at end-April rate of Rp 7970/US$. The end-June rate was Rp 14,500/US$.

The banking sector has historically been fragile, but the economic crisis that began in 1997 has severely weakened many banks, and a wholesale restructuring of the banking sector is underway. It is difficult to predict how many banks will emerge intact from the process. Consequently, the government's role in the banking sector has increased: it has provided direct liquidity support to the banks of over Rp 140 trillion (US$9.4 billion) as of June 1998, or about 20 percent of 1997 GDP, and is concurrently restructuring the banking system (see IBRA). Over the longer term, it appears that foreign banks will be invited to play a larger role in the Indonesian banking sector; legislation allowing unrestricted foreign ownership of banks is currently being prepared.

Regulatory Structure

Bank supervision is carried out under the authority of the Managing Director for Banking Supervision at the central bank, Bank Indonesia. After concerns about the health of the rapidly expanding banking system arose in the early 1990s, Bank Indonesia took steps to strengthen its regulatory control and supervision efforts. Reporting requirements were tightened and more frequent on-site inspections were instituted. Bank Indonesia also merged on-site and off-site inspection teams so that one team would have full responsibility for each institution. In addition, it adopted a "CAMEL" rating approach based on evaluations of capital, asset quality, management supervision, earnings, and liquidity.

Banking regulations were stiffened too. The minimum capital adequacy ratio (CAR) for commercial banks was raised to 8 percent at the end of 1993. (The government, however, lowered the CAR to 4 percent in mid-1998.) In September 1998, the paid-in capital required to establish a new commercial bank, including a joint-venture bank, increased to Rp 3 trillion (US$280 million). Existing banks do not have to meet a paid-in capital requirement. Loan loss provision requirements were raised in 1994, and again in early 1998. Legal lending limits were phased in by early 1997 to control banks' exposure to single groups of borrowers. (A maximum of 20 percent of the bank's capital can be lent to any corporate group, and a maximum of 10 percent of capital to any affiliated group.) Other regulations included a maximum loan-to-deposit ratio of 110 percent; a maximum net open position for foreign exchange banks of 25 percent of capital; and a prohibition on investing in equities.

Despite a seemingly solid regulatory structure, the financial and economic crisis revealed serious weaknesses in the government's oversight of the Indonesian banking sector. Audits by international accounting firms have revealed that banks routinely circumvented the legal lending limits, and underreported and inadequately provisioned for shaky assets. It is estimated that over 60 percent of bank loans are non-performing. Substantial and unhedged foreign debt by both banks and borrowers has also led to significant financial sector deterioration. It is clear that both the banks and the supervisory and regulatory system need to be overhauled.

IBRA

The government of Indonesia established IBRA in January 1998 to (a) carry out a restructuring of the banking sector; and (b) administer the government guarantee on bank liabilities. Responsibility for the latter has since been transferred to Bank Indonesia. Banks that received a substantial amount of liquidity support have been placed under IBRA supervision. Seven banks under IBRA supervision were "frozen" (closed) in April 1998. As of June 1998, there were 53 banks under IBRA supervision, including the two largest private banks, Bank Central Asia and Bank Danamon. It is estimated that over 70 percent of banking system assets are under government control.

Under the restructuring plan that is being worked out with the assistance of the International Monetary Fund, the World Bank, and the Asian Development Bank, the banks under IBRA supervision are to undergo full portfolio reviews by international accounting firms. An asset management unit (AMU) is also being set up to deal with non-performing assets. Viable banks are to be recapitalized – with foreign participation invited – while non-viable banks are to be closed. The scope of the task, however, is enormous, because worsening economic conditions mean that previously sound banks continue to deteriorate along with the economy as a whole. Many observers believe that most of the banks not under IBRA supervision are in serious financial condition as well. Thus, it is difficult to estimate how many banks will remain after the restructuring process is complete.

U.S. PRESENCE IN THE MARKET

Four U.S. financial institutions – Citibank, Chase Manhattan, American Express, and Bank of America – enjoy grandfather status under Indonesian regulatory system and operate fully-owned branches. Although three of these four banks concentrate only on corporate lending, they are permitted to provide a full range of banking services.

The following eight U.S. banks have representative offices which provide services such as the facilitation of trade financing, but cannot accept deposits or make loans:

Bank of Boston	J.P. Morgan
Bankers Trust	NationsBank
Bank of New York	Republic National
First Union National Bank (formerly CoreStates Bank)	Union Bank of California

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In 1972, Indonesia stopped issuing new licenses to foreign banks, and no new foreign bank entered the market until after the 1988 financial sector deregulation which permitted joint ventures. (The 10 foreign banks that owned and operated branches, including the four U.S. banks listed above, had been established prior to 1972.)

Recently, the government of Indonesia has reduced the restrictions on the scope of foreign banking activity in Indonesia, though some issues remain.

- Forced Divestiture: The1988 financial reforms permit a foreign bank to form a joint venture with a domestic bank, provided the foreign bank is a "major bank" in its home country, and that reciprocal access is available to Indonesian banks. The local joint venture partner must have an equity interest of at least 15 percent. However, a provision of Indonesian banking law, not yet enforced, requires that the foreign and domestic partners plan to increase the level of Indonesian ownership in the joint venture bank. Concern over this "Indonesianization" provision was allayed by Indonesia's December 1997 offer on financial services in the WTO, which stated that "[n]o transfer of share ownership shall take place without the consent of all parties in the joint venture concerned."

- Discriminatory Capital Requirements: The 1997 Indonesian financial services offer in the WTO also pledged to eliminate discriminatory capital requirements for joint-venture banks by the end of 1998. Under existing rules, these banks must have twice the capital of domestic banks, and regulatory authorities compute capital adequacy ratios and legal lending limits for foreign branches using only capital of the branch and not the capital of the parent bank. These rules restrict the amount of business these banks can do in Indonesia.

- Foreign Ownership: In 1997, the government of Indonesia lifted limits on the foreign purchase of shares in all nonbank firms listed on the Jakarta Stock Exchange, while the limit for foreign ownership of publicly listed banks remained at 49 percent. However, discussions underway in June 1998 indicated that the government was planning to lift all foreign ownership limits on banks, both listed and non-listed, by late 1999 in an effort to attract foreign capital to the banking sector. The government's June 1998 Letter of Intent to the International Monetary Fund states that "all restrictions on foreign ownership of banks will be lifted as part of the prospective amendments to the banking law."

- Remaining Issues: Foreign banks can offer the same banking services as domestic banks, and U.S. banks operating in Indonesia generally report that they do not feel significantly restricted in their operations. However, there are restrictions on the number of expatriates for whom an investor can obtain work permits. These personnel limits, which apply not only to banks but to all foreign companies doing business in Indonesia, are considered restrictions. In addition, foreign banks are currently limited to opening branches in Jakarta and seven other cities: Bandung, Batam Island, Denpasar, Medan, Semarang, Surabaya, and Ujung Pandang, while domestic banks face no branching limits. As Citibank is the only U.S. bank to have opened branches outside Jakarta, in Bandung and Surabaya, this limitation has not yet become a hindrance. U.S. banks also report difficulties in complying with a government regulation that requires 20 percent of new lending to go to small and medium enterprises – a segment of the economy where U.S. banks have relatively little direct experience.

Exchange Rates Used:

June 1998	14,900 Rupiah/US$
September 1998	10,700 Rupiah/US$

INDONESIA

SECURITIES

SUMMARY

Indonesia's capital market expanded rapidly over the last decade, led by growth of the equity market. Trading on the Jakarta Stock Exchange (JSX) – the dominant securities market in the country – increased from only 27,000 shares per day in 1988 to 254 million shares per day in mid-1998. Like the banking sector, however, the stock market was hard hit by the economic crisis that struck Indonesia beginning in mid-1997. Market capitalization declined by 30 percent in Rupiah terms from May 1997 to May 1998, and by an even more dramatic 83 percent in U.S. dollar terms. Indonesians described this collapse with the proverb, "already brought down, then hit by the falling ladder."

The lack of a well-developed bond market remained a limiting factor for Indonesia's financial sector, and arguably contributed to the financial and economic crisis. Lacking a deep domestic market for bond financing, and facing relatively high domestic interest rates for bank loans, many rapidly expanding Indonesian companies borrowed abroad during the early 1990s, running up private offshore debts of about US$80 billion by 1997. These loans were largely unhedged, because companies counted on the Rupiah's continuing depreciation at a slow and predictable rate against the U.S. dollar. The loans were also largely short-term, but it was common practice for lenders to roll over the principal on a yearly basis.

When the exchange rate crisis hit in mid-1997, companies suddenly faced loan payments that were very large in Rupiah terms. In addition, lenders balked at providing new loans and became increasingly reluctant to roll over short-term loans. The supply of foreign capital that Indonesia had come to rely on abruptly dried up. The flow of capital reversed course as foreigners and Indonesians alike began taking their wealth out of the country. As of mid-1998, a priority issue for the Indonesian government and business sector was to restore confidence so that capital inflow would resume. A longer-term issue was development of a more vibrant and self-reliant domestic capital market.

Foreign firms generally enjoy ready access to the Indonesian securities market. Financial reforms introduced in 1987 allowed foreign firms to form joint ventures with Indonesian partners in the securities market as underwriters, broker-dealers, and investment managers. Merrill Lynch operates a joint-venture brokerage firm in Jakarta. Morgan Stanley and Bankers Trust are also active. The 49 percent restriction on foreign purchases of all listed firms, with the exception of banks, was lifted in 1997. Discriminatory capital requirements on foreign securities firms were expected to be removed in 1998.

DESCRIPTION OF THE MARKET

Structure of the Market

The securities industry is still under development in Indonesia, and is dominated by the equity market. Indonesia has two stock exchanges: the JSX and the much smaller Surabaya Stock Exchange. The Indonesian government created the JSX in 1977, and for the next 15 years an agency called BAPEPAM operated the exchange and regulated securities trading. In 1987, the government of Indonesia took steps to deregulate the capital market and began encouraging companies to go public. In 1992, the JSX was privatized; BAPEPAM became solely a regulatory body like the U.S. Securities and Exchange Commission. By mid-1998, there were 287 companies listed on the Jakarta and Surabaya stock exchanges, compared with only 25 companies in 1988.

Rapid growth of the Indonesian economy translated into rapid growth of the stock market, but the market took a severe beating in 1997-98. Market capitalization expanded rapidly from US$33 billion at the beginning of 1994 to US$100 billion in mid-1997. But the collapse of the rupiah and the severe economic contraction that followed effectively erased the previous years' growth, reducing market capitalization to only US$17 billion by May 1998. Market value remained concentrated among the largest companies. In May 1998, the 20 largest firms accounted for over 70 percent of equity market capitalization.

The Indonesian market for bonds and other debt instruments remained small. About US$1.8 billion worth of bonds were outstanding as of April 1998. Only about US$100 million worth of bonds were traded on the JSX in May 1998. The domestic debt market lacked a benchmark government bond, since the Indonesian government is not allowed to borrow domestically. Instead, the principal debt instruments were issued by Bank Indonesia: SBI (Sertifikat Bank Indonesia), a bill that the central bank uses to conduct open-market operations; and SBPU (Surat Berharga Pasar Uang), a corporate promissory note endorsed by commercial banks. In April 1998, there were Rp 20.6 trillion (US$2.8 billion) in SBIs and Rp 3.3 trillion (US$440 million) in SBPUs outstanding. In 1998, the government of Indonesia was seriously considering changing its laws in order to permit the issuance of government bonds.

Lacking an active domestic bond market, many Indonesian companies issued bonds and commercial paper abroad in the 1990s. Indonesian firms raised US$10.7 billion on international capital markets in 1996.

In a significant step, the government of Indonesia in September 1997 removed the 49 percent limit on foreign ownership of companies' shares listed on the Jakarta and Surabaya Stock Exchanges, with the exception of banks. (The limit on foreign ownership of bank stocks was expected to be removed in 1998.) Foreigners have been important participants in the growth of the market, and they owned 25 percent of Indonesian stocks, by value, as of April 1998. There were no restrictions on foreign ownership of debt instruments or on foreign joint-venture securities firms underwriting fixed-income debt issues.

In 1997-98, the U.S. Agency for International Development provided assistance to the government of Indonesia to establish a futures trading system for key agricultural commodities. The system, still in its early stages as of mid-1998, is governed by a body called BAPEPTI (Commodity Trading Oversight Board) under the authority of the Ministry of Industry and Trade.

Regulatory Structure

The Capital Market Law of 1995 governs the Indonesian securities sector. The Ministry of Finance, which has authority over BAPEPAM, determines capital market policy. BAPEPAM licenses and regulates companies that act as broker-dealers, underwriters, and investment managers. It also regulates prospectuses and other disclosure documents. Finally, BAPEPAM oversees the Clearing Guarantee Corporation and the Central Securities Depository.

Since 1996, BAPEPAM has had on-line facilities to monitor price movements on the JSX, allowing it to check for signs of unusual trading activity or market manipulation. Even so, episodes of alleged insider trading have continued.

U.S. PRESENCE IN THE MARKET

Merrill Lynch established a joint venture brokerage operation in 1995; by May 1998 it was the eighth most active brokerage firm on the JSX, in terms of trading. Bankers Trust has a joint venture brokerage as well. Morgan Stanley has equity participations with one of the largest domestic brokerages, PT Makindo.

Other major U.S. brokerage houses participate in the Jakarta stock market through their regional offices based in Hong Kong and Singapore.

The largest custodians in the market are foreign banks. Citibank continues to play a significant role in this market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

U.S. and other foreign firms generally enjoy good access to the Indonesian securities market, both as purchasers and brokers. Indonesia took a significant step in opening up its capital markets in 1987, when it authorized foreign firms to act as broker-dealers, investment managers, and underwriters in partnership with Indonesian firms. The joint-venture requirement has not changed, but Indonesia is expected to lift discriminatory capital requirements on foreign firms in 1998. There are relatively tight limits on the number of foreign personnel who can be employed by securities firms; these restrictions apply to firms in other industries as well.

Current levels of openness to foreign participation in the stock market are not fully bound under GATS. For example, in September 1997, the government of Indonesia lifted limits on foreign purchases of shares on the JSX, allowing 100 percent foreign ownership of all firms except for banks; the banking law was being revised in late 1998 to remove this remaining exception.

Jakarta Stock Market Statistics

	May 1997	May 1998	Percent Change
Market Size			
Market Capitalization (Rp trillions)	246	175	-29%
Market Capitalization (US$ billions)	101	17	-83%
Listed Companies	261	287	10%
Bond Market Capitalization (Rp trillions)	0.7	0.6	-14%
Bond Market Capitalization (US$ billions)	0.3	0.1	-80%
Daily Average Activity			
Trading Value (Rp billions)	268	494	84%
Trading Volume (million shares)	251	254	1%
Foreign Ownership			
Net Purchases during month (Rp billions)	57	-35	

Source: Jakarta Stock Exchange homepage: www.jsx.co.id, as of mid-July 1998.

Exchange Rates Used:

May 1997	2,440 Rupiah/US$
April 1998	7,500 Rupiah/US$
May 1998	10,525 Rupiah/US$

JAPAN

BANKING

SUMMARY

Japan generally provides *de jure* national treatment for foreign banks, and in a few isolated instances, has provided better than national treatment. Nonetheless, until recently foreign banks have remained only marginal players in the Japanese banking market. This was partly a reflection of Japan's regulatory environment and partly the consequence of exclusionary business practices. Strong relationships between members of related business groups, often involving cross-shareholding arrangements, have made it extremely difficult for nonmembers (i.e., foreign banks) to compete effectively in the Japanese banking market. The beginning of the unwinding process of cross-shareholding, the flight to quality from some of the weaker Japanese banks, strategic business tie-ups between foreign and Japanese institutions, and the ability of foreign banks to capitalize on expanded opportunities for new products and services as a result of deregulation have combined to begin to expand the presence of foreign banks in Japan.

The recognized overcapacity in the Japanese banking industry has discouraged new entrants and the murky accounting of loan quality has discouraged equity purchases of existing Japanese banks. However, the Big Bang initiative to reform the Japanese financial system, and extremely low yen interest rates, have improved business opportunities for existing foreign financial institutions, including banks. Relaxed restrictions on cross-entry between sectors in the financial industry, and permission for banks to market investment trusts (similar to U.S. mutual funds) are features of the "Big Bang" that have been beneficial to developing new opportunities for foreign and domestic banks in Japan. The attention of foreign financial institutions has been focused on asset management, targeting Japanese individual financial assets, estimated at 1,200 trillion yen, that have traditionally been placed in bank deposits and postal savings.

Foreign Banking Operations in Japan

As of:	12/31/93	6/30/98
All Foreign Banks		
Total number of branches	145	144
Bank subsidiaries	9	9
Majority owned acquired banks	0	0
Representative offices	112	113
Joint venture banks	0	0

As of:	12/31/93	6/30/98
U.S. Banks		
Number of branches	41	41
Trust bank subsidiaries	6	6
Majority owned acquired banks	0	0
Representative offices	10	10
Joint venture banks	0	0

As of year end 1997, 19 U.S. banks had operations in Japan, 13 banks had 41 branches with assets of US$33.1 billion and ten banks had subsidiaries with assets of US$1.4 billion. Among these subsidiaries are six trust companies and four leasing companies. Ten U.S. banks also maintain representative offices in Japan. In contrast, as of year-end 1993, 19 U.S. banks in Japan operated 41 branches with assets of US$18.3 billion and 15 subsidiaries with assets of US$2.3 billion.

In contrast, the presence of Japanese banks in the United States is many times larger. At the end of 1997, 29 Japanese banks in the United States operated 31 agencies with assets of US$24.9 billion, 61 branches with assets of US$205.3 billion, and 17 subsidiaries with assets of US$62.5 billion. In contrast, as of year-end 1993, 54 Japanese banks in the United States operated 48 agencies with assets of US$49.0 billion, 84 branches with assets of US$272.1 billion, and 26 subsidiaries with assets of US$63.0 billion. Japanese banks or individuals controlled four Edge or Agreement Corporations with assets of US$136 million. Japanese banks maintain 39 representative offices in the United States.

DESCRIPTION OF THE MARKET

Structure of the Market

The structure of the Japanese banking market is beginning to change as a result of the "Big Bang" financial deregulation initiative announced by Prime Minister Ryutaro Hashimoto in November 1996, particularly in terms of sweeping away the demarcations between types of banks, as well as allowing cross-entry with securities and insurance companies by 2001. However, at present, the banking sector remains divided into city banks, long-term credit banks, trust banks, regional banks, and various specialized institutions.

The largest Japanese banks are the nine "city banks," which are similar to American money center banks. This is a decrease from 11 city banks in 1994, reflecting the failure of Hokkaido Takushoku in November 1997 and the merger of Bank of Tokyo and Mitsubishi Bank in April 1996. The nine city banks had total assets in 1997 of US$2.92 trillion and a total market share of 26 percent, down from 35 percent in 1993. City banks have nationwide branch networks, generally make short-term loans and fund their activities primarily through consumer and business deposits and short-term money market instruments. They tend to have a stable commercial customer base, frequently involving share ownership with their most significant commercial clients.

The three long-term credit banks were created decades ago to provide long-term loans to private industry. The liabilities of long-term credit banks are primarily medium-term bank debentures with maturities of up to five years. Long-term loans make up the majority of their assets, although long-term credit banks also are active in bond markets as investors, underwriters, and as "commissioned banks" in the issuance of corporate debt instruments. Assets outstanding of the three long-term credit banks totaled US$606 billion in 1997. Their market share in 1997 was five percent, down from eight percent in 1993. Falling profitability and the difficulty in continuously issuing debentures led to severe financial problems for Nippon Credit Bank in spring 1997, resulting in a bailout by life insurance companies. The Long-Term Credit Bank (LTCB) also suffered financial difficulty in summer 1998 and in October 1998 it was nationalized by the Japanese government.

Due to the segmented nature of scopes of business, trust activities can only be handled by trust banks. Thus, securities firms and commercial banks find it advantageous to have a trust bank subsidiary – not to pursue trust bank business per se or to do banking transactions, but to handle any trust-type activities in their normal lines of business. There are 53 trust banks in Japan, with total assets in 1997 of US$2.2 trillion. Financial system reform under the 1993 Financial System Reform Act, which permitted mutual entry in other financial business fields by establishing a separate subsidiary, led to an increase in the number of trust banks since 1993. At present, nine are foreign trust bank subsidiaries established in the mid-1980s. Seventeen are Japanese banks established pursuant to the April 1993 Financial System Reform Act. In addition, 19 regional banks have been licensed to do certain trust banking business directly, without establishing separate subsidiaries (two regional banks in Okinawa had been engaged in trust business prior to 1993). Eight of the Japanese trust banks and the nine foreign trust bank subsidiaries established in the mid-1980s are permitted to engage in a full range of trust banking business. The rest of the trust banks are restricted to a narrower range of non-core trust business only, and are prohibited from managing pension funds. From the early 1990s, the trust banks' business began to suffer as a result of the steep fall in Japanese asset prices and the subsequent economic recession that put many of their loans in jeopardy. In addition, as a result of the 1995 Framework Financial Services Agreement between the United States and Japan, other financial sector firms, particularly investment advisors, have been able to enter the pension fund management business, further eroding the profitability of the trust banks. U.S. trust banks have been performing better than their Japanese counterparts in recent years.

There are 127 regional banks in Japan - 64 "first-tier" regional banks, of which some are quite large, and 63 "second-tier" banks. The number of regional banks increased significantly in 1989 with the conversion of 66 *sogo*, or mutual savings and loan institutions, into second-tier regional banks, more than doubling the total number of regional banks. Altogether, regional banks had US$2.1 trillion in total assets at the end of 1997 and a combined market share of 19 percent, down from 28 percent in 1993. Regional banks traditionally have relied on savings deposits from individuals to fund their activities. Their assets are concentrated in loans, particularly to small businesses, but their asset base also includes some domestic securities and some foreign assets.

In addition, there are other specialized institutions involved in banking activities. Credit cooperatives (*shinyo kumiai*) and credit associations (*shinkin*) take deposits and lend to individuals and small businesses. Agricultural cooperatives perform the same function for farmers. The Norinchukin bank is owned by agricultural cooperatives and acts as a clearinghouse for transactions among regional agricultural financial institutions, and between those institutions and other non-agricultural financial institutions. It is also a concentrated correspondent bank for the agricultural cooperatives.

An extremely important element in the overall deposit-taking system in Japan is the postal savings system, which competes with conventional banking institutions for personal deposits. By law, these funds must be transferred to the Finance Ministry's Trust Fund Bureau, which then manages the funds either by directly investing in money market instruments and public securities, or by reallocating the funds to the Fiscal Investment and Loan Program (FILP) where they are used for public investment projects or on-lent through public sector financial institutions. Postal savings system deposits averaged ¥198 trillion in 1994, and in September 1998 were ¥247 trillion. It is the largest financial institution in the world. Lending by FILP-related public sector financial institutions accounted for virtually all new lending growth in 1997 and 19.8 percent of all loans outstanding, up from 16.6 percent in 1993. The 30 percent growth in postal savings deposits since 1993 partially reflects a flight to quality from weak private sector banks to the government run postal savings system, since the postal savings system enjoys a full faith and credit guarantee. As part of a reform of the Fiscal Investment and Loan Program, postal savings funds will no longer be required to be deposited with the Trust Fund Bureau as of FY2001, and the funds will instead be managed by the successor organization to the Ministry of Posts and Telecommunications, a new postal agency to be established in 2001 as an annex to the new General Affairs Ministry.

Until April 1, 1998, only "authorized foreign exchange banks" could do a full range of foreign exchange business. This system was changed with the revision of the Foreign Exchange Law effective April 1, 1998, which allowed a much broader range of participants (in addition to banks) to conduct foreign exchange business. The principal requirement that Japanese residents buy or sell foreign means of payments from or to an authorized bank or licensed exchange broker in Japan, has been lifted. In conjunction with these changes, MOF issued an administrative notice effective March 31 to expand the scope of foreign exchange activities allowed for securities firms, which appears to respond to industry requests. As a result, all of the first-tier regional banks have announced that they will withdraw from foreign exchange yen settlement business and arrange for the city banks to handle these transactions for them. Instead, the regional banks will specialize in foreign exchange and cross-border money remittance transactions.

The following table summarizes assets held by the various kinds of banks in Japan:

Assets of Banks in Japan by Type of Bank
In billions of yen

Japanese Banks:	Loans	Deposits	Number	Total Assets
City Banks	221,656	218,414	9	378,242
Long-Term Credit Banks	45,802	9,726	3	78,437
Trust Banks	54,543	21,160	7	286,640
First -Tier Regional Banks	139,786	171,260	64	199,130
Second-Tier Regional Banks	53,660	61,094	63	70,055
Credit Associations	71,387	100,611	401	113,613
Credit Cooperatives	17,076	21,801	351	26,377
Labor Credit Associations	6,481	10,559	47	11,700
Agricultural Cooperatives	21,102	69,619	2,083	72,046
Central Cooperative Bank for Agriculture and Forestry	17,460	28,887	1	48,239
Postal Savings System*	1,001	240,540	40	247,249
Foreign Banks:	**Loans**	**Deposits**	**Number**	**Total Assets**
Commercial Banks	8,622	8,989	93	51,848
- of which U.S.	n/a	n/a	19	n/a
Trust Banks	n/a	n/a	9	n/a
- of which U.S.	n/a	n/a	6	n/a

Notes: The number of banks is as of April 1, 1998. Total assets are as of year-end 1997, except for the postal savings system (3/31/98). In addition to the institutions in the table above, there are 17 trust bank subsidiaries of Japanese financial institutions established under the April 1993 Financial System Reform Act. Asset data of these subsidiaries are not available.

* The vast majority of postal savings assets are required to be deposited with the Ministry of Finance's Trust Fund Bureau, which onlends the funds through the Fiscal Investment and Loan Program. Technically, these loans are not

assets of the postal savings system, but rather the postal savings system's assets would be the deposits with the Trust Fund Bureau.

While most Japanese banks are privately owned, there are a number of public sector banking and finance institutions. State-owned banks in Japan implement government policies through lending to specific sectors to fulfill government policy objectives. Examples include loans to less developed areas of the country, for environmental protection, and to small businesses which generally pay lower returns and carry higher risks. State-owned banks usually do not take deposits, although the postal savings system, which indirectly lends funds to the state-owned banks through the Fiscal Investment and Loan Program, does. Advantages include the ability to borrow under the government Fiscal Investment and Loan Program at generally lower than market rates, and government guarantees of their borrowing in the market. Generally, however, government-owned financial institutions in Japan do not compete directly with private sector or foreign banks.

Available data on the assets of government-owned banks is limited, with only loan data available. As of December 31, 1997, loans made by government-owned financial institutions (see below) excluding the Japan Export-Import Bank, which functions more as an export credit agency with most of its assets placed outside Japan, totaled 134 trillion yen.

Lending by Public-Sector Finance Institutions
(as of December 31, 1997)

	Loans (¥ trillion)
Japan Development Bank	15.8
People's Finance Corporation	9.1
Housing Loan Corporation	72.7
Agriculture, Forestry & Fisheries Finance Corp.	4.4
Japan Finance Corp. for Small Business	7.1
Hokkaido & Tohoku Development Corp.	1.5
Japan Finance Corp. for Municipal Enterprise	19.9
Small Business Credit Insurance Corp.	0.6
Environmental Sanitation Business Finance Corp.	1.1
Okinawa Development Finance Corp.	1.7
TOTAL	133.9

The most serious challenge to the health of the Japanese financial system in the 1990s has been the growing problem of non-performing loans. Most lending in Japan is secured, usually by real estate or with third-party guarantees. As long as the pledged collateral held its value and the economy remained robust, the danger of defaults and of losses accruing from defaults was minimized. But as asset prices plummeted from their peak values in 1989/90, and the growth of the Japanese economy slowed markedly, Japanese banks across the board have faced a serious problem in managing their increasing exposure to nonperforming loans. Inadequate disclosure requirements have made it difficult to fully evaluate the severity of the bad-loan problem plaguing Japan's banking industry, although disclosure requirements have been expanded recently.

In June 1998, the 19 major Japanese banks reported that their problem loans at the end of March 1998 totaled 21.98 trillion yen (about US$160 billion). The percentage of the problem loans for the 19 major banks in terms of total loans was 6 percent, higher than the 5.4 percent reported for the entire banking system. The amount of problem loans and the percentage of the problem loans to total loans by type of banks follow.

Reported Japanese Bank Problem Lending
(as of March 31, 1998)

	Billions of yen	Percentage of Total Lending
City banks	12,819	4.8
Long-term credit banks	4,680	10.0
Trust Banks	4,479	8.4
Total 'Top-19'	21,978	
First-tier regional banks	5,198	3.7
Second-tier regional banks	2,582	5.3
TOTAL	51,736	

Note: The 19 major banks are comprised of the city banks, the long-term credit banks and the trust banks. Regional banks are not among the 19 majors, but are included in the above table for comparison purposes.

New disclosure standards for non-performing loans, applied for the first time in FY97, led to a larger-than-expected increase of 39 percent in disclosed non-performing loans relative to the previous standards. The new disclosure standards include more comprehensive definitions of problem loans than those previously applied, and U.S. categorization was used as a basis for new standards measuring risk elements. The old disclosure rules require Japanese banks to report the aggregate amount of loans in each of three categories: (1) loans to bankrupt borrowers; (2) loans with interest payments past due 6 months or more; and (3) restructured loans, for which the interest rate has been reduced below the Official Discount Rate. A key problem with the old rules is that banks would informally restructure loans so that they could avoid categorization. The new disclosure rules broaden the second category to include loans with interest payments past due 3 months or more, and broaden the definition of "restructured loans" to include loans to borrowers receiving renegotiated and more favorable terms due to problems with repayment, including loan forgiveness. Despite the intention of enhanced transparency, the new disclosure rules standards have not eliminated market concern about the reliability of disclosed bad loan figures. Bank analysts argue that improved uniformity in the reporting of restructured loans and consolidated disclosure is necessary.

Internally, and for reporting to the Financial Supervisory Agency, banks calculate "self-assessments" of the quality of their loan portfolios, according to rules which are more broad-based and include: loans where collection is deemed to be not feasible or loans that are deemed to have no value (Category IV); seriously doubtful loans with high loss potential but for which reasonable estimate of such losses is difficult (Category III); loans where known information about possible credit problems of borrowers, etc. causes management to have doubts as to the collectibility beyond the normal risk tolerance criteria (Category II); and loans not included in other three categories , i.e. loans which raise no specific doubt as to the complete collection (Category I). Many market experts are now urging the banks to disclose these more comprehensive asset quality assessments, to improve transparency and market confidence in the banks.

The credit cooperatives and agricultural financial institutions also have significant bad loan exposure, the latter particularly to the group of failed specialized housing lenders (*Jusen*). Norinchukin bank was the single largest lender to the *Jusen*, whereas agricultural financial institutions as a whole were the lenders of about 40 percent of all *Jusen* borrowing. Agricultural financial institutions increased their real estate lending aggressively during the very last stage of the asset bubble in the early 1990s, following constraints imposed by the Finance Ministry that limit commercial banks' growth in real estate lending to no more than the growth in total lending. In 1993, the agricultural financial institutions agreed, albeit reluctantly, to share in the burden of bailing out the *Jusen* through interest forgiveness. The debate over who should pay for the clean-up of the *Jusen* dominated Japanese politics throughout the spring of 1996, and resulted ultimately in the June 1996 injection of public funds, the July 1996 establishment of the Housing Loan Administration Corporation, and record-high bad loan write-offs in the year ending March 1996.

A number of organizations have been set up to deal with the bad loan problem, including the Housing Loan Administration Corporation, the Cooperative Credit Purchasing Corporation, and the Resolution and Collection Bank. These entities have made only slow progress in selling off bad assets of the housing lenders, credit cooperatives, and banks. (Legislation passed by the Diet in the fall of 1998 will restructure these organizations.)

Following the failure of Hokkaido Takushoku bank in November 1997, the Japanese government increased the public funds available to support the financial sector, allocating ¥30 trillion (US$214 billion) in December 1997. Of that total, ¥17 trillion (US$121 billion) was used to replenish the resources of the Deposit Insurance Corporation and ¥13 trillion (US$93 billion) was made available for capital injections into the banks. In April 1998, the government injected ¥1.8 trillion (US$13 billion) fairly evenly into 21 banks. In October 1998, the Diet passed legislation to abolish the 13 trillion fund, but replace it with a ¥25 trillion fund for recapitalization of weak, but viable banks, and an ¥18 trillion yen fund to be used to nationalize large insolvent banks, as well as leaving the ¥17 trillion fund for the Deposit Insurance Corporation in place. The legislation also authorized the creation of "bridge banks" to maintain credit to "sound borrowers" in the event of a medium-sized bank failure.

Regulatory Structure

The Japanese banking market is highly segmented, although the restrictions are gradually eroding under the "Big Bang." Banks, including foreign institutions, must obtain a different type of license depending on the type of banking business they would like to enter (for example, commercial banking license, trust banking license, or long-term credit bank license, although no long-term credit bank licenses have been issued since the 1950s). Foreign banks so far primarily have selected commercial banking licenses, although there are a few foreign trust banks. Establishment by foreign banks is regulated by the Banking Law. Full branch licenses are permitted and there is no discrimination in terms of types of activities against foreign branches, although foreigners are required to obtain a license for each branch while domestic banks are not. Minimum capital requirements for commercial (city) banks and trust banks is 2 billion yen, while the minimum for long-term credit banks is 20 billion yen. We are not aware of any licensing or other restrictions that discourage new foreign banks from establishing a banking presence in Japan.

Under the Banking Law banking business was reserved for banks. The April 1993 Financial System Reform Act permits Japanese securities firms to engage in banking business, including a limited range of trust banking business through separate subsidiaries and a broader range of foreign exchange business. The April 1998 revision of the Foreign Exchange and Trade Control Law abolished the "authorized foreign exchange bank" system, and subsequent regulatory changes expanded the scope of foreign exchange business allowed to securities companies, although foreign exchange settlement business remains reserved for banks.

Until June 1998, supervision and regulation of the banking industry was carried out by multiple administrators, including the Ministry of Finance, the Bank of Japan, and the industry's self-regulatory organizations. The Finance Ministry had authority for licensing banks, and for regulating and supervising commercial banks, trust banks, smaller banking institutions, life and nonlife insurance companies, and consumer finance companies, both Japanese and foreign, as well as the Tokyo International Financial Futures Exchange (TIFFE). With Finance Ministry oversight, self-regulatory functions were carried out by the TIFFE, the Federation of Bankers Associations, and by other bank-related self-regulatory groups. The Bank of Japan supervised banks based on contractual agreements with individual banks. Under the new scheme effective June 22, 1998, the new Financial Supervisory Agency is responsible for all supervision activities, while the Finance Ministry retains its policy planning role for the banking, securities, and insurance industries. Administrative reform plans call for MOF's remaining financial policy powers to shift to the FSA in April 2001. Meanwhile, emergency banking legislation passed in October 1998 has created a temporary, three-year Financial Revitalization Commission, comprised of a Cabinet Minister and three other members, which has authority to direct the FSA and MOF on matters related to bank recapitalization, nationalization, and closure, as well as general bank supervisory policy.

Various laws regulate foreign bank mergers and acquisitions. Essentially, treatment of foreign bank M&A is not different from treatment applied to local banks. For example, the Banking Law requires approval of all bank M&As by the Finance Minister. The Foreign Exchange and Foreign Trade Law also apply to foreign M&A, but do not provide any restrictions on foreign investment in Japanese banks. Establishing a joint venture bank is essentially no different from establishing a foreign presence. There is no legal quantitative limit on the degree of foreign ownership in joint venture banks. There is also no minimum capital requirement for foreign bank investment in joint venture banks.

Several steps have been taken since the 1994 National Treatment Study to further relax regulations in the banking sector. Most of these steps represent extensions of liberalization measures taken in earlier years.

Money Markets

As a proxy for repurchase agreements, the bond loan market has grown to be a major component of Japan's money market since it was created in April 1996. The incentive to use bond lending as a proxy for repurchase agreements arises from the securities transaction tax, which makes true repurchase agreements economically unattractive. The outstanding size of the bond loan market reached about 38 trillion yen (roughly US$290 billion) at the end of May 1998, roughly the same size as the call money market. The size of the market is likely to continue growing as the Bank of Japan began conducting market operations in the "repo" markets late in 1997 in order to strengthen its ability to influence interest rates.

Other typical short-term money market instruments are as follows with the average outstanding (unless otherwise indicated) at end-March 1998: call money (39 trillion yen) ; discount bills (22 trillion yen); certificates of deposit (40 trillion yen); commercial paper as of the end of August 1998 (13 trillion yen); government short-term securities as of the end of 1998 (13 trillion yen); and the Tokyo offshore market (9 trillion yen). A rough estimate of the total size of the money market, including the bond loan market, is 174 trillion yen ($1.25 trillion).

Commercial Paper

Restrictions on the issuance of commercial paper have gradually been liberalized over the past several years. The 1995 U.S.-Japan bilateral financial services agreement permitted foreign securities firms not meeting the qualification criteria to issue yen commercial paper with a parent guarantee. In 1996, issuance of commercial paper with a parent guarantee was more broadly allowed. In addition, the requirements that issuers be listed on a Japanese exchange or have three years of continuous financial disclosure were eliminated, while minimum rating requirements were lowered. In April 1998, the first domestic direct placement of commercial paper was launched as rules that effectively forced issuance of domestic commercial paper through approved dealers were removed. The short- and long-end maturity restrictions were completely eliminated by June 1998. Also in June, MOF eliminated its system of administrative notices (*tsutatsu*), which effectively abolished the prohibition on Japanese financial institutions and the offshore affiliates issuing commercial paper in Japan, and eliminated the minimum sales unit per investor for domestic and foreign commercial paper previously set at 100 million yen (US$714,300). In May 1998, a bill was submitted to the Diet to eliminate the restriction that nonbanks not be allowed to use the proceeds from commercial paper for lending purposes, which has been a longstanding concern for U.S. firms. As of November 1998, the Diet had not yet enacted the bill but it is expected to consider the bill in a future session.

Asset/Capital Positions of Banks

Combined core-business operating profits reported by Japan's 19 major banks for FY97 declined sharply to ¥3.57 trillion (about US$26 billion), down 20.9 percent from ¥4.51 trillion in FY96. On a pretax net basis, calculated after including bad loan write-offs, the banks posted a combined loss of ¥ 4.55 trillion (U$33 billion) in FY97, much larger than the combined net loss of ¥163 billion yen in FY96. Fourteen of the 19 banks posted net pretax losses in FY97. Core-business operating profits are defined as operating revenues minus operating expenses, and do not include bad loan writeoffs, and gains and losses from sales of land and equities. The combined core-business operating profits and net losses and the percentage in terms of combined assets follow:

Profitability for Top-19 Japanese Banks
(FY 1997)

	Trillions of yen			Percentage	
	Assets	Core-business Operating Profits	Net losses		
	(A)	(B)	(C)	(B)/(A)	(C)/(A)
FY 96	775.2	4.56	-0.16	0.59	0.02
FY 97	747.4	3.57	-4.55	0.48	0.60

For FY98, which ends in March 1999, the Federation of Bankers' Associations compiled and released the following information based on banks' "official" projections: Major banks project that their combined operating profits will fall by another 15 percent, to ¥3.03 trillion yen (US$22 billion), but their net pretax profit position is expected to improve dramatically, with the banks posting combined profits of ¥1.1 trillion (US$8.2 billion). All 19 banks assert that they will post net profits in FY98, reflecting their plan to sharply curtail bad loan disposal in FY98. Next year's planned ¥1.8 trillion in combined bad loan disposal is less than one-fifth of the total for FY97. The Federation notes that market and economic conditions will likely influence whether banks can meet these expectations.

Despite the losses incurred by the major commercial banks in FY97, all of them posted capital adequacy ratios above the eight percent minimum required for international operations by the Bank for International Settlements. However, the Japanese government provided considerable help to the banks in calculating their March 1998 ratios, in the form of the infusion of 1.82 trillion yen of public money, the option of book-value accounting for equity holdings, and a special two-year measure to allow banks to count a part of the unrealized gains on their land holdings as Tier 2 capital, without subjecting the gains to corporate income tax until those gains are realized. As reported by the banks at the end of May 1998, their fiscal year-end capital adequacy ratios ranged from a high of 10.32 percent for LTCB to a low of 8.53 percent for the Bank of Tokyo-Mitsubishi. As one indication of the difficulty of relying on published capital adequacy figures, in June LTCB was rumored to be in trouble, and in October it applied to be nationalized (thereby indicating it was in fact insolvent).

U.S. PRESENCE IN THE MARKET

As of fiscal year-end 1997 (March 31, 1998), there were 93 foreign commercial banks in Japan, all operating as branches, of which 19 were American-owned. Most of the growth in the foreign bank presence in Japan occurred in the 1970s and 1980s. At the end of 1970, there were only 18 foreign banks in Japan, with a total of 38 branches. These numbers grew to 64 and 86, respectively, by 1980, and to 82 and 122, respectively, by 1990. As of fiscal year-end 1997, there were a total of 144 foreign bank branches (some banks have more than one branch in Japan). Of this latter total, U.S. banks operated 41 branches.

In 1985, the trust banking market was opened to a fixed number of foreign financial institutions. As of June 30, 1998, nine have been permitted to enter the market (one more than the number of Japanese banks doing a full range of trust business). Of the nine, six are U.S. trust banks. All are subsidiaries. After an initially uncertain start in which some foreign trust banks did quite well but others did not, the combined earnings of the nine foreign trust banks have improved recently. In the Japanese fiscal year ending 1997, the nine foreign trust banks posted combined net profits of 3.9 billion yen ($32 million), up 85 percent from the prior fiscal year.

Since 1985, a number of foreign banking entities have been allowed to enter the domestic securities market through branches of offshore securities subsidiaries, provided their equity stake in their subsidiaries is no more than 50 percent. At present, there are 12 such securities branches, four of which have U.S. parents. In addition, there are three other U.S. banks that have entered the domestic securities market through branches of offshore securities subsidiaries where their equity stake exceeds 50 percent, following a 1994 MOF ruling permitting entry with no capital participation limit if firewall rules are implemented. Beginning in 1991, several securities firms were granted banking licenses, primarily to conduct foreign exchange operations. As of July 1997, five such banking licenses had been authorized. All five belong to offshore banking subsidiaries of U.S. securities firms.

In addition, as of June 30, 1998, there are 113 representative offices of foreign banking institutions in Japan (of which 10 have U.S. parents). This compares to 112 in 1993, 131 in 1989, and 71 in 1974. These offices are limited primarily to observing the market and to reporting on developments to their home office. They are not allowed to take deposits or to make loans. Most banking institutions establish a representative office prior to applying for a bank branch license.

No acquisition of a Japanese bank by a foreign bank (including by a U.S. bank) has occurred as of the time of this report, but neither have any U.S. financial institutions expressed an interest in acquiring a Japanese bank. However, the Finance Ministry continues informally to assure the U.S. Treasury Department that acquisition is possible and that the ministry would approve such a purchase, if and when an interest is expressed.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Management of Pension Funds

After close to 15 years in the market, U.S. trust banks are beginning to have limited success in the US$1 trillion public and private pension fund market in Japan, despite the added competition from investment advisors in the past few years as liberalization of pension management has taken place (See Investment Management section in the Securities chapter). Since 1993, foreign trust banks in Japan have increased their aggregate management of public pension funds from 1.7 percent to 7.2 percent of total assets, and management of private pension funds from 0.3 percent to 0.9 percent.

In the past, the principal obstacle facing U.S. and foreign trust banks in Japan in gaining a greater share of the pension fund management market was the practice of awarding management mandates to fund managers on the basis of corporate relationships rather than on the basis of investment performance. Often these relationships involved some degree of cross shareholding. While this practice still exists, there has been a shift toward performance based allocation as recognition of the significant potential underfunding of pension accounts grows with the low returns available in the

Japanese financial markets. A key factor in making U.S. and foreign trust bank management more attractive has been the phasing out of asset allocation guidelines over the past several years. These guidelines had forced all fund managers to invest in a "balanced portfolio" rather than in assets or currencies where they have greatest expertise.

Remaining areas to be pursued include strengthening the fiduciary responsibilities of pension plan sponsors in order to encourage sponsors to pay greater attention to performance, adopting standardized performance evaluation criteria along the lines of those of the U.S. Association for Investment Management and Research (AIMR), and valuing all pension fund assets at current market value rather than at book value. The shift to market value accounting has started for pensions with employee pension funds (EPFs) which are required to mark financial assets to market beginning FY97. However, no schedule has been set for introducing such a standard for other pension programs. U.S. trust banks believe that if the changes described were adopted, pension fund plan sponsors would be in a better position to accurately assess the relative performance of fund managers, including the performance of foreign trust banks.

Many of the provisions of the 1995 bilateral Financial Services agreement (see below) were aimed at expanding market access for investment advisory companies, although U.S. trust banks also benefitted from the elimination of asset allocation guidelines and other measures. Prospective deregulation measures are expected to include broader application of market value accounting, although all of the details are not yet clear. In 1998, MOF's advisory council on corporate accounting released a report recommending enhanced pension disclosure in corporate financial statements, including marking to market corporate pension assets and reflecting the "real"picture of beneficiary obligations starting in FY 2000. During the summer of 1998, the Securities Analysts Association of Japan developed a draft proposal for standardization of a corporate pension fund performance reporting system. The draft proposal is expected to be finalized by early 1999 for implementation as early as April 2000. These measures are anticipated to benefit U.S. financial institutions by providing more transparency and comparability in disclosed performance data.

Accounting and Disclosure

U.S. banks have complained that weaknesses in Japan's approach to accounting and disclosure of information by financial intermediaries (and nonfinancial corporations) give a distorted picture of counterparty risk, the financial well-being of Japanese banks, and credit evaluation of prospective borrowers. Insufficient disclosure, as noted above with respect to nonperforming loan portfolios, also clouds the picture.

Lack of Transparency

A chronic complaint of U.S. financial institutions operating in Japan is the lack of transparency in the Japan's regulatory environment. This has been a longstanding problem that unnecessarily complicates the ability of foreign (and U.S.) banks to do business in Japan. These complaints persist even though the Finance Ministry has taken steps in recent years to improve communications and increase its frequency of contact with U.S. banks.

Issuance and Use of Commercial Paper

Restrictions on the issuance of commercial paper have been relaxed as part of the "Big Bang" deregulation initiative, addressing the complaints of past potential issuers that the rating, listing, and disclosure requirements are too severe. The restriction prohibiting nonbanks from using the proceeds from the issuance of commercial paper for lending purposes may be eliminated as early as 1999, once legislation that has already been submitted to the Diet is passed.

TREASURY-MOF FINANCIAL MARKET NEGOTIATIONS

In the mid-1980s, following the Yen-Dollar Agreement between the U.S. Treasury Department and the Japanese Finance Ministry, many of the issues on the bilateral agenda focused on bank-related areas of interest (i.e., development of a deeper and more liquid money market, deposit rate deregulation, access to the public bond underwriting market, securities licenses for banks, and the introduction of certain derivatives products, including forward rate agreements). While most of the banking issues have been resolved, at least with respect to the ability of foreign banks to obtain market access "in principle," most U.S. banks still feel that the business climate in Japan could be greatly improved if the regulatory environment were made more transparent. Also, despite considerable progress of late in improving accounting and disclosure practices, foreign bankers still see much room for improvement in accounting and disclosure in both the financial markets and the real economy.

In February 1995, Treasury and the Ministry of Finance (MOF) signed a bilateral Financial Services Agreement under the U.S.-Japan Framework for a New Economic Partnership, as the latest step in a 15-year series of discussions with the Japanese government on liberalization of financial services. Periodic reviews of the agreement have generally found the government of Japan fully implementing the Agreement, in some cases ahead of schedule. The agreement covered several areas with practical benefit for foreign banks, including improvements in the pension fund market for trust banks, the removal of many existing restrictions on cross-border capital transactions and greater transparency.

Additional deregulation has been ongoing under the auspices of Prime Minister Hashimoto's "Big Bang" financial liberalization initiative, announced in November 1996. The goal of the initiative is to make Japan's financial market comparable with those of London and New York by utilizing the three guiding principles of "free, fair, and global" to achieve widespread deregulation. One of five government advisory councils formed to make recommendations on the specific measures to be implemented under the "Big Bang" focused on banking sector issues. The recommendations of the council focused primarily on eliminating segmentation between types of banks in Japan, and allowing cross-entry between the banking, securities, and insurance sectors. Treasury will continue to monitor the progress of this initiative within the context of regular financial services consultations with MOF and other agencies.

One of the first liberalizations under the "Big Bang" initiative was a comprehensive revision of the Foreign Exchange Law implemented on April 1, 1998. The Foreign Exchange Law completed the cross-border capital liberalizations pursued under the 1995 bilateral agreement. Practical benefits for foreign (and domestic) banks include removal of restrictions on Japanese overseas deposits and permission for Japanese to freely buy foreign currencies from and sell them to foreign financial institutions, among other things. Most importantly, the new Foreign Exchange Law made it clear that there should be no limitation on cross-border and domestic capital transactions involving foreign exchange unless otherwise specifically legally restricted.

In June 1997, also under the auspices of the Framework, the governments of the United States and Japan engaged in a new dialogue called the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy. Under the Enhanced Initiative, meetings of high-level officials and five expert-level groups covering telecommunications, housing, medical devices/pharmaceuticals, financial services, and deregulation/competition policy have been conducted over the past year. Discussions for the financial services group have been held in tandem with the review meetings for the bilateral agreement mentioned above and have provided a forum for reviewing the deregulation efforts being made by the Japanese government under the "Big Bang" initiative.

As part of the successful conclusion of the WTO's financial services negotiations in December 1997, Japan committed itself to remove certain restrictions on overseas deposits and trust contracts and services related to capital transactions, such as trading in foreign exchange, and to generalize to the other members of the WTO the benefits of its bilateral financial services agreement with the United States.

JAPAN

SECURITIES

SUMMARY

In the past, Japanese financial markets have been heavily regulated and compartmentalized with narrowly defined scopes of business for various financial service providers. Several developments over the past few years have helped to partially liberalize the markets, while holding out the promise for further deregulation and liberalization.

The U.S. Department of the Treasury and the Japanese Ministry of Finance (MOF) signed a bilateral Financial Services Agreement in February 1995, as a step in a 15-year series of ongoing discussions with the Japanese government on liberalization of financial services. Among other breakthroughs, this agreement provided for much-improved access by foreign investment advisory firms to Japan's massive pool of pension funds, liberalization in the packaging and sale of new securities products and derivatives, and the removal of many existing restrictions on cross-border capital transactions. Review meetings after the signing have generally found the government of Japan implementing the agreement faithfully, in some cases ahead of schedule.

Following the announcement of the "Big Bang" deregulation initiative by Prime Minister Hashimoto in November 1996, Treasury and MOF have also discussed its progress, prospects, and implementation during regular review meetings. As part of the "Big Bang," five advisory councils to MOF prepared reports recommending legal and regulatory changes to achieve "free, fair, and global" financial markets in Japan by 2001. The Japanese government has carried out most of the recommended measures scheduled to be implemented to date in the reports. Treasury will continue to monitor the implementation of this initiative as it is carried forward.

Many of the barriers identified in previous reports have been addressed by the 1995 agreement and deregulation under the "Big Bang" initiative. Remaining problems include the lack of freedom to offer new securities products due to a discretionary and time-consuming new product approval process, limited access to the domestic lead-underwriting business, and inadequate transparency of the regulatory process. Of particular concern has been the introduction in Japan of a Securities Investor Protection Fund, discussed in more detail below, which may have the effect of imposing extremely large liabilities on its members.

The stock market remains at a low level, in terms of both prices and volume, following the bursting of the asset-price bubble in the late 1980s. This has impacted the profitability of securities companies in Japan, and contributed to the failures during 1997 of the fourth and seventh largest Japanese securities firms and a number of smaller firms. More recently, world market volatility has caused some Japanese firms to lose substantial amounts in their international operations. Low stock market volume has also been attributed to lack of enthusiasm for stocks from individual investors, due to low returns and numerous scandals involving securities firms throughout the 1990s. Scandals last year, involving illegal payments to a racketeer, resulted in penalties – including fines, temporary suspensions of business, and management resignations – assessed on the three largest Japanese securities firms. Despite these problems, many of the U.S. securities firms in Japan have prospered, introducing business tie-ups with Japanese financial institutions or purchasing businesses and assets from Japanese firms, and expanding into new areas of business.

DESCRIPTION OF THE MARKET

Equity Markets

Japan has eight stock exchanges (Tokyo, Osaka, Nagoya, Kyoto, Hiroshima, Fukuoka, Niigata, and Sapporo), and an over-the-counter (OTC) system called Japan Automated Securities Dealers Quotation system (JASDAQ). Market capitalization of the Tokyo Stock Exchange (TSE) as of the end of 1997 was ¥280.9 trillion (US$2.2 trillion). At the end of 1997, there were 2,387 firms listed on Japanese stock exchanges. On the TSE, there were 1,805 domestic firms and 60 foreign firms listed.

Total volume for Japan's eight exchanges in 1997 was 130.7 billion shares, valued at ¥151.4 trillion (US$1.2 trillion). Of that total, the TSE accounted for 82 percent of the shares traded and 72 percent of the value of shares traded. The Nagoya and Osaka exchanges make up most of the rest of the volume, with the others combined totaling only 1.2 percent of shares traded and 2.2 percent of value. Over the counter, 1.46 billion shares of 847 companies were traded in 1997. This figure represents an increase over 1993 trading volume of 1.22 billion shares, but still well below the levels of the late 1980s. New equity financing by all listed companies in 1997, including rights offerings, public offerings, private placements, and exercise of warrants, totaled ¥939 billion (US$7.2 billion), down from ¥1,533 billion (US$13.2 billion) in 1996, but approximately equal to the 1994 total.

As of end-March 1998, financial institutions remained the largest holders of Japanese equities with 40 percent of the total. Banks held just over a quarter of all stocks, down only slightly from fiscal 1993. Non-financial corporations and individuals each held 24 percent, about the same ratio as at the end of fiscal 1993. Foreign shareholding of Japanese equities, however, rose markedly from 5.5 percent in March 1994 to 9.8 percent in March 1998.

Bond Markets

Japan has a large and active government bond market, as well as a developing corporate bond market that has expanded rapidly over the past few years. Total government and corporate bonds outstanding at the end of 1997 was ¥482 trillion (US$3.7 trillion), or 95 percent of Japanese GDP. During fiscal 1997, Japanese companies issued a record ¥8,800 billion (US$67.7 billion) of yen bonds, a 56 percent increase over the previous year. The Bond Underwriters Association reported that there were 557 corporate bond issues in fiscal 1997, up from 370 issues in fiscal 1996, and only 88 issues five years ago. In the first quarter of 1998, ¥4,300 billion (US$30.5 billion) of straight bonds were issued. Issuance of samurai bonds fell to ¥1,610 billion (US$12.4 billion) in fiscal 1997 from ¥3,800 billion (US$32.8 billion) in fiscal 1996, due primarily to recent currency swings.

Total outstanding corporate bonds, including bank debentures, as a percent of GDP was just over 26 percent at the end of 1997. Trading volume of bonds (domestic bonds and yen-denominated foreign bonds) on the TSE and OTC markets in Tokyo was ¥3,418 trillion (US$26.3 trillion) in 1997. Bank debentures account for roughly half of total outstanding corporate bonds, while straight corporate bonds account for another quarter. Convertible bonds, bonds with warrants, and yen-denominated foreign bonds make up the remainder.

The Japanese government amended its withholding tax laws for corporate bonds issued outside of Japan, including a safe harbor for corporate bonds held by non-Japanese. It is reported that the Japanese government is also considering amending its withholding tax laws for Japanese government bonds (JGBs), as well as other means to assist in making the JGB market more efficient.

Derivatives Markets

Japanese government bond (JGB) futures are traded on the TSE. The volume of trading has fallen over the past several years. One explanation is that, with the continuous rise in JGB prices in recent years, JGB futures trading has become more risky for those trying to engage in arbitrage (and indeed most trade for arbitrage rather than hedging). The number of 10-year JGB futures contracts, the most widely traded contracts, fell to under 12 million in 1997, after reaching just over 15 million in 1993. Futures on 20-year JGBs are also traded, although volume is quite small at only 2,167 contracts in 1997. Five-year JGB futures trading volume fell to 118,447 contracts in 1997, after 261,172 contracts were traded in the instruments' inaugural year in 1996. It is reported that the TSE is considering means to assist in making the JGB futures market more efficient.

Stock index futures are also traded in Japan. TOPIX (all stocks listed in the First Section of the TSE) futures are traded on the TSE while Nikkei 225 and Nikkei 300 futures are traded on the Osaka exchange. The number of TOPIX contracts has risen to just over 3 million in 1997, up from 2.6 million in 1994. In addition, TOPIX options and options on JGB futures are traded in relatively small quantities on the TSE. On the Osaka exchange, the volume of Nikkei 225 futures contracts rose from 6.2 million in 1994 to 7.5 million in 1997.

Individual stock options were introduced in July 1997 on both the Tokyo and Osaka exchanges. Trading on the limited number of issues available has been lighter than hoped, due in part to late announcement of the implementing regulations for the new product, as well as tax and regulatory disincentives. Only 70,896 contracts traded on 30 underlying stocks during 1997 on the TSE.

The Tokyo International Financial Futures Exchange (TIFFE) was established in 1989, initially with three products – futures on three-month Euroyen and Eurodollar interest rates and the yen/dollar exchange rate. Options on three-month Euroyen futures were launched in July 1991, while one-year Euroyen futures were launched in July 1992. However, trading is dominated by three-month Euroyen futures, while one-year Euroyen and three-month Eurodollar futures have not traded at all over the past year. Trading on TIFFE peaked in 1994 with annual turnover of over 40 million contracts, having risen sharply in 1993 and 1994. Annual turnover fell about 20 percent in 1995, before stabilizing at around 27 million contracts in 1996 and 1997.

Membership in TIFFE continues to decline from 216 members as of April 1994 to 180 members as of March 1998. Foreign membership has decreased slightly during the same period from 24 firms to 23 firms, of which 15 are clearing members and 10 are American firms. The U.S. firms are comprised of one bank and nine securities firms, the same composition as in 1994.

Investment Trusts and Pension Funds

Sales of investment trusts, Japanese mutual fund vehicles aimed primarily at retail investors, have been lackluster during this decade, given the poor performance of the stock market and scandals involving securities firms, the primary distributors of investment trusts, that have eroded investor confidence. Total net assets of stock investment trusts have declined after peaking in 1989, while total net assets of bond investment trusts have risen somewhat over the same period. At the end of 1997, total net assets of stock investment trusts totaled ¥9.9 trillion (US$76 billion), while those of bond investment trusts totaled ¥30.7 trillion (US$236 billion). This compares to total net assets of stock and bond funds at the end of 1994 of ¥17.5 trillion (US$175 billion) and ¥26.0 trillion (US$260 billion), respectively.

The pension fund market has continued to expand. At the end of March 1998, corporate pension money in Employee Pension Funds (EPFs) and Tax Qualified Pension Plans (TQPs) totaled ¥48.7 trillion (US$345 billion) and ¥19.2 trillion (US$140 billion) respectively, representing an increase in corporate pension funds of over 30 percent (in yen terms) since March 1994. The assets of the Pension Welfare Public Corporation (Nempuku), which manages a portion of the public sector pension assets, reached ¥22.6 trillion (US$161 billion) at the end of March 1997.

Market Regulation

Until recently, regulation of securities companies was carried out by the Securities Bureau of the MOF and the Securities Exchange Surveillance Commission (SESC). Beginning June 22, 1998, a new Financial Supervisory Agency (FSA) was created to supervise banks, securities firms, and insurance companies. The FSA has initially been staffed primarily with regulators drawn from the Banking and Securities Bureaus of the Ministry of Finance (MOF). While policy planning will remain with the MOF, supervision and regulatory enforcement will reside with the FSA.

The securities industry is also governed by the Japan Securities Dealers' Association (JSDA), which serves as a self-regulatory body, under the oversight of the MOF. The JSDA also administers the OTC market. All securities firms, including foreign firms, are required to be members of the JSDA, and there is foreign participation on the Board of Directors. Similarly, the Japan Securities Investment Advisors Association (JSIAA) and the Japan Investment Trust Association (JITA) have compulsory membership and act as self-regulatory organizations for investment advisors and investment trust managers, respectively.

The Securities and Exchange Law (SEL) defines the securities business and securities products and reserves these areas specifically for securities firms. Participation in each of the four major securities activities – dealing, brokering, underwriting, and distribution – requires licenses from MOF, although the licensing system will be changed to a registration system as of December 1, 1998. Specific lines of business identified as "high-risk," such as underwriting and OTC derivatives, will continue to require approval from the regulator. Other types of businesses have been allowed for securities companies under a positive side business list, defined under the SEL.

Specific changes to be implemented under the "Big Bang" initiative include the change to the registration system mentioned above, the expansion of primary securities business activities, as well as side businesses, deregulation of brokerage commissions in two phases, a review of securities-related taxes, reform of regulations for the domestic mutual fund industry and the sale of offshore funds in Japan, and elimination of barriers between securities and banking activities. As a result of the last item, securities subsidiaries of banks will be allowed to engage in the full range of securities businesses, including the sale of mutual funds. At present, banks' securities subsidiaries can only deal in fixed income products. Following the revision of the Foreign Exchange Law, effective April 1998, MOF also revised the regulations governing securities firms to allow a broader scope of foreign exchange activities.

In reaction to the failure of securities firms in the fall of 1997, the authorities are planning to augment funds available to protect investors by introducing an expanded mechanism called the Securities Investor Protection Fund (SIPF) on December 1, 1998. The new Fund will draw together existing investor protection mechanisms and add to those funds with mandatory contributions from all securities firms. After three years of collections, it is anticipated that the SIPF will contain ¥50 billion (US$355 million). A formula for assessing these contributions has not yet been decided. The SIPF is to cover all cash deposits and other assets of non-institutional investors held by securities firms until March 2001, in keeping with the Japanese government's pledge related to bank deposits. After that time, a ceiling amount per investor will be imposed. Although the law requires all securities companies to be members of an insurance fund as of December 1, 1998, new segregation rules expanding the scope of customer securities required to be separated from proprietary accounts will not be implemented until April 1, 1999. Combined with the unlimited coverage per customer account until March 2001, this gap will impose an uncertain, and potentially extremely large, liability on the members of the new SIPF. Foreign securities firms, in particular, have requested that

Fund members should meet minimum capital adequacy and asset segregation standards before joining in order to limit the responsibility of solvent members of the Fund for financially troubled firms that may not have segregated customer assets from their own.

TIFFE is regulated by the FSA. The impact of the "Big Bang" on futures includes changes in law and exchange rule tot improve the regulatory structure with respect to segregation of customer funds, default, insolvency, and risk disclosure. There will also be more flexibility to offer products through various intermediaries and a phase-out of fixed commissions.

Foreign Portfolio Investment

There are no quantitative restrictions on inward portfolio investment to Japan, although some restrictions by industry based on national security concerns do exist for direct investment. In addition, corporate practices like cross-shareholding limit the percentage of shares in individual firms and in the overall market that foreign investors can actually purchase, while informal restrictions on management participation by foreign shareholders limit the attractiveness of Japan's equity market to foreign investors.

The ability of Japanese nationals to invest offshore was facilitated by the implementation of the revised Foreign Exchange Law on April 1, 1998. The revision of this law removed restrictions on resident overseas deposits and eliminated prior notice requirements on foreign portfolio investment, although ex post reporting requirements remain, while allowing a much broader range of participants (in addition to banks in Japan) to conduct foreign exchange business. The "authorized foreign exchange bank system" has been dismantled, and the principal requirement that Japanese residents buy or sell foreign means of payments from or to an authorized bank or licensed exchange broker in Japan, has been lifted. In conjunction with these changes, MOF issued an administrative notice effective March 31 to expand the scope of foreign exchange activities allowed for securities firms, which appears to respond to industry requests.

U.S. PRESENCE IN THE MARKET

At the end of 1997, there were 290 licensed securities companies in Japan, with 183 of them holding licenses for the full range of securities businesses. Of those, 58 are foreign firms with 69 branches in Japan. Twenty-two U.S. securities firms have 28 branches in Japan. This compares with 48 foreign branches, of which 18 were American, in 1994. In addition, 60 foreign securities firms, of which 9 are U.S. firms, have representative offices in Japan. This total is down from 92 foreign representative offices, and 14 American representative offices in 1994.

In 1997, foreign firms expanded their share of equity trading volume, with U.S. firms becoming the top three volume traders at times, in part as a result of the disciplinary actions resulting in trading suspensions of several large Japanese firms. Some foreign firms are making record profits, and many are expanding their operations in Japan in response to expected opportunities afforded by the "Big Bang" deregulation. After concentrating for many years on institutional clients, a few U.S. firms are introducing retail operations in Japan, either through acquisitions of the retail businesses of Japanese firms or business tie-ups. In addition, foreign firms are greatly expanding their operations in asset management, both in the pension fund and mutual fund areas, following the expansion of access under the 1995 Framework Financial Services Agreement.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no serious instances of denial of national treatment to U.S. securities, investment management or investment advisory firms. However, some regulations hinder the ability of U.S. financial firms to fully participate in and provide services to Japanese market participants. An example is the cumbersome new product approval process for securities products, which limits the ability of U.S. firms to exploit their competitive advantage in innovative products. In addition, although there have been signs of improvement, the lack of transparency in the formation of new regulations and the lack of a public comment period for proposed regulatory changes limit the possibility for formal consultation with the regulatory authorities.

Entry and Establishment

As noted above, entry and establishment of securities firms are regulated by the SEL. As part of the "Big Bang" deregulation initiative, the license system for securities firms is to be replaced with a registration system that will allow firms to open business after registering with the FSA, subject to certain rules, including minimum capital requirements. Approval to undertake certain "high-risk" lines of business will still be required. These changes are slated to take place on December 1, 1998.

Foreign firms are also governed by the Foreign Securities Companies Law, which requires that individual foreign securities branches be treated as independent of each other. Thus, each branch must seek separate licenses and be separately capitalized. This law will also be amended as of December 1, so that all branches of a single foreign firm will be treated as a unit, and will fall under the registration, rather than licensing, system.

Investment Trust Management

Numerous changes have occurred over the past several years providing for more meaningful access for foreign investment advisory and investment trust management firms. The 1995 Framework Financial Services Agreement provided for simplified entry by allowing a single firm to hold both investment advisory and investment trust licenses, and expanded the scope of funds that could be managed by investment advisory companies to include the Pension Welfare Service Corporation

(Nempuku), and other public and corporate pension funds. In addition, asset allocation guidelines for pension funds are being phased out, providing more flexibility for fund management and enhancing the competitiveness of foreign fund managers. These changes resulted in a drastic expansion of assets under management by foreign investment advisory and investment management firms (albeit from a very small base). All investment advisors, including Japanese and foreign firms, increased pension funds under management by 42.9 percent in 1997. As of the end of September 1998, investment trust assets managed by all foreign firms rose above a 10 percent share for the first time, despite a decline in overall net assets managed in this sector. Also, in fiscal 1997 alone, foreign trust banks' combined corporate pension fund management nearly doubled, rising 98 percent, while assets under management by Japanese trust banks increased only 4 percent.

As part of the "Big Bang" initiative, distribution of investment trust products will also become less restricted. In the past, only sales through securities firms or costly direct marketing were allowed. As such, foreign firms without extensive retail presence in Japan were at a disadvantage. Beginning in December 1997, investment trust companies were allowed to rent space within bank branches to sell their products, and from December 1998, banks will be allowed to sell investment trust products directly on behalf of investment trust firms. Also from December 1998, investment trust managers will be able to delegate authority to sub-advisers, enabling foreign-based firms to use their overseas affiliates to make use of global investment capacity. Regulations permitting the sale of offshore funds in Japan are also being streamlined.

Underwriting Corporate Securities Issues

Until very recently, restrictions on the types of corporate securities that could be issued, their interest rate structures, eligibility requirements for issuers, new product approval requirements, and the dominant role played by the largest Japanese securities firms prevented much activity by foreign firms in underwriting corporate securities. Regulatory changes over the past few years have significantly loosened these restrictions, and foreign firms are beginning to have more success in this area, although activity is still quite limited. In June 1998, a U.S. firm was the lead manager of the largest domestic bond issue ever managed by a single foreign firm, a ¥50 billion (US$355 million) issue. This was the first corporate issue of straight bonds of significant size managed by a single foreign firm. However, this success represents a small beginning as the foreign share of lead management rose from only 0.7 percent in fiscal 1996 to 2.8 percent in fiscal 1997.

FINANCIAL MARKET DISCUSSIONS

As Japan's current regime of securities regulation is commensurate with its GATS commitments, the focus in Japan is less on the denial of national treatment than on deregulation.

Under the U.S.-Japan Framework for a New Economic Partnership ("the Framework"), the U.S. Department of the Treasury and MOF signed a bilateral Financial Services Agreement in February 1995, as the latest step in a 15-year series of discussions with the Japanese government on liberalization of financial services. Among other breakthroughs, this agreement provided for much-improved access by foreign investment advisory firms to Japan's massive pool of pension funds, liberalization in the packaging and sale of new securities products and derivatives, and the removal of many existing restrictions on cross-border capital transactions. Review meetings after the signing have generally found the government of Japan implementing the agreement faithfully, in some cases ahead of schedule.

On November 11, 1996, Prime Minister Ryutaro Hashimoto announced that his government would undertake sweeping deregulation of Japan's financial system by 2001, an initiative dubbed the "Big Bang". The goal is to make Japan's financial market comparable with those of London and New York by utilizing the three guiding principles of "free, fair, and global" to achieve widespread deregulation. Five government advisory councils – the Committee on Foreign Exchange, the Business Accounting Council, the Securities and Exchange Council, the Financial System Research Council and the Insurance Council – produced recommendations in June 1997 for specific measures to carry out the "Big Bang" objectives. In the spring of 1998, a package of legislation to implement a large number of these deregulation measures was submitted to the Diet, and final approval was received in early June. Implementation of the bulk of the measures will occur on December 1, 1998. Treasury will continue to monitor the progress of this initiative within the context of regular financial services consultations with MOF.

In June 1997, also under the auspices of the Framework, the governments of the United States and Japan engaged in a new dialogue called the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy. Under the Enhanced Initiative, meetings of high-level officials and five expert-level groups covering telecommunications, housing, medical devices/pharmaceuticals, financial services, and deregulation/competition policy have been conducted over the past year. Discussions for the financial services group have been held in tandem with the review meetings mentioned above and have covered the deregulation efforts being made by the Japanese government under the "Big Bang" initiative.

Exchange Rates Used:

1994	100 ¥/US$
1995	103 ¥/US$
1996	116 ¥/US$
1997	130 ¥/US$
1998	141 ¥/US$

KOREA

BANKING

SUMMARY

Korea became entangled in the Asian economic crisis in late 1997 and is currently implementing broad-based reforms of its economic and financial system in cooperation with the International Monetary Fund (IMF), the World Bank, and the Asian Development Bank. These reforms include substantial liberalization of the capital markets, well beyond commitments undertaken when Korea joined the Organization for Economic Cooperation and Development in 1996. Existing restrictions on foreign investment in Korea have been largely dismantled.

As part of the economic reform program, the government has committed to a fundamental overhaul of its weak and noncompetitive financial system. The prudential regulatory framework is being strengthened. Bank and other financial institutions are now expected to operate in a more open and transparent, as well as financially sound manner. The reform process is still underway, but already a large number of merchant banks have been closed, several of Korea's largest commercial banks have effectively been taken over by the government and five commercial banks have been taken over by five more healthy banks. Nonetheless, the entire financial sector continues to face many problems, including a growing portfolio of nonperforming loans.

The entire financial sector regulatory structure has been changed. Supervisory authority over the banking, securities, and insurance sector has been consolidated into the newly created Financial Supervisory Commission (FSC), which is also in charge of financial system restructuring. The FSC is also in the process of designing improved prudential standards. The FSC reports directly to the Prime Minister and has been given a broad mandate over the operations of the financial sector.

Despite improvements, foreign banks operating in Korea continue to face competitive barriers. The major problem continues to be the requirement to consider local branch rather than parent company capital. This affects foreign banks' funding and lending operations. Restrictions on foreign exchange flows continue, though the government is now in the process of drafting a complete revision of the Foreign Exchange Law and considerable liberalization is anticipated. Foreign banks are now allowed to set up subsidiaries in Korea. Restrictions on foreign investment have been substantially liberalized and restrictions on foreign ownership of land have been completely removed. Hostile and friendly mergers and acquisitions, including of financial institutions, are now allowed.

DESCRIPTION OF THE MARKET

Structure of the Market

The banking system in Korea is in the process of a fundamental restructuring program that began in late 1997 when Korea turned to the international community for assistance. The Korean government has committed to a thorough reform of its financial system and to make that system more open and transparent. Korea has had a long tradition of government control of the financial sector, using directed credit and preferential interest rates to promote key industries. Under the conditions of the IMF program, the government is to have ceased this activity. Financial institutions are expected to replace government direction with prudent credit standards and proper risk management. As a result of past poor credit decisions, the collapse of several major corporate groups during 1997 left a number of domestic banks in very weak condition. This situation worsened following the late 1997 financial crisis as banks were faced with severe liquidity problems. Meanwhile, the level of banks' nonperforming loans continued to grow. The government is implementing, in coordination with its international donors, a full-scale reform plan designed to bring the entire financial system back to economic health and to ensure that the system operations in a market-oriented, prudential manner in the future.

Until June 1998, the domestic banking system in Korea was composed of 26 domestic commercial banks (16 nationwide banks, 10 regional banks) and four specialized banks. At the end of June 1998, the FSC ordered five weak, smaller commercial banks to be taken over by five larger commercial banks. As financial restructuring continues, additional changes are expected to take place in the number of domestic banks.

Commercial banks continue to play a significant role in Korea's banking system. Assets of the nationwide commercial banks totaled approximately 539 trillion won (US$318 billion) at the end of 1997. Banks in Korea tend to focus on short-term lending. Nationwide domestic commercial banks have traditionally been subjected to hands-on government involvement in their operations. The government continued to play a major role in the selection of bank presidents as late as 1997, though it now says this practice has ceased. The smaller regional banks are oriented more towards serving small- and medium-sized businesses in their respective provinces. Each has branches in Seoul and additional branches in their provinces. Banks have grown conservative in their lending practices in order to avoid additional damage to their own balance sheets.

The specialized banks have operated beyond their original purpose, which was to supply credit to sectors where it was insufficient. They are subject to many of the same controls as commercial banks, but have the advantage of being able to borrow directly from the government and to issue debentures. They have recently expanded into commercial banking as well and deposits represent a major source of funds. The specialized banks' assets amounted to approximately 86 trillion won (US$51 billion) at the end of 1997.

Nonbank financial institutions (NBFIs) represent a noteworthy portion of in Korea's financial system, representing by some accounts about one-third of total financial system assets. The Bank of Korea classifies the following as NBFIs: three development banks (the Korea Development Bank, the Export Import Bank of Korea, and the Korea Long-Term Credit Bank), 31 investment trust companies, 30 merchant banks (almost half have been closed by the authorities), 31 life insurance companies and more than 4,000 savings institutions. In the past, NBFIs have in general been more loosely supervised by the regulatory authorities. This is expected to change with consolidation of supervision under the FSC. The role of NBFIs in the future is unclear, as many are in financially worse shape than the commercial banks – some, particularly among the merchant banks, have already been closed and others may follow.

Regulatory Structure

The regulatory framework for the financial sector has completely changed following the economic crisis. Legislation passed by the National Assembly in December 1997 established the FSC, which reports to the Prime Minister. The legislation consolidated regulation of the entire financial system under the FSC and its regulatory arm, the Financial Supervisory Service (FSS). The FSC came into being on April 1, 1998.

On January 1, 1999, the four existing regulatory bodies covering banking, securities, insurance, and nonbank financial institutions are scheduled to be fully integrated into the FSS. The legislation creating the FSC in theory allows it considerable autonomy in its decision-making and regulatory authority. The FSC is taking the lead in financial system reform and is also designing prudential standards to guide the regulatory authorities under its jurisdiction. The Bank of Korea and the Ministry of Finance and the Economy continue to play important roles in the formulation and administration of monetary and credit policy.

U.S. PRESENCE IN THE MARKET

Fifty-three foreign banks from 16 different countries have a total of 69 branches in Korea. Most have tended to specialize in wholesale banking. Total assets of foreign banks amounted to 46 trillion won (US$27 billion) at the end of 1997, or about 8.5 percent of total assets held by deposit money banks (commercial nationwide domestic banks, and foreign banks). Foreign banks also operate 24 representative offices.

The 12 U.S. banks operating in Korea have a total of 23 branches. Total assets are approximately 11.3 trillion won (US$6.7 billion), or approximately 2 percent of total assets of deposit money banks. One U.S. bank has a representative office in Korea. Another U.S. bank also has a non-controlling interest in KorAm bank, a joint venture with Korean investors. U. S. banks also have interests in nonbank subsidiaries or affiliates which include a leasing company, merchant banks, and a credit card company.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In its early economic development, Korea needed foreign exchange for its export-led economy and to support its companies in their overseas activities. As a key source of foreign exchange, foreign banks were given relatively favorable treatment compared to domestic banks in some areas. As Korea began to register current account surpluses in the mid-1980s, these preferences were eliminated and other aspects of Korean banking regulation and policy which favored domestic banks impacted on foreign banks' ability to lend in local currency and hence to serve their customers' needs. While some of the restrictions on foreign banks have been removed or reduced, foreign banks still have a smaller presence in the Korean market than they did prior to the 1980s.

A major impediment inhibiting the ability of foreign banks to compete in Korea is the Korean government's continuing use of local branch capital as the benchmark for determining a variety of funding and lending limits. Korea requires foreign branches to be separately capitalized and other regulations are based on local branch capital. For example, a foreign bank's prudential lending limits are based on its branch capital as opposed to its total capital, which will undoubtedly be much higher. While the Korean government has argued that this treatment is necessary for prudential regulatory reasons, it differs from that in the United States and most other industrialized countries which base prudential limits on the worldwide capital of a foreign branch's parent bank. Although domestic banks are also subject to limits based on the size of capital, the "capital" employed in their case is the entire bank's capital.

One area of bank operations which is affected by using branch rather than parent firm's capital as the benchmark are the single customer loan limits. The single customer loan limits further constrain bank lending practices because of government-imposed limits on loans to companies in the largest business groups and policy-based lending requirements to small-and medium-sized enterprises. Domestic banks also face the same restrictions but have the kind of broader branch coverage and local lending expertise to undertake this lending on a more prudent basis. The Korean government believes that the single customer loan limit (45 percent of a bank's equity) is necessary for prudential reasons and is discussing with the IMF lowering the limit to 25 percent. The branch capital limits also affect foreign bank activity in the forward foreign exchange market through overbought/oversold limits.

While foreign exchange regulations have been liberalized over the past four years and the government is now undertaking a full-scale revision of the Foreign Exchange Law, tight controls on the introduction of new financial instruments, an area where foreign banks would be particularly competitive, remain in place. Previous restrictions on foreign capital inflows have been removed.

Foreign banks are also disadvantaged in access to local currency funding. The use of swap lines has been a major source of local currency funding for foreign banks and earlier efforts by the government to limit the use of swap lines were major issues in financial policy talks between Korea and the U.S. in the early 1990s. As a result of the economic crisis, the Korean government has increased swap lines in order to generate needed foreign exchange. In July 1998, position limits were abolished for foreign exchange swap lines. However, the Korean government has not committed to maintaining this less restrictive stance once the crisis is over. The interbank money market remains underdeveloped. It is dominated by Korean banks and foreign banks do not consider it a reliable source of funding, especially during periods of tight market liquidity.

Effective March 1998, foreign banks are allowed to set up subsidiaries in Korea. Effective June 26, 1998, the government removed all restrictions on land ownership by foreigners. Foreign financial institutions are now allowed to participate in non-hostile and hostile mergers and acquisitions of domestic financial institutions. In the aftermath of the economic crisis, the Korean government has been encouraging increased foreign investment in the financial sector.

The United States and Korea began negotiations in July 1998 on a bilateral investment treaty (BIT). The BIT may contain reciprocal commitments with respect to national treatment and most favored nation treatment on and after establishment in financial services. Negotiations continue between the two governments, with a third round of talks scheduled for mid-November 1998.

As part of an overall financial sector program agreed upon with the IMF, Korea has gone considerably beyond its GATS commitments in the banking sector. The Korean government has agreed to bind all financial market opening commitments made in the OECD accession process in the WTO, a step it was unwilling to take during the WTO financial services talks. Restrictions on foreign bank subsidiaries were removed. Foreign banks are now allowed to acquire Korean banks and restrictions on land ownership have been removed.

Exchange Rate Used:

1997 end-of-period	1,695 Won/US$

KOREA

SECURITIES

SUMMARY

The Korean securities market is in the process of fundamental change. Korea is currently implementing a reform and restructuring program in cooperation with the International Monetary Fund (IMF) and other international financial institutions. This program involves significant capital market liberalization. Foreign participation in the equity and bond markets has been substantially liberalized.

Government interference with, and manipulation of, equity market prices has been virtually eliminated. Supervisory authority for the securities industry has been delegated from the Ministry of Finance and the Economy (MOFE) to the newly formed Financial Supervisory Commission (FSC), which reports to the Prime Minister.

The number of branches of foreign securities firms has increased since 1994, as more firms converted their representative offices into branches. Foreign firms can now form subsidiaries in Korea. There are five U.S. branches and seven representative offices at present.

Stock market trading continues to be dominated by individual investors, with foreign investors playing a growing role. The over-the-counter (OTC) market is now open to foreigners and a separate OTC market dealing in foreign-owned securities which had reached government-imposed foreign share limits is now virtually defunct in the aftermath of the government's removal of most such limits. The bond market is now open to foreign investors for both corporate and government bonds, although as yet there is little foreign participation.

Many of the regulatory and legal barriers for foreign securities firms and foreign investors have been removed. Limitations still remain on the operations of representative offices. Branch offices have to meet certain minimal capital requirements depending on their business activities. Consultation with affected foreign firms about regulatory changes has improved and the government has adopted a number of reform proposals made by foreign firms. Current issues of major concern to foreign firms are primarily ones of the need for increasing market liquidity and transparency.

DESCRIPTION OF THE MARKET

The Korean securities market has felt the effects of the Asian Economic Crisis which hit Korea in November 1997. Korea is currently in the process of implementing a reform and restructuring program in cooperation with the IMF, the World Bank and the Asia Development Bank. This program involves significant capital market liberalization and the introduction of greater openness and transparency in financial markets. Participation of foreigners in equity markets has been significantly liberalized, with complete liberalization (with few exceptions) scheduled for the end of 1998.

Earlier in 1998, foreign portfolio investors were limited to 55 percent aggregate and 50 percent individual ownership of most companies. These restrictions have now been eliminated. In the case of state-owned companies, the limits are 30 percent and 3 percent respectively, though these limits are scheduled to increase (though not be completely abolished). There are no limits on foreign ownership of listed bonds or commercial paper. Later in 1998, restrictions on foreign ownership of any security traded in the local securities market are scheduled to be lifted.

The Korean government has stopped efforts to artificially maintain and manipulate equities prices and the Stock Market Stabilization Fund was abolished formally on May 4, 1996, though it had been dormant for some time. The deposit requirement ratio which required that stock purchase orders be accompanied by a cash deposit was abolished on April 1, 1998. Limits on a stock's daily price movements are set at 12 percent. Government interference in the operations of the market has declined considerably. The capitalization of the Korean Stock Exchange (KSE) stood at 75 trillion won (US$46 billion) at the end of 1997. The value of bonds outstanding was 224 trillion won (US$132 billion) at the end of 1997. The number of listed companies on the KSE was 776 at the end of 1997, up from 693 companies listed in 1993. Bankruptcies and mergers and acquisitions are expected to lower that number over the course of 1998.

Trading averaged 41.2 million shares a day in 1997. The Korea Composite Stock Price Index, which measures aggregate price performance, closed 1997 at 376.3, a sharp decline from its 1996 close at 651.2. The first six months of 1998 saw further declines in stock prices as economic recession took hold.

The major law governing the securities market is the Securities and Exchange Act (SEA). The SEA was enacted in 1962, but has been revised several times since then, most significantly in 1998. The SEA separates the banking and securities industries. Article 29 of the SEA requires banks and other financial institutions to obtain government approval to engage in the securities business. Article 51 prohibits securities companies from engaging in a business other than the securities business without government approval.

Regulation of the securities industry had been performed by the Securities and Exchange Commission and the Securities Supervisory Board (SSB), formerly under the control of the MOFE. On April 1, 1998, as a result of financial reform legislation passed by the National Assembly, the Securities and Exchange Commission was abolished and replaced by the Securities and Futures Commission (SFC). The SFC was placed under the newly formed Financial Supervisory Commission (FSC), which was established to serve as Korea's integrated financial institutions' regulator. Additionally, the SSB reports to the FSC until January 1, 1999, when the SSB is scheduled to be merged with three other financial institution regulators. The four merged bodies will form the Financial Supervisory Board, which is the executive arm of the FSC.

There are currently 35 domestic Korean securities companies with operating licenses, an increase of three since 1994, though some face possible suspension of their licenses due to financial problems. There are 21 foreign securities firm branches (five U.S.) authorized, an increase from 10 in 1994. There are also eight representative offices (seven U.S.). This is a decline from the 26 authorized in 1993, generally reflecting a conversion from representative offices into branches. Foreign securities firms may now establish subsidiaries in Korea. There are three joint venture foreign securities companies established with Korean partners (two U.S. and one from Hong Kong). Merchant banks are also allowed to undertake selected underwriting opportunities.

There are currently seven regular foreign members of the KSE and two special members. Regular members pay annual membership fees of 12.7 billion won (US$9.2 million) and special members pay an annual membership fee of 2 billion won (US$1.5 million).

On the main exchange of the KSE, stocks continue to be traded in two sections. Newly listed stocks are assigned to the second trading section for at least one year before being eligible to be assigned to the first trading section where margin trading is possible. Stocks showing poor performance can be transferred back to the second section from the first section.

Individuals continued to dominate daily trading on the Exchange, accounting for 75 percent of the trades in 1997. Institutions accounted for 18 percent and foreign investors accounted for 7 percent. The KSE established the stock index futures and options markets in May 1996 and July 1997 respectively, using the Korea Stock Price Index (KOSPI) 200, a capitalization-weighted index composed of 200 representative stocks selected from a broad range of industries.

There is an OTC market operated by the Korea Securities Dealers Association which is now open to foreigners. A separate OTC market for foreigners trading in stocks which had reached their foreign share purchase limits is now virtually defunct with the removal of aggregate and individual foreign purchase limits for most stocks.

The Korean bond market is divided between government/public and corporate bonds. Bonds trade on both the main exchange and the OTC markets, with 95 percent of corporate and convertible bonds trading in the OTC market. About 62 percent of Korea's outstanding bonds are government/public, mainly Monetary Stabilization Bonds. Seventy percent of corporate bonds are straight discount or coupon bonds with warrants, both guaranteed and non-guaranteed. As of the end of 1997, corporate bonds worth 90 trillion won (US$53 billion) were outstanding. Corporate bonds amounting to 34 trillion won (US$20 billion) were issued in 1997. The slow liberalization of the bond market, which began in 1994, when foreigners were first permitted to buy very limited types of corporate bonds, was accelerated after the November 1997 financial crisis and the bond market is now fully open to foreign investors.

Several restrictions limit foreign financial institutions' ability to manage mutual funds. Under the Securities Investment and Trust Business Act, only investment trusts and merchant banks may manage mutual funds. However, effective July 1, 1998, the Foreign Capital Inducement Act's regulations were amended to repeal previous restrictions on foreign equity participation in investment trust companies and investment advisory companies.

As of July 1998, 32 domestic and ten foreign securities firms have received licenses to purchase offshore securities for Korean residents.

U.S. PRESENCE IN THE MARKET

There are presently five branches and seven representative offices of American securities firms operating in Korea. Foreign securities companies may now establish subsidiaries, though to date no American firm has established a subsidiary in Korea. One American firm has established an investment trust operation in Korea, and also has a branch office for its international mutual funds.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Restrictions on foreign purchase of Korean securities firms have been removed. Subsidiaries are now permitted. In licensing foreign representative offices, the MOFE authorizes only liaison activities, i.e., offices that exchange information with the home office. Representative offices may not engage directly in domestic securities-related business in Korea, including purchases in the stock market. They cannot generate income, including commissions for any of their activities. Representative offices conduct research and perform services, acting as marketing agents for their parent companies. They identify clients for their parent companies and facilitate business with offshore entities in the area of corporate finance and sales of foreign securities.

As noted earlier, branches are permitted. The minimal capital requirements for branches and joint ventures vary by the number of activities in which the firm wishes to participate. The paid-in capital requirement for brokerage services is only 10 billion won (US$7 million), for brokering and dealing services is 30 billion won (US$22 million) and for full services, i.e., brokering, dealing and underwriting, is 50 billion won (US$36 million).

As part of the financial reform process, which began even before the economic crisis hit Korea in November 1997, the government is considering a wide range of liberalization and deregulation proposals. Consultation with affected foreign companies about regulation in the securities industry has improved considerably. The government, initially through the Financial Reform Commission and later, through the Financial Supervisory Commission, has actively sought the views of foreign securities firms.

Foreign investors may now sell stocks short and the requirements for borrowing stock have been relaxed. Both of these regulatory changes, implemented on May 22, 1998, were proposed by foreign securities firms. Regulatory changes are now posted simultaneously in Korean and English on the Internet. The KSE no longer calculates commissions and commission levels have been liberalized.

Foreign securities firms in Korea have made additional proposals for regulatory and market reform, some of which are under consideration by the government. These proposals deal not so much with national treatment issues as with improving market liquidity and transparency.

As in the banking sector, changes made in the past year in the securities sector go beyond the commitments contained in Korea's GATS offer. OECD financial market opening commitments will be bound in the WTO. Foreign participation in the band and OTC market is now allowed. Limits on foreign portfolio investment have been liberalized well in advance of government timetables. Limits on foreign equity participation in investment trust companies and investment advisory companies have been lifted. Foreign securities firms may now establish subsidiaries in Korea and may purchase Korean securities firms.

Exchange Rates Used:

1997 end-of-period	1,695 won/US$
June 1998 (for fees charged)	1,373 won/US$

MALAYSIA

BANKING

SUMMARY

Malaysia's banking and financial system came under increasing stress with the onset of the regional financial crisis in mid-1997. Despite a generally well-developed supervisory and regulatory framework and an accelerated effort in early 1998 to strengthen finance companies through mergers, deflation in property and other asset markets by mid-1998 had placed a number of commercial banks and finance companies at risk and in need of recapitalization. Non-performing loans rose steadily from roughly 6.8 percent for the banking system in 1997 to 10.8 percent in July 1998, and were projected to increase to between 20-25 percent by year-end 1998.

Following a significant credit crunch in early 1998, precipitated in part by a "flight to quality" by depositors, Bank Negara Malaysia (the central bank) announced it would guarantee all principal and interest in Malaysian banking institutions. However, the economy continued to worsen and credit growth fell well below central bank targets. At the end of June, the government of Malaysia reversed measures it had put in place in 1997 to reduce the current account deficit and to curtail strong credit growth. It began a significant easing of monetary policy and announced new fiscal stimulus packages totaling RM12 billion (US$3 billion). It established an Asset Management Corporation (Danaharta) to purchase non-performing loans from the banking sector, created a special purpose vehicle (Danamodal) to recapitalize banking institutions, established a corporate debt restructuring committee to facilitate loan workouts, and strengthened bankruptcy laws.

On September 1, 1998, as part of a broader effort to reflate the economy, and stabilize its currency, the government of Malaysia took drastic action by fixing the exchange rate of the ringgit to the U.S. dollar at 3.8 RM/US$ and instituting selective capital controls. Malaysia's principal objectives in instituting the controls are to eliminate offshore trading in the ringgit and insulate the domestic economy from external risks posed by short term capital flows. Overseas trading of Malaysian securities will cease and investors must now hold Malaysian securities, or the ringgit proceeds from their sale, for at least one year. The government of Malaysia has stressed that the measures maintain general convertibility of current account transactions, and do not impair repatriation of interest, profits and dividends and commissions on investments.

Following the September 1 actions, the central bank rolled back certain provisioning and disclosure standards that had been in place since January 1998. It also relaxed some prudential lending restrictions on property and share purchases that had been imposed prior to the onset of the financial and economic crisis.

As of June 1998, there were 13 foreign banks operating in Malaysia out of a total of 35 commercial banks in the country. Despite sustained efforts by the government of Malaysia to develop the domestic banking industry and limit foreign competition, foreign banks retained a respectable 21.2 percent share of banking sector assets at the end of June 1998.

Malaysia has issued no new commercial banking licenses other than those restricted to offshore activities since 1979. Acquisition of existing domestic banks is not a viable option for foreign banks. Individual ownership in domestic banks is limited to 10 percent for an individual and 20 percent for others, with aggregate total foreign investment in any one entity limited to 30 percent. Banking regulations in place since 1994 require all existing foreign branch banks to incorporate locally, a rule that has increased costs for foreign banks and led to less efficient forms of organizational structure. Finally, foreign banks continue to be affected by immigration regulations that limit cross-border entry of expatriate banking personnel.

In addition to limitations on entry and hiring of expatriate workers and forced incorporation, there are other important restrictions on expansion and operation by foreign banks. All nonresident controlled companies are required to source at least 60 percent of their domestic credit needs with a Malaysian-owned bank, although the government of Malaysia has agreed to relax this limit to 50 percent by the year 2000. Foreign banks are also prohibited from establishing new branches. For regulatory purposes, any off-premises automated teller machine is considered a separate branch.

DESCRIPTION OF THE MARKET

Structure of the Market

The banking system in Malaysia consists of seven types of institutions: commercial banks, finance companies, merchant banks, an Islamic bank, discount houses, foreign bank representative offices, and offshore banks (see table for percentage of banking sector assets, loans and deposits). Commercial banks, finance companies, merchant banks, and discount houses are required to be licensed under the Banking and Financial Institutions Act of 1989 (BAFIA) and form the core of the banking system. As of December 31, 1997, the licensed banking system in Malaysia included 35 commercial banks, one Islamic Bank, 39 finance companies, 12 merchant banks, and 7 discount houses. Total banking sector (comprising the commercial banks, finance companies, and merchant banks) assets were RM677.8 billion (US$174 billion) at end-1997. The banking sector remains the largest financial intermediary in the country, accounting for almost 61 percent of the total assets of the financial system.

An important differentiation in the treatment of large versus small banks was established in December 1994. Under the new regulations, BNM reclassified both foreign and domestic banks into two tiers. Tier-1 banks are defined as well-managed and well-capitalized banks whose equity exceeded RM500 million (US$125million) in December 1994 and RM1 billion (US$261 million) by end-1998. Only tier-1 banks are allowed to participate in equity derivatives, undertake securities borrowing and lending, and expand into regional operations. The tiering process was intended to encourage voluntary mergers of smaller banks but in practice has served to encourage smaller institutions to grow, in order to reach tier-1 status. As of December 31, 1997, there were 10 tier-1 commercial banks, of which 4 were foreign-owned, and 25 tier-2 banks, of which 9 were foreign-owned.

Domestic Banks

The six largest domestic banks are Maybank, Bank Bumiputra Malaysia, RHB Bank, Public Bank, Bank of Commerce, and Sime Bank. Bank Bumiputra has 100 percent federal government shareholding. The majority shareholders of Maybank are a unit trust fund and the National Equity Corporation. The six largest banks account for more than 65 percent of domestic banking assets as at end-June 1998. The largest bank, Maybank, with consolidated assets of US$43.8 billion in mid-1997 is a publicly listed company whose two largest shareholders – a unit trust fund and a foundation established by the government of Malaysia to assist indigenous Malaysians and promote their ownership of share capital – own approximately 55 percent of the bank's equity. Maybank is more than twice the size of the next largest bank, wholly government-owned Bank Bumiputra, which is subject to a greater degree of directed policy lending, given its charter to serve the needs of indigenous Malaysians. The regional economic downturn has affected the profitability of all major banks and has played a role in the 1998 acquisition of troubled Sime Bank by Rashid Hussain Bank (RHB). Further mergers and reorganizations within the banking sector are likely in the year ahead.

Foreign-owned Banks

Sustained efforts by the government of Malaysia to develop the domestic banking industry have eroded foreign banks once dominant share of the market. Long-standing regulations have prohibited foreign banks from expanding their branch networks since 1966. Therefore, all foreign banks granted licenses after 1966 have had to remain one-branch banks. The last foreign bank allowed entry into the market was Bank of Nova Scotia in 1973. Bank of China was promised a license for a subsidiary in 1996, but has yet to set up an operation in Malaysia. By 1997, foreign banks represented less than 10 percent of the branch network, compared to 78 percent in 1960.

Regulations enacted in 1989 required each of the then 16 foreign bank branches to locally incorporate within five years as Malaysian banks. Their foreign parent banks, however, were permitted to retain 100 percent ownership in the new subsidiaries. By September 1994, the end of the local incorporation exercise, there remained 14; two of the original foreign branches had been sold to Malaysian interests to become domestic banks. Later, two of the 14 subsidiaries merged, leaving 13 as of June 30, 1998. Twelve domestic banks were partially foreign owned as of June 30, 1998, the same number as four years earlier on June 30, 1994.

Despite restrictions on their growth, the thirteen wholly foreign-owned subsidiaries operating in Malaysia as of June 1998 have managed to retain a 22 percent share of total banking system assets, a 21.2 percent share of deposits and 22.2 percent share of loans, largely due to high levels of service and superior international financial linkages (U.S. banks hold 2.9 percent share of commercial bank deposits and 3 percent share of loans). While foreign and domestic banks are permitted to undertake the same types of banking activities, those banks that had branch networks established before 1966, including Hong Kong and Shanghai Banking Group, Overseas-Chinese Banking Corporation, and Standard Chartered Bank are the foreign banks with the most substantial retail and consumer presence. With the exception of Citibank which is a strong retail player with only three branches, the remaining foreign banks focus on wholesale and international banking. Bank Negara has not imposed any new restrictions on foreign banks' operations since the 1994 National Treatment Study. All commercial banks in Malaysia are now permitted to open foreign currency accounts for their customers and allowed to deal freely in foreign currencies and enter into forward transactions to hedge their positions. All foreign banks were exempted in 1996 from rules which preclude banks from sharing credit information with their foreign parents.

Finance Companies

After banks, the 39 finance companies listed as of early 1998 were the second largest group of financial institutions in the country with a 22 per cent share of the banking sector's assets. Four were 100 percent foreign controlled, while five others had at least some foreign equity participation. The focus of finance company lending has been in the area of consumer credit, especially fixed-rate hire purchase loans (i.e., auto loans). A high concentration of business among a few companies, as well as severe losses resulting from the tight liquidity and high interest rate environment of the latter part of 1997, are leading to a major shake-up of this sector. The consolidation of the finance company industry will be in the form of: (1) merger of smaller finance companies with six identified anchor finance companies; (2) absorption of finance companies by parent commercial banks; or (3) strategic alliances. Upon completion of the consolidation exercise, there will be eight core finance companies, comprising six anchor finance companies and another two finance companies which have formed strategic alliances with other banking institutions.

Merchant Banks

The 12 merchant banks comprise the third largest set of financial institutions with a six percent share of the banking sector's assets. Formed in the early 1970s to provide more specialized financial services unavailable through commercial banks, merchant banks offer a wide range of activities, including syndication of loans, corporate advisory services, underwriting, and portfolio management. Of Malaysia's twelve merchant banks, all are owned by commercial banks except one.

Islamic Banks

An Islamic banking system has been established in Malaysia as an alternative to the conventional banking system. It offers interest-free services including leasing and hire purchase, profit-sharing, and joint-venture financing. Bank Islam is the only purely Islamic bank, although since 1993 commercial banks have been allowed to offer Islamic banking services. At the end of 1997, four foreign banks offered Islamic banking services.

Offshore Banking

The offshore banking market came into being with the establishment of the Labuan International Offshore Financial Center (IFOC) in 1990. Currently, there are over 1,000 offshore companies, of which 54 are offshore banks and 17 are offshore insurers operating in Labuan IOFC. The government intends to continue efforts to effectively promote and market Labuan. To date, Labuan has not attracted the scale of foreign currency operations anticipated by the government of Malaysia, primarily due to competition from more accessible and developed offshore centers in Singapore and Hong Kong.

Regulatory Structure

Bank Negara Malaysia (BNM) is the principal regulatory authority. Established in 1959, BNM's principal objectives are to issue currency and keep reserves safeguarding the value of the currency; to act as a banker and financial adviser/agent to the government of Malaysia; to promote monetary stability and a sound financial structure; and to influence the credit situation to the advantage of the country. Monetary policy, banking policy, and bank supervision are the responsibility of the central bank. BNM is run by a board of directors, usually five to eight members, who are appointed by the King of Malaysia. The chief executive officer is the governor of Bank Negara who presides over meetings of the board. The Bank Regulation Department formulates regulatory policy for the banking industry while the Banking Supervision Department conducts periodic investigations into banks' activities.

Although BNM is the primary regulatory authority, on certain issues it must refer to or seek the approval of the Minister of Finance. BNM can recommend the granting or revocation of an operational license to a bank, for example, but cannot approve it. That authority rests with the Minister of Finance. Other actions that require the approval of the Finance Minister include the granting of loans to rehabilitate troubled banks, and the assumption of control over troubled banks. The Minister of Finance remains the more powerful authority, but in practice usually exercises such authority only after receiving a BNM recommendation. On rare occasions, the Ministry of Finance will act on its own initiative, as it did in 1993 when it directed BNM to halt trading in forward foreign exchange markets.

Commercial banks are required to comply with a minimum risk-weighted capital requirement of 8 percent formulated along the lines of the Basle Capital Accord. Commercial banks are also required to comply with a minimum capital funds requirement of RM20 million. Credit to a single customer is restricted to 25 percent of a banks capital base, reduced from 30 percent effective April 1, 1998. Large loans (credit facilities which in aggregate exceed 15 percent of a bank's capital) are limited to 50 percent of total credit facilities. Banks are generally prohibited from granting loans, advances and credit facilities to their directors and staff; corporations where they are interested as director, manager, agent or guarantor; corporations in which they have an interest in the shares; firms in which the directors or staff are interested as partner, manager or guarantor; or close family members. At present, banks are restricted from lending more than 20 percent of total loans to the broad property sector and 20 percent for the purchase of shares. Bank Negara has issued guidelines on money laundering which require banks to determine the true identity of customers, develop transaction profiles, and establish document retention policies to identify inconsistent transactions. Bank are also required to identify a single reference point in their organizations to which unusual or suspicious transactions can be reported.

Capital Controls

On September 1, 1998, the government of Malaysia took what it described as "drastic measures" by imposing capital controls and fixing the value of the ringgit at RM3.8/US$1. The government of Malaysia stated that the objectives of the controls were to eliminate manipulation of ringgit exchange rates, stabilize short-term capital flows, and to protect Malaysia from the contagion effects of external developments. The measures reduce the ability of nonresidents to engage in ringgit transactions among themselves, require settlement of imports and exports in foreign currencies, discourage short-term capital inflows by requiring them to remain in country for at least one year, restrict Malaysian investments overseas, and limit the amount of foreign currency individuals and corporations can take out of the country. The government of Malaysia has stressed that the measures maintain general convertibility of current account transactions and free flow of foreign direct investment; and that they do not impair repatriation of interest, profits and dividends and commissions on investments. The government of Malaysia has stated that the controls are temporary measures which will be retracted once stability is restored in the international financial markets and there is an international consensus to reform the international financial infrastructure to address the problems associated with destabilizing capital flows, which it believes in large part caused the recent economic difficulties.

U.S. PRESENCE IN THE MARKET

As of mid-1998, three U.S. commercial banks were licensed to operate in Malaysia. All three entered as branches. The largest U.S. bank in Malaysia is Citibank N.A. (licensed since 1959) with three branches and assets, as of June 1998, of US$2.8 billion. Bank of America N.T. & S.A. (also licensed since 1959) has a single branch and assets of US$447 million and Chase Manhattan Bank N.A.(licensed 1964) has a single branch and assets of US$194 million. Citibank is the only U.S. bank in Malaysia that offers full retail and corporate services. Bank of America and Chase Manhattan Bank serve primarily corporate clients. U.S. banks currently hold 17 percent of the foreign-controlled commercial bank assets in Malaysia, a percentage that has remained relatively stable for the last 20 years.

The government of Malaysia has not ruled out further liberalization of the financial sector. However, its focus now is to further strengthen prudential and supervisory standards and increase transparency and disclosure in the banking sector. The government of Malaysia believes that all the measures that have and will be put in place to this end will pave the way for further liberalization in the future.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Since no new bank licenses are being awarded outside of the Labuan IOFC, the only means of entry into the Malaysian banking market, other than through a representative office, is through the purchase of an existing institution. Under current Malaysian law, ownership in domestic banks is limited to 10 percent for an individual and 20 percent for others. The maximum permissible aggregate foreign shareholding allowed in a licensed banking institution remains 30 percent. In addition, since 1994, banking rules have required all existing foreign branch banks to incorporate locally, a rule that has increased costs for foreign banks and has resulted in less efficient forms of organization.

U.S. financial institutions also continue to be adversely affected by limits on cross-border movement of banking personnel through immigration regulations. Malaysia has shown flexibility in allowing more than the current limit of two expatriate employees per bank. However, such decisions are made on a case-by-case basis and are frequently subject to time-consuming delays.

U.S. banks, as well as all other foreign banks, also face discriminatory treatment with respect to expansion and operations. All nonresident controlled companies are required to source at least 60 percent of their domestic credit needs with a Malaysian-owned bank. Foreign-owned companies are estimated to comprise about 10 percent of the total market for domestic banking credit. This credit sourcing requirement is scheduled to decline to 50 percent by the year 2000.

Foreign banks, unlike domestic banks, are prohibited from establishing new branches, a regulation that severely constrains the ability of U.S. banks to attract depositors. For regulatory purposes, any off-premises automated teller machine is considered to be a separate branch. These restrictions were not alleviated by the local incorporation of existing branches.

Foreign banks are afforded the same treatment as domestic banks with regard to money market instruments, access to the central bank discount window, and availability of offshore capital via swaps. Nevertheless, while the rules governing Malaysian financial and capital markets are generally transparent, the substantial discretionary power of financial authorities creates a degree of uncertainty when approvals are required. Although, in general, Bank Negara policy is to respond to queries or applications within two weeks, U.S. banking officials report continuing problems in getting important paperwork through Bank Negara channels. They cite unanswered queries and long delays as substantial impediments to doing business in Malaysia.

Malaysia's GATS schedule of commitments with respect to the banking sector binds Malaysia to maintain current policies affecting foreign participation (i.e., the commitments were made on a standstill basis whereby the government of Malaysia gives an undertaking that the current policy affecting foreign participation will not be reversed). Malaysia's WTO financial services commitments provide for a significant easing of current restrictions on expatriate workers increasing from three to five the number of foreign specialists or experts each institution can bring in to manage activities related to trade financing, corporate finance, treasury management, and information technology. The government of Malaysia has shown on occasion considerable flexibility, on a case by case basis, with regard to its bound limits on expatriate workers

Malaysian Banking Sector
Assets and Liabilities, January 1, 1998
(RM billions)

	Commercial Banks	Finance Companies	Merchant Banks
ASSETS			
Cash	3.1	0.2	0.1
Central Bank	47.2	16.1	3.5
Amounts Due	63.7	5.7	6.2
Securities	40.6	12.2	5.0
Loans	276.1	102.5	23.0
Other	50.4	15.7	6.5
TOTAL	481.1	152.4	44.3
LIABILITIES AND CAPITAL			
Amounts Due	79.6	25.5	10.8
Deposits	300.4	106.5	26.4
Other Liabilities	61.3	10.4	2.8
Capital	39.8	10.0	4.3
TOTAL	481.1	152.4	44.3

Source: Bank Negara Malaysia
Note: Deposits do not include negotiable certificates of deposit.
U.S. Embassy estimate for average 1998 RM/US$ exchange rate: 3.8 RM/US$1.

Top Five Commercial Banks in Malaysia
January 1, 1998

Bank	Start-Up Year	Assets (RM millions)	Branches
Malayan Banking Berhad	1960	98,814	249
Bank Bumiputra Berhad	1966	45,970	195
RHB Bank (Formerly DCB Bank)	1966	37,886	140
Public Bank Berhad	1966	30,095	173
Bank of Commerce Berhad	1973	19,535	50

U.S. Embassy estimate for average 1998 RM/US$ exchange rate: 4.0 RM/$.
Source: Bank Negara Malaysia

Financial Sector Assets, Loans and Deposits
Held by Finance Companies, Merchant Banks and Islamic Banks
(as of December 31, 1997)

	TOTAL ASSETS		DEPOSITS		LOANS	
	RM billions	% of total	RM billions	% of total	RM billions	% of total
Commercial Banks*	450.1	72.3	292.9	69.2	299.2	71.3
Finance Companies	134.3	21.6	105.3	24.9	98.2	23.3
Merchant Banks	38.0	6.1	25.0	5.9	22.5	5.4
Banking System	622.4	100.0	423.2	100.0	419.9	100.0
Islamic Bank	5.1		3.5		3.2	

*Excludes the Islamic Bank
Source: Bank Negara Malaysia

Bank Profitability, Capitalization & Asset Quality
(Percentages)

	December 1994		June 1998	
	Foreign-owned Banks	Malaysian Controlled Banks	Foreign-owned Banks	Malaysian Controlled Banks
Non-performing Loans	6.1	15.4	3.5	7.5
Risk-weighted Capital Ratio	18.2	10.3	13.0	10.6
Return on Assets	2.2	1.2	n/a	n/a

Source: Bank Negara Malaysia

MALAYSIA

SECURITIES

SUMMARY

Prior to the regional financial crisis that began in July 1997, the Kuala Lumpur Stock Exchange (KLSE) had grown into one of the most vibrant and diverse Asian markets outside Japan. The spread of the crisis, and to a degree some poorly received policy responses to it, severely eroded investor confidence. By end of August 1998, the Kuala Lumpur Stock Exchange had lost approximately 73 percent of its capitalization and the ringgit 67 percent of its dollar value since the start of the crisis in early July 1997. Furthermore, GDP declined 4.8 percent for the first half of 1998 (year-on-year), loan growth slumped to just 7.5 percent (year-on-year), and consumption demand dropped precipitously.

On September 1, 1998, as part of a broader effort to reflate the economy, and stabilize its currency, the government of Malaysia took drastic action by fixing the exchange rate of the ringgit to the U.S. dollar at RM3.8/US$1 and instituting selective currency controls. Malaysia's principal objectives in instituting the controls are to eliminate offshore trading in the ringgit and insulate its domestic economy from external risks posed by short-term capital flows. Overseas trading of Malaysian securities has ceased and investors must now hold Malaysian securities, or the ringgit proceeds from their sale, for at least one year from September 1, 1998. The government has stressed that the measures maintain general convertibility of current account transactions, and do not impair repatriation of interest, profits and dividends and commissions on investments. Prior to the crisis, the government was progressively implementing institutional and regulatory reforms in an effort to attract further foreign capital and to create a regional financial center. Economic realities, however, have slowed implementation of some of these initiatives.

Foreign ownership in Malaysian stockbroking companies is limited to 49 percent of capital; only one securities firm holds a large minority stake in a Malaysian stockbroking firm. (The only firm granted 49 percent equity in a Malaysian securities firm to date is a U.S. firm.) Prior to institution of currency controls, U.S. firms interested in a Malaysia portfolio generally operated through subsidiaries in the regional hubs of Hong Kong and Singapore. Foreign firms are permitted to register in Malaysia as investment advisers and to conduct market research for overseas clients.

Although relatively small, Malaysia's market for private, fixed-income instruments had shown some signs of growth prior to the crisis, but it has since stagnated. The market for Malaysian Federal government securities, dominated by the Employees Provident Fund (the country's mandatory-contribution retirement system), had stagnated as recent years' redemptions have often exceeded issues – a situation which will change rapidly if, as expected, the government issues bonds to fund its planned US$14 billion in fiscal stimulus and bank recapitalization measures. Malaysia has a growing pool of pension funds and the government, up until September 1, had instituted a number

of measures to further develop the fund management industry, including allowance of 70 percent foreign ownership in local fund management companies working with both local institutional and unit trust funds.

DESCRIPTION OF THE MARKET

Regulatory Regime

On March 1, 1993, the Malaysian Securities Commission (SC) assumed regulatory responsibilities which had been distributed over a number of government bodies. In addition to the securities industry, the SC regulates property trust schemes, takeovers and mergers of companies, and unit trusts. The SC also has regulatory responsibility for two derivatives markets, the Malaysia Monetary Exchange (MME) and the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE).

In addition to the SC, three other agencies participate in the regulation of the securities industry. The KLSE is a self-regulatory, private sector organization. The Registrar of Companies (ROC), an arm of the Ministry of Domestic Trade and Consumer Affairs, administers the Companies Act of 1965. While the SC administers the Code for Takeovers and Mergers, the Foreign Investment Committee (FIC), chaired by the Director-General of the Economic Planning Unit of the Prime Minister's Department, approves applications under certain circumstances, such as exemptions on the basis of national policy.

The government has long envisioned Malaysia as a future regional financial center similar to Singapore. In working toward achieving this goal, the government has announced plans to introduce new derivatives instruments; develop secondary debt markets; provide more disclosure and transparency; institute punitive measures to deter insider trading; and develop the recently established the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ), which has yet to make its first offering, as a market where smaller high-tech enterprises can list with fewer requirements. Economic realities, however, have slowed implementation of a number of these initiatives.

Equity Market

The Kuala Lumpur Stock Exchange (KLSE) was founded in 1973 as a result of a bifurcation created between the Malaysian and Singapore stock markets. The KLSE's most rapid periods of development occurred after October 1989, when the Finance Minster prohibited firms incorporated in Malaysia from cross-listing on the Singapore exchange and in 1993 when Malaysia's weighting in emerging market index funds was separated from that of Singapore. KLSE development was driven by issuance of federal government securities in the 1980s, by privatization of parastatal enterprises in the late 1980s and early 1990s, and until most recently by corporate and large infrastructure listings.

At the end of 1997, first board companies numbered 444 and second board companies 264. A fully automated computerized order and execution system provides the KLSE with the capability to cope with high trading volumes that averaged roughly US$1 billion a day in the first half of 1997. The KLSE operates a call market system through SCORE (System on Computerized Order Routing and Execution). The Securities Clearing Automated Network Services Sdn Bhd (SCANS), a wholly-owned subsidiary of KLSE, provides clearing operations. In August 1997, the KLSE instituted the T+5 Rolling Settlement System, applicable to all instruments on the exchange, as an interim step towards T+3 in the future.

Foreign ownership in a Malaysian stockbroking company is limited to 49 percent of its paid-in capital, unless otherwise approved by the Ministry of Finance. Stockbroking companies are either private or public companies. As of March 1998, Malaysia had 62 stockbroking companies, 54 of which were public companies with both local and foreign corporate shareholders. In addition, the KLSE had 52 corporate and 53 individual members; of the corporate members, 11 were foreign owned.

After shrugging off the tequila effect of Mexico's 1994 financial crisis, strong macro economic performance, corporate and large infrastructure project listings, and regional market exuberance led the Kuala Lumpur Composite Index to (KLCI) 1,271 in late February 1997, just shy of its all time record of 1,314 in January 1994. The bottom began to drop out in July 1997 when Thailand's financial woes sparked investor caution in the region. Government measures to curb public spending and clamp down on reckless private sector lending appeared to help stem the tide. Other measures, however, raised concerns about liquidity, disclosure and transparency. Particularly troubling were the one-week designation of 100 KLCI stocks to inhibit short selling; limits on currency swap transactions; allowance of public companies to finance the purchase of their own stocks by third parties (since rescinded); prohibition of short selling and stock borrowing and lending arrangements; and the sidestepping of regulations in the purchase of ailing Renong Berhad by its healthier subsidiary. Hong Kong, South Korea and Indonesia provided further bad news late in 1997. At the end of 1997, KLSE market capitalization had diminished, from year-end 1996, by 53.4 percent to RM375.8 billion (US$94 billion). Through the first half of 1998, as the regional crisis took on a more global form; the KLSE continued to slump with the KLCI dipping to as low as 262.

Falling victim to the KLSE crash were several regulatory and institutional initiatives. In October 1997, in the midst of the crisis, the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) was established as an alternate market with less restrictive listing requirements (in particular, no profit reporting requirements) where smaller high-tech enterprises could have easier access to equity capital. The MESDAQ is to operate in a full disclosure-based regulatory environment and will be self-regulated by market intermediaries with the SC providing oversight. Poor investor sentiment as well as the suspension of all stock borrowing and lending arrangements (in place since 1995 as a risk management and market-making tool) had slowed development of the MESDAQ, which, as of September 1998, has not begun operations.

Also on hold is implementation of the next phase towards a full-disclosure based regulatory system for the KLSE by the year 2001, as well as enhanced enforcement. Nevertheless, the passage of the Financial Reporting Act of 1997 established the Malaysian Accounting Standard Board and the Financial Reporting Foundation, putting in place an institutional financial reporting framework of international standard. Furthermore, Malaysia's insider trading laws were amended in April 1998 to broaden the definition of insider trading; increase the range of sanctions, including civil sanctions; require additional disclosure from directors and chief executive officers (CEOs); and increase the powers of the SC over directors and CEOs. The SC is also considering plans for risk-based capital adequacy requirements for stockbroking companies.

To add further market depth, guidelines were announced in September 1997 to allow for public-listed companies to buy back their own shares on the KLSE. Also, in April 1997, the SC released guidelines for the listing of foreign-based companies on the KLSE. At this stage only foreign-based companies with substantial Malaysian interests will be allowed to have primary listings in Ringgit. The SC, however, intends to widen in phases the scope of companies which are allowed to list. The SC did not receive any applications for foreign listings during 1997, which can be attributed to the downturn in market conditions as well as a freeze on submissions for new listings, rights issues and corporate listings imposed in December 1997.

Dramatic measures were adopted on September 1, 1998, when Malaysia imposed currency exchange controls and fixed the value of the ringgit to the U.S. dollar at RM3.8/US$1. Details of these controls are still being clarified. However, one objective achieved has been the elimination of overseas trading of Malaysian securities, which were primarily conducted in Singapore. In addition, foreign investors must now hold Malaysian securities, or the Ringgit proceeds from their sale, for at least one year, or until September 1, 1999, if assets were purchased prior to September 1, 1998.

Bond Market

There are no restrictions on the types of instruments that may be offered in Malaysia's bond market. In terms of tradable bonds on the secondary market, government issues, known as Malaysian Government Securities (MGSs), dominate. The first zero coupon Khazanah bonds were issued in 1997 in an effort to provide benchmarks for the growing Islamic and other bond markets. Other tradable bonds are fixed interest corporate issues listed on the Kuala Lumpur Stock Exchange (KLSE) including fixed-rate straight bonds, convertible redeemable bonds, convertible irredeemable bonds, and Cagamas bonds. To reduce the cost of raising debt, Malaysian banks in the past have provided guarantees to improve companies' bond ratings. The Scripless Securities Trading System (SSTS), introduced in 1990, conducts trades.

The domestic bond market in Malaysia was given a boost in 1986 when Bank Negara Malaysia (the central bank) established Cagamas Berhad, a government corporation that issues mortgage-backed securities (Cagamas bonds). Strong economic growth between 1987 and 1989 enabled the government to reduce external borrowings by prepaying some foreign loans with domestic financing, thereby improving the liquidity of MGSs. Privatization and tax revenue growth after 1989 has steadily reduced the need for domestic government borrowing and consequently the secondary market for public debt has become sluggish.

The government of Malaysia recognizes the importance of revitalizing the secondary markets for public debt to provide pricing benchmarks for further capital market development. Consequently, two new issues of MG were floated in 1997, a RM1 billion (US$250 million) 10-year issue in October and a RM2 billion (US$500 million) 5-year issue in November. Secondary markets, in spite of these efforts, remained sluggish as redemptions exceeded issues by RM1.4 billion (US$450 million) in 1997 and banking institutions preferred to hold on to existing or newly issued securities to meet statutory liquidity requirements. This may change, however, if, as expected, the government issues bonds to fund significant portions of approximately US$14 billion in planned fiscal stimulus and bank recapitalization measures and taps local sources to fund the recently established Asset Management Corporation, known as Danaharta which is designed to purchase banking system non-performing loans.

The market in government debt is dominated by the Employee Provident Fund (EPF), Malaysia's mandatory-contribution retirement system, which is required statutorily to hold a large portion of its assets in MGSs. At the end of 1997, the EPF held 56 percent of the stock of outstanding government securities, the banking sector held 20 percent and insurance companies held 8 percent.

Private debt securities have gained significant momentum in recent years as more Malaysian corporations ventured to raise funds locally. In 1997, outstanding private debt securities rose to RM47.5 billion (US$11.9 billion), still just 25 percent of total outstanding bonds. Most of the RM15.5 billion (US$3.9 billion) raised in 1997 was by unlisted corporations, and largely to fund major infrastructure projects which now may have to be delayed due to the financial crisis.

Designated principal dealers underwrite government primary issues (MGSs, Khazanah bonds, T-bills, Cagamas bonds, and Negara bills) and provide two-way quotations for the secondary market. Principals or approved dealers consist of commercial banks, merchant banks and discount houses. Financial institutions are designated as principal dealers based on their individual volumes of bond activities. Branches of foreign commercial banks are included among principal dealers.

Fund Management

Up until very recently, fund management in Malaysia had generated a fair amount of foreign interest in light of the country's growing pool of pension funds. Investable funds of Malaysia's provident and pension funds grew by 13.7 percent in 1997 to RM143.8 billion (US$37.0 billion), the bulk of which are under the domain of the EPF. The government began taking steps in 1995 to further develop the country's fund management industry by providing tax incentives for local fund managers, allowing EPF accountholders to transfer up to 20 percent of their retirement accounts in excess of RM 50,000 (US$10,250) to unit trust funds and external fund managers, and allowing joint venture foreign fund management companies to manage domestic institutional and unit trust funds.

Local fund management companies in which foreign equity is less than 50 percent are unrestricted in the types and amounts of local funds they can raise. There are eight licensed local joint venture fund management companies. A joint venture with a U.S. firm surrendered its license in 1998. Foreign Fund Management Companies (FFMCs) consisting of joint ventures with at least 30 percent local equity can manage local institutional funds, but not local unit trust funds, provided the FFMC sources at least US$100 million in funds from outside Malaysia and at least RM10 million (US$2.5 million) within Malaysia. In December 1996, the SC said it would allow the first 10 joint venture FFMCs to apply to manage local unit trust funds. Only two joint venture FFMC applications to manage local unit trusts have been approved by the SC. Fully foreign-owned FFMCs in Malaysia are allowed only to manage global or regional funds on behalf of clients outside Malaysia. At the end of 1997, joint venture FFMCs numbered four and fully foreign-owned FFMCs also numbered four.

Derivatives

The economic crisis has highlighted the need for the government to further develop derivative instruments to enable investors in Malaysian assets to manage currency and other market risks. The Kuala Lumpur Options and Financial Futures Exchange (KLOFFE), established in 1995, offered only one product in 1997, Kuala Lumpur Stock Exchange Composite Index futures (FKLI), comprising 100 composite stocks. Total volume on the KLOFFE in 1997 rose by 395 percent to a record 382,974 FKLI contracts, reflecting increased hedging activities in response to uncertainties in the currency markets. As part of future development, KLOFFE plans to launch equity index options and individual equity options.

The Malaysia Monetary Exchange (MME), established in 1996, offers three-month KLIBOR futures contracts. Trading volume was moderate in 1997 with total turnover increasing to 76,382. The MME plans to introduce currency futures and options in 1998. Activity on the Kuala Lumpur Commodities Exchange (KLCE) is confined mostly to trading of crude palm oil futures.

Capital Controls

On September 1, 1998, the government of Malaysia took what it described as "drastic measures" by imposing capital controls and fixing the value of the ringgit at RM3.8/US$1. The government stated that the objectives of the controls were to eliminate manipulation of ringgit exchange rates, stabilize short-term capital flows, and to protect Malaysia from the contagion effects of external developments. The government has stressed that the measures maintain general convertibility of current account transactions, and do not impair repatriation of interest, profits and dividends and commissions on investments. The government has stated that the controls are temporary measures which will be retracted once the international financial infrastructure addresses destabilizing capital flows which the government blames in large part for recent economic difficulties.

U.S. PRESENCE IN THE MARKET

Merrill Lynch's joint venture with Smith Zain Securities, a member of the KLSE, is the only foreign joint venture stockbroking firm licensed in Malaysia with U.S. participation. Merrill Lynch's 49 percent ownership in Zain represents the largest percentage of foreign ownership in a Malaysian stockbroking joint venture; most other joint ventures top out at 30 percent.

Of Malaysia's 62 KLSE member stockbroking companies, 10 firms have significant foreign ownership interest. Aside from Merrill Lynch, no other U.S. securities firm has applied to operate in Malaysia either as a branch, or as a joint venture with a Malaysian stockbroking firm. Malaysia has 21 representative offices of foreign investment advisors, none of which are American, and 79 country and investment funds. Merrill Lynch is also the only U.S. investor which currently holds shares in a company which is a member of the KLSE, although several are reportedly exploring the possibility of minority participation. Joint venture Foreign Fund Management companies number 4 and fully foreign-owned FFMCs also numbered four. Only one joint venture FFMC application to manage local unit trusts has been approved by the SC. Only one U.S. company holds a stake in a local fund management company.

No U.S. firms are designated as principal dealers in the government bond market; U.S. banks are approved dealers, however. U.S. firms may participate in underwriting on a cross-border basis only if the underwriting is not denominated in Malaysian Ringgit.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign ownership of a KLSE member firm is restricted to a maximum 49 percent share if a positive contribution to the local stockbroking industry can be demonstrated. New licenses for joint venture securities firms providing broking and underwriting services are subject to an economic needs test. At this juncture, no new brokerage license approvals are anticipated as the government is encouraging industry consolidation. Branching is generally not permitted; however, the Securities Commission allowed 24 percent foreign-owned Hwang-DBS Securities' to assume failed Omega Securities obligations in return for a branch.

Foreign fund management companies (FFMCs) can have up to 70 percent foreign shareholding, provided they have locally sourced funds of at least RM10 million (US$2.5 million) and outside sources of US$100 million. Generally, local funds must be sourced from institutional funds and collective investment schemes other than unit trusts. However, a limit of ten FFMCs with 70 percent foreign shareholding can seek approval from the Securities Commission to manage funds of local unit trusts.

While there are no restrictions on foreign firms trading in the corporate debt market, foreign purchases of government debt are limited to Negara bills, T-bills, and MGSs.

Although there are generally transparent rules governing Malaysian financial and capital markets, the financial authorities maintain substantial discretionary authority when approval is required for certain transactions. Foreign financial institutions are treated no differently from domestic financial institutions vis-à-vis opportunities to comment on, and be notified of, regulatory changes.

Generally speaking, current levels of openness to foreign participation in Malaysia's securities markets are fully bound in Malaysia's GATS schedule of commitments. Malaysia already permits up to 49 percent foreign equity ownership in local stockbroking firms even though this commitment will not take effect under its GATS obligations until July 1, 2000. The government has shown flexibility, on a case by case basis, with regard to its bound limits on expatriate workers.

Funds Raised in the Capital Market
(Ringgit millions)

Sector	1993	1994	1995	1996	1997p
By Public Sector					
Government Securities					
Malaysian Government Securities (MGS)	1,600.0	2,229.1	2,000.0	6,000.0	3,000.0
MGS Advanced Subscriptions		270.9			
Khazanah Bonds (KB)					794.4
Government Invest Issues (GII)	1,200.0	3,000.0	750.0		
Malaysian Savings Bonds (MSB)	948.0				
New Issues of Government Securities	3,748.0	5,500.0	2,750.0	6,000.0	3,794.4
Less: Redemptions					
MGS	2,224.5	3,549.0	2,250.0	3,809.0	3,648.0
KB	0.0	0.0	0.0	0.0	0.0
GII	200.0	200.0	500.0	900.0	1,400.0
MSB	93.0	69.8	37.8	34.0	154.8
Less: Government Holdings	50.0	(97.0)	(2.6)	(74.1)	(1.2)
Net Funds Raised by Public Sector	1,180.5	1,778.2	(35.2)	1,331.1	(1,407.2)
By Private Sector					
Shares					
Ordinary Shares[1]					
Initial Public Offers	912.7	2,972.9	4,175.0	4,099.2	4,755.7
Rights Issues	1,176.9	3,436.7	5,240.2	5,268.5	8,524.9
Private Placement	658.8	798.9	1,146.9	4,554.4	3,125.3
Special Issues	684.2	1,249.4	875.5	2,002.3	1,818.8
Preference Shares					
New Issues of Shares	3,432.6	8,457.9	11,437.6	15,924.4	18,224.7
Debt Securities[2]					
Straight Bonds	2,109.8	1,021.7	3,929.9	2,675.4	3,832.0
Bonds with Warrants	1,089.6	2,861.4	3,607.7	5,563.7	3,300.3
Convertible Bonds	164.6	1,323.1	863.1	1,784.1	1,994.9
Islamic Bonds		300.0	800.0	2,350.0	5,249.7
Cagamas Bonds	1,650.0	4,760.0	3,022.0	4,665.0	5,169.0
New Issues of Debt Securities	5,014.0	10,266.1	12,222.7	17,038.2	19,545.8

Sector	1993	1994	1995	1996	1997p
Less: Redemptions					
Private Debt Securities[3]	474.2	383.5	1,249.1	1,765.0	1,358.0
Cagamas Bonds	900.0	850.0	2,635.0	750.0	1,640.0
Net Issue of Debt Securities	3,639.8	9,032.6	8,338.6	14,523.2	16,547.8
Net Funds Raised by Private Sector	7,072.4	17,490.5	19,776.2	30,447.6	34,772.5
Net Funds Raised from Capital Market	8,252.9	19,268.7	19,741.0	31,778.7	33,365.3
Short-Term Securities					
Commercial Paper	1,715.0	16,601.9	20,216.5	34,320.5	55,994.2
Cagamas Notes	2,685.0	2,490.0	3,395.0	5,790.0	13,890.0
New Issues of Short-Term Securities	4,400.0	19,091.9	23,611.5	40,110.5	69,884.2
Less: Redemptions					
Commercial Paper	100.0	14,228.2	18,842.7	31,009.2	53,238.0
Cagamas Notes	2,382.0	2,855.0	1,945.0	5,290.0	11,700.0
Net Issue of Short-Term Securities	1,981.0	2,008.7	2,832.8	3,811.3	4,946.2
TOTAL	10,170.9	21,277.4	22,564.8	35,590.0	38,311.5

[1] Excludes funds raised by the exercise of Employee Share Options Scheme, Transferable Subscription Rights Warrants, and Irredeemable Convertible Unsecured Loan Stocks.

[2] Excludes bonds issued by the banking institutions.

[3] Includes all straight bonds, bonds with warrants, convertible, and Islamic bonds.

p = Preliminary.

Average RM/US$ exchange rates are as follows: 1993, 2.57 RM/ US$; 1994, 2.62 RM/$; 1995, 2.50 RM/$; 1996, 2.51 RM/$; 1997, 2.81.

Source: Bank Negara 1997 Annual Report

Licensed Stockbrokers with Foreign Ownership Interests
(as of December 31, 1997)

KLSE Member Stockbroking Co.	Foreign Participation	Country	Percentage
Straits Securities Sdn Bhd	G.K. Goh Holdings Ltd.	Singapore	30
Seagroatt & Campbell Sdn Bhd	Caisse Nationale de Crédit Agricole	France	30
K & N Kenanga Bhd	Morgan Grenfell Asia Holdings Pte Ltd & Ors	Singapore	26
Smith Zain Securities Sdn Bhd	Merrill Lynch Investments PLC	USA	49
Ke Zan Securities Sdn Bhd	Kim Eng Holdings Ltd	Singapore	30
Mohaiyani Secutities Sdn Bhd	Asia Equity Holdings Ltd	Bermuda	30
OCBC Securities Sdn Bhd	OCBL Holdings Singapore Pte Ltd	Singapore	30
Thong KHJC Sdn Bhd	Kay Hian Holdings Ltd	Singapore	30
Apex Securities Sdn Bhd	Jarding Fleming Holdings Ltd	BVI, UK	30
Hwang-DBS Securities Sdn Bhd	DBS Securities Malaysia Pte Ltd	Singapore	24

Source: Malaysian Securities Commission

Capital Market Debt Instruments, Amount Outstanding[1]
(Ringgit millions)

Instrument	1993	1993	1995	1996	1997p
Malaysian Government Securities	66,018.1	64,969.1	64,719.1	66,910.1	66,261.7
Government Investment Issues	2,000.0	4,800.0	5,050.0	4,150.0	2,750.0
Malaysia Savings Bonds	1,273.0	1,177.3	1,130.6	1,092.0	918.4
Private Debt Securities[2]	10,081.0	15,131.2	22,700.9	33,517.0	46,543.4
Cagamas Bonds	5,015.0	8,925.0	9,312.0	13,227.0	16,756.0

[1] Refer to instruments with a maturity period of more than one year
[2] Exclude debt securities issued by the banking institutions. Private Debt Securities are assumed to be redeemed or converted at maturity
p = Preliminary

Average RM/US$ exchange rates are as follows: 1993, 2.57 RM/US$; 1994, 2.62 RM/US$; 1995, 2.50 RM/US$; 1996, 2.51 RM/US$; 1997, 2.81.

Source: Bank Negara 1997 Annual Report

MEXICO

BANKING

SUMMARY

The implementation of the North American Free Trade Agreement (NAFTA) on January 1, 1994 and the financial crisis of 1994-95 radically altered the Mexican banking sector. Under NAFTA, foreign financial affiliates (basically wholly-owned Mexican subsidiaries of U.S. and Canadian banks, including the U.S. and Canadian banking subsidiaries of foreign-owned firms) were permitted to engage in the full range of banking activities subject to minor exceptions and market share restrictions. Initially, limitations may be placed on the maximum market share of U.S. and Canadian institutions, but these limitations will be phased out by the year 2000. NAFTA set an individual limit of 1.5 percent of the banking sector's aggregate capital and an aggregate limit of 8 percent. The individual limit will remain constant during NAFTA's transition period (January 1, 1994 to December 31, 1999) but the aggregate limit was scheduled to increase from 8 percent in 1994 to 15 percent by 2000. NAFTA also imposed a permanent limit on the size of NAFTA bank affiliates formed through mergers with or acquisitions of Mexican banks. Such institutions would be limited to the equivalent of 4 percent of the banking sector's capital.

As a result of the 1995 financial crisis, Mexican banks faced a dramatic increase in their overdue loans and a serious capital drain. In order to assist the banks, the Mexican government instituted a number of capitalization and debt-relief programs. As part of this package, the government passed financial reform legislation in March 1995 which liberalized foreign ownership and capital limit requirements for banks. This reform law lowered the amount of equity a NAFTA investor would need to hold for a bank to be considered a NAFTA affiliate from 99 percent to 51 percent.

In addition, the financial reform legislation permitted the Ministry of Finance and Public Credit to authorize on a case-by-case basis the acquisition by NAFTA-based banks of Mexican banks that exceed the 1.5 percent (transition) and 4 percent (permanent) market share limit. In those cases, the capital of the acquired bank may not exceed 6 percent of the banking sector's capital. The new limit is only applied to the capital of the acquired bank rather than the capital of the combined institution. The NAFTA individual and aggregate market limits still apply to the *de novo* establishment of financial institutions. Finally, the reforms raised the aggregate capital limit to 25 percent for NAFTA-based banks including the capital of acquired banks authorized by the Finance Ministry on a case-by-case basis. The NAFTA aggregate capital limits remain in place (but are not a binding constraint) for foreign affiliates that did not acquire Mexican banks on that basis.

The financial crisis also accelerated the consolidation of the Mexican banking sector. In 1992, Mexico had 20 banks. By 1994, the number had increased to 58 banks, of which 17 were foreign banks. The 1994-95 crisis produced a wave of mergers, interventions, and alliances with foreign banks. As of June 1, 1998, 38 banks (18 domestic banks, 20 foreign banks) were operating in

Mexico. The Mexican government is also winding up the affairs of 10 intervened domestic banks. Alliances have also flourished since the crisis. Foreign banks currently hold substantial investments in two of the top three Mexican banks.

The Mexican banking sector continues to be highly concentrated. As of December 1997, the top three banks held 56 percent of the sector's assets and capital. As of June 30, 1998, Mexican banks had seven agencies and three representative offices in the United States.

DESCRIPTION OF THE MARKET

The modern Mexican banking system was created in the 1920s with the creation of the National Banking Commission (1924), the passage of the Banking Law (1924), and the founding of the Bank of Mexico (1925). The Ministry of Finance is the primary regulator of the banking system. It issues licenses and sets general credit and fiscal policies. The Bank of Mexico implements Ministry of Finance policies, controls monetary policy, and operates the balance of payments system. The National Banking and Securities Commission (CNBV) is responsible for supervision and vigilance. The National Securities and National Banking Commissions were merged in April 1995.

Under recently proposed legislation, the CNBV would be transferred from the Ministry of Finance to the Bank of Mexico and given greater autonomy. The Bank of Mexico would increase its role in the drafting of financial regulations and gain control of foreign exchange policy. However, some political parties are pressing for a fully autonomous CNBV.

Commercial Banks

Mexico's commercial banks, with the exception of the local Citibank branch (now converted to a subsidiary) and Banco Obrero (a bank owned by the Mexican Labor Federation), were nationalized in 1982. The banks were sold to investors in 1991 and 1992 for 38.6 billion pesos (US$12.4 billion). The buyers of the banks paid a substantial premium for their acquisitions, on average over three times book value. Many of the buyers did not have substantial banking experience. The period of 1992-94 saw a rapid expansion of credit as banks fought for market share. Mortgage lending exploded and banks adopted very liberal lending policies. At the same time, the banks did very little to develop new deposit products.

The onset of the 1994-95 crisis produced a rapid deterioration in the banks' loan portfolios and a dramatic need for additional capital. The Mexican banking system's non-performing loans increased 143 percent from December 1994 to December 1995. By the end of 1996, the private sector had injected more than 63 billion pesos into the banking system. In addition, the Mexican government purchased billions of pesos worth of non-performing loans through FOBAPROA, the deposit insurance fund, intervened in several banks, and created a number of debtor assistance programs.

Commercial banks are required to contribute to FOBAPROA, a bank insurance fund managed by the Bank of Mexico. All banks make periodic contributions based on the level of their liabilities. The fund can inject capital into banks experiencing capital problems in exchange for partial or complete control of the bank. During the crisis, FOBAPROA purchased a large number of non-performing loans from the banking sector and assumed control of several intervened banks. As of February 1998, FOBAPROA had total gross liabilities of approximately US$65 billion and assets of approximately US$26 billion, for an estimated negative net worth of US$39 billion or 8.8 percent of GDP. Under recently proposed legislation, FOBAPROA would be split into a deposit insurance fund, FOGADE, and an asset recovery commission, COREBI. FOGADE will be funded by government allocations, bank contributions, and financing. The Ministry of Finance may set different fees for banks based on their perceived level of risk. Unlike FOBAPROA, FOGADE will not give unlimited protection to bank's obligations. COREBI will have a six-year life span and will be charged with selling FOBAPROA's assets.

According to CNBV's June 1998 statistical bulletin, the Mexican banking sector has assets of 1,114,415 millions of pesos (US$125.2 billion). This number, however, excludes the assets of intervened banks, banks in "special circumstances," and loans held by FOBAPROA, making it difficult to quantify the true state of the Mexican banking system.

The financial crisis accelerated the consolidation of the Mexican banking sector. The number of banks increased from 20 in 1992 to 58 in 1994, of which 17 were foreign banks. The 1994-95 crisis produced a wave of mergers, interventions, and alliances with foreign banks. As of June 1, 1998, 38 banks (18 domestic banks, 20 foreign banks) were operating in Mexico. The Mexican government is also winding up the affairs of 10 intervened domestic banks. The crisis also encouraged Mexican banks to enter into strategic alliances with foreign banks. For example, the Bank of Montreal holds a 16 percent stake in Bancomer, Mexico's largest bank. J.P. Morgan and HSBC Holdings together have a 28.5 percent stake in Serfin. Foreign banks also hold stakes in Bital and Inverlat.

Mexican commercial banks can issue three types of stock: A, B, and L. Series A shares must constitute 51 percent of a bank's voting shares and must be held by Mexican citizens, Mexican corporations, the Mexican government, development banks, FOBAPROA, or financial holding groups. Series B shares have unrestricted ownership with foreign investment of up to 49 percent. Series L shares have limited voting rights and unrestricted ownership of up to 40 percent of the common capital stock. Under recently proposed legislation, Series A and B shares would be merged into a new type of common capital stock, Series O, with no restrictions on foreign ownership.

The Mexican government and banking sector have increased the banking system's transparency and efficiency in recent years. In January 1997, the CNBV implemented new accounting practices for banks under a modified version of U.S. GAAP. The new accounting rules do not address troubled debt restructuring or require cash flow statements but do require banks to adopt inflation accounting.

Mexico is not a signatory to the Basle Capital Accord, although risk-based capital rules have been implemented on a modified basis. Financial and banking authorities have taken steps to improve bank inspection procedures in recent years and have received advice and training from international organizations. However, despite positive steps, deficiencies still remain. Beginning in 1997, banks were required to report "suspicious" transactions and were required to meet certain record-keeping and reporting requirements aimed at reducing money laundering. Although a credit bureau had been in place for many years, it has been recently revamped and modernized.

Development Banks

The Mexican banking system contains six government-owned development banks that lend to priority sectors, often through commercial banks. Development banks have been moving toward market-based financing and lending in recent years as opposed to subsidized lending. As of December 31, 1997, the development banking system held assets of 421.5 billion pesos (US$51.8 billion). Loans made up 84.9 percent of assets. As of December 31, 1997, overseas issues represented 10.9 percent of the banks' liabilities, local securities 29.4 percent, and interbank and international financial institution loans represented 53.7 percent.

Nacional Financiera (Nafinsa) is the dominant development bank, followed by Banobras and Bancomext. Nafinsa targets micro, small, and medium-sized businesses. It is often the government's agent for international financial transactions and promotes capital market development. Nafinsa also operates a neutral investment fund through which foreign investors may purchase an interest in Mexican Series A shares. The fund facilitates the expansion and liquidity of secondary markets and increases operating volumes. Nafinsa controls almost 49 percent of development bank assets and almost 50 percent of liabilities. Banobras, Mexico's infrastructure finance bank, holds almost 21 percent of the system's assets and 20 percent of its liabilities. Bancomext, the export finance bank, holds almost 19 percent of the assets and 18 percent of the liabilities.

U.S. PRESENCE IN THE MARKET

The Mexican banking sector continues to be highly concentrated. As of December 1997, the top three banks held approximately 60 percent of the sector's assets and capital. The 20 foreign banks currently operating in Mexico control 16.3 percent of the sector's assets and 15.6 percent of its capital. Ten U.S. owned banks are currently operating in Mexico. As of April 1998, there were 103 foreign bank representative offices, of which 21 represented U.S. banks. Mexican banks had seven agencies and three representative offices in the United States as of June 30, 1998.

In addition, institutions from OECD countries have used U.S. or Canadian subsidiaries to establish affiliates in Mexico via NAFTA. NAFTA's rule of origin is based on the country where the foreign financial institution is incorporated. The nationality of the institution's investment is immaterial.

These OECD member investors control a substantial portion of the market share of foreign banks in Mexico.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Under NAFTA, foreign financial affiliates (basically wholly-owned subsidiaries in Mexico owned by foreign banks domiciled in Canada or the United States, including the U.S. and Canadian banking subsidiaries of foreign-owned firms) were permitted to engage in the full range of banking activities subject to minor exceptions and market share restrictions. Individual and aggregate banking market share limits apply to U.S. and Canadian bank subsidiaries during a phase-in period. Between 1994 and 2000, an individual bank is limited to net capital of 1.5 percent of the total net capital of all Mexican and foreign commercial banks. Net capital is a measure that includes basic capital, essentially paid-in capital plus capital reserves adjusted by retained earnings and asset valuations, and complementary capital. It is estimated that total capitalization of the Mexican banking system is 98.5 billion pesos, or US$9.85 billion at an exchange rate of 10 pesos/US$. Thus, the 1.5 percent limit is US$148 million. Additionally, NAFTA set an aggregate net capital limit for U.S. and Canadian banks of 8 percent of net capital of the system in 1994 (US$1.22 billion equivalent as of May 1994), increasing in equal annual increments to 15 percent in 2000. These market share limits will disappear in the year 2000, but between 2000 and 2004 the Mexican government may unilaterally freeze new entries by NAFTA-based banks for a period of three years if the aggregate market share of the banks exceeds 25 percent of the banking sector's net capital. The Mexican government can only invoke this safeguard one time between January 1, 2000 and December 31, 2003. Second, a permanent safeguard allows Mexico to request consultations with the United States and Canada if the aggregate market share of NAFTA-based banks exceeds 25 percent of the sector's net capital, with a view to remedial action including a temporary freeze on the market share of the banks.

Under the NAFTA agreement, U.S. and Canadian, and other foreign banks through subsidiary banks established in the United States and Canada, were permitted to acquire Mexican banks as long as the combined capital of the acquired bank and a foreign subsidiary of the investor did not exceed the market share limit, or, after the transition period, 4 percent of the capital of the system. If the acquiring bank was already established in Mexico, both banks had to be merged and the 4 percent limit was applied to the merged institution. However, as a result of the 1994-95 financial crisis, Mexican banks faced a dramatic increase in their overdue loans and a serious capital drain. In order to assist the banks, the Mexican government instituted a number of capitalization and debt-relief programs. As part of this package, the government passed financial reform legislation in March 1995 permitting the Ministry of Finance and Public Credit to authorize on a case-by-case basis the acquisition by NAFTA-based banks of Mexican banks that exceed the 1.5 percent (transitional) and 4 percent (permanent) market share limits. The limit on those acquisitions and mergers was raised to 6 percent of the banking sector's capital. The new limit is only applied to the capital of the acquired bank rather than the combined institution, and at the time of its implementation, signified that all but the three largest banks in Mexico could be controlled by NAFTA-based banks. The NAFTA individual and aggregate market limits still apply to the *de novo* establishment of financial institutions, but the aggregate capital limit including those specially-authorized acquisitions was raised, to 25 percent of banking system capital.

The 1995 financial reform law changed the NAFTA full ownership requirement from 99 percent ownership of the subsidiary's common stock to 51 percent ownership in order to encourage joint ventures between foreign banks and Mexican banks.

The Mexican government introduced a financial reform package before Congress in March 1998. The package deals with the FOBAPROA bank insurance fund controversy and various regulatory issues, including a lifting of the current 6 percent banking sector limit for foreign bank acquisitions of and mergers with Mexican banks. (The latter, if approved, would allow foreign banks to buy the three largest Mexican banks.) As of November 1998, it appears that the FOBAPROA portion of this package will be approved in some form this year. The rest of the regulatory reforms, including the lifting of the market capitalization restriction on foreign bank acquisitions and of mergers with Mexican banks, will not be addressed before 1999.

The implementation of NAFTA on January 1, 1994 committed Mexico to applying the principle of national treatment to U.S. and Canadian financial institutions. Since the implementation of NAFTA, North American owned bank subsidiaries have been able to offer the same services as Mexican financial institutions with several minor limited exceptions. Foreign financial institutions may only establish one institution of the same type in Mexico. In addition, they can only establish subsidiaries and not branches in Mexico. Mexican subsidiaries may not establish branches, subsidiaries, or agencies outside of Mexico. Finally, during the transition period, subsidiaries may only sell subordinated debentures to their foreign parent company.

Mexico has recently agreed to extend the benefits of NAFTA to OECD-based financial institutions. OECD-based financial institutions would be subject to NAFTA-style individual and aggregate market share limits during the NAFTA transition period. They would also be subject to the two NAFTA safeguards. As a result of the OECD agreement, overall aggregate market limits would be doubled, reaching 30 percent for commercial banks. Under the agreement, if, during the transition period, NAFTA-based institutions reached their aggregate market share limits, they would be entitled to draw on the OECD quota. The converse is not true.

Exchange Rates Used:

1992 end-of-period	3.11 pesos/US$
1997 end-of-period	8.14 pesos/US$
June 1998 period average	8.90 pesos/US$

MEXICO

SECURITIES

SUMMARY

The implementation of the North American Free Trade Agreement (NAFTA) opened the Mexican securities market to U.S. and Canadian firms. Under NAFTA's national treatment guarantee, U.S. securities firms and investment funds, acting through local subsidiaries, have the right to engage in the full range of activities permitted in Mexico. U.S. and Canadian firms will be subject to market share limitations during NAFTA's 1994-99 transition period.

Mexico has one securities exchange, the Bolsa Mexicana de Valores (Bolsa). The exchange has three sections: the main section, a section for medium-sized Mexican companies (MMEX), and a section for trading securities issued in overseas markets (the International Quotations System). A new exchange, the Mexican Derivatives Exchange (MEXDER), has been approved although trading has not yet begun. As of September 1998, there were 33 brokerage houses operating in Mexico. There are five foreign brokerage firms operating in Mexico. Three of the five are subsidiaries of U.S. firms. Of the five representative offices in operation, three represent U.S. firms.

Trading in money market operations continues to dominate the securities market, accounting for over 95 percent of the trading activity. Money market trading is concentrated in government instruments. As of September 1998, a total of 787.9 billion pesos (US$77.9 billion) in government securities was outstanding.

The securities industry is regulated by the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores, or CNBV), the Ministry of Finance, and the Bank of Mexico (BOM). The Bolsa and the Mexican Association of Trading Intermediaries exercise limited self-regulatory functions.

Foreign investment plays an important role in the Mexican securities market. As of December 1997, foreign investment accounted for 31 percent of the Bolsa's market capitalization. Foreigners held 11 percent of the government securities held outside of the BOM in December 1997. Foreign entities may freely invest in government securities. Foreign investors may also purchase non-voting shares through mutual funds, trusts, offshore funds, and American Depositary Receipts. They also have the right to directly buy limited or non-voting shares as well as free subscription shares, "B" shares, which carry voting rights. Finally, foreigners may purchase "A" shares (normally reserved for Mexican citizens) indirectly through a neutral fund operated by the Mexican development bank Nafinsa. Foreigners invest in the fund, which in turn holds title to the actual shares.

DESCRIPTION OF THE MARKET

Domestic Securities Market

Mexico has one established securities exchange, the Bolsa Mexicana de Valores (Bolsa). Stocks, warrants, fixed-income securities, government securities, and metals contracts are traded on the exchange.

The securities market is regulated by the CNBV, a semi-autonomous agency of the Ministry of Finance. The National Securities Commission was merged with the National Banking Commission in April 1995. Under recently proposed legislation, the CNBV would be transferred from the Ministry of Finance to the BOM and given greater autonomy. The Ministry of Finance and the BOM also have regulatory authority under the current regulatory scheme. The Bolsa and Mexican Association of Trading Intermediaries act as self-regulating organizations. A new Code of Ethics for the Mexican Securities Industry was passed in 1997 and the Bolsa is currently creating a new disciplinary committee.

As of September 1998, 33 brokerage houses were in operation. Twenty-two brokerage houses belong to financial groups and eleven operate independently. Thirteen of the brokerage houses have U.S. subsidiaries. Brokerage commissions are not regulated. Brokerage houses conduct most of the trading, but banks' money market and foreign exchange desks are active in buying and selling securities. Three rating agencies are authorized to operate in Mexico. Two of the agencies, Standard and Poor's and Duff and Phelps, are U.S. firms.

Stock Market

The Bolsa has three sections: the main section, the mid-cap section (MMEX), and the International Quotations System. As of December 1997, the Bolsa had a market capitalization of 1.26 trillion pesos (US$154.8 billion). One hundred ninety-eight issuers were listed on the stock market with 155 quoted on the main section in 263 stock series. The average daily trading in 1997 was 1.5 billion pesos (US$189.6 million). Total trading volume for the year came to 24.7 billion shares.

The MMEX was originally launched in July 1993. In December 1997, there were 39 issuers and 59 series listed on the MMEX. The annual value traded on the MMEX in 1997 was 2.5 billion pesos (US$316.1 million) with a total of 635.6 million shares changing hands. In November 1996, the first MMEX issuer moved from the mid-cap section to the main section. A second issuer followed in March 1997.

In July 1997, the Bolsa opened a new section, the International Quotations System (Sistema Internacional de Cotizaciones, or SIC), for listing and trading shares of foreign companies that are already quoted on other CNBV-authorized markets. Shares of four foreign issuers are currently being traded on the SIC.

Stocks are sold for cash and payment takes place within 48 hours (T+2). Short sales were introduced in 1991 on stocks with high marketability. The volume of short sales has been relatively low. In 1997, the volume of short sales was 37.5 million shares traded, a 62 percent drop from 1996. The introduction of a new securities lending system may soon spark growth.

Money Market

Money market operations dominate trading on the Bolsa, accounting for 97 percent of the value of the securities traded in 1997. The principal money market instrument is the Mexican treasury bill, the Cete (Certificado de la Tesoreria de la Federación). In December 1997 Cetes represented almost 51 percent of outstanding public sector debt instruments. Cetes are discount bills with a par value of 10 pesos and are available in maturities of 28, 91, 182, and 357 days. Cetes are auctioned weekly by the BOM, usually in a multiple-rate auction. The majority of Cetes are purchased by institutional investors such as banks, brokerage houses, and pension funds. Cetes are sold in the secondary market directly or through repurchase operations. In December 1997, foreigners held roughly 8 percent of the outstanding Cetes.

Tesobonos (Bonos de la Tesoreria de la Federación) are treasury bills denominated in U.S. dollars and payable in pesos at the current market exchange rate. The Mexican government paid off all outstanding Tesobonos in February 1996.

The most important private money market instruments are certificates of deposit and banking notes with yield payable at maturity, bankers' acceptances, and commercial paper. Banking instruments are traded over-the-counter as well as on the Bolsa.

Capital Market

The BOM auctions two principal long-term government securities: Bondes (Bonos de Desarollo) and Ajustabonos. Bondes are development bonds with roughly three-year maturities. They have a face value of 100 pesos and are sold at a discount. They pay interest every 28 days and are indexed to the three-month Cete yield. Ajustabonos are three- and five-year bonds whose interest payments and redemption at maturity are indexed to inflation in order to guarantee a real return. Ajustabonos pay interest quarterly based on a 100 peso par value adjusted for inflation.

Mexico's privatized pension funds, Afores, are the major buyers of Mexican long-term government securities. In December 1997, Bondes and Ajustabonos represented approximately 30 percent of outstanding public sector debt instruments.

The government introduced a new instrument, Udibonos, in May 1996. Three- and five-year Udibonos are offered twice a month in the BOM's primary auction. Udibonos are denominated in units of investment (Udis). Udis are an accounting unit that is adjusted to changes in the Mexican National Consumer Price Index.

Mutual Funds

Foreign banks and securities firms may offer and manage mutual funds through their Mexican subsidiaries under NAFTA. Foreigners may also own mutual fund management companies that are not affiliated with banks or securities firms. The CNBV regulates the mutual fund industry.

At the end of 1997, 284 mutual funds were operating as equity funds, debt funds, and capital investment funds in Mexico. Total assets reached approximately 71 billion pesos (US$8.7 billion) in December 1997. Foreign investment accounted for 3 percent of the mutual funds' total assets. Foreign investment in Mexican mutual funds grew 50 percent in nominal terms and 30 percent in real terms in 1997.

Pension Funds

In 1995 and 1996, the Mexican government passed pension privatization legislation. The reforms established individualized pension funds and tied pension benefits to individual contributions. The new system became operational in 1997. Under the system, funds are managed privately and workers may select their fund managers (Afores). Workers may choose to remain in the old system of defined benefits or move to the new system. Workers opting for the new system will have up to four years to choose an Afore. By November 1997, over 80 percent of the Mexican workers covered by the Mexican Social Security System had opted for the new system and selected an Afore.

Financial intermediaries from NAFTA countries which participate as fund managers are accorded national treatment. Of the 17 Afores authorized since February 1997, eight have foreign participants (including four U.S. companies) and two are wholly owned by U.S. companies.

Foreign Investment

Mexican financial markets continue to become more international in scope. At the end of 1997, foreign investment in the stock market totaled US$48.9 billion or 31 percent of the Bolsa's capitalization.

Foreign investment in Mexican companies' voting stock is limited to minority positions in certain sectors, including most financial companies. Foreigners may purchase free subscription shares ("B" shares) directly. "B" shares carry voting rights. They may also freely purchase limited or nonvoting shares. In order to purchase interests in "A" shares which carry voting rights and are normally reserved for Mexican investors, foreigners may invest in the shares via Nafinsa's neutral fund. Finally, foreigners may invest through offshore funds or through American Depositary Receipts (ADRs). ADRs are certificates that represent a set number of shares and are traded in U.S. markets.

As of December 1997, 47 percent of foreign stock investment was in ADRs, 40 percent in free subscription shares, 10 percent in Nafinsa's neutral fund, and 3 percent in the Mexico Fund, a closed-end fund incorporated in Maryland. Foreigners also made minor investments in stock listed on the MMEX and in warrants.

Derivatives Market

The Mexican Derivatives Exchange (MEXDER) was approved on May 13, 1998 but has not yet begun trading. MEXDER will be completely self-regulating. Brokerage houses, credit institutions, authorized exchange houses, and non-financial companies or partnerships will be able to trade on the new exchange. (Brokerage houses and banks operating on the MEXDER can do so only through subsidiaries specially constituted to participate in this market.) The exchange will initially trade dollar futures, futures based on the IPC stock index, and bond futures. Trading will be conducted by open outcry. After approximately one year, an electronic market will commence operations. Interest in MEXDER is high. The exchange initially offered 165 seats but the overwhelming response made it necessary to increase the number of seats to 192. The exchange currently has a waiting list for seats.

There is not a clear division of responsibility regarding the regulation of futures and options. The BOM drafts regulations for peso and interest rate futures and in many cases the CNBV carries out the supervisory function. The BOM would be the regulator of over-the-counter forwards and options. However, the BOM is also the regulator for some exchange-traded futures and options.

U.S. PRESENCE IN THE MARKET

Of the 33 brokerage houses currently operating in Mexico, five are subsidiaries of foreign firms. Three of the five foreign brokerage houses are U.S. firms. U.S. brokerage houses hold 7 percent of Mexican brokerage houses' total capital. The top three Mexican brokerage houses handled 24 percent of the total trading in 1997. Three of the five operational representative offices are of U.S. origin. Direct branching is not permitted.

Mexican residents may issue equity and debt securities in overseas markets. Mexican companies have been extremely active in foreign financial markets in recent years. Overseas issues are subject to prior approval by Mexican regulatory authorities for prudential reasons. The United States is the most important overseas market for Mexican issuers and U.S. firms are actively involved in underwriting Mexican offshore securities issues.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The implementation of NAFTA in 1994 permitted U.S. and Canadian securities firms to enter the Mexican market for the first time through subsidiaries. Under NAFTA's national treatment guarantee, U.S. firms' subsidiaries can engage in the full range of securities activities open to Mexican firms and are subject to the same rules and regulations. Non-NAFTA country firms may enter the Mexican market under NAFTA's provisions via their U.S. or Canadian subsidiaries. This allows them to circumvent the fact that Mexico's GATS offer of December 1997 is less liberal than treatment accorded under NAFTA.

Under NAFTA, U.S. and Canadian subsidiaries have individual and aggregate market shares limits during NAFTA's 1994-99 transition period. The individual market share limit caps the authorized capital of a single securities firm at 4 percent of the global capital of all Mexican and foreign securities firms. Roughly speaking, global capital is paid-in capital and capital reserves adjusted by earnings and changes in asset valuation.

NAFTA originally set an aggregate capital limit of 10 percent of the global capital of all Mexican and foreign securities firms in 1994. The limit is currently 18 percent of global capital and will increase to 20 percent in 1999. The limit will be completely eliminated in the year 2000. However, between 2000-04, Mexico may freeze for up to three years the global capital of U.S. and Canadian firms if it represents 30 percent of aggregate capital. Except for these capital limits, NAFTA members face no national treatment barriers in Mexico's securities sector.

In 1995, the Mexican government liberalized regulations governing investment in financial institutions. Foreigners may invest directly in Mexican brokerage firms through Series "B" shares. Series "B" shares may represent up to 49 percent of a brokerage's capital. The limit was 30 percent prior to 1995. In addition, the 1995 reforms permitted foreign institutions to acquire Mexican financial institutions and convert them into affiliates without being subject to capital limits, subject to CNBV approval. Since the reforms, two foreign financial institutions have purchased Mexican financial institutions. There have been no further developments since 1995.

Exchange Rates Used:

1997 period average	7.91 pesos/US$
1997 end-of-period	8.14 pesos/US$
September 1998 end-of-period	10.11 pesos/US$

PHILIPPINES

BANKING

SUMMARY

The Philippines has 54 commercial banks, including 14 foreign branches and four bank subsidiaries majority-owned by foreign banks. The top five banks control 35 percent of banking assets. The Philippines has not been spared from the financial crisis affecting most of Asia since July 1997. The peso depreciated 35 percent and interest rates rose, triggering sharp increases in non-performing loans and adversely affecting some of the smaller financial institutions in the country.

Bangko Sentral ng Pilipinas (BSP), the central bank, regulates banking. Overall, it has performed well in managing the economic turmoil stemming from the crisis: as of October 1998, liquidity had been restored to financial markets and the exchange rate, although fragile, had generally stabilized.

As of June 1998, foreign banks controlled about 16 percent (US$9.6 billion) of commercial bank assets, and U.S. banks alone accounted for 5.3 percent (US$3.2 billion). The 1948 prohibition on the entry of new foreign banks remained in effect until May 18, 1994, when a new banking act allowed up to 10 foreign banks to enter by establishing full service branches. Since all ten branch licenses have been issued, additional foreign banks are again restricted from establishing branches in the Philippines. Three U.S. banks have established full-service branches, but only Citibank, N.A., engages in retail banking. Foreign banks can also enter the Philippines by investing in or acquiring up to 60 percent in the voting stock of a *de novo* bank subsidiary or a locally incorporated bank. However, no U.S. bank has yet established such a presence.

Foreign banks operate under additional restrictions not applied to their domestic counterparts. Capital adequacy ratios and legal lending limits are based on the locally incorporated capital of the branch, and net-due-to-head-office borrowings need to be fully converted to pesos to qualify as capital for certain regulatory requirements. These restrictions mitigate much of the benefit in establishing branches. There are also limits on branching, automatic teller machines, remittances of profits, and ownership of land and buildings. Another important limitation in the 1994 legislation is a requirement that Filipino-controlled banks control at least 70 percent of banking system assets.

DESCRIPTION OF THE MARKET

Structure of the Market

The Philippine banking system includes commercial banks, thrifts, and rural banks. As of June 1998, the Philippines had 1,011 banking institutions of all types, with 6,472 branches or offices. Many of these are small, undercapitalized, family-owned institutions, never considered strong, which have now been weakened further by a surge in non-performing loans stemming from a depreciated peso, poor liquidity, and/or a weak economy, and increased capitalization requirements.

Commercial banks dominate the banking industry and account for over 90 percent of banking system assets. From 1993 to 1997, the commercial banking system has grown rapidly, with assets, deposits, and loans all increasing over 25 percent yearly. There are currently 54 commercial banks operating in the Philippines, compared to 33 in 1993, with total assets of 2.5 trillion pesos (US$59 billion) as of June 1998. Most of the 36 Filipino-controlled commercial banks, or their holding companies, are listed on the Philippine Stock Exchange.

Foreign- and Filipino-owned commercial banks and branches can obtain either a regular commercial bank license or an expanded commercial bank license. The expanded commercial bank license allows foreign banks to become universal banks and engage in a variety of other financial activities, including securities underwriting. In order to obtain an expanded license, the institutions must meet higher capital requirements.

The Philippine government maintains three wholly-owned banks which specialize in agricultural lending, development finance, and loans to small and medium enterprises.

Foreign Banks

Commercial banks in the Philippines include 14 branches of foreign banks and four banking subsidiaries which are majority-owned by foreign banks, with assets totaling 403 billion pesos (US$9.6 billion). A 1994 law allowed the entry of foreign banks into the Philippines for the first time since 1948. In 1995 and 1996, ten new branch licenses were granted to foreign banks (one U.S.), joining four existing foreign branches (two U.S.) whose presence predated the 1948 law. Four new bank subsidiaries which are majority-owned by foreign banks were also established. There are also 29 representative offices (5 U.S.) and 16 offshore banking units (5 U.S.) in the Philippines. ING Bank (Netherlands) is the only foreign institution with an expanded commercial bank license. Several Philippine commercial banks have branches and remittance offices in the United States, specializing in providing banking services to Filipino workers sending remittances back home; only one provides full banking services.

Condition of the Industry

The Asian financial crisis has negatively affected banks in the Philippines. Thinner interest spreads due to heightened competition received a setback when the crisis pushed the peso to historic lows in January 1998. Prime bank lending rates, which had dropped to 11-12 percent, rebounded as high as 17 percent in reaction to increased reserve requirements, tighter liquidity, and soaring overnight interest rates. Ordinary business rates were generally much higher.

The level of non-performing loans (NPLs) in the commercial banking sector climbed from less than 3 percent at the end of 1996 to 4.7 percent at the end of 1997. Partly due to a stricter definition of past-due loans, the NPL ratio rose to 9.6 percent in May 1998. The Bankers Association of the Philippines forecasts that NPLs will probably reach 12 to 13 percent of outstanding loans by the end of 1998, a level considered manageable, before the trend reverses. On a brighter note, however, interest rates began to decrease in April 1998, as liquidity eased and the Central Bank reduced reserve requirements.

Thus far, the regional crisis has forced the BSP to place under receivership one small commercial bank due to its nonperforming loan portfolio. The country's smaller institutions, however, have been more affected. So far, six thrifts and 14 rural banks have been closed. These institutions, however, account for only a very small portion of the system's total assets.

Capital Requirements

The Philippines has not yet adopted BIS standards. The Central Bank is seeking legislative authority to adopt the international capital standards in revisions to the General Banking Law, which were recently submitted to Congress. However, Philippine banks are required to maintain a minimum capital to risk assets ratio of 10 percent. This ratio differs from the BIS standards in that it only recognizes Tier 1 capital, assets are only assigned either a zero percent or 100 percent risk weighting, and off-balance sheet items are not included.

Minimum capital requirements are being raised in stages for existing banks. They are now 3.5 billion pesos for an expanded commercial bank and 1.625 billion pesos for a regular commercial bank. The minimum capital required for an expanded commercial bank will rise to 4.5 billion pesos at the end of 1998, 4.95 billion pesos at the end of 1999, and 5.4 billion pesos at the end of 2000. For a regular commercial bank, the minimum requirements are 2.0 billion pesos at the end of 1998, 2.4 billion pesos at the end of 1999, and 2.8 billion pesos at the end of 2000. Capital requirements are 5.4 billion pesos for new expanded commercial banks and 2.8 billion pesos for new regular commercial banks.

Regulatory Structure

Bangko Sentral ng Pilipinas (BSP) is the central monetary authority mandated to provide policy direction in the areas of money, banking, and credit. It also has supervisory authority over the operations of banks. The BSP has complete fiscal and administrative autonomy. A Governor, appointed by the President, administers the BSP and chairs the Monetary Board, which establishes policy. The Bankers Association of the Philippines is the commercial banks' lobby. In coordination with the BSP, it commits members to regulatory-like policies.

The Philippine Deposit Insurance Corporation, patterned after the Federal Deposit Insurance Corporation, was established to provide protection for depositors. It is also the designated receiver for troubled banks. The PDIC insures peso deposits up to 100,000 pesos (US$2500) at all banks, whether foreign- or Philippine-owned. It does not insure dollar deposits at offshore banking units.

The Philippines has a very strict bank secrecy law that shields account information, even from the government. An effort to eliminate bank secrecy as part of a 1998 tax reform bill failed. The World Bank had made lifting bank secrecy a condition for a Banking Sector Reform Loan, but appears to be settling for less than full compliance. The government is considering lifting bank secrecy for DOSRI (directors, officers, shareholders, and related interests). The Philippines has no law on money laundering.

President Estrada has promised to implement additional financial sector reforms, including further hikes in minimum capitalization requirements to foster mergers and consolidation, reductions in reserve requirement, stronger prudential standards, and substantive changes to the country's General Banking Act. Liberalizing restrictions on foreign bank entry, ownership, and branch establishment are possible areas for improvement. Legislation would be required, however, to raise ownership limits.

U.S. PRESENCE IN THE MARKET

As of June 30, 1998, foreign-controlled banks accounted for 16 percent of commercial bank assets, including 5.3 percent held by U.S. banks as of end-June 1998. As of year-end 1993, foreign banks accounted for 8 percent of assets, with U.S. banks holding 6 percent.

Three U.S. banks, Citibank, Bank of America, and Chemical Bank (now Chase), have established branches in the Philippines. Only Citibank, which was established in the Philippines in 1902, engages in retail banking. Five other U.S. banks maintain representative offices in Manila to facilitate investment and trade financing, but do not engage in commercial banking. Five U.S. banks also operate offshore banking units, and are only authorized to conduct non-peso-banking operations.

Citibank is the largest foreign bank and the seventh largest commercial bank in the Philippines; it has one direct branch with four [sub] branches. The bank believes it has found a particular niche in foreign exchange trading and derivatives. Bank of America and Chase each have one direct branch. Although licensed as full service branches, they currently offer only wholesale banking products. Bank of America had long conducted retail banking through BA Savings Bank, a thrift in which it held a minority interest, but it recently sold its stake to its Philippine partners.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign Branches

Before May 18, 1994, when President Ramos signed Republic Act 7721 (An Act Liberalizing the Entry and Scope of Operations of Foreign Banks), the entry and licensing of new, wholly foreign-owned banks was prohibited under the 1948 General Banking Act. The 1994 Act opened a five-year window permitting up to ten new foreign banks to enter the market as full-service branches (retail and wholesale banking). Two U.S. banks (Citibank and Bank of America) operate branches under pre-1948 licenses. All ten foreign branch licenses have already been issued; therefore, additional foreign banks are, in effect, restricted from entering the Philippine banking market in branch form. There are no plans to increase the number of foreign branch licenses, which would require legislation. However, Development Bank of Singapore and a Philippine commercial bank (Bank of Southeast Asia) opted to consolidate and started operating as DBS Bank Philippines, Inc., on September 1, 1998. This has made available one slot for the entry of one more foreign bank via the branching mode to complete the 10 branches allowed by law. A foreign bank cannot have both a subsidiary bank and a branch license.

Under a 1996 banking circular, commercial banks with the equivalent of the prescribed minimum capital can obtain an expanded commercial bank (universal bank) license. However, U.S. banks indicate that the central bank will not allow them to apply for an expanded commercial bank license as a branch because of Glass-Steagall restrictions.

The 1994 banking law also places restrictions on the number and location of branches established by foreign banks. Each foreign bank is permitted to open a total of six offices, but three are required to have BSP Monetary Board approval with regard to location. The four existing foreign branches are also permitted to establish six new sub-branches, in addition to those grandfathered when restrictions were imposed in 1948. Automated Teller Machines (ATMs) are of limited value in bypassing branching restrictions. Current regulations limit the use of off-site ATMs (those not located in a branch) to dispensing cash and handling credit card and utility payments. Foreign banks are, however, able to participate in shared ATM networks on an equal basis with Philippine banks.

Foreign branches must assign 210 million pesos (US$5 million) in capital for the first three branches; additional branches require 35 million pesos (US$875,000) per branch. American bankers do not, however, consider these requirements onerous. For regulatory capital purposes, Net-Due-to-Head-Office (NDTHO) borrowings are limited to a maximum of four times the permanently assigned branch capital. The branches of foreign banks must also remit and convert at least 15 percent of their NDTHO accounts into pesos with adjustments allowed for significant involvement in certain activities, e.g., exports. For computing the limits on foreign exchange holdings, the BSP requires that NDTHO borrowings be 100 percent converted to pesos.

Capital adequacy ratios and single borrower/sector lending limits for foreign branches are based on local capital instead of consolidated global capital, to a large degree eliminating the benefit in establishing branches.

Banks are required by law to lend 25 percent of their loanable funds for agriculture/agribusiness purposes and 10 percent to small and medium enterprises (SMEs). These requirements apply to all banks, but foreign banks are disadvantaged in meeting the requirement by their inability to freely expand their branch networks.

Subsidiary Banks

The 1994 law permits foreign banks to enter the Philippine banking market by investing in up to 60 percent of the voting stock of a *de novo* banking subsidiary or a new bank or by acquiring up to 60 percent of the voting stock of an existing locally-incorporated bank. Regulators have stated that they are studying the possibility of allowing up to 100 percent ownership in the case of distressed banks as part of the measures in response to the Asian Crisis. Prior to liberalization, foreign banks were restricted to 30 percent of total voting shares of a domestic commercial bank, with an additional 10 percent subject to the approval of the President of the Philippines. A foreign bank acquiring control of an existing bank or establishing a new banking subsidiary must list 10 percent of the shares on the local exchange. Philippine law prohibits foreign-owned banks and branches from collectively controlling more than 30 percent of the banking system's assets.

A foreign bank seeking to enter the Philippine banking market in *de novo* form has to be widely owned and publicly listed unless more than 50 percent of its equity is held by its home government. The bank is considered widely owned if there are at least 50 shareholders, with no individual owning more than 15 percent of the bank's stock. In addition, a bank had to be among the top 150 banks worldwide (by net worth) or among the top five banks in its home country. These were the criteria by which the ten branch licenses were awarded to the leading banks from the Philippines' main trading partners and neighbors. One U.S. bank (Chemical, now Chase) received a new license to establish a branch. So far, no U.S. bank has been interested in acquiring control of an existing Philippine bank or establishing a new bank subsidiary.

Restrictions

All three U.S. banks and most foreign commercial banks operating in the Philippines are enjoined from making direct, local-profit remittances to their head offices more than once a year. One U.S. bank has been unable to make direct remittances since 1989 under a BSP regulation prohibiting remittances by a foreign bank engaged in litigation with the Philippine Deposit Insurance Corporation (PDIC) or with outstanding PDIC assessments. At issue is the PDIC determination that head office borrowings are equivalent to deposits and that local foreign-owned branches should pay PDIC premiums on such borrowings. The banks contend such transactions are borrowing and not subject to PDIC premiums. The Supreme Court ruled in Citibank's favor in August 1998, but the government has the right to seek reconsideration by the full court.

Constitutionally-mandated restrictions which affect all foreigners, including banks, prohibit direct ownership of land and buildings by foreigners, although they may acquire up to 40 percent ownership in condominium projects. Other laws limit ownership in financial institutions and prohibit ownership in certain industries, such as mass media and retail trade.

In its schedule of commitments under GATS, the Philippines bound foreign ownership levels that were generally below those allowed under current laws. In banking, the bound limit is 51 percent. Although the GATS commitments were disappointing, the new administration has publicly floated the idea of allowing 100 percent foreign ownership of troubled banks. This, however, would require legislative action.

U.S. and other foreign financial service providers operating in the Philippines participate fully in the processes leading to changes in laws and regulations pertaining to such services. Their opinions are solicited, and on some occasions they have been asked to testify before the Philippine Congress. U.S. bankers were consulted in the shaping of the 1994 liberalization law.

Assets and Liabilities of the Philippine Financial System
Year-end 1993 and Year-end 1997
(US$ millions)

	December 31, 1993			December 31, 1997		
	Assets	Liabilities	Net Worth	Assets	Liabilities	Net Worth
Total Financial System	47,310	40,560	6,750	75,762	65,318	10,444
Banking System	42,339	37,431	4,908	70,446	62,163	8,283
Commercial Banks	*38,329*	*33,939*	*4,390*	*63,944*	*56,726*	*7,218*
Thrift Banks	*3,086*	*2,730*	*356*	*5,084*	*4,235*	*849*
Rural Banks	*924*	*762*	*162*	*1,417*	*1,201*	*215*
Nonbanks	4,971	3,129	1,842	5,316	3,155	2,161

Peso values converted to US$ at exchange rates of 23.978 P/US$ (12/31/93) and 40.116 P/US$ (12/31/97).
Source: Bangko Sentral ng Pilipinas

Distribution of Assets Held by Commercial Banks
Percentage of the Total
Year-end 1993 and Year-end 1997

	December 31, 1993	December 31, 1997
100% Filipino-Owned Banks	67.8%	55.0%
Majority Filipino-Owned Banks	23.9%	30.2%
Majority Foreign-Owned Banks	n/a	1.1%
Foreign Branch Banks	8.3%	13.6%
of which: U.S. Branch Banks	*6.0%*	*6.9%*

n/a - no majority foreign-owned banks existed in 1993
Source: Bangko Sentral ng Pilipinas

PHILIPPINES

SECURITIES

SUMMARY

Generally, the Philippine securities market is small compared to markets of the West, and has not grown as fast as its Asian neighbors. Trading tends to be concentrated in government securities, with about half of government paper carrying maturities of less than one year. Other, smaller markets exist for equities, corporate bonds, and mutual and pension funds. There is no futures market and the futures exchange was closed in 1996 due to fraud.

Primary regulatory and oversight responsibility is granted to the Philippines Securities and Exchange Commission, which was established in 1936 and modeled after its U.S. counterpart. Primary responsibility for the oversight of the government securities market, however, is granted to the Department of Finance and the Philippine central bank. There are no restrictions on access to international markets.

Several branches of U.S. banks are active in the foreign exchange and government securities markets, and four U.S. brokerage firms hold seats on the Philippine Stock Exchange, the oldest such exchange in Asia. Restrictions on foreign firms exist in the areas of entry, ownership, and the domestic underwriting and distribution of Philippine securities by firms not domestically licensed. Foreign firms operating in the Philippines participate fully in the legislative process.

DESCRIPTION OF THE MARKET

The markets for private debt and equity are not well developed. Government securities and private sector equities are the dominant instruments in the Philippines' securities market. Long-term commercial paper and corporate bonds have not yet developed into important sources of capital.

Financial institutions in the Philippines include universal banks, which are licensed to broker, deal, and underwrite bonds and equities directly, without the need to establish separate subsidiaries to sell those services. In practice, however, many universal banks maintain separate investment houses for securities-related operations and activities. A few also have separate entities to handle brokerage activities.

Before the law liberalizing the entry of foreign banks was signed in May 1994, universal banking was confined to domestic banks. Since the law took effect, only one foreign bank has started providing securities-related services, although a second has applied.

Government Securities Market

The Philippine government finances the bulk of its budgetary deficits with short-term debt instruments, usually 91-, 182-, and 364-day T-bills. It has, however, recently begun to issue 2-, 5-, 7-, 10-, and 20-year obligations denominated in pesos; 10-, 20-, 30-, and 100-year obligations denominated in U.S. dollars; and 5-and 7-year securities in yen. All have sold well, despite the Asian financial crisis and the Philippines' recent economic downturn. Some of the bonds carry below-market coupon rates but are reserve eligible and, thus, appeal to institutions with reserve requirements.

Commercial banks dominate both the primary and secondary markets for trading of public sector securities. Since 1986, the government has issued securities by auction. Only accredited dealers can participate in the auction, and most of the 46 dealers are commercial banks. All three U.S. branch banks (Citibank, Bank of America, and Chase Manhattan) are primary dealers.

Possibly because it commands higher interest rates, the over-the-counter secondary market is relatively inactive. The secondary market that does exist is dominated by the top six commercial banks. U.S. financial institutions, such as commercial banks, investment banks, and mutual funds are active investors in Philippine T-bills.

Equity Market

Founded in 1927, the Manila Stock Market is one of Asia's oldest. In 1963, some brokers from the Manila exchange set up a rival exchange in the newer Manila business center, Makati. In 1993, the two exchanges were merged as the Philippines Stock Exchange (PSE).

Although older, the PSE has not progressed as rapidly as the exchanges of other ASEAN member countries. However, the Philippine Central Depository, Inc. (PCDI) has recently taken over the custody of shares being traded at the PSE, permitting scripless trading to take place. In addition, the Securities Clearing Corporation of the Philippines is expected to commence operations in fourth quarter of 1998, thereby facilitating the cash clearing/delivery amongst brokers of the PSE.

As of June 1998, 223 Philippine companies are listed on the PSE, of which some 50 are actively traded. Four firms account for over one-third of the market's US$30 billion capitalization and dominate the Philippine stock index. Historically, a relatively small number of Filipino families and family-owned/controlled firms have owned the majority of the shares of the listed and actively traded stocks. This leads to a market that is rather thin and susceptible to insider information. Control by a handful of individuals and families is still present through vast cross-holdings over listed and non-listed companies. As such, even a corporate decision to move a large block of shares among themselves is in itself market influencing even without the benefit of insider information. The entry of more IPOs in the market, however, has expanded the breadth of the market and increased competition to the traditional stocks. And the PSE, through its Compliance, Disclosure, and Surveillance Department, has recently begun to step up efforts trying to control insider trading.

All firms undergo an independent external audit before they are allowed to be listed. An assessment is performed in accordance with Philippine Generally Accepted Accounting Practices (GAAP), which are patterned after U.S. GAAP. Of late, the PSE has vigorously campaigned for transparency, requiring timely and complete disclosures from listed firms.

Participants in the equity market include universal banks, broker-dealers, and investment houses. Universal banks can offer a full range of securities activities. Broker-dealers are limited to brokerage and dealing, and must have minimum net capital (capital minus certain non-liquid assets) of 5 million pesos (US$125,000), or at least 5 percent of total indebtedness, whichever is higher. Investment houses can participate in a broader range of activities, such as securities underwriting and the provision of consultancy and advisory services. Amendments made to the Investment Houses Act in 1997 require existing investment houses to increase their capital from 100 million pesos to 300 million pesos by November 1999. New investment houses are automatically subject to the 300 million peso minimum capital requirement. Subject to prior Bangko Sentral ng Pilipinas (BSP, or Central Bank) authorization, these entities can also act as investment and portfolio managers. The major underwriters in the domestic market are investment house affiliates of the universal banks.

Corporate Bond Market

Several top-tier corporates have issued Long-Term Commercial Paper (LTCP). LTCPs are typically 3-5 year maturity, with floating interest rates. LTCPs generally are pegged to the 91-day T-bill rate, although some issues are fixed for the term of issue. LTCPs are the primary instruments issued in the domestic capital markets and are an alternative source of funding from commercial banks. A larger number of firms have issued bonds in overseas markets, particularly in the United States, Europe, and Japan.

Mutual Funds and Pension Funds

Mutual funds are available in the Philippines, although they have yet to become popular and the total asset value is relatively small. Broker-dealers are prohibited from managing mutual funds and pension funds. Banks, investment houses, and financial institutions authorized by the BSP to engage in trust, other fiduciary or investment management activities may manage such funds. The minimum capital required for a financial institution to engage in trust activities is 250 million pesos (US$62 million). Philippine residents may invest freely in offshore mutual funds.

Futures Market

There is no futures exchange in the Philippines. The Manila International Futures Exchange was closed in June 1996 because of the prevalence of fraud in the market. The Philippines Securities and Exchange Commission (see below) is formulating plans to reestablish a futures exchange under tighter regulations, and has received some design assistance from the U.S. CFTC. It is unlikely an exchange will be formed before 2000. The BSP regulates universal banks who trade over-the-counter derivatives products.

Introduction of New Financial Products

Although new financial products face few legal constraints to their introduction, the Philippine market is relatively unsophisticated and there is little interest in such instruments. The BSP recently granted derivatives licenses to a few foreign and local banks, which will help pave the way to greater risk management in the market.

Regulatory Agencies

Patterned after the American regulatory model, the Philippines Securities and Exchange Commission (SEC) was established in 1936. In addition to its regulatory responsibilities, the SEC registers companies and corporations, keeps and examines records of annual financial statements, and investigates and prosecutes breaches of the Corporation Code. Oversight responsibility extends to underwriters, brokers and dealers, financing companies, and mutual funds. The Department of Finance (through its Treasury Bureau) and the Central Bank oversee the government securities market.

Access to International Capital Markets

Philippine residents not sourcing foreign exchange from the banking system may freely invest offshore without government-imposed limits or approval. If the foreign exchange for investment is obtained from the banking system, the limit is US$6 million per investor per year. There are no restrictions on the issuance of equity overseas, except for limits on foreign ownership of certain industries prescribed by the Philippine Constitution.

U.S. PRESENCE IN THE MARKET

Branches of U.S. banks operating in the Philippines are active traders of foreign exchange and government securities, including futures. Citibank, a major player in the government securities market, together with Bank of America, are accredited to deal in government securities. Citibank, Merrill Lynch, Bankers Trust, and Ackerman and Company are U.S. companies with brokerage firms that own seats on the PSE.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Securities broker/dealers incorporated under foreign laws are not allowed to operate as branches in the Philippines. They may enter the Philippine securities markets as a wholly-owned, locally incorporated, broker/dealer. In the case of investment houses, which are allowed a broader range of securities activities (i.e., underwriting), foreign participation is limited to 60 percent ownership or less. The foreign ownership limit on firms engaged in trust activities and mutual fund management is 40 percent. After entry, there are no further distinctions made between wholly or partially-owned foreign and domestic firms.

Subject to certain restrictions in the Constitution and the 1991 Foreign Investment Law, foreigners are allowed to own shares in Philippine companies. Before 1991, Philippine law limited foreign ownership in most sectors to 40 percent. Publicly listed companies enforced these limits through the use of two classes of stock: A shares reserved exclusively for Philippine investors and B shares that were available to both Philippine and foreign investors (and traded at a premium). Since 1994, few firms have issued separate classes of shares to restrict foreign ownership and some listed firms have merged their share classes. Some firms operating in industries where foreign ownership is limited (banking, utilities, real estate, etc.) still find the issuance of A and B shares a useful tool for complying with the law.

Foreign financial firms (that is, firms not licensed to operate in the Philippines) can participate in the underwriting and distribution of Philippine security issues in foreign markets, but may not do so in the domestic market. U.S. firms are also able to provide cross-border advisory and brokerage services.

U.S. and other foreign financial service providers operating in the Philippines participate fully in the processes leading to changes in laws and regulations pertaining to such services. Their opinions are solicited and on some occasions they have been asked to testify before the Philippine Congress and to make their views known to legislators and administration officials.

Under the Philippine-U.S. Tax Treaty, the maximum tax rate on interest income that can be imposed on American investors is 15 percent. However, U.S. investors report that, when investing in Philippine government securities, a withholding tax of 20 percent is applied. Obtaining rebate of the 5 percent excess tax withheld is often extremely difficult.

In its schedule of commitments under GATS, the Philippines bound foreign ownership levels that are generally below those allowed under current laws. For investment houses (securities underwriting), the Philippines' bound foreign ownership limit is 51 percent (60 percent under existing law). For factoring and financial leasing, the bound limit is 40 percent (60 percent under current law). In insurance (both life and non-life) the bound limit is 51 percent (up to 100 percent allowed under existing law).

Philippine Securities Market
As of December 31, 1997

Type of Security	Value (US$ millions)	Percent of Total
Government Securities	17,757	65.6
of which: Short-Term	*9,776*	*36.1*
Capital Market Instruments	9,215	34.0
of which:		
Shares of Stock	*7,934*	*29.3*
Long-Term Commercial Paper	*1,251*	*4.6*
Bonds, Warrants, and Asset-Backed Securities	*30*	*0.1*
Short-Term Commercial Paper	117	0.4
TOTAL	27,089	100

Sources: Philippines Securities and Exchange Commission; Bangko Sentral ng Philipinas; Department of Finance, Treasury Bureau.

POLAND

BANKING

SUMMARY

Poland's banking system has dramatically expanded and has become more efficient in recent years. In terms of assets the banking system has been growing at about twice the rate of the economy as a whole; however, it still remains small in absolute and relative terms when compared with the banking systems in Western Europe. In late 1997, a major milestone in the process of developing a healthy, modern and competitive banking sector was reached: the private sector at last controls a majority of the banking system's assets and equity, as well as about 40 percent of its deposits. Foreign banks play an increasingly leading role in the economy, particularly by providing greater competition and improving product offerings and services. Overall, the banking sector's asset base will need to grow appreciably in the future to meet the financial needs of the business and personal sectors.

The new Banking Act, which went into effect on January 1, 1998, created the Commission for Banking Supervision, which is responsible for supervising banks and licensing new banks. The National Bank of Poland's General Inspectorate for Banking Supervision acts as the commission's executive body. Banks are required to contribute to and participate in the deposit insurance program operated by the Bank Guarantee Fund.

As of June 1998, U.S. financial institutions had a majority interest in nine banks, which together control 4 percent of the banking system's capital and less than three percent of net assets and deposits. Poland has generally provided equal treatment for U.S., foreign, and domestic banks. However, the National Bank of Poland has followed a policy of requiring foreign, but not domestic, applicants to give financial assistance to troubled Polish banks in order to receive a banking license. The banking authorities will not be able to continue this discriminatory policy after December 31, 1998, because Poland has committed to the Organization for Economic Cooperation and Development (OECD) after that date it will provide national treatment for financial institutions from OECD member states. There also exists a nationality requirement for at least one of the bank executives of a foreign banking operation in Poland.

DESCRIPTION OF THE MARKET

Structure of the Market

As of the end of 1997, the Polish banking system had approximately US$72 billion in net assets, equal to about 55 percent of the country's Gross Domestic Product (GDP). The Polish banking system can be divided into five segments: the National Bank of Poland (NBP), the state-owned commercial banks, the foreign-owned or controlled banks, the Polish-owned private banks, and the cooperative banking system (Refer to Table I). As of December 31, 1997, there were 83 commercial banks and 1,295 cooperative banks operating in Poland.

The NBP is the central bank of the state pursuant to the constitution and implementing legislation that went into effect on January 1, 1998. Among other things, it manages official foreign exchange reserves, conducts foreign exchange operations, provides banking services to the government, and provides banks with refinancing facilities. The Monetary Policy Council (MPC) sets monetary policy and, in consultation with the government, foreign exchange rate policy. The MPC consists of the President of the NBP and nine other members appointed by the President and the legislative branch.

As of the end of 1997, the state held a majority interest in fifteen of the commercial banks, including three of the largest four banks. The state-owned banks possessed nearly 60 percent of the banking system's deposits, almost 50 percent of net assets, 43 percent of net loans, but only 36 percent of the capital. Poland's government and the NBP since 1989 have privatized six large banks, and the government intends to privatize another five in 1999. The government also has announced plans to privatize the two other remaining large, financially troubled banks by 2001, the Bank for Food Economy (BGZ) and the Polish Savings Bank (PKO BP). This would leave the government with just a few small banks, which play a minor role in the banking sector.

Foreign investors at the end of 1997 operated in Poland through 27 majority owned commercial banks and two foreign bank branches. They also had a controlling minority interest in two other large commercial banks. This represents a significant increase since the 1994 National Treatment Study. For example, in 1995, foreigners held a majority ownership stake in only nine banks and two branches. If the government achieves its bank privatization goals for 1998, foreign investors could possibly achieve control over a majority of the banking system's assets and equity and nearly a majority of its deposits. Starting in 1995, foreigners have been aggressively increasing their share of the Polish banking market. Foreigners have taken a majority or controlling minority interest in almost every large commercial bank that has been privatized to date, and they also have established numerous new banks or purchased existing small private banks to convert to uses for their own purposes.

The Polish private sector had a majority interest in 39 commercial banks, including 11 regional cooperative banks, as of December 31, 1997. This includes the two Polish banks with a minority but controlling interest held by foreigners. Generally, these banks are small and/or specialized (e.g., the Environmental Protection Bank or BOS), though two medium-size banking groups have emerged, centered around BIG Bank Gdansk and Kredyt Bank PBI.

Cooperative banks, the smallest of the five segments, is going through a process of consolidation and transformation. The number of cooperative banks has shrunk from 1,653 in 1993 to 1,295 in 1997. At the end of 1997, over 10 percent of the cooperative banks failed to meet the minimum 8 percent risk-based capital ratio. The cooperative banks share of the banking system's net assets declined to 4.5 percent at the end of 1997 from 4.6 percent the year previously. The cooperative banks and the regional banks are expected to consolidate further. Moreover, the government is working with the European Bank for Reconstruction and Development on plans to privatize the troubled Bank for Food Economy. The cooperative banking system traditionally has supported the Polish agricultural sector, which itself has been struggling since 1989. About a quarter of Poles work on farms, but generate less than 7 percent of GDP.

Banks in Poland may offer a wide range of products and services. The new Banking Act effective January 1, 1998, explicitly authorizes banks to engage in a variety of activities, which previously had not been clearly defined legally. In practice, however, no major differences exist in the permissible activities of banks in Poland under the new and old banking law. Banks in Poland are allowed to take demand and time deposits, maintain other bank accounts, extend loans and guarantees, issue bank securities, and performing bank settlements. In addition, banks may make cash advances, process checks and bills of exchange, issue and process bank (debit and credit) cards, make forward financial transactions, buy and sell debt, safekeep valuables, perform foreign exchange operations, endorse bills and notes, and perform operations relating to the issue of securities. The new mortgage bank law, effective as of January 1, 1998, provides that only specially licensed mortgage banking entities may obtain the benefit of a super-priority security interest in the mortgaged property. Thus, banks will have to either create a subsidiary to engage in mortgage banking activities or accept a lesser security interest. Many large banks have expressed interest in establishing a mortgage banking subsidiary.

Even with the legal authorization to do so, many banks have been slow in expanding and improving the range and quality of their products and services. Competition among commercial banks has developed unevenly since the collapse of communism in 1989. Foreign banks have competed intensely for international corporate accounts (e.g., General Motors, Lucent, etc.) and business from large state-owned enterprises (e.g., the telephone company), but they generally stayed away from small- and medium-size businesses and consumers. In the beginning of the post communist era, the state-owned foreign trade bank (Bank Handlowy) focused on servicing Polish exporters, and the other state-owned banks concentrated on servicing their existing clients, mostly large state-owned enterprises. Until recently, the state-owned savings banks (principally PKO BP and PEKAO SA) practically monopolized the retail market. These two banks at the end of 1997 held a majority of the banking system's deposits. Over time, however, competition has heated up in almost every sector. Foreign banks and private Polish commercial banks recently have increased their shares of the retail market; attracting retail deposits provides a lower-cost source of funds than borrowing on the interbank market. Moreover, banks have become more willing to lend to the medium and small businesses, and competition for the largest companies (private, state-owned or international) has become even more intense.

There are numerous signs of the recent efforts to expand products and improve quality of service. Foreign-owned banks especially have been leaders in introducing new products and services. For example, banks in 1997 tripled their issuance of bank (credit and debit) cards to1.7 million customers; Citibank was an innovator in this field. Banks have been rapidly building ATM networks. At the end of 1997, Poland had an estimated 1,600 machines installed and was expected within a year or two to double that number. For years, Polish banks had put a large share of their resources in Treasury bills and bonds, rather than making loans. Now, they have reduced the relative importance of government paper in their portfolios, and have substantially increased their lending to the business sector and to consumers, especially for car loans. Lending for housing, cars and installment purchases increased by almost 200 percent in 1997. Banks are increasingly providing foreign exchange and derivative products. The volume of foreign exchange transactions (spot and deposit transactions, forwards, swaps) increased by over 300 percent in 1997. Still, the banking sector has plenty of room to expand. In the retail sector, less than half of all Poles had any type of account with a bank in 1997. For businesses, banks make few long-term loans and tend to evaluate creditworthiness based almost exclusively on the amount of collateral, rather than the merits of a business proposal.

The largest banks have established a National Clearing House (NCH) with 17 regional centers. The NCH has developed several clearing systems: a fully electronic clearing system (ELIXIR); a limited electronic clearing system (SYBIR) to function in conjunction with the system of transporting documents; and a system for transport of clearing documents by courier.

Regulatory Structure

The new Banking Act, effective January 1, 1998, is intended to bring Poland's banking regime in line with EU and international standards with regard to bank regulatory requirements, including minimum capital requirements and other bank regulations. Also, it opened up the market to foreign banks operating through branches, as Poland had committed to do in its accession to the OECD. Finally, it provided for the creation of a new supervisory organ, the Commission for Banking Supervision, which replaced supervision by just the NBP.

In 1998 Poland revised its regulatory regime primarily to bring it into harmony with European Union (EU) regulations. Previously, the NBP and its General Inspectorate for Banking Supervision (GIBS) licensed, supervised, and sanctioned banks. The new Banking Act established the Commission for Banking Supervision (CBS). The CBS is responsible for supervising banks, licensing new banks, and imposing sanctions. It consists of the NBP President, the Director of GIBS, and representatives from the Finance Ministry, the Securities and Exchange Commission, and the Bank Guarantee Fund. The GIBS acts as the commission's executive body.

In 1997, the GIBS conducted 118 inspections of 42 commercial banks and 378 inspections of cooperative banks. It employed the inspection methods used by the Federal Reserve System. The NBP President suspended the activities of one commercial bank and eight cooperative banks in 1997. In the period 1991-1997, the NBP has required 17 commercial banks and 287 cooperatives to implement corrective measures.

The supervision and assistance from the NBP has contributed to the improvement in the financial health of the banking sector. The new Banking Act requires that banks maintain a capital base at a level that represents no less than 8 percent of risk-weighted assets and off balance sheet commitments. A new bank for the first 12 months will need to meet a 15 percent capital base requirement and a 12 percent requirement for the next 12 months. Corresponding to EU standards, a bank as of January 1, 1999, must have the equivalent of a minimum of five million ECU in capital. The NBP does not provide capital ratio information, other than to say that as of December 31, 1997, eight commercial banks (out of 83) did not meet the 8 percent minimum capital requirement. We believe that the eight included two large state-owned banks and six small private banks, and that no foreign-owned banks fails to meet this test. The percentage of bad loans in the commercial banks' portfolios has dropped from 31.0 at the end of 1993 to 10.4 percent at the end of 1997.

Since 1995, all commercial banks and cooperatives have been required to contribute to the Bank Guarantee Fund (BGF), which provides deposit guarantees for customers and technical and financial assistance for troubled banks. In 1997 the BGF supported 11 commercial banks and 24 cooperatives with approximately US$120 million of assistance. Also, it paid almost two million dollars to cover deposits at the bank and cooperatives declared bankrupt in 1997.

U.S. PRESENCE IN THE MARKET

As of June 1998, U.S. investors have a fifty-percent or greater interest in nine banks in Poland. Citibank, GE Capital, and Bank of America have wholly-owned banks, which provide a wide range of services and products. Citibank in 1991 was the first U.S. bank to enter the Polish market and still remains the leading U.S. bank with over US$100 million of capital. Ford and General Motors/Opel have opened wholly-owned banks primarily to provide car loans. American Express obtained a banking license in order to offer its debit and credit cards in Poland. In 1998, American International General bought a majority interest in a small Polish bank, Bank Podlaski, to support its consumer credit activities. Moreover, the Polish-American Enterprise Fund, created as part of the U.S. government's assistance to Poland, founded and for now retains a 50 percent interest in two specialized banking institutions, PAM Bank (which provides mortgages) and PPABank (which lends to small- and medium-businesses). As of the end of 1997, these nine banks combined had 4 percent of the banking system's capital, 2.4 percent of its assets, and 1.8 percent of its deposits. On December 31, 1997, the only foreign country with a larger share than the United States of the Polish banking system was Germany; Holland had a slightly smaller share than did the United States.

Chase Manhattan/Chemical Bank maintains a representative office in Warsaw but has no banking license and, thus, cannot provide banking services (such as originating loans or taking deposits) in Poland.

In addition, J.P. Morgan and two European financial institutions in 1997 together acquired a 27 percent interest in Bank Handlowy, the formerly state-owned trade bank, which provided J.P. Morgan and its partners substantial control over management of the bank. As of the end of 1997, Bank Handlowy, whose shares are now publicly traded, had over 10 percent of the banking system's capital, nearly 7 percent of its assets, and less than 4 percent of its deposits.

Euronet, a U.S. firm traded on the Nasdaq Stock Market, has built and manages a network of over 300 ATM's in Poland as of the end of 1997 and plans to expand further.

Foreign and U.S. banks have concentrated on corporate lending, especially for international businesses operating in Poland. Leading other foreign banks ranked by country of origin are: German banks (Dresdner Bank, West deusche Landesbank, Deutsche Bank, Vereinsbank, Berliner Bank), Dutch banks (ING and ABN AMRO, Rabo Bank), Austrian banks (Raiffeisen-Centrobank, Bank Creditanstalt, Volkwagen Bank), French banks (Credit Lyonnais, Societe Generale), an Irish Bank (Allied Irish Bank) and a Korean bank (LG Petro Bank). Other than VW Bank, these banks concentrate on servicing the Polish offices of their home clients. However, there is greater interest in some of the larger banks to compete for Polish corporate and retail business. U.S. banks are trying to build up their retail bases – Citibank and GE Capital have developed credit card businesses, and Ford and General Motors/Opel provide automobile loans.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In 1992, the NBP indicated it did not intend to issue any more licenses for foreign banks to establish in branch form. Poland made a commitment to the OECD to liberalize its financial services sector after December 31, 1998. The new Banking Act, effective January 1, 1998, implemented Poland's commitment to allow foreigners to operate in branch form.

Prudential lending limits for foreign bank branches in Poland are based on local paid-in equity, not the parent bank's equity, effectively removing much of the advantage of establishing a branch. No U.S. bank has entered the Polish banking market in branch form.

The main treatment issue for U.S. financial institutions has been the licensing policy of the NBP. After 1991, the NBP pursued a policy of requiring a foreign applicant for a banking license to either purchase or financially assist a troubled Polish bank. The Commission for Banking Supervision will determine what, if any, financial assistance a foreign bank is required to provide in order to obtain a banking license either as a joint stock company or a branch. Foreign firms wanting to provide banking services have the option of either (1) acquiring an existing firm with a banking license or, (2) creating a new firm and obtaining a license. In either case, the NBP has required the applicant to provide financial assistance to troubled banks, not necessarily to the bank that the foreign firm acquires. Helping a foreign bank does not obviate the requirement for obtaining a banking license. A foreign investor can obtain a banking license for one bank while providing financial assistance, such as soft credits, to a troubled bank. In other words, the foreign applicant is not required to purchase a troubled bank, only to help it. Domestic applicants do not have to provide such financial assistance. Under its commitments to the Organization for Economic Cooperation and Development (OECD), Poland must provide national treatment to banks from OECD member countries (which includes the United States) after December 31, 1998. Thus, the NBP after December 31, 1998 will either have to end this financial assistance policy or require that domestic applicants also provide financial assistance to troubled Polish banks.

There exists a nationality requirement for some – at least one – of the bank executives of foreign banking operations in Poland. The Banking Act gives discretion to the Commission for Banking Supervision on granting licenses. Though the Banking Act does not specify that any of the bank executives be Polish, the Commission has the discretionary authority to continue that policy - established by its predecessor in granting licenses, the NBP. Poland reserved the right to do so in its offer to the WTO. In addition, the appointment of two of the members of a bank's management board, including the president, requires the approval of the Commission for Banking Supervision. This approval is required for both foreign and locally incorporated banks.

The Polish government provides guarantees for deposits, which supplement the deposit guarantees of the Bank Guarantee Fund, to three large state-owned banks, PEKAO SA, PKO BP, and the Bank for Food Economy (BGZ). These supplementary guarantees are scheduled to expire on December 31, 1999.

A foreign owner may convert Polish zloty to foreign currency and remit abroad without need of a foreign exchange permit its share of bank profits and proceeds from the sale of its shares or liquidation of the bank. Poland has also committed to the OECD to liberalize its foreign exchange regime, and the government is working on legislation which would allow for full convertibility in or outside of Poland for current account transactions and non-portfolio capital transactions. The latter transactions would still require permits in certain cases. The government hopes to implement this legislation by January 1, 1999.

In its Financial Services Offer of December 1997 to the WTO, Poland agreed to impose no limitations on national treatment with respect to banking and other financial services for commercial presence and the presence of natural persons. Furthermore, the limitations on market access for banking services were (1) a nationality requirement for some – at least one – of the bank executives, and (2) establishment of a bank only in the form of a joint stock company, though after January 1, 1999, or the date of entry into force of the Fifth Protocol, whichever is later, establishment will be permitted through licensed branches. The Fifth Protocol has not yet been ratified.

Poland's GATS offer in the banking sector is unbound with respect to cross-border supply and consumption abroad for both market access and national treatment limitations. As for the activities of U.S. financial institutions in the banking sector (i.e., commercial presence) it appears to be fully bound. Poland has begun negotiations to join the EU, and as part of the accession process, Poland will harmonize its banking regime with the directives and policies of the EU. This may lead to further opening of the market for EU investors. While there are no significant national treatment or MFN issues now in the banking sector, when Poland joins or prepares for accession to the EU then U.S. investors may see that EU investors receive different or preferential treatment compared with U.S. investors. This would be the same preferential treatment that U.S. investors face when investing in EU countries.

Polish Banking System
(Shares of Banking System's Net Assets, Capital, and Deposits as of December 31, 1997)

Types of Institutions	Number	Net Assets (percent)	Capital (percent)	Deposits (percent)
Commercial Banks	83	95.5	95	94.8
State-owned Banks	*15*	*50*	*32*	*58*
Private Sector Banks	*68*	*45.5*	*63*	*36.8*
Polish-majority Banks	*39*	*30.5*	*39.1*	*24.1*
Foreign-majority Banks	*29*	*15*	*23.9*	*12.7*
U.S.-majority Banks	*8*	*4*	*2.4*	*1.8*
Cooperative Banks	1,295	4.5	5	5.2
Total Banking System	1,378	100	100	100

Net assets are defined as "total assets less accumulated depreciation, specific provisions, and valuation allowances."

Sources: National Bank of Poland, General Inspectorate of Banking Supervision, Summary Evaluation of the Financial Situation of Polish Banks; Gazeta Bankowa for data on U.S.-majority banks.

POLAND

SECURITIES

SUMMARY

Poland has made substantial progress in rebuilding its capital markets after decades of communist rule. Already it has a rapidly growing and well-supervised equities market – the Warsaw Stock Exchange (WSE) and the over-the-counter market (CETO) – and a vibrant and fairly liquid Treasury bills market. As of late 1998, the total market capitalization of the equities market was around US$13 billion, which was nearly 9 percent of Gross Domestic Product (GDP). Treasury bonds are traded on the WSE, but they are not nearly as liquid as Treasury bills. Corporate bonds, commercial paper, and most futures and derivatives for now are not publicly-traded. Institutional investors, principally banks and to a lesser extent insurance companies, dominate the capital market. Mutual funds and individual investors play a small but growing role.

The Polish Securities and Exchange Commission (SEC) and the National Bank of Poland (NBP) supervise the public trading and private trading among banks and brokerage houses of securities. Both have earned good marks from the European Bank for Reconstruction and Development (EBRD) and other analysts for their supervision of the capital markets.

U.S. financial institutions have established a significant presence in the Polish capital markets. Four of the 37 brokerage houses are U.S.-owned or controlled, including one of the leaders owned by Citibank. The Pioneer Group through its four local mutual funds has garnered an 80 percent share of the mutual fund market in Poland. A number of U.S. investment banks in Poland provide advisory, underwriting, and fund management services. Poland extends national treatment to U.S. firms offering financial services in connection with issuance and trading of securities. This treatment conforms with Poland's commitments made to the Organization for Economic Cooperation and Development (OECD) and with its financial services offer made in the WTO.

DESCRIPTION OF THE MARKET

Stock and Bond Markets

The Polish capital markets are small, though developing rapidly. The WSE, revived after fifty years in dormancy, plays the leading role in the trading of equities and Treasury bonds. Open-ended mutual funds active in bonds and equities have operated in Poland for several years, and CETO became active in 1997. Treasury bills, commercial paper, and corporate bonds are privately placed and traded. An active secondary market exists for Treasury bills, which have been the most liquid of all debt or equity investments. New products such as derivatives (e.g., indexed products, swaps), futures, and options have begun to appear in Poland.

The WSE has developed swiftly since its reestablishment in 1991. It practically doubled total market capitalization and number of companies traded in 1996 and again in 1997. National Investment Fund (NIF) shares contributed significantly to the increase when they started trading in June 1997. At the end of 1997, the shares of over 140 companies were listed on the WSE with a total market capitalization of 44 billion Polish zloty (almost US$13 billion) or about 9 percent of GDP. Equity volume on the WSE was 52.3 billion zloty (US$16.0 billion) in 1997. Over 71 percent of the 1997 volume on the WSE was equity trades, in addition to 11 percent in NIFs. As of late 1998, the number of traded companies had climbed to 189, and total market capitalization was approximately 45 billion Polish zloty (US$13 billion) or about 9 percent of GDP. The government is currently completing the first stage of privatization of the telephone company (TPSA), which should increase the total market capitalization of the WSE by over 50 percent to about US$20 billion or over 13 percent of GDP. Treasury bonds for now are the only debt securities listed on the WSE. At the end of 1997, some 44 bond issues were traded on the WSE worth about 12 billion Polish zloty (US$3.5 billion). In 1997, the U.S. Securities and Exchange Commission granted the WSE the status of a designated offshore securities market. In January 1998, the WSE initiated trading in its first derivative product, WIG 20 futures (which is a product tied to the WIG 20 stock index). The state owns over 90 percent of the shares of the WSE, and over fifty banks and brokerage firms own the balance of the WSE's shares.

CETO is in its infancy, but growing quickly. From two listings at the beginning of 1997 it had 14 at the end of the year and 23 by June 1998. As of December 31, 1997, the total market capitalization of the companies listed on CETO equaled 130 million Polish zloty (US$37 million), which is .02 percent of GDP. CETO is owned by nearly fifty banks and brokerage houses.

Private placements (offers made to less than 300 persons) of corporate equities and debt and the public trading off the regulated markets (i.e., WSE and CETO) of Treasury bills and bonds is permitted by the 1997 Law on the Public Trading of Securities. Over 20 billion Polish zloty (US$5.7 billion) worth of Treasury bills and 26 billion Polish zloty (US$7.4 billion) of Treasury bonds were outstanding at the end of 1997. Companies issue short-term commercial paper in three forms: as a privately-traded debt instrument, as a bill of exchange/promissory note (not regulated like a bond), or as a loan document under the Civil Code (also not regulated like a bond). Approximately US$800 million worth of short-term commercial paper was outstanding as of March 1998. Due to the current legal requirement in the 1995 Law on Bonds that a trustee with unlimited liability must be appointed for a publicly traded bond issue, there have been no publicly traded corporate bond issues.

Institutional investors dominate the Polish capital markets. Nonetheless, an increasing number of individual investors have opened investment accounts. As of the end of 1997, roughly 1.2 million people or 5 percent of the adult population had an investment account compared with nearly 900 thousand in 1996. Also, there were over 35 million holders of NIFs when distribution ensued in November 1996. Banks by far play the biggest role in the capital market, holding 64 billion Polish zloty (US$18 billion) of debt and equity securities at the end of 1997; three-quarters of that total were Treasury bills and bonds. In 1997, insurance companies had about 4.6 billion Polish zloty (US$1.3 billion) of investments, of which they invested nearly two-thirds in Treasury bonds, almost 20 percent in Treasury bills, and less than 10 percent in publicly traded equities. As discussed below (Foreign Portfolio Investment), foreign institutional investors play a major role on the WSE and in the Treasury bills and bonds markets.

As of mid-1998, nine firms were authorized to manage investment funds in Poland. Altogether they managed twenty open-ended mutual funds investing in debt and equity securities with nearly two billion Polish zloty (US$570 million) of assets. The 1997 Act on Investment Funds authorizes the creation of closed-end and mixed investment funds, but as of mid-1998 no such funds had been established.

In 1999, the government plans to implement pension reform, which will create privately-managed pension funds. These new pension funds are expected to become major investors in the Polish capital market.

Only exchange members (entities providing brokerage services) may operate on the WSE. Foreign brokerage firms, even 100 percent foreign-owned ones, may operate in Poland, but they must – like domestic firms – obtain a permit and maintain a minimum level of capital and a minimum number of licensed brokers on staff. At the end of 1997, there were 37 exchange members, all but 15 of which were affiliated with a bank. Exchange brokers are responsible for concluding, registering and settling transactions. As of the end of 1997, there were 293 licensed exchange brokers on the WSE, including 94 specialist brokers who help make markets in specific securities.

Market Regulation

The Polish Securities and Exchanges Commission (SEC) pursuant to the 1997 Law on Public Trading of Securities and the 1997 Act on Investment Funds regulates the WSE, CETO, investment funds, commodity exchanges, and the National Depository. It reviews and approves the prospectus for each new issue and licenses brokerage houses and brokers. The SEC has been ranked as one of the best regulators in the region according to the EBRD.

The Banking Supervision Commission of the NBP pursuant to the 1997 National Bank of Poland Act and the 1997 Banking Law supervises the activities of banks, which are active in the primary and secondary markets for Treasury bills and bonds, corporate bonds, and commercial paper. The NBP has received high marks from the EBRD and others for its supervision of the banking sector. The Chairman of the SEC is ex officio a member of the NBP's Banking Supervision Commission. The Polish SEC regulates bank securities activities. Banks are required to obtain a license from the Polish SEC to broker trades.

The 1997 Pension Reform Laws established the National Office for Pension Funds, which will supervise pension funds when major pension reforms are implemented. Privately-managed pension funds are expected to become operational in 1999.

Foreign Portfolio Investment

Foreigner institutional investors as of the end of 1997 held an estimated one-third of the securities traded on the WSE (US$14 billion), nearly 10 percent of the Treasury bills (over US$500 million), and around 15 percent of Treasury bonds (about US$1.2 billion). The Polish capital market has an insignificant number of foreign individual investors.

Poland is a net capital importer and has very little outward investment. As of the end of 1996, Poland had less than US$800 million invested abroad, most of which was direct investment between related entities. The government is preparing a new Foreign Exchange Law which, among other things, would liberalize the rules for Poles wanting to make portfolio investments in member countries of the OECD.

U.S. PRESENCE IN THE MARKET

U.S. firms play a significant role in the Polish capital markets. As of the end of 1997, four of the 37 brokerage houses licensed to operate on the WSE were owned by U.S. controlled firms. Citibrokerage, owned by Citicorp, is one of the leading brokerage houses. Citibank is active in the primary and secondary markets for Treasury bills, Treasury bonds, corporate bonds, and commercial paper markets.

The Pioneer Group in 1991 established Pioneer First Trust Fund in Poland, which operates four local mutual funds. It also formed Pioneer Poland Brokerage House, which handles the securities trading for those mutual funds. As of mid-1998, Pioneer's four mutual funds had garnered an 80 percent share of the total mutual fund market in Poland.

Many U.S. investment banks offer advisory and underwriting services, including, among others, Merrill Lynch and Bankers Trust. These firms often lead the underwriting or otherwise participate in syndicated loan offerings by Polish companies. Roughly three billion dollars worth of Polish syndicated loans were placed in 1997. In addition, U.S. firms have acted as fund managers for four of the fifteen National Investment Funds, which were created as part of the government's mass privatization program.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

U.S. financial institutions can – and do – provide brokerage, investment banking services, underwriting, and fund management services in Poland. U.S. firms have not asserted that they have not received national treatment. However, U.S. financial institutions that participated as fund managers with two NIFs did state that their fund management contracts were improperly terminated by the government-appointed fund supervisory boards of those NIFs.

The 1997 Law on the Public Trading of Securities, the 1997 Banking Law, and the 1997 Act on Investment Funds provides national treatment for U.S. firms. As part of the accession process to the OECD, Poland committed to giving companies from OECD member states both access to the Polish financial services market and national treatment. Furthermore, Poland committed in its December 1997 financial services offer in the WTO to national treatment, without reservations, in connection with "Other Financial Services" for both commercial presence and presence of a natural person. "Other Financial Services" included, among other things, participation in issues of all kinds of securities (excluding Treasury papers) and provision of services related to such issues, trading of publicly-traded securities for one's own account or for customers, asset management services, and advisory and other auxiliary services to financial services.

RUSSIA

BANKING

SUMMARY

The collapse of Russia's financial system in August 1998 will result in a significant restructuring of the banking sector. Mergers, expansion of medium- and small-sized banks, greater roles for state banks and foreign financial institutions are all possibilities as the restructuring process unfolds.

Prior to the crisis, Russia's banking sector was already undergoing consolidation. After the first private banking license was issued in 1988, the number of private banks in Russia grew dramatically, to around 2,500 in 1995. Subsequently, the number has steadily declined to around 1,600 by mid-1998. Liquidity problems, stiffer competition from domestic and foreign lenders, as well as tighter Central Bank of Russia (CBR) regulations contributed to this trend. Despite the large number of banks, banking assets only accounted for 29 percent of GDP at the beginning of 1998, with state-owned savings bank (Sberbank) holding around three quarters of all retail deposits.

Banking activity is regulated by the CBR, an independent agency. The CBR's Chairman is nominated by the President but appointed by the State Duma (Parliament) to which the CBR is held accountable. The Federal Commission for the Securities Market (FCSM) has authorized the CBR to license and supervise professional securities market activities conducted by banks.

As of mid-1998, three wholly owned U.S. banks and nine with US participation were licensed to operate in Russia. U.S. banks report that they have not been subject to discriminatory treatment and have not been restrained from engaging in any of their planned banking activities. Formally, however, there are regulations that discriminate against foreign-owned banks. They are subject to higher minimum charter capital requirements than domestic banks, are required to have Russian nationals as 75 percent of their employees and 50 percent of local management, and must have one of the executive officers meet specific language and qualification criteria. The CBR also has imposed a 12 percent ceiling on the amount of foreign-owned paid-in bank capital as a percentage of total paid-in capital of all banks. However, in mid-1998, foreign investment was well below that ceiling. Also, while regulations permit foreign banks to enter Russia as branches, as a matter of policy the CBR restricts banks with foreign ownership to establishment only as subsidiaries. U.S. bankers report that these requirements have not impeded their operations in Russia.

DESCRIPTION OF THE MARKET

The collapse of Russia's financial system in August 1998 will have a profound effect on Russia's banking system. On August 17, the Russian government decided to simultaneously devalue the ruble, restructure its domestic Treasury bill obligations, and impose a moratorium on the payment of financial credits to nonresidents. Russian banks, including foreign-owned banks in Russia, faced a challenge to cope with the sweeping adverse effects of these decisions. Approximately, 30 percent of the banking system's assets were in traditionally safe government paper (Table I). In addition, 18 percent of the system's liabilities were to foreign creditors, often for short-term maturities, reflecting the increased access to foreign capital Russian banks had begun to enjoy in 1997. The cumulative effect of the government's decisions forced banks to scramble for survival and led to a breakdown of payments discipline in the banking sector. The CBR took measures to restore the payments system, provide liquidity to the banking system, and begin the process of restructuring the banking system.

In September 1998, the CBR had formulated initial ideas for restructuring the banking system. The CBR had begun to ascertain the financial viability of banks based upon balance sheet information as well as banks' ability to fulfill payment obligations in special one-day payments clearing operations. The CBR has indicated that it plans to place banks into four groups: (1) sound banks with a strong capital base with no substantial liquidity problems; (2) stable regional banks that should become the cornerstone of the regional banking system; (3) large banks that are unable to continue independently but may not be closed due to high social and economic costs; and (4) insolvent banks that have no future prospects. For banks in the first three categories, the CBR will develop individual strategies and methodologies for providing support, as appropriate. Banks in the fourth group will have their banking licenses revoked and liquidated. The CBR is also considering the creation of a special body for restructuring banks that would manage the assets of insolvent banks, including organizing their transfer to financially stable banks through mergers or acquisitions. Some mergers have already begun and medium and small-sized banks not effected by the market turmoil have increased their banking activities. Foreign banks may also have a larger role in providing capital and expertise. The bank restructuring process, however, is still at an early stage and will take months to unfold.

As of July 1, 1998, Russia had 1,598 licensed banks (Table II). Of these banks, 146 had foreign ownership participation, 17 of which were wholly owned by foreign interests. Despite the large number of banks, banking activity has been a relatively small part of Russia's overall economic activity. As of the beginning of 1998, total banking assets were R636 billion (US$106 billion), about 25 percent of Russia's GDP. Foreign banks account for roughly 7 percent of the total. Total capitalization for the banking system (excluding the state-owned savings bank, Sberbank) was R96 billion (US$16 billion) as of January 1, 1998, with foreign banks' share estimated at 4.3 percent of the total. Many Russian banks remain undercapitalized.

Banking activity has been concentrated in several large banks (Table III). The 200 largest banks accounted for 88.4 percent of the system's total assets as of January 1998. Sberbank is the largest and dominates the market, accounting for about one-quarter all banking assets. Other large banks are part of so-called financial industrial groups (FIGS) in which banks have cross share holdings in commercial groups. For example, Uneximbank is associated with the trading company Interros, the oil refinery Sikanko, Norlsk Nickel, the telecommunications provider Svyazinvest, Northwestern Shipping, Perm Motors and several newspapers. At the beginning of 1998, 75 FIGS were officially registered, linking around 1,150 industrial firms with 160 banks. A large number of banks are soiled "pocket" banks, entirely controlled by and dedicated to serving a single enterprise. Banking activity is concentrated in Moscow, with eighteen of the top twenty banks based in the capital city. Sberbank has the largest branch system with 1,907 registered branches (Table II).

Russia's private banking sector was already undergoing consolidation before the 1998 financial crisis. Liquidity problems, more intense competition and stricter supervision contributed to these trends. After the first private banking license was issued in 1988, the number of licensed banks exploded to more than 2,500. Since August 1995, the number of banks has declined steadily. Viable banks have tended to grow, often acquiring banks that have been liquidated.

After passage of the Law on Banks and Banking Activities in July 1995, the CBR began to use its new authority to revoke licenses when banks reported incorrect data, performed operations outside the area for which they were licensed, evidenced an unsatisfactory financial position and/or could not fulfill obligations to depositors and creditors. However, the CBR's powers are limited to revoking licenses; it cannot shut down the operations of unlicenced banks. Even though by July 1, 1998, the CBR had revoked 927 licenses (none of which were wholly-owned foreign subsidiaries), only 439 of those institutions had been liquidated (Table II). The CBR's powers to close banks will be strengthened with the passage of bank bankruptcy legislation currently pending in the legislature.

Although nearly half of the banking system's funding comes from deposits, the vast majority of retail depositors opt for Sberbank. This preference is largely due to the implied government guarantee on its deposits as well as Sberbank's extensive national branch and agency network. At the beginning of 1998, Sberbank accounted for 77 percent of all personal bank deposits, up from 68 percent two years earlier. This share will increase since, in response to the August financial crisis, the CBR has permitted depositors to transfer their accounts to Sberbank in order to secure a government guarantee for their funds. Some private-owned banks had begun to work to attract retail deposits, however, the absence of deposit insurance, according to some analysts, has impeded the growth of retail deposits outside of Sberbank. Legislation is pending that would enact such an insurance program, and the CBR has recently eased regulatory requirements that limited retail deposit taking.

Other activities of Russian banks include investments in securities (equities and government bonds), inner-bank lending, foreign exchange, futures operations, export financing, custody services, the servicing of government budget accounts (although this was supposed to be phased out by July 1, 1998), the issuance of tradable debt instruments, and investment banking activities (i.e., dealer/broker, asset management, depository and clearing services).

Weak credit analysis capability, the generally poor quality of data from most enterprises and ineffective bankruptcy laws and enforcement of bankruptcy judgments are cited as reasons that have hampered the growth of bank lending to enterprises, particularly those outside a bank's FIG. A new general bankruptcy law enacted in March 1998 should help strengthen the legal infrastructure. In addition to improving the legal infrastructure and banks technical abilities, the future growth of lending to enterprises is also likely to depend upon reduced government demand for borrowing, contributing to substantially lower interest rates.

The financial condition of Russia's banking system has generally been considered fragile. Unfavorable macroeconomic trends (high inflation and government borrowing), weak management, risky credit policies in not adapting to more stable inflation and exchange rate regimes, the need for stronger regulation and supervision over diverse and fast-growing activities, the infrequent use of internationally acceptable accounting standards, and low profitability contributed to the weakness of banks.

Beginning in April 1996, the CBR instituted a reporting system to help them evaluate banks' financial condition. According to this system, at the beginning of 1998, 39 percent of the banks had no signs of financial problems, while 27 percent were showing the first signs of problems. These banks accounted for 85 percent of all banking assets. The rest of the banks either exhibited temporary difficulties, the first signs of possible bankruptcy, or were financially insolvent. The later condition was reported by 23 percent of all banks, but they accounted for only 3 percent of all banking assets; 34 percent of all operating credit institutions were termed as "problem." The portion of bad loans (i.e., those classified as "loss") has been between 4-5 percent since 1996.

Debit cards have become increasingly popular. At the beginning of 1998 Russian banks had issued cards of major companies: 828,000 Visa; 878,000 Europay/MasterCard; 3,700 American Express; and almost 700 Diners Club. Nearly 28,000 retailers accept debit cards. Additionally, there are three major interregional domestic card systems: Union Card, Zolotaya Corona, and STB-card, each having several hundred thousand cards active at the beginning of 1998. Local card systems also exist. Very few of the cards issued in Russia are credit cards.

The number of ATMs approached 1,200 at the beginning of 1998, with most concentrated in Moscow and St. Petersburg.

Regulatory Structure

The banking sector is regulated by the CBR, an independent agency. The Chairman and members of the Board of Directors are appointed for four year terms and make decisions based on a majority vote with a quorum of seven, including the Chairman. The CBR is accountable to the State Duma (parliament) since the Chairman and the 12 member Board of Directors are submitted by the President or, in the case of the Directors, with the President's approval, but are appointed by a Duma vote. Moreover, the CBR is required to submit an annual report to the Duma. The CBR works with the government of the Russian Federation to elaborate and conduct a uniform monetary policy aimed at ensuring and protecting the stability of the ruble. The CBR also is statutorily responsible for issuing cash for circulation, being the lender of last resort for banks, establishing rules for conducting payments settlements and banking operations, and issuing and revoking bank licenses.

The CBR also licenses and supervises professional securities activities of banks under a three-year general license granted by the Federal Commission for the Securities Market (FCSM) in July 1997. The CBR and the FCSM have collaborated on drafting the regulations for professional market activities, including depositories, trust management and clearing and settlement, and have worked jointly on the adoption of qualification examinations for banking professionals involved in securities activities.

The Law on Banks and Banking Activities passed by the Duma in 1995 lays out rules for licensing bank operations and requiring reports to the CBR. This law provided a legal and regulatory framework for the CBR to monitor banking activities and revoke licenses based upon a bank's failure to meet its obligations. The CBR has strengthened its supervision and regulation of the banking sector, including the formation of a special unit, OPERU-2, to oversee the activities of the 14 largest institutions. The CBR has been gradually raising capital adequacy ratios, introduced a new Chart of Accounts at the beginning of 1998 as a major step toward international accounting standards, tightened licensing procedures, required banks to establish internal controls, and adopted provisioning requirements for non-performing loans.

The CBR plans further progress on prudential regulation. Minimum capital for banks will be increased to 1-5 million ECU (US$0.9-4.5 million), effective January 2001. Only those meeting the ECU 5 million minimum will be given full banking licenses, with smaller institutions limited in their banking activities and their geographic scope. Mandatory capital adequacy ratios will be raised to 8 percent for all banks in 1999. The CBR has adopted provisions for 1999 requiring the reporting of two-tier capital, with both tier-1 and tier-2 capital being used to meet prudential provisions. The CBR also plans to require off-balance sheet positions to be covered by capital requirements in line with Bank for International Settlements standards. The CBR also is seeking stronger legislative authority to deal with problem banks, to require consolidated reporting from nonbanking organizations affiliated with a bank, and to continue moving toward international accounting standards. Tighter licensing procedures and enforcement of new money laundering legislation (in the revised criminal code and narcotics law as well as stand-alone legislation pending before the Duma) are designed to reduce the use of the banking system for such purposes by criminal elements.

U.S. PRESENCE IN THE MARKET

Three wholly-owned U.S. banks and nine with U.S. participation are licensed to operate in Russia. Several U.S. banks have license applications pending.

U.S. banks are engaged in a variety of activities including: international trade financing, foreign exchange operations, corporate lending (including syndicated loans), cash management, money market operations, international (Eurobond) debt placements for both corporate and public issuers, custody services and wholesale banking. U.S. institutions are among the organizations licensed to act as primary dealers on the Russian government debt market. To date, U.S. banks have chosen not to offer ATM services in Russia. Most U.S. banks operate primarily in Moscow, although one has opened a branch office in St. Petersburg. Due to the current state of development of the Russian banking sector, U.S. banks are major players in most market segments in which they operate, as they are often more experienced and better-capitalized than their Russian counterparts.

TREATMENT OF US FINANCIAL INSTITUTIONS

The Law on Banks and Banking Activities permits foreign banks to establish subsidiaries, branches, and representative offices in Russia. However, as a policy matter, the CBR in recent years has permitted foreign banks to establish only as subsidiaries instead of as branches. The statutory licensing requirements are the same as for domestic banks except foreign institutions have to provide balance sheet data and audits for the most recent three years and the written consent of the supervisory body in the home country consenting to the establishment of the new entity (if required by the home county). The law also allows the CBR to impose additional requirements on foreign-owned banks, pertaining to mandatory regulations, endorsement of managing personnel, listing of permitted banking operations, and minimal capital requirements. Since January 1996 foreign-owned banks have been able to establish full service subsidiaries that provide retail and commercial services to Russian clients. These activities had been restricted by a 1993 Presidential Decree. Russian firms are now permitted to have more than one ruble account, allowing them to have different accounts with different banks.

Foreign-owned banks are allowed to establish new banks or to engage in joint ventures. With respect to establishing a new bank, in April 1997 the CBR adopted a two-step licensing process. The CBR headquarters first reviews the license application and issues a "Protocol of Intent." The applicant then presents the necessary documents to the local CBR branch in the territory in which it wishes to establish. Subsidiaries of foreign banks are permitted to open branches in Russia, with the permission of the CBR headquarters and OPERU-2 or the local CBR branch in the territory in which the branch is to be established. Nonresident banks can participate in joint ventures in any proportion, but are required to have permission from the founders of the bank in question as well as the CBR. Resident credit organizations may be issued a permit allowing the sale of shares to a nonresident if the foreign share holdings do not exceed 1 percent of its charter capital. Permission is required from the CBR if nonresidents are to own more than 1 percent of participatory shares in a resident bank's charter capital.

There are several areas where U.S. and other foreign banks are subject to different regulatory requirements than their Russian counterparts. For example, the minimum capital requirement for foreign banks is ECU 10 million, versus ECU 1-5 million for domestic banks. Under the Law on Banks and Banking Activity of 1996, the CBR can impose a ceiling on the amount of total foreign investment in the banking industry. The current ceiling is 12 percent. Additionally, the CBR has the legal right to use reciprocity in specifying the scope of licensed activities of foreign banks in Russia. Some Russian-controlled banks have urged the CBR to exercise this reciprocity, claiming that Russian banks are unable to open branch offices in the United States. Vneshtorgbank and Promstroybank have opened representative offices in the United States, and in early 1998 three-private banks had pending applications. Some U.S. banks have reported delays in the processing of their applications. The CBR maintains, however, that its licensing procedures are guided by objective criteria and not a policy of reciprocity.

In April 1997, the CBR adopted new regulations relating to the staffing of foreign banks. According to these regulations, 75 percent of the staff must be Russian citizens. If the head of the foreign-owned bank is a foreign citizen, then 50 percent of the local management board must be Russian citizens. The regulations also require the head and the chief accountant (roughly equivalent to the Chief Financial Officer) of foreign banks to be Russian speakers. Heads of banks in Russia are required to have an appropriate degree and two years of relevant banking experience.

U.S. financial institutions report that, in practice, they are not subjected to discriminatory treatment which adversely affects their ability to operate in the Russian market and can engage in any banking activities they wish. U.S. banks contacted for this study have indicated that the higher charter capital requirements are not an issue, as most already have charter capital in excess of the minimum. U.S. institutions voiced little concern about the overall capital ceiling imposed on foreign banks, noting that the foreign banks' share, at around 4.3 percent as of July 1, 1998, is well below the ceiling. Some banks, however, believe the ceiling could be a deterrent to new banks seeking to establish a presence in Russia or Russian banks seeking foreign partners as the share of foreign bank capital approaches the ceiling; others believe that the CBR will raise the ceiling if it became a constraint.

Most U.S. institutions operating in Russia have small expatriate staffs and report no problems complying with Russian staffing pattern requirements. Difficulty in getting education and language credentials approved by Russian government officials stems from cumbersome bureaucracy rather than discriminatory treatment.

RUSSIA – BANKING

Financial services will be an important issue in Russia's accession to the WTO. As of July 1998, the Russian government had not yet submitted its offer on financial services. As a general principle, the CBR states that it supports an open and competitive financial services market.

Table I
Russian Banking System Consolidated Balance Sheet

	1/1/96		1/1/97		1/1/98	
	Rub (bn)	%	Rub (bn)	%	Rub (bn)	%
			Assets			
Reserves	36.6	10.7	48.3	9.3	72.9	11.5
Foreign Assets	46.1	13.5	73.7	14.2	81.6	12.8
Claims on Extended Government	62.6	18.3	150.9	29.0	191.1	30.1
Claims on Non-Financial State-Owned Enterprises	62.5	18.3	80.2	15.4	64.3	10.1
Claims on Private Enterprises	133.8	39.1	166.5	32.0	225.9	35.5
Claims on Other Financial Institutions	0.5	0.2	0.2	0.0	0.0	0.0
			Liabilities			
Demand Deposits	69.3	20.3	92.4	17.8	133.7	21.0
CDs and Savings	126.4	36.9	169.3	32.6	189.3	29.8
of which: *Deposits in Foreign Currency*	*57.1*	*16.7*	*72.0*	*13.9*	*85.0*	*13.4*
Money Market Instruments	11.9	3.5	26.7	5.1	27.9	4.4
Foreign Liabilities	30.0	8.8	60.7	11.7	115.4	18.1
Deposits by Extended Government	9.7	2.8	12.1	2.3	17.4	2.7
Credits by Monetary Authorities	8.0	2.3	12.8	2.5	8.8	1.4
Capital Accounts	66.7	19.5	124.8	24.0	150.0	23.6
Other Accounts	20.2	5.9	21.2	4.0	-6.6	-1.0
BALANCE	342.2	100.0	520.0	100.0	635.9	100.0

Note: From data supplied to International Financial Statistics published by the IMF. Includes Sberbank and eliminates double counting.
Source: Central Bank of Russia

Table II
Banking Establishments, License Revocations, and Liquidations

Banks	1/1/95	1/1/96	1/1/97	1/1/98	7/1/98
Total Number	2,517	2,295	2,029	1,697	1,598
With Foreign Participation	n/a	n/a	152	145	146
-- 100%	n/a	n/a	13	16	17
-- 50-100%	n/a	n/a	10	10	11
Bank Branches	5,486	44,148	39,549	6,353*	4,987*
of which:					
-- Sberbank	*n/a*	*38,567*	*34,426*	*1,928**	*1,907**
-- 100% Foreign	*n/a*	*n/a*			*4*
Banks With Licenses Revoked	65	n/a	570	852	927
--Of which: Liquidated	*45*	*317*	*351*	*408*	*439*

* Break in data. New data records branches registered in the state registration book and assigned a number.

Source: Central Bank of Russia.

Table III
Top Ten Banks Ranked by Assets
(Ruble Billions)

A. As Of 7/1/98

Banks	Assets	Capital	Deposits
1. Sberbank	379.8	17.3	155.2
2. SBS-Agro	72.3	2.9	11.7
3. Inkombank	49.5	3.0	17.4
4. Rossiyskiy Credit	31.4	1.7	8.2
5. Menatep	30.3	2.0	6.4
6. Uneximbank	23.9	5.1	7.6
7. International Industrial Bank	22.6	2.1	11.7
8. Alfa-Bank	21.9	0.8	2.1
9. Vneshtorgbank	21.7	5.2	6.9
10. Gazrombank	14.9	2.3	4.0

Table III
Top Ten Banks Ranked by Assets
(Ruble Billions)

B. As of 1/1/98

Banks	Assets	Capital	Deposits
1. Sberbank	324.6	19.9	136.6
2. SBS-Agro	41.3	2.5	9.4
3. Inkombank	41.2	2.3	20.5
4. Rossiyskiy Credit	31.8	1.8	8.5
5. Menatep	26.0	2.0	6.9
6. Uneximbank	25.0	5.9	8.2
7. Vneshtorgbank	21.9	6.3	7.3
8. International Industrial Bank	19.0	2.0	12.1
9. Alfa-Bank	15.0	1.1	6.2
10. Mosbusiness-bank	13.2	1.0	2.2

Table III
Top Ten Banks Ranked by Assets
(Ruble Billions)

C. As of 1/1/97

Banks	Assets	Capital	Deposits
1. Sberbank	256.5	15.3	106.0
2. Vneshtorgbank	27.9	6.1	7.5
3. Inkombank	22.2	2.0	11.2
4. Uneximbank	20.6	2.9	11.0
5. Mosbusinessbank	17.8	1.0	0.6
6. Rossiyskiy Credit	16.3	1.2	3.7
7. Tokobank	14.5	1.1	1.1
8. SBS	13.9	1.3	3.3
9. Menatep	12.3	1.0	3.2
10. National Reserve Bank	11.2	1.6	2.2

Table III
Top Ten Banks Ranked by Assets
(Ruble Billions)

D. As of 1/1/96

Banks	Assets	Capital	Deposits
l. Sberbank	119.8	6.1	61.1
2. Vneshtorgbank	26.1	3.8	9.6
3. Agroprombank	18.6	0.3	5.0
4. Uneximbank	17.7	1.4	8.1
S. Inkombank	14.7	1.1	7.6
6. Mosbusinessbank	13.1	0.7	3.1
7. Rossiyskiy Credit	12.0	0.6	1.7
8. Mfk	11.3	1.1	1.9
9. Imperial	10.1	1.0	1.3
10. Moscow Industrial Bank	10.0	0.5	2.0

Note: Data from published reports and is not compatible with data in Table I.
Source: Financail Izvestia.

Table IV
Size Of Russian Banks by Capital
(Percentage of All Banks)

Bank Size by Capital	1/1/95	1/1/96	1/1/97	1/1/98	7/1/98
Over R 20 Million	1.2	4	9.3	17	2.2
R 1-20 Million	33	54.5	62.8	64.5	64.3
R1 Million or Less	65.8	41.5	27.9	18.5	13.7

Source: Central Bank of Russia

RUSSIA

SECURITIES

SUMMARY

The rapid development of Russia's securities market and associated growing pains over the last four years have been overshadowed by the devastation of Russia's financial markets in 1998. Russia's equity market deteriorated from the best performing in the world in 1997 to the worst by mid-1998. The government securities market was virtually eliminated by the government's decision on August 17 to restructure its debt maturing through the end of 1999. The float of the ruble and subsequent significant downward pressure on the exchange rate caused organized foreign exchange spot and futures trading to close.

Nevertheless, substantial progress has been made in Russia over the last four years with respect to market development, legislation and regulation. The financial sector became one of the most dynamic and market-oriented in Russia's economy. The Federal Commission for the Securities Market (FCSM), the primary regulator of securities markets, was established and began to exert its authority through licensing procedures and creating a regional network. At times, however, regulation and enforcement were outpaced by the explosive growth in market activity. Similarly, the development of the market infrastructure to support increasingly large and complex transactions lagged, acting as a drag on domestic market growth. Key issues include the need for stronger protection of shareholders' rights, an improved tax regime, and domestically-based clearing and settlement infrastructure. The low level of securities market activity caused by events in 1998 may provide an opportunity to address some of these shortcomings so that the operation of Russia's securities market will be improved once market sentiment reverses.

Foreign investors and institutions with foreign participation are active and prominent in Russia's capital markets and engage in a wide variety of activities. Foreign firms do not report any significant discriminatory treatment.

DESCRIPTION OF THE MARKET

The Russian securities market started from scratch when the privatization of Russia's economy began in 1992. Growth was rapid, particularly beginning in the second half of 1996. The ruble became increasingly stable, interest rates lower, credit ratings were assigned to the Russian Federation and other entities, the London Club private debt rescheduling was concluded, and Russia was included in global investment indices. The new equity and debt markets gave rise to a variety of investment instruments at an astonishing pace. Among them were corporate securities (principally equities), federal government debt issues (GKOs, i.e., Treasury Bills, and OFZs, i.e., bonds); local government bonds, futures contracts on commodities, stocks and currencies, gold certificates; and veksels (promissory notes).

A few statistics provide a sense of dramatic growth in Russia's securities market. The over-the-counter Russian Trading System (RTS) was created in May of 1995. By the end of that year the RTS had a market capitalization of US$10 billion and averaged daily turnover of US$2.6 million (Tables I and II). By the end of September 1997, RTS market capitalization had grown over fivefold, reaching US$ 56.5 billion with daily turnover averaging nearly US$69 million. The nominal stock of federal government securities similarly increased from R73 billion (US$15.7 billion) at the end of 1995 to R385 billion (US$66 billion) at the end of 1997. Average daily turnover rose from a modest R0.8 billion in 1995 to a respectable R4.27 billion in 1997.

Adverse economic conditions in emerging markets affected Russian markets in the last quarter of 1997. Conditions progressively worsened through 1998. Local banks encountered declining liquidity and nonresidents reassessing their risks, contributed to a steady, marked decline in equity prices. On August 17, 1998, the Russian government and Central Bank of Russia (CBR) announced: (1) a mandatory rescheduling of its domestic debt (GKOs and OFZs) maturing through December 1999; (2) a floating exchange rate policy with the ruble's upper band against the US$ set at R9.5/US$; and (3) a 90-day moratorium on repayment of financial credits extended by nonresidents, on margin calls on credits supported by pledged securities, and on forward foreign exchange contracts. Further exchange rate pressures led the CBR to abandon defending the ruble, resulting in its fall to around R21/US$ in early September, rebounding to around R16/US$ by the end of that month.

Events over the last year have been nearly as dramatic as those over the previous three-year existence of Russia's securities market. The RTS equity index stood at 83 at the end of 1995, rising to 498 by the end of September 1997, dropping to 151 by the end of June 1998 and then another 100 points to 42 as of the end of September 1998. RTS market capitalization had fallen to US$28 billion by the end of June and to US$8 billion by the end of September, US$2 billion lower than at the end of 1995. The August 17 decision caused MICEX (Moscow Interbank Currency Exchange) to halt secondary trading of government securities, the nominal stock of which was R394 billion (US$64 billion) at the end of July. The precipitous decline of the ruble resulted in MICEX closing its foreign exchange futures operation and, eventually, even its spot trading. Trading in many other financial instruments (as well as most business activity in general) ground to a halt after the payments and settlements system ceased to function due to a lack of liquidity in the Russian banking system. In sum, the erosion of confidence in Russia's securities market was capped by a collapse of Russia's securities market.

Reviving the market will take time and requires measures to rebuild confidence. Until the Russian government concludes negotiations on rescheduling its debt subject to the August 17 decision the secondary market will be in limbo. Meanwhile, to conduct monetary policy, the CBR introduced a new instrument, the Central Bank bond (nicknamed "beaver" bills after their Russian acronym, OBR) on September 2, 1998. Initial auctions for the bills were unsuccessful, but the sixth auction, held September 30, attracted modest interest. One region, Tatarstan, has announced its intention to reschedule a US$100 million Eurobond issue. Other corporate and regional borrowers are currently negotiating with creditors to reschedule their obligations. There is incipient interest in trading defaulted Russian bank debt, in the expectation that a government bailout of the Russian banking sector will result in at least partial payment of these obligations.

Looking back over the last four years, organized securities trading has undergone significant transformation. In 1993, Russia had 120 stock exchanges and trader organizers regulated by the Ministry of Finance. Under the 1996 Securities law and subsequent regulations, the newly created FCSM required all exchanges to be re-licensed by the first of October 1997. Exchanges had to comply with more rigorous requirements, including minimum capital of ECU 2 million (US$2.3 million). By the end of 1997, eleven stock exchanges and organizers of trading had been licensed by the FCSM, a substantial consolidation of the market.

Securities trading in Russia is dominated by two exchanges, MICEX and the RTS, with the new Moscow Stock Exchange (MSE) aiming for retail trade. MICEX was founded in 1992 and is owned by 32 commercial banks and institutions, including the Central Bank of Russia, the Finance Ministry and the Moscow City government. The exchange boasts 500 participants from all Russia's regions. MICEX is the official venue for foreign currency trading and the exclusive exchange for trading government securities. In September 1996, MICEX launched futures contracts on GKOs and US$/ruble. In March 1997, MICEX was licensed for equity trading and by the end of the year listed nine shares and traded 18 others. By July 1998, 155 securities were traded on MICEX, including 77 equities and 78 regional bonds. Despite the decline in equity trading, the share of MICEX in total turnover increased in September 1998 to about one-third, about the same as RTS's share of the total. In part, trading on MICEX was aided by its Clearing House and National Depository Center which offered clients settlement and clearing services.

In 1995 MICEX was the primary venue for foreign exchange trading with an average daily turnover of US$108 million. Interbank deals later became the norm and transactions on MICEX declined. At the end of 1997, commercial banks faced declining liquidity, interbank foreign exchange dealing virtually vanished, and the MICEX spot market recaptured its preeminent role. However, following the sharp decline of the ruble, on August 27, 1998, traditional auction trading sessions which had been held on MICEX since 1992 were terminated. Currency trading on MICEX continued through SELT (System of Electronic Lot Trading), which was put into effect on MICEX in September 1997. By August 1998, trading volumes on SELT were practically equal to the volume of traditional auction trading. When SELT became the sole venue for foreign exchange trading on MICEX, the official exchange rate was set by the CBR on the basis of SELT quotations.

On October 6, 1998, a new foreign currency trading regime came into effect on MICEX. Two special sessions are held: (1) a morning session is limited to the CBR, importers, and exporters; and (2) an afternoon session is for banks trading for their own account, to the extent permitted by CBR regulations. The CBR introduced new regulations requiring exporters to sell 50 percent of their proceeds on MICEX. The approximate turnover of MICEX's currency trading at the special session in October 1998 was US$100-200 million per day.

The largest venue for equity trading Russia is run by the not-for-profit RTS, an off-exchange Nasdaq-like over-the-counter system. Created in May 1995, RTS grew to have more than 400 members in 30 locations. RTS improved market transparency by publishing prices and transaction volumes. As of the end of June 1998, RTS had 107 listings, including 64 common and 43 preferred shares. Despite the large number of listings, nearly two-thirds of turnover each year has been in six most actively traded shares. By September 30, the number of listings had shrunk to 87 (51 common, 36 preferred). Average daily turnover had fallen to around US$1 million, compared with US$62 million in 1997. Trading on RTS-2 of less liquid shares of smaller companies ceased completely. In response to the lack of liquidity in the market, RTS allowed non-cash barter trades.

The MSE was formed in February 1997, with the support of the City of Moscow, aimed at developing retail securities trade. More than a hundred investment houses, banks and other financial institutions paid into the MSE's charter capital. By the end of 1997, MSE listed 29 stocks, including the principal domestic listing for Gazprom shares, and four municipal issues.

Although finance and banking activity are concentrated in Moscow (94 of the top 100 investment firms), there are six licensed regional exchanges: St. Petersburg, Yekaterinburg, South Urals, Siberian, Vladivostok and Saratov. On regional exchanges, trade volumes are lower and prices higher. As many of these exchanges are not connected electronically with Moscow, the lack of information creates an opportunity for arbitrage. However, MICEX has united six other regional trading systems into one electronic trading system.

Collective investment instruments had a quick start in Russia. Voucher Investment Funds (VIF) targeted collecting vouchers from Russia's privatization of some 18,000 firms that began in 1992. VIFs eventually amassed 45 million vouchers, about 32 percent of all bearer privatization vouchers issued nationwide. Weak management, taxation, and the lack of regulatory oversight resulted in VIFs not becoming effective investment vehicles. By the end of 1997, the number of such funds had declined from 690 in mid-1994 to 350. A February 1998 Presidential Decree placed supervision of VIF's under the FCSM, raising the possibility that these funds might be converted into the more investor-friendly Unit Investment Funds (UIFs). UIFs were launched in November 1996 by Presidential Decree. By the end of 1997, there were 22 licensed UIFs. Most were open-end funds, but assets under management remain small, around US$38.5 million. Difficulties in asset valuations due to the illiquid market and uncertain value of GKOs and OFZs caused most UIFs to suspend operations after August 17. In early September the FCSM ordered UIFs with more than 10 percent of their portfolios invested in government activities to suspend operations. Most have announced their intention to resume activity after the government debt restructuring has been concluded.

A pilot program to launch an organized corporate bond market in 1997 was delayed due to the sharp rise in interest rates in the fourth quarter of that year. In 1994, 41 corporate bond issues were registered, increasing to 75 in 1995, but sliding back to 37 in 1997. Corporate issuers appear to prefer issuing promissory notes, or "veksels" to meet their cash needs. Non-governmental pension funds were permitted under a 1992 Presidential decree and have been established by some of the larger manufacturing, mining and banking institutions. A 1998 law provides a stronger legal basis and regulation of these funds.

Depositary receipts became a popular investment instrument for foreign investors and major Russian firms. The first American Depositary Receipt (ADR) for a Russian company was issued in 1994. By the end of 1997, 20 Russian companies had ADR programs. Russian companies also issued Global Depositary Receipts (GDRs) traded on European exchanges. Investors are attracted to these instruments by their liquidity and lower risk in clearing and settlement. According to some estimates, as of September 1997 approximately 40 percent of Russia's stock market free float was in the form of depositary receipts traded outside Russia.

Market Regulation

Market regulation, and the legal framework that underpins it, has improved significantly over the last four years, bringing order to a market that had outstripped the government's ability to effectively regulate it. While market oversight continues to improve, considerable work remains to be done, especially in increasing the enforcement powers.

Initially, the Ministry of Finance and the CBR functioned as market regulators. The Federal Commission on Securities and the Capital Market of Russia was created in 1994 and assumed regulatory powers from the Finance Ministry and the State Property Committee. The 1996 Securities law designated the FCSM as the successor organization and as supervisor of the securities market. The CBR and the Ministry of Finance retained limited supervisory roles. The CBR is responsible for registering new share issues for banks. In July 1997, the FCSM issued the CBR a three-year general license to license and supervise securities activities of banks. The Ministry of Finance is responsible for registering insurance company securities issues, T-bills, and municipal and regional bonds

The FCSM is a federal executive agency with ministerial status. The Commission consists of six members, one of whom is the Chairman, appointed by the President. In June 1997 the Commission named members of its 15-member Collegium consisting of representatives of the Commission, federal government, the legislature, and the CBR. The Commission issues licenses, approves share registrations, oversees market activities, authorizes self-regulatory organizations, and administers exams for market professionals. In 1997, the Commission established offices in 15 regions of Russia to supervise and advise regional capital markets activities. While the Commission may revoke licenses or disapprove share registrations, its enforcement powers remain limited

The 1996 Securities Law more clearly defines the activities of professional market participants (brokers, dealers, trust managers, depositories, clearing agents, registrars, trade organizers, and stock exchanges). In 1996 there were around 5,000 investment institutions operating in Russia and 500 registrars. In 1997 the FCSM adopted more stringent licensing standards and required professional market participants with old licenses to preregister by October 1997. As of June 1998 the FCSM had licensed 1,303 broker/dealers, 126 depositories, and 180 registrars.

In July 1997 the FCSM assumed responsibility for registering new share issues and reports. The Commission is to review the prospectuses for new share issues and approve or reject them within thirty days of submission. The companies are to submit a report on the results of the distribution within 15 days after the last share is issued. As a practical matter, registration often takes longer. During 1997 the FCSM registered 3,265 share issues and 2,231 reports. The headquarters of the FCSM retains the authority for registrations by Russia's 460 largest firms.

In 1997 the FCSM began active examinations of professional securities market participants. The Commission examined approximately 300 participants (e.g. registrars, brokers/dealers), 230 companies, and 16 mutual funds and referred information on 984 investment companies operating without a license to the Ministry of Internal Affairs for possible legal action.

Under regulations adopted in August 1997, the FCSM issued licenses to two self-regulatory organizations (SROs): the National Association of Stock Market Participants (NAUFOR) and the Professional Organization of Registrars, Transfer Agents, and Depositories (PARTAD). These SROs can assist the Commission in regulating and supervising broker/dealer and registrar activities by establishing rules for their members and ensuring compliance.

Volatility in the securities market that began in the last quarter of 1997 provoked the FCSM to work together with market participants to institute "circuit-breakers" to instill more orderly trading. In October the FCSM ordered trading to be suspended on the RTS when the prices changed by more than 5 percent. This limit was subsequently increased to 7.5 percent.

The Russian market has developed rapidly but still has a number of areas that require further work. Corporate governance and the protection of shareholders rights remain important issues. Investors in Russia point to the siphoning of profits from public companies to narrowly held affiliates or holding companies as one problem. Other abuses of shareholder rights include illegal share dilutions, lack of notification to shareholders of material issues, the violation of voting procedures and the inability of shareholders to obtain representation on corporate boards due to illegal actions by management.

The FCSM has limited enforcement and investigative powers. However, the FCSM has begun to exercise its authority to approve registrations and prospectuses more actively to protect shareholders. Recently, the FCSM issued a new regulation requiring issuers to publish draft prospectuses to provide shareholders an opportunity to raise their concerns on any potentially objectionable issues before the FCSM approves the new share issue. Shareholders who initiate court proceedings report more success in winning judgments, although enforcement remains a problem. In July 1997 the Russian government created a new State Commission for the Protection of Investors' Rights on the Russian Securities Market chaired by the Prime Minister and in July 1998 the government adopted a program to strengthen laws and regulations protecting investors' rights.

The taxation system also impedes capital market development in Russia. Brokers/dealers are subject to a 43 percent profits tax, capital losses cannot be offset against gains, and there is a lack of clarity of deductible expenses in the acquisition of shares, and nonresidents are subject to a 20 percent tax on the gross sales of non-government securities. VIFs' and private pension funds' earnings are subject to double taxation. These problems, combined with uneven tax administration, have encouraged much Russian market activity to remain offshore.

While market infrastructure is improving, there are still considerable difficulties in registering, clearing, and settling trades. Registering a trade can be complicated, requiring a trip to wherever the company's book is kept (often far from Moscow). Although regulations require that companies with more than 500 shareholders use an independent licensed registrar, some large companies use their own registrars, who are vulnerable to pressure from the issuing company. The consolidation of registrars in 1997 resulted in about 90 percent of the 200 licensed registrars handling more than 100,000 accounts of 10 or more share issues, helping to facilitate registration and reduce costs.

Clearing and settlement were well organized for the government debt market in MICEX, but less so for other securities activities, contributing to the preference for offshore settlement. MICEX adapted its system for debt clearance and settlement for equities when it started trading equities in early 1997. However, the rest of the equities market relied upon broker-to-broker settlement. With the nearly doubling in the volume of equities turnover in October 1997, RTS members sought a more reliable, faster system. They agreed with the Depository Clearing Company (DCC) in February 1998 to clear all RTS trades through the DCC. The project, however, has not been fully implemented. With the lull in market activity, the RTS is considering other options. The FCSM, also recognizing the utility of improving market infrastructure, is pursuing the idea of establishing a national depository system under the authority of a September 1997 Presidential Decree.

Foreign Portfolio Investment

Foreign portfolio investment has grown exponentially, from US$100 million in 1995 to US$9.9 billion in 1996 to US$46.4 billion in 1997 (compared to direct foreign investment of US$6.2 billion). Most of this investment was directed to the government bond market, with foreigners holding approximately 30 percent of total GKOs. As of the fourth quarter of 1997, assets of 20 major foreign investment funds totaled US$2 billion, 70 percent of which was accounted for by five firms.

U.S. PRESENCE IN THE MARKET

The FCSM does not keep statistics by nationality, but securities firms wholly or jointly owned by U.S. firms are active in Russia's securities market. These firms engage in a wide variety of activities, including trading and custody. They are permitted to serve as primary dealers on the government securities market and are members of NAUFOR, RTS, and MICEX. The Bank of New York was the depository for all Russian ADRs as of the end of 1997.

Although Russia's lack of adequate custody services was initially a problem, U.S. mutual funds have invested in Russia since April 1995. At that time, the Templeton Fund began to invest funds in Russia using a Russian custodian, Chase Manhattan Bank International, contingent upon the custodian's agreement to make arrangements to exercise tight and frequent supervision over registrars with which it operates. Since that time, improvement in Russia's custody infrastructure has helped expand U.S. mutual fund investment in Russia.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Investment firms with U.S. participation do not report that they are subject to any discriminatory treatment. Only resident firms can be licensed by the FCSM to conduct professional securities market activities in Russia. In the licensing process, the FCSM reserves the right to ask additional information from firms with nonresident participation. The Presidents and Chief Accountants of these firms must be resident in Russia. In the fall of 1997 the FCSM issued regulations requiring the heads of investment firms to be Russian citizens but rescinded them quickly.

Until January 1, 1998, foreign investors wishing to repatriate earnings from investments in Russian government securities were required to enter into a forward foreign exchange contract with an authorized bank which, in turn, entered into a compensatory foreign exchange contract with the CBR, a mirror of the forward contract. This restricted nonresidents' ability to quickly repatriate funds. Contract conditions and non-transparency of privatization tenders have made it difficult for foreign firms to compete or even participate. The government has been moving toward a more open, competitive system of privatization. In the summer of 1997, a consortium with significant foreign participation won a stake in a major Russian telecommunications firm in the country's largest privatization to date.

Table I – Stock Market Performance
1995-98
(End of Period; US$ Index; Market Capitalization in US$ billions)

	1995	1996	1997	June 1998	Sept. 1998
RTS					
Index	82.92	200.5	396.86	151.35	43.81
Capitalization	10	21	45	28	8
MT					
Index	63.02	144.3	302.68	114.79	29.54
Capitalization	n/a	26.62	67.03	37.86	9.79

RTS = Russian Trading System. Index used 21 shares at their closing price for the day. Since January 1, 1998, capitalization and index are calculated using all stocks traded on the RTS. Source: National Association of Stock Market Participants (NAUFOR)

MT = Moscow Times Index. Index uses 50 different shares at the daily average price. Source: Skate Newsletter

Table II – Russian Stock Market Turnover
1995-98
(US$ millions)

	1995	1996	1997	Jan-July 1998	August 1998	September 1998
RTS*	217	3,537	15,659	7,426	218	26
MICEX	–	–	977	2,058	116	24
MSE	–	–	350	1,010	52	19

*RTS-1.
Source: MICEX

SINGAPORE

BANKING

SUMMARY

Banking in Singapore is essentially split into two markets: an offshore market and a domestic market. The offshore Asian Dollar Market is by far the larger of the two, with total assets, as of March 1998, of S$820 billion (US$513 billion) versus S$310 billion (US$193 billion) in the domestic market (excluding the Post Office Savings Bank). Singapore actively encourages foreign participation in the offshore market, which is dominated by U.S. and other foreign banks. As a result, among the 153 commercial banks in Singapore, 141 are foreign-owned. These are generally branches of their overseas parent, 106 of which are offshore banks. In addition, 78 of the 80 merchant banks in Singapore are foreign-owned. These are also primarily offshore operations.

The services a bank is allowed to offer in Singapore and the extent of its operations depend on which of the three types of banking licenses it holds. Thirty-four banks in Singapore hold "full licenses" that permit them to offer a full range of local and foreign currency banking services. This includes all 12 locally incorporated banks (with 273 branches), and the 22 foreign banks (with 88 branches) that entered the Singaporean market before 1971. Thirteen foreign banks have restricted licensed branches (1 each) in Singapore which allow them to conduct only wholesale corporate banking and international banking activities. Ninety-six foreign banks operate in Singapore with offshore licenses, which were first granted in 1973. Initially offshore licenses only permitted a bank to deal in foreign exchange and the Asia Dollar Market. However, offshore banks are now able to offer most of the services of a restricted license banking office.

The domestic retail banking market is considered overbanked by the government of Singapore, which has imposed a long-standing freeze on the number of full or restricted banking licenses issued. With one exception made under special circumstances, the Monetary Authority of Singapore (MAS) has not granted a full or restricted license to either domestic or foreign interests since 1973. As a result, new entry is limited to an offshore bank license. Several U.S. banks have expressed an interest in changing to full license status. Foreign banks that already have full licenses do not enjoy the same market access as domestic banks. Foreign full license banks cannot open new branches, and they are severely limited compared to domestic banks in the operation of off-premise automatic teller machines (ATMs). They are permitted, however, to offer computer and telephone banking services to their individual and corporate clients, and install electronic terminals at corporate clients' premises. The maximum permissible level of foreign ownership in domestic banks is 40 percent, unchanged since the 1994 National Treatment Study. There has been some improvement of treatment for offshore banks. The overall lending limit to residents was raised from S$100 million to S$200 million. This commitment was bound by Singapore in its 1997 financial services offer in the WTO Financial Services Agreement. In early 1998, the government indicated its intention to initiate financial sector reforms which are expected gradually to increase competition in the domestic retail banking market over the next few years. However, no specific steps have been taken or announced.

Foreign banks do enjoy some advantages in treatment compared to locally incorporated domestic banks. For example, domestic banks may be required to maintain branches and ATMs that they would prefer to close and to service small, relatively unprofitable deposits. In addition, capital requirements imposed on domestic banks are higher and more stringently defined than those imposed on foreign banks by their home regulatory authorities. Largely because of their domination of the offshore market, foreign banks in Singapore accounted for 40 percent of all nonbank deposits from residents, and nearly half of all loans to nonbank residents at year-end 1997. They also controlled about 70 percent of total trade financing and had about half of total net banking profits.

U.S. banks have continued to expand the size of their assets in Singapore in recent years. At the end of 1996, the latest year for which data are available, U.S. banks had S$77.2 billion in assets compared to S$40.7 billion at the end of 1992. There are currently 13 U.S. commercial banks with five sub-branches, six U.S.-controlled merchant banks and one partially U.S.-controlled merchant bank. The number of representative offices maintained by U.S. banks in Singapore has increased to four from two since 1994. Three U.S. commercial banks have full licenses, although one decided to withdraw from retail banking in 1994.

DESCRIPTION OF THE MARKET

Structure

Singapore embarked on a strategy to develop into an international financial center in the late 1960s. To implement that strategy, the government has deliberately sought to attract financial intermediaries to conduct offshore operations in Singapore by fostering a favorable tax and operating environment and by adopting a liberal but selective admission policy.

The Singapore government requires banks to maintain separate operations or "units," with their own set of books and balance sheets, for transactions in the domestic and external currency markets. Most of the 233 commercial and merchant banks in Singapore operate external currency units, known as Asian Currency Units (ACUs). Under the Banking Act, ACUs may not incur assets or liabilities denominated in Singapore dollars. On the other hand, ACUs do not have to hold required reserves against their liabilities, or observe minimum liquidity ratios. The offshore units also enjoy a concessionary tax rate of 10 percent. ACUs operate primarily in the Asian Dollar Market, the Asian counterpart of the Eurodollar market. As in its European counterpart, transactions are largely interbank, though nonbank customers also participate. The Asian Dollar Market has been the key to Singapore's growth as a major financial center. Bank operations in the domestic market, known as Domestic Banking Units (DBUs) may engage in transactions in both foreign and local currency, but face more stringent regulation. DBUs must hold a minimum cash balance of 3 percent of their liabilities with the MAS. In addition, they must hold 18 percent of their liabilities in liquid assets (10 percent must be in the form of Singapore government securities, while the other 8 percent may be held in cash, government securities and/or trade bills). DBUs are subject to the standard income tax rate of 26 percent.

Comparison Between the Domestic Banking Market and the Asian Dollar Market

End of Period	1993	1994	1995	1996	1997	As of February 1998
Total Assets						
Domestic Banking Units (S$ millions)	192,103	227,651	252,960	281,409	320,645	310,237
Asian Currency Units (US$ millions)	386,103	416,345	478,233	506,870	557,185	513,340
Loans & Advances to Nonbank Customers						
Domestic Banking Units (S$ millions)	91,369	106,814	126,521	144,998	162,234	159,923
Asian Currency Units (US$ millions)	136,857	145,823	173,265	180,506	173,255	152,245

Note: All figures reflect commercial banks and merchant banks. Domestic banking unit figures also reflect finance companies. Exchange rates ranged between 1.60 (1993) and 1.48 (1997).

Source: Monetary Authority of Singapore, Monthly Statistical Bulletin, April 1998.

Singapore restricts transactions in local currency (Singapore dollars) for use outside of the country. Singapore is particularly sensitive about its currency because of the Republic's unusually high dependence on external trade (2.7 times GDP). As a consequence, changes in the value of the Singapore dollar have a large impact on inflation. In response to concerns that excessive restrictions may jeopardize Singapore's ability to integrate with other regional economies, however, the government has made some adjustments in the use of the Singapore dollar overseas. Rules enacted in 1992 allow banks, including offshore banks, to make Singapore dollar loans overseas through their DBUs for the following purposes: 1) exports from or imports into Singapore; 2) performance bonds on behalf of Singapore parties, including guarantees in the construction industry; and 3) hedges by forward sales of Singapore dollar receipts from exports to Singapore. In 1998, the government announced that the regulation requiring banks to consult the MAS on the use overseas of Singapore dollar credit facilities exceeding S$5 million would be amended to stipulate that this rule applies only to nonresidents. The MAS is also working out guidelines to allow subsidiaries of Singaporean companies, and joint ventures between Singaporean and foreign companies, to borrow in Singapore dollars for projects that promote Singapore's integration with other regional economies, and to provide more flexibility for nonresidents to access Singapore dollars from the domestic capital markets.

The Monetary Authority of Singapore

The MAS is the regulator of the financial sector and the *de facto* central bank. Currency is issued and controlled by a separate board, the Board of Commissioners of Currency of Singapore (BCCS). Both bodies are statutory boards – quasi government agencies organized like corporations – operating under the Ministry of Finance. The MAS, established in 1971, is responsible for formulating and implementing Singapore's monetary policies and regulates the financial sector through the Monetary Authority of Singapore Act, the Banking Act, the Finance Companies Act, the Development Loans Act, the Local Treasury Bills Act, the Insurance Act, the Securities Industry Act, and the Futures Trading Act.

Apart from setting stringent requirements, the MAS has a selective policy on the admission of both local and foreign financial institutions. Singapore has no insurance mechanism for bank deposits. Foreign financial institutions are required to tender "comfort letters" to MAS assuring that their Singapore operations maintain sound liquidity and financial position at all times and that the parent will, on demand, make up for any liquidity shortfall in the Singapore operations.

In mid-1997, the government announced the creation of a Financial Sector Review Group – chaired by the Deputy Prime Minister Lee Hsien Loong – tasked to formulate strategies for the development of Singapore's financial services sector. The Group commissioned a private sector committee to offer recommendations on financial reform, and established a number of committees to study banking disclosure standards, corporate finance and securities exchange issues. In January 1998, following other key personnel changes within MAS, Mr. Lee took over as MAS chairman, replacing the Finance Minister who previously had dual posting. In April, the MAS announced a major reorganization to "give greater focus to efforts to develop Singapore as a major financial center in Asia, and globally." As part of this reorganization, a new "financial sector promotion department" and "planning and policy coordination unit" were created to formulate and implement strategies to develop the financial sector, and to strengthen policy integration and strategic planning within MAS, respectively. A "financial supervision group" was formed to integrate and enhance all supervisory functions and to develop risk-based supervisory procedures, distinguishing strong players from weaker ones, and allowing more room for innovation. A Committee on Banking Disclosure appointed by the Monetary Authority of Singapore (MAS) submitted a report designed to improve financial statement disclosure requirements for Singapore's banks. These requirements will enhance disclosure related to nonperforming loans, loan loss reserves, classification of investment securities, contingent liabilities, significant concentrations of loan exposure, and maturity structures of loans and deposits. Singapore's deputy prime minister also announced that the MAS will implement risk-focused bank examinations.

Commercial Bank Licenses and Activities

As noted in the Summary, thirty-four commercial banks in Singapore hold "full licenses" and are thereby permitted to offer a full range of local and foreign currency banking services. There is no monetary limit on the Singapore dollar lending activities of full licensed banks, but they must get permission from the MAS before opening new branches, or relocating existing ones. The MAS also considers ATMs equivalent to branches and subjects these activities to the same controls.

"Restricted" licenses, introduced in 1971, are held by 13 commercial banks, all foreign owned. They can operate in the offshore Asian Dollar Market under the same terms as full licensed banks, but the activities of their Domestic Banking Units are limited. Restricted banks face no restrictions on the amount of their Singapore dollar lending to residents, but they can only have one main branch, cannot offer general savings accounts, and cannot accept fixed interest-bearing deposits of less than S$250,000 (about US$156,000) from nonbank customers.

The remaining 106 commercial banks hold "offshore" licenses. Offshore licenses are now the only option available to new entrants to Singapore's commercial banking industry. These banks operate primarily in the Asian Dollar Market. They cannot accept any interest-bearing Singapore dollar deposits from resident nonbank customers (except approved financial institutions), nor can they open more than one branch.

Since the MAS began granting offshore licenses in 1973, it has permitted offshore banks to make limited Singapore dollar loans, in response to their argument that the inability to lend to loyal customers in the domestic market would cost them offshore business. The MAS raised this "resident funding limit" (the maximum amount in domestic loans such banks may have outstanding at any time) from S$100 million in 1993 to S$200 million in 1997. This commitment was bound by Singapore in the 1997 WTO Financial Services Agreement.

Singapore Local Commercial Banks

Apart from foreign bank branches, Singapore's domestic commercial banking industry is made up of six major banks and their six subsidiaries. All 12 have full licenses. Over the years, the industry has consolidated around the "Big Four" banks: the Development Bank of Singapore (DBS), the Overseas Chinese Banking Corporation, the Overseas Union Bank, and the United Overseas Bank. Together, these four banks accounted for four-fifths of local banks' S$182.0 billion (US$123.0 billion) in total assets at end 1997. Two-thirds of the 252 bank branches in Singapore belong to the Big Four, which also own or control seven of the 19 finance companies and six other local banks.

Among the 12 local commercial banks, two – DBS and Keppel Bank – are controlled by the government. Temasek Holdings, the government's investment arm, is the principal shareholder of DBS. Similarly, Temasek Holdings is one of the main shareholders of Keppel Corporation, which is the largest shareholder of Keppel Bank. It is common for senior government officials to sit on the boards of both domestic and foreign banks and for officials of both foreign and domestic banks to be on the boards of government-linked companies and the government's statutory boards. The MAS must approve the appointment of all directors of locally incorporated banks.

Foreign ownership of publicly listed banks is limited through the use of "local" and "foreign" shares on the stock exchange. Only Singapore residents may purchase "local" shares. "Foreign" shares are restricted to a maximum of 40 percent of total equity, and individual (or related group) foreign investments kept to 5 percent of total shares. Foreign equity in each of Singapore's four largest banks is currently near the 40 percent limit.

Full Licensed Commercial Banks in Singapore
1996-97

	Total Assets[1] (S$ millions)	Net Profit After Tax (S$ millions)	Number of Banks	Number of Branches	Number of ATMs
Singaporean	182205	1786	12	275	673
All Foreign[2]	141360	595	22	89	61
U.S.	41974	265	3	9	3

[1]Assets do not include contingent liabilities and commitments.
[2]Includes The Bank of Tokyo, prior to merger with The Mitsubishi Bank, on April 1, 1996.

Source: KPMG Peat Marwick 1996 Survey of Financial Institutions in Singapore.

Restricted License Commercial Banks in Singapore
1996-97

	Total Assets[1] (S$ millions)	Net Profit After Tax (S$ millions)	Number
Singaporean[2]	n/a	n/a	n/a
All Foreign	76463	134	13
U.S.	7999	3.9	1

[1]Assets do not include contingent liabilities and commitments.
[2]All local banks are full-license banks.
Source: KPMG Peat Marwick 1996 Survey of Financial Institutions in Singapore.

Offshore License Commercial Banks in Singapore
1996-97

	Total Assets[1] (S$ millions)	Net Profit After Tax (S$ million)	Number
Singaporean[2]	n/a	n/a	n/a
All Foreign	384141	641	99
U.S.	17247	52.9	7

[1]Assets do not include contingent liabilities and commitments.
[2]All local banks are full-license banks.
Source: KPMG Peat Marwick 1996 Survey of Financial Institutions in Singapore.

Merchant Banks in Singapore
1996-97

	Total Assets[1] (S$ millions)	Net Profit After Tax (S$ millions)	Number
Singaporean	1812	23	2
All Foreign	52342	532.6	76
U.S.[2]	8827	118.4	7

[1]Assets donor include contingent liabilities and commitments.
[2]Excluding joint ventures in which U.S. interests do not have a majority share.
Source: KPMG Peat Marwick 1996 Survey of Financial Institutions in Singapore.

Post Office Savings Bank

The Post Office Savings Bank (POSB) is modeled after the Japanese system. The POSB currently has over 130 branches and 660 ATMs. Total deposits in its five million savings accounts amounted to S$25.0 billion (US$16.9 billion) in March 1997. The POSB redeposited about 40 percent of its deposits into the banking system in 1997 with both domestic and foreign commercial banks. Underscoring the POSB's importance, these redeposits accounted for 14 percent of total fixed deposits from nonbank customers.

The POSB was separated from the Postal Services Department under the Post Office Savings Bank Act in 1972 to mobilize domestic savings for public sector development. Since interest earned in POSB accounts is exempt from income tax, the POSB pays a lower interest (3.75 and 4.125 percent on savings accounts up to and over S$50,000, respectively, as of May 1998) than those offered by commercial banks. The POSB cannot offer corporate accounts, finance foreign trade, or conduct foreign exchange transactions. POSB invests about 10 percent of its holdings in government securities, and may offer loans only for housing. The POSB is regulated directly by the Ministry of Finance rather than by the MAS. In July 1998, government-owned DBS Bank announced plans to acquire the POSB by the end of November 1998.

Merchant Banks

Eighty merchant banks currently operate in Singapore, of which 78 are foreign-owned. Their principal activities are underwriting, securities management, and interbank lending. Foreign owned merchant banks are generally established in Singapore as locally incorporated subsidiaries. Merchant banks must be approved by the MAS. Although they do not obtain licenses under the Banking Act, merchant banks can establish ACUs, which must comply with the Banking Act requirements. To obtain permission from MAS to operate as a merchant bank in Singapore, a financial institution's head office must be established as a bank, merchant bank, securities firm, or investment house. MAS reviews applications on a case-by-case basis and is likely to approve only the larger, better established applicants.

Merchant banks can raise funds from shareholders, or borrow from other financial institutions. Sixty-five percent of their funds are raised in the interbank market. They do not need to maintain statutory reserve and liquid asset requirements.

Nonbank Financial Institutions and Bank Representative Offices

Singapore's nonbank financial institutions include finance companies and money brokers. There are 19 finance companies in the Republic, with 99 branches and total assets of S$23 billion (US$14 billion). All but three are locally owned. Finance companies, like commercial banks, provide loans to nonbank customers. They also provide leasing, accounts receivable financing, and factoring services. Governed by the Finance Companies Act, they can accept time and savings deposits, but they cannot offer checking accounts, deal in gold or foreign exchange, or grant unsecured loans above S$5,000 (about US$3,200). Nor can finance companies issue Singapore dollar negotiable certificates of deposits or directly finance international trade. They can only deal in Singapore dollars, and they generally pay and charge higher interest rates than banks. Starting January 1995, finance companies with capital funds of at least S$100 million may, with MAS' prior approval, deal in gold, precious metals or foreign currencies, or acquire stocks and securities denominated in foreign currencies.

There are nine money brokers in Singapore. Six are foreign owned, and three are joint ventures between foreign and local companies. They function as intermediaries between banks for the placement of currency deposits and foreign exchange transactions. They are not obliged to disclose particulars about their transactions until they are concluded, which serves to maintain the confidentiality of the parties involved.

Sixty-nine foreign commercial banks, including four from the United States, and two merchant banks have representative offices in Singapore. The representative offices are not permitted to carry out financial transactions, but can act only as liaison offices for their parent banks.

THE U.S. PRESENCE IN THE MARKET

There are currently 13 U.S. commercial banks with five sub-branches in Singapore. Three are full licensed banks, although one of these (Chase Manhattan) has opted to focus exclusively on "restricted" and "offshore" banking activities since 1994. The two other U.S. full licensed banks are Bank of America and Citibank. American Express Bank is the only U.S. financial institution with a "restricted" license. There are nine U.S.-incorporated offshore banks operating out of Singapore. Additionally, there are six merchant banks which are fully U.S.-owned, one merchant bank partially U.S.-owned, and four U.S. bank representative offices in Singapore. Since 1994, a merchant bank controlled by Security Pacific has closed due to the merger between Security Pacific and Bank of America. Another merchant bank, controlled by First Chicago Bank, was upgraded to an offshore branch.

The Singapore assets of U.S. commercial banks have risen almost 90 percent between 1992 and year-end 1996, to reach a total of S$77.2 billion (US$54.8 billion). They recorded a combined net profit of S$811.8 million (US$575.7 million), in the year ending March 1996.

TREATMENT OF U. S. FINANCIAL INSTITUTIONS

Singapore's laws do not distinguish between foreign and domestic companies in the banking industry. The only legal and accounting distinction that exists is between the offshore (ACUs) and domestic units, and in the type of license held. However, the laws governing the banking industry provide the MAS with broad discretion in many areas, which the regulating body exercises on a case by case basis.

Those U.S. banks wanting only to engage in offshore activity are generally happy with their operations in Singapore. Foreign banks note that the problems they confront are confined to their domestic retail activities. The Singaporean government contends that its restriction on the domestic, retail activities of foreign banks are designed to protect Singapore's financial system and Singaporean depositors, and to preserve monetary control. The MAS considers Singapore overbanked in the retail sector and maintains that its ban on new full banking licenses is designed to prevent excessive competition, which it argues could threaten the stability of the banking system.

The MAS also claims that, given the openness and small size of Singapore's economy, a substantial expansion in the foreign share of the banking market could jeopardize its control over domestic monetary conditions if foreign banks withdraw or reduce their operations in the Republic on instructions from their head offices.

Outstanding concerns regarding the domestic retail market include the following:

- The MAS has not approved a new full banking license to either foreigners or locals since 1973. Several U.S. banks have expressed an interest in a full license if the current freeze is lifted.

- MAS policy limits foreign equity in local banks to 40 percent (raised from 20 percent in 1992), with individual (or related group) foreign investments kept to 5 percent of total shares.

- Commercial banks must seek permission to open new branches. The MAS routinely grants permission to local banks, but has not allowed a foreign bank to open an additional branch in over 20 years.

- The MAS defines offsite ATMs as branches, so foreign banks generally cannot locate ATMs beyond the walls of their premises. The MAS has allowed, as an exception, U.S. banks to open ATMs at Singapore's international airport. The MAS has also allowed foreign banks to install electronic terminals in the offices of corporate clients, and to provide computer and telephone banking services. The electronic terminals permit a more limited range of activities than ATMs.

- MAS will not permit U.S. and other foreign basks to set up a new ATM network to compete with Singapore's only existing network, NETS, which is owned by the Big Four and two other local banks. MAS's rationale is that a new network would circumvent the existing ban on foreign banks opening new ATMs. Meanwhile, although the government does not prohibit foreign banks from participation in the existing network, the operators of NETS have turned down requests by U.S. banks to participate.

- Only one foreign bank (Hong Kong Bank), and seven local banks, have to date obtained authorization from the government-run Central Provident Fund (CPF), a national pension, to operate "CPF investment accounts" through which Singapore citizens can make approved investments with their pension savings. The CPF Board has turned down requests by foreign banks to operate such accounts, saying they are not seeking new applicants to the program.

There are also some areas in which the MAS exercises its flexibility to the advantage of foreign banks. For example, foreign banks have the freedom to include interbank borrowings from their head offices, branches, and other banks as capital funds. This is not allowed for local banks. This gives foreign banks the flexibility to borrow from the interbank market to increase loan or investment portfolios, as the prudential limits on loans and investments are pegged to capital funds.

To achieve its goal of becoming an international financial center, Singapore embarked in 1998 on a long-term process to further liberalize its financial services sector. One of the initial actions taken was to increase the Singapore dollar resident loan limit from S$200 million (US$125 million) (committed under GATS) to S$300 million (US$188 million). Although the MAS is reportedly also considering measures to allow greater foreign participation in the local retail banking sector, it has yet to announce these measures. For the most part, Singapore's banking regime as of mid-1998 is similar to its GATS schedule of commitments made in December 1997.

Exchange Rates Used:

March 1996	1.41 S$/US$
March 1998	1.60 S$/US$

SINGAPORE

SECURITIES

SUMMARY

Singapore has five equity sub-markets that operate under the umbrella of the Stock Exchange of Singapore (SES). These include: the Mainboard for major domestic and foreign stocks, a bond market tagged to the local equity securities markets, a secondary over-the-counter market (SESDAQ) for small and medium-sized corporations, an options market, and the Foreign Board for foreign companies not able to meet the listing requirements for the Mainboard. A sixth secondary over-the-counter market for primarily Malaysian offshore stocks was closed in September 1998 as a result of newly-imposed capital and currency controls in Malaysia. The Singapore International Monetary Exchange (SIMEX), established in 1984, was Asia's first financial futures market. The Monetary Authority of Singapore (MAS) regulates the overall financial sector, including the securities and futures industries, but has delegated much of the day-to-day regulation of the markets to the relevant exchanges. A recently-appointed government committee has proposed that SES regulatory powers be reduced – in conjunction with maximum company disclosure – to generate more vibrant markets.

Foreign securities firms generally have the same right to establish and offer financial products as do domestic firms with respect to government securities, unit trusts, and financial futures. There are restrictions, however, on the extent to which foreign stockbroking firms can trade in the equity securities markets for Singapore resident clients. SES regulations restrict foreign equity ownership of SES member companies to 49 percent, with the exception of two joint ventures approved prior to 1990 and the special category of "international members" which are wholly foreign-owned stockbroking companies in the SES. While authorized to trade for nonresident clients, these SES international members are permitted to trade Singapore-dollar denominated securities for resident clients only if the transaction value per contract is S$5 million (US$3.1 million) or above. SES international members also may not vote in an election of members to the SES Committee (that is, the Board of Directors of the SES). In 1995, the SES created a category of "approved foreign brokers" who are permitted to trade only non-Singapore dollar denominated stocks on the exchange. All other foreign stockbroking firms licensed in Singapore (SES "non-member companies") must trade local securities through SES members.

The SES currently has 33 member and 57 "non-member" companies. Two U.S. companies have substantial equity stakes in two domestic members of the SES. Apart from these, one U.S. brokerage firm is an "international member" of the SES. An additional 11 U.S. securities firms are active in Singapore as non-members of the exchange, mostly trading offshore stocks for Singapore resident clients. Foreign financial institutions, including nine U.S. companies, are also active in the fund management industry, offering a total of 50 unit trusts and funds (similar to mutual funds). Foreign financial institutions, including U.S. firms, dominate activity in the futures market, with about 85 percent of the 24 million contracts traded on SIMEX in 1997 involving offshore clients. Two of the eight primary dealers in Singapore government securities are foreign-owned, including one from the United States.

Residents of Singapore face no capital controls or restrictions in obtaining offshore financial instruments. Local companies, however, face restrictions when seeking to issue Singapore dollar-denominated securities or notes in overseas markets. Foreign companies can participate in underwriting foreign issues made by local companies.

DESCRIPTION OF THE MARKET

Singapore is a small but prosperous city-state with a population of 3.5 million residents (including 500,000 non-citizens) and a per capita GNP of about US$26,000. The financial services sector, including banks and other financial institutions, accounted for nearly 11 percent of Singapore's S$143 billion (US$90 billion) in GDP in 1997. It has been a longstanding goal of the Singapore government to develop Singapore into a regional financial center, primarily by attracting foreign financial institutions to set up offshore operations in the city-state.

In 1986, the government revised the Securities Industry Act (SIA), and enacted the Futures Trading Act (FTA). Both of these acts give broad powers to the MAS to regulate the securities and futures industries. The MAS is a statutory board – a quasi-government body organized like a corporation – under the Ministry of Finance. Established in 1971, the MAS regulates the entire financial sector through the Banking Act, the Finance Companies Act, the Development Loans Act, the Local Treasury Bills Act, and the Insurance Act, as well as the two laws mentioned above. The MAS exercises stringent oversight over financial institutions in Singapore, and has broad discretion in licensing local and foreign financial institutions to operate in the republic. The MAS also serves as Singapore's *de facto* central bank, and is responsible for formulating and implementing Singapore's monetary policy.

The MAS provides a variety of licenses for the securities and futures industries. Besides generally stipulating that the licensees must be of good character, knowledgeable, and have adequate financial resources, the SIA and the FTA give the MAS broad powers to "vary any condition or restriction or impose further conditions or restrictions" in granting the licenses. The MAS has delegated much of the day-to-day regulation of the markets to the relevant exchanges over the years. The government securities market is administered directly by the MAS.

The Securities Industry Council (SIC), created by the original SIA, still advises the Minister of Finance on all matters relating to the securities industry. The SIC is a bipartite body made up of government officials and representatives appointed from the private sector by the Minister of Finance. The SIC also has regulatory power to investigate transgressions of rules in the nonstatutory

Code on Take-overs and Mergers and to summon any person to provide information accordingly. The SIC acts in close coordination with the MAS.

In December 1997, as part of a broad effort to liberalize the financial services sector, the government set up an SES Review Committee to consider and recommend changes in the operation of the SES in order to enable Singapore "to participate fully in the dynamic global network of capital markets." In May 1998, another government-appointed committee proposed the adoption of a U.S. system of regulation based on minimum exchange regulations and maximum disclosures by companies in order to generate greater vibrancy in the securities markets. Under this system, securities regulations would be centralized at the MAS, while the SES assumes primarily promotional responsibilities.

The Equity Markets: The Stock Exchange of Singapore

Presently, Singapore's equity market is comprised of five sub-markets organized under the umbrella of the SES. In descending order of size, the five are:

- the Mainboard, the primary market for major domestic and foreign companies;
- the Debentures, Bonds, Loans and Transferable Subscription Rights (DBL & TSR) market;
- SESDAQ, a secondary OTC market trading in shares of small and medium-sized corporations;
- the Stock Options market; and
- the Foreign Board, a market for foreign companies not qualified to list on the Mainboard.

The SES Mainboard is dominated by large Singapore government-linked corporations, such as the former government monopoly Singapore Telecom, but the exchange has encouraged more listings by locally incorporated subsidiaries of multinational corporations in recent years. As of the end of April 1998, the SES Mainboard listed a total of 302 companies, including 52 foreign companies, with a market capitalization of S$304 billion (US$190 billion). This represents approximately a 50 percent growth in the total number of SES-listed companies and a doubling of SES-listed foreign companies over the past four years. As a guard against the internationalization of the Singapore dollar, all foreign companies had been permitted only to issue non-Singapore dollar shares on the exchange. In October 1996, the government permitted those with substantial (30 percent) Singapore operations to list in Singapore dollars as well. Since the beginning of the regional financial crisis in mid-1997, average stock prices on the SES Mainboard have fallen by over 40 percent, while total market capitalization (especially in US dollar terms) has also declined despite new listings.

The DBL & TSR market is tagged to the Mainboard and SESDAQ. A total of 284 debentures, bonds, loans, and TSRs were listed at the end of April 1998, with market capitalization of S$27 billion (US$173 billion).

The government launched the SESDAQ – modeled after the U.S. Nasdaq Stock Market – in February 1987 to allow small and medium-sized firms that the market views as having a higher risk but good growth potential to raise capital. There are currently 62 stocks traded on the SESDAQ with market capitalization of S$3.2 billion (US$2 billion). Compared to four years ago, this represents nearly double the number of listed firms but slightly less in terms of total market capitalization. In December 1997, the government announced that foreign companies may begin to list in non-Singapore dollars on SESDAQ.

Finally, there were seven companies offering 102 call and put options on only four stocks in the fledgling options market (set up in March 1993), and one foreign company listed on the Foreign Board as of April 1998.

(Note: In September 1998, the SES was compelled to close a sixth equity market – a secondary over-the-counter market for primarily Malaysian offshore stocks called "CLOB International" – after the Malaysian government imposed general capital and currency controls in reaction to the regional financial crisis. In 1997, this market accounted for about 40 percent (in volume) and 12 percent (in value) of the monthly turnover on the SES. As of the end of April 1998, CLOB International quoted 129 stocks (including 12 Malaysian, nine Hong Kong, and eight other foreign countries) with a total market capitalization of S$143 billion (US$90.2 billion).)

The growth of offshore banking activities and the influx of foreign capital (mainly Japanese as the yen appreciated) spurred rapid growth in the Singapore equity markets beginning in the mid 1980s. Liberalized rules on the use of Central Provident Fund (CPF) savings – a national pension fund – which allowed individual Singaporean investors to use their savings to purchase "trustee" equities on the SES also fueled a bull market in 1993. Growth appears to have peaked in 1993, however, as competition from foreign financial centers increased while Singapore remained constrained by its relatively small domestic capital market. Although the number of SES listed companies continued to grow, total turnover value on the Mainboard, the CLOB International and SESDAQ markets declined from a peak of S$134 billion (US$83.9 billion) in 1993 to S$114 billion (US$71 billion) in 1997. This was reduced further by the closure of CLOB International in September 1998.

Foreigners are generally free to invest in local equity and debt instruments. Foreign shareholdings, however, are limited in local companies in the sectors of defense, banking and other financial services, mass media, and in the national carrier (Singapore Airline) in which the government is the principal shareholder. Such companies maintain dual listings on the exchange, with allowable foreign shareholding ranging from 40 to 49 percent. In 1997, the government began to reduce the number of such dual-listed companies.

SES Membership

The SES is owned by its 33 members, 17 of which are 100 percent Singapore-owned, nine are joint ventures with foreign partners, and seven are wholly foreign-owned "international members." Under the supervision of the MAS, the SES sets its own criteria for membership and listing, and regulates the activities of its members. The SES Committee, which runs the exchange, is made up of four stockbrokers elected from the membership and five individuals appointed by the four elected stockbrokers and approved by the Minister of Finance. One of the five appointed members is also appointed as SES's executive chairman.

Current SES policy limits foreign ownership of domestic member firms to 49 percent equity. In 1987, the SES announced that it would accept applications for joint ventures with up to 70 percent foreign ownership – with final SES action on the applications contingent on meeting certain criteria during three years of operation. Nine firms applied, two of which gained membership, three disbanded their partnerships, and four have not requested final SES approval. In 1990, when the SIBS instituted the "international member" category, it closed the 70 percent joint venture category, but grandfathered the two joint ventures that had gained membership. All new joint ventures have since been subject to the 49 percent limit.

The SES approved seven out of 10 applicants for "international member" status in 1992, with the price of each seat purchased at S$8.2 million (US$5.1 million). Although there is no ownership limitation on "international members," these foreign stockbroking firms are only permitted to trade in lots of S$5 million (US$3.1 million) or above when executing transactions of SES-listed Singapore dollar-denominated securities for Singapore resident clients. For transactions of non-Singapore dollar denominated SES-listed or quoted securities, international members may freely transact orders of any size with residents and nonresidents. International members are not eligible to vote in elections for, nor can they be elected to, the SES Committee.

In 1995, the SES created a new category of non-member "approved foreign brokers" who are permitted to deal in non-Singapore dollar denominated equity securities or bonds listed or quoted on the SES for resident and nonresident clients. For resident clients other than corporate accredited investors, however, it is required that the transaction value of non-Singapore dollar denominated equity securities per contract not be less than S$5 million (US$3.1 million) or its equivalent in foreign currency. There are presently five such approved foreign brokers.

There is no cap on the number of local or international members the SES can accept. However, the total number of SES memberships has remained constant since 1992. The SES has considerable discretion in approving or denying applications for membership, and it tends to focus on larger, better established firms.

In addition to SES member firms, 57 non-member securities firms – all of which are either wholly foreign-owned or joint venture firms – are licensed to operate in Singapore. These firms can trade SES-listed securities only through member firms. They are permitted to trade offshore stocks for Singapore residents.

Unit Trusts and Funds

Unit trusts and funds are similar to mutual funds in the United States. Their importance has grown over the last decade as their increasing variety has attracted a growing number of local investors, particularly risk-averse small investors. Unit trusts and funds are regulated under the Singapore Companies Act by the Ministry of Finance's Registry of Companies and Businesses. Trustees are screened and approved by the Minister under the Companies Act.

As of the end of 1997, there were 161 local and foreign financial institutions in Singapore offering 101 unit trusts and managing a total of S$125 billion (US$78.1 billion) in local and foreign funds, nearly double the value in 1994. Fifty of the unit trusts were managed by foreign firms. This strong growth was attributable primarily to fund management companies transferring funds invested in Asian markets previously managed by their offices in the region to Singapore for management. Over 90 percent of the funds managed from Singapore were sourced from foreign investors, including about 50 percent from Europe and the United States. Nearly 70 percent of these funds were invested in equities, with about 10 percent of the total invested in Singapore. In 1998, as part of its broad financial sector liberalization efforts, the government announced that it will allocate S$35 billion (US$21.9 billion), up from S$10 billion (US$6.3 billion), in public sector funds to private fund managers over the next three years.

U.S.-based mutual fund companies may market their funds to Singapore residents, provided the necessary prospectuses are registered with the Singapore Registrar of Companies. There are also no barriers to foreign-owned financial institutions offering Singapore-based unit trusts and funds. There are currently nine U.S. asset management companies operating in Singapore.

The Financial Futures Market: SIMEX

The government, looking for niches in the financial services industry, established SIMEX as Asia's first financial futures market in 1984. Developed out of the former Gold Exchange of Singapore, SIMEX continues to provide commodity futures contracts in gold and energy products. SIMEX modeled its open outcry trading system, its regulations, and other aspects of its market operations after the Chicago Mercantile Exchange (CME). To ensure a sufficient volume of transactions and liquidity, SIMEX has also joined in a "mutual offset system" (MOS) with the CME, which enables a position opened in one exchange to be offset or closed in the other without having to pay an additional margin to the other exchange. MOS allows for around-the-clock trading. Given its international outreach, SIMEX remains open even on local public holidays.

As of 1998, there was a total of 12 futures contracts and six options contracts available on SIMEX. Trading interest was dominated by the three-month Eurodollar and Euroyen interest rate futures, and the Nikkei-225 stock index futures and options contracts. In January 1997, SIMEX launched the Taiwanese Stock Index futures and options contracts based on the index compiled by Morgan Stanley Capital International (MSCI), which comprised 77 component stocks representing 67 percent of the Taiwan stock market. In April 1998, the exchange announced that it will start trading Singapore, as well as Malaysian and Thai, stock index futures and options contracts in the second half of the year.

SIMEX is governed by the Futures Trading Act of 1986 and is supervised by the MAS, but it exercises its own strict financial requirements and screening processes in admitting new traders and regulating their activities. The requirements are transparent and do not discriminate in any way between local and foreign traders. U.S. and other foreign traders and intermediaries dominate the futures market, with about 85 percent of the 24 million contracts traded on the exchange in 1997 taken by overseas clients. Floating rate instruments, derivatives, and other new financial products are readily offered in Singapore by both foreign and domestic traders without restriction. The MAS encourages development of greater financial product and technological sophistication. Both foreign and domestic banks must obtain approval from the MAS, however, before introducing any new type of financial product.

Singapore Government Securities

The Singapore government, with regular budget surpluses and official foreign reserves of S$119 billion (US$74 billion), does not currently need to issue securities to finance expenditures – although the government has recently announced again its intention to make the government and government-linked companies more reliant on the securities market for future borrowings. The MAS issues securities under the Government Securities Act and the Development Loans Act as debt instruments to regulate liquidity in the money market and to provide financial institutions with liquid assets to meet reserve requirements. The government restructured its debt market in 1987 to develop a more active and liquid secondary market, which would also serve as a benchmark for developing a corporate debt securities market. Government-set interest rates were abolished and a weekly auction system modeled alter the U.S. Treasury auctions was adopted.

The MAS regularly issues its securities in the form of book-entry bonds with maturities of two, five, and seven years, and Treasury bills of three, six or twelve months maturity, to the public through eight primary dealers who act as market makers and provide two-way quotes. One of the two foreign primary dealers is U.S.-owned. There are no discriminatory barriers for foreign participation in this market. The Singapore government also issues nonmarketable government debt to the CPF board. At end 1997, outstanding Singapore government book-entry bonds issued stood at S$15 billion (US$9 billion). Average daily turnover in Singapore government securities in 1997 reached S$534 million (US$334 million), while daily repurchase agreements averaged S$267 million (US$167 mil).

To create greater depth in the market, the government is expected to issue l0-year bonds in the near future.

U.S. PRESENCE IN THE MARKET

U.S. stockbroking firms account for 11 out of the 57 SES non member brokerages. U.S. companies also currently own substantial equity in two domestic SES members, namely: BT Brokerage (49 percent owned by Bankers Trust); and Vickers Ballas (20 percent owned by Citicorp). Merrill Lynch Singapore became an SES international member in 1995, after acquiring one of the seven originally-approved international members (Smith New Court Securities).

There is also a strong U.S. and foreign presence in Singapore's financial futures market. Nine of the 35 corporate clearing members are U.S.-based. Additionally, one is a joint venture with a local firm. There are also five U.S. firms among the 25 non-clearing members of SIMEX. Two of SIMEX's 11 commercial associate members are U.S. firms. The U.S. presence, however, is not strong in the individual member and trading permit holder categories. Only five of the 471 individual members and trading permit holders are U.S. residents. Most U.S. customers trade through U.S.-based members of the SIMEX. Presence in this market is limited only by the availability of seats. Prospective traders must seek seats through the open market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign securities firms, including U.S. companies, have the same right to establish and offer financial products as do domestic firms with respect to government securities, unit trusts, investment banking, and financial futures. Introducing new financial products generally requires government approval.

Current regulations, however, restrict foreign equity ownership of SES regular members to 49 percent, with the exception of two joint ventures approved prior to 1990 which were permitted up to 70 percent foreign ownership. The Financial Sector Review Committee – formed in 1997 and headed by Deputy Prime Minister and MAS Chairman Lee Hsien Loong – is known to be studying the possibility of liberalizing the SES membership structure.

One U.S. securities firm (Merrill Lynch Singapore) became an international member of the SES in 1995. Although SES international members are 100 percent foreign owned, they are restricted in their trading in equity securities on behalf of Singapore resident clients and cannot vote in elections for the SES Committee. SES international members are subject to a restriction on the size of lots they must trade when executing transactions for residents of SES-quoted securities denominated in Singapore dollars. (Note: Investment managers, however, are exempt from several prudential requirements relating to exposure to a single client and exposure to a single security, which the MAS argues puts them in a better competitive position vis-à-vis SES members.)

Foreign securities firms may freely offer to Singapore residents domestically managed unit trusts and funds. They may also offer foreign mutual funds to residents if the necessary prospectuses are registered with the Singapore Registrar of Companies.

Residents face no capital controls or restrictions in obtaining offshore financial instruments for investments. Foreign companies can participate in underwriting foreign issues of local companies without restriction. There are restrictions, however, on the issuance of offshore Singapore dollar-denominated securities.

Generally, current levels of openness are bound in Singapore's GATS offer. However, Singapore has not bound itself to approving new memberships in the SES (e.g., international members) or new primary and registered dealers of Singapore government securities. The MAS is undertaking a comprehensive review of the financial services sector with a view to further liberalization. A "stockbroking committee" set up by the government recently submitted a number of recommendations to the MAS for consideration. Chief among these is a change in regulations to allow foreigners to own up to 70 percent of a local stockbroking firm, thereby raising the ownership limit from the current 49 percent.

SOUTH AFRICA

BANKING

SUMMARY

As of December 31, 1997, banking in South Africa was conducted by 56 fully licensed institutions and 59 representative offices of foreign banks. The industry is dominated by four large banks whose combined assets account for almost 80 percent of total bank assets. Foreign banks are estimated to hold about 6.7 percent of total bank assets. There is significant cross-shareholding among banks, industrial companies, and insurance and other financial services organizations. None of the banks are state-owned. Despite high interest margins and a return on assets of 1.2 percent (equal to that of U.S. banks), South African banks are hampered by high cost ratios and a relatively low return on equity of 12.1 percent.

The Bank Supervision Department, a part of the South African Reserve Bank, is responsible for regulating banks, mutual banks and mutual building societies. The Financial Services Board is responsible for other financial institutions that operate on an agency and/or principal basis.

There is currently only one U.S. bank (Citibank) with a full commercial banking license, which operates through a branch focusing on corporate business. Four other U.S. banks have representative offices.

Beginning in May 1995, foreign banks were permitted to establish in branch form in South Africa. However, several restrictions are placed on their foreign branches. Foreign bank branches can only accept deposits provided the initial deposit is more than US$200,000 and this balance is maintained at all times. A foreign bank that wants to establish a branch or acquire a locally incorporated bank must maintain at least US$l billion in net assets (total assets less total liabilities) at all times, and at least 18 months prior to its application. A foreign branch must also maintain its own endowment capital (unencumbered assets less liabilities) of not less than the greater of US$10 million or 8 percent of the amount of risk weighted assets and other contingent liabilities. The local capital of the branch rather than the consolidated capital of the parent bank is also used to compute the branch's risk weighted capital ratio, legal lending limit, and other capital driven thresholds – in effect, eliminating many of the benefits of establishing in branch form. Foreign branch management must include at least two persons residing in South Africa, one of whom is the Chief Executive Officer. The clearing system is owned and controlled by the four largest locally-incorporated banks; all other banks must clear through the big four. Locally-incorporated commercial banks are also favored over foreign commercial banking operations in bidding on government contracts.

DESCRIPTION OF THE MARKET

Structure of the Market

As of December 31, 1997, South African banks had total assets of approximately US$109.8 billion of which US$94.6 billion consisted of outstanding loans. Of the 56 commercial banks, four have assets in excess of US$18 billion, five "medium sized" banks have assets in excess of US$1 billion and remaining "small" banks have assets of less than US$600 million. In addition, there are four mutual banks, 10 subsidiaries of foreign banks, 12 direct branches of foreign banks, and 59 registered representative offices of foreign banks.

The banking system is dominated by the four largest locally-incorporated banks (the "big four"), Standard Bank, ABSA, First National, and Nedcor. All four have operations internationally although only Standard Bank appears to have a strategy of expansion abroad, especially in other African states. Between them, these banks control about 80 percent of total South African banking assets and a similar percentage of outstanding loans. In recent months, mergers between large banks, insurance companies, and merchant banks have been consummated as local firms try to achieve the scale necessary to compete with the international competitors coming into their market. South African commercial banks provide a full range of corporate banking services to all sectors of the retail and corporate markets. However, in general they will not make loans (other than overdrafts) of less than US$2,000. The retail sector of the market is serviced mainly by nonbank lenders.

Mutual banks conduct the same business as commercial banks, with the main difference being shareholding; mutual banks are not equity banks and their depositors are regarded as their shareholders. Capital adequacy requirements are lower for mutual banks.

Foreign banks from the UK, Germany, France, the Netherlands, Taiwan, Greece, and Cyprus operate either through subsidiaries or as investors in local operations. Citibank, the only U.S. bank with a full banking license in South Africa, has established one branch. Bankers Trust, Chase, First Union, and Bank of America have representative offices. The overbanked and relatively sophisticated nature of the market have mitigated against many foreign banks joining the South African banking market.

At year end 1997 the average BIS capital adequacy ratio of local banks was 10 percent against the 8 percent required by regulation. Total nonperforming loans totaled US$3.2 billion, or 3.2 percent of total loans outstanding. Nonperforming loans are defined as "overdue loans" in South Africa. Although no specific definition exists for overdue loans, banks are expected to report on overdue loans from four months (and longer) in arrears. Of nonperforming loans, 43 percent were related to housing, 12 percent to installment loans, and 45 percent overdrafts and other. Bankers say that the huge upsurge in mortgages and other facilities granted to the previously disadvantaged (and unbanked) population and a recent trend to provide mortgagees for a higher percentage of the mortgaged property, have contributed to the majority of nonperforming loans. Banks have established specific reserves equivalent to 45 percent of total nonperforming loans. Loans to municipal and provincial governments and authorities have also contributed to nonperforming loans. In recognition of the risk associated with these loans, the regulators have increased the capital requirement on all such loans from 0.8 percent to 8 percent.

Aggregate revenues of all banks amounted to US$6.6 billion in 1997. In recent years the percentage of total income attributable to interest margin has been declining steadily as fee income becomes more important. Meanwhile, bank cost ratios are high by international standards (65 percent of operating income versus 62 percent in the United States). This is attributable to the large branch networks, investment in new technology, lack of economies of scale, massive security costs because of the high crime rate, and low productivity. In an effort to deal with this problem, banks are investing heavily in technology, closing branches, and laying off employees.

Aggregate pretax bank income for 1997 was US$1.52 billion. After deducting a tax charge of US$420 million (27.6 percent), net profit was US$1.1 billion. With expenses totaling US$5.7 billion and net interest and transaction fee income totaling US$4.86 billion, South African banks as a group were able to turn a profit based only on their trading and investment income and not from their core operations. Banks attribute this to competition, the high cost of personnel, and the cost of imported technology.

Regulatory Structure

The South African regulatory framework has evolved around the need to regulate specific financial activities and is based on institutional rather than functional lines. The function of deposit-taking, however, is regulated in terms of the Banks Act, 1990, and supervised by the bank Supervision Department of the Reserve Bank. Regulation applies whether the business is structured as a separate subsidiary company or as a branch of a foreign banking company. Once a South African banking institution is authorized, all its activities are subject to Bank Supervision Department prudential supervision, even if some of its activities are also regulated by another regulator. With the advent of universal banking, and the fact that all nonbank supervision is under the Financial Services Board (part of the Department of Finance), a system of "lead regulator" has been in effect. This does not exempt an institution entirely from any one regulator's requirements, but it does prevent double regulation in certain areas. New legislation has been introduced before a Parliament to further clarify South African banking regulations and to bring them into line with international "best business" standards.

There is currently no deposit insurance or deposit guarantee program in place in South Africa.

U.S. PRESENCE IN THE MARKET

Foreign banks operated in South Africa through 12 direct branches and 10 subsidiary banks as of year-end 1997. (Foreign banks operated through six bank subsidiaries as of year-end 1993.) They have been allowed to establish in branch form only since May 1, 1995.

Citibank is the only U.S. bank with a full commercial banking license. Citibank has a fully licensed branch in South Africa and a marketing office in Durban. Four other U.S. banks have representative offices; none are presently considering upgrading their status.

Foreign banks focus on providing differentiation of corporate banking products and quality service. Their retail banking activities are limited, in large part due to the minimum deposit requirement placed on their foreign branches, and the fact that the retail market is in general considered overbanked in the middle and upper income categories. They specialize in such areas as privatization and project finance, international treasury and cross-border transactions, and access to international debt and equity markets. But these operations face stiff competition from a small group of local players whose focus has narrowed to corporate work for South African blue chips expanding abroad.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks may establish bank subsidiaries, branches, or representative offices in South Africa. A foreign bank approved by the registrar of banks may also acquire up to 100 percent of the shares of a local bank or hold 100 percent of the capital of a nonbank subsidiary established in South Africa. (Locally incorporated banks do not establish subsidiary banks.) Foreign subsidiary banks are treated in precisely the same manner as any other South African bank and are not limited as to the scope of their activities or regulated differently from other local institutions.

Foreign banks with at least US$l billion in net assets (total assets less total liabilities) may establish branches in South Africa or acquire full ownership of local banks upon approval of the registrar of banks. The following licensing requirements must be met in order for a foreign bank to establish a branch in South Africa:

- The foreign institution on its own, or a foreign institution and the banking group of which such foreign institution forms a part, shall hold net assets, as certified by auditors and reflected in the audited annual financial statements, of a value of at least US$1 billion, while foreign institution itself shall hold net assets of at least US$400 million. This level of assets must also have been held for at least 18 months prior to the submission to establish a branch. Intangible and "not readily marketable" assets must be excluded from total assets.

- The foreign institution should have a long-term investment grade debt rating from an internationally recognized rating agency.

- Management must comprise at least two persons residing in South Africa, one of whom is the Chief Executive Officer.

- The business operations must at all times be covered and supported by a letter of comfort and undertaking issued from the parent company.

- The branch must have its own capital of not less than the greater of US$10 million or 8 percent of the amount of risk weighted assets and other contingent liabilities. The capital adequacy ratio is based in the local capital of the branch rather than the consolidated capital of the parent bank.

For prudential and regulation purposes, the local capital of the branch is used to compute the legal lending limit and other capital driven thresholds, effectively removing much of the advantage of establishing a branch. Moreover, foreign bank branches are limited in their business by being able to accept deposits only from corporations or other "juristic persons," or from individuals provided the initial deposit is more than US$200,000 and this balance is maintained at all times. Foreign branches are not able to have a net open position in foreign currencies of more than 15 percent of net capital and reserves.

The clearing system in South Africa is owned and controlled by the four largest locally-incorporated banks; all other banks must clear through the big four. Citibank and the small domestic banks are negotiating with the Reserve Bank, so far unsuccessfully, to obtain membership. Locally-incorporated commercial banks are favored over foreign commercial banking operations in the bidding on government contracts. This is true only in the commercial banking sector, not the investment banking sector.

1996 Key Statistics for Leading South African Banks

	Return on Assets	Return on Capital	Capital/ Tier I Assets	Charges for Bad Debts/ Avg. Balances	Cost Ratio
ABSA	0.96	15.36	6.5	0.60	70.47
Boland	1.42	15.00	6.3	1.37	58.33
First National	1.17	21.34	7.3	0.94	62.49
Nedcor	1.44	21.89	8.4	0.52	61.38
Standard Bank	1.38	21.12	8.6	0.55	65.48

SOUTH AFRICA

SECURITIES

SUMMARY

Foreign participation in South Africa's two securities exchanges and one futures exchange – the Johannesburg Stock Exchange (JSE), the Bond Exchange of South Africa (BESA), and the South African Futures Exchange (SAFEX) – has increased significantly during the past three years. U.S. firms have established a presence in the equities, bond, and derivatives markets and are expanding their involvement steadily.

A restriction on foreign membership in the JSE was lifted in 1996. Several U.S. firms are trading members of the BESA and non-clearing members of the SAFEX. Although the Financial Services Board (FSB) is responsible for the coordination of overall regulatory policy affecting financial markets, the JSE, BESA, and SAFEX operate on a self-regulatory basis subject to the provisions of the Stock Exchanges Control Act of 1985. In order to enhance competitiveness and tighten regulatory oversight, the three exchanges in consultation with the FSB have agreed in principle to amalgamate all trading activities in one national exchange.

Financial authorities expect to present to Parliament a carefully-coordinated array of regulatory proposals within the next year aimed at bringing South Africa's regulatory and supervisory structure into conformity with global best practices. This will facilitate transition to unrestricted cross-border financial transactions based on a policy of national treatment. Looking forward, the Ministry of Finance is laying the ground for regional integration of financial markets by negotiating cross-listing agreements, integrated payments systems, and harmonized regulatory and technical standards with members of the Southern African Development Community (SADC).

A precipitous fall in the value of the South African rand in mid-1998 along with a sharp fall in equity prices caused nonresidents to reassess portfolio positions. According to South African Reserve Bank statistics, nonresident holdings of public sector and Eurorand bonds issued on behalf of South African parastatals increased during the first half of 1998 by R8.9 billion (US$1.4 billion) and R2.1 billion (US$323 million), respectively. Net foreign investment in South African shares during this period amounted to R19.4 billion (US$3.0 billion). Continued pressure on the rand and fallout from other emerging market realignments, however, resulted in a sharp reversal of foreign portfolio investment beginning in May 1998. Foreign investors reduced their holdings of South African bonds by R12.4 billion (US$2.0 billion) between May and July. Yet at the same time, foreigners remained net purchasers of JSE-listed equities in the amount of R12.0 billion (US$1.8 billion). Emerging market volatility and a global reassessment of risk by foreign investors is expected to place continued pressure on South African securities markets to bring regulatory, corporate governance, disclosure, and technological standards fully into line with major exchanges worldwide.

DESCRIPTION OF THE MARKET

Regulation

The FSB, comprising prominent industry representatives, supervises South African nonbank financial markets and portfolio managers. It licenses exchanges, conducts investigations, participates in the approval of new listings, approves amendments to exchange rules (with the right to impose rules unilaterally), and advises the Minister of Finance on regulatory matters. Under the oversight of the FSB, the three exchanges operate as self-regulating entities in accordance with procedures adopted by members in consultation with the FSB.

The regulatory structure of financial markets in South Africa has been undergoing significant change with the aim of reintegration into global markets after years of isolation and foreign exchange controls. The South African government has enunciated the goal of opening markets to unrestricted cross-border participation based on assurances of national treatment, elimination of exchange controls, and regulatory supervision in accordance with international standards.

Foreign Exchange Controls

Although foreign exchange controls have been relaxed significantly since 1994, South African corporations and individuals hold an estimated R2,000 billion (US$308 billion) in domestic assets still subject to capital account restrictions. Most large South African corporations have embarked on strategies of international diversification and are attempting to gain footholds in overseas markets. Many have pursued this goal through exchange-neutral asset swap arrangements with foreign investors approved by the South African Reserve Bank. The rapidly-growing Eurorand market constitutes another external source of funding for South African corporations. Although these factors are gradually venting some of the excess demand for offshore investment, there remains a large overhang of potentially volatile funds among South African investors. This has motivated South African authorities to maintain a carefully-staged approach to exchange control liberalization. Foreign investment in South African equity and debt instruments is not subject to foreign exchange regulation. As noted below, foreign investment and trading in South African securities have risen dramatically in tandem with market liberalization and deregulation.

Bond Market

The BESA was licensed by the FSB in 1996 as a self-regulatory financial exchange to replace the previous over-the-counter bond market. Members include major domestic issuers, intermediaries, and financial institutions. Foreign companies must incorporate as a public company in South Africa or register as an external company under the Companies Act of 1973 to acquire membership as either Trading or Broking Members. All members are required to meet capital adequacy requirements based on European Union guidelines. Several U.S. banks are BESA Trading Members, including J.P. Morgan Securities, Merrill Lynch, and Morgan Guaranty Trust of New York. The Ministry of Finance recently introduced an auction-system for primary issues and appointed 12 primary dealers (including five foreign securities companies) for the marketing of South African government capital market debt instruments. Two U.S. firms, J.P. Morgan and Merrill Lynch, are among the 12. These dealers enjoy exclusive dealing rights with respect to all domestic auctions of government bonds.

Compared to the equity market, the bond market enjoys very high liquidity, although trading is restricted to a few issues – primarily government (Republic of South Africa, or RSA) bonds and public utilities bonds. There is no significant corporate bond issuance. Total turnover in 1997 increased by 36 percent to R4.6 trillion (US$708 billion). Foreign participation in the market has risen rapidly since 1994. A sharp rise in Eurorand bond issues since 1995 has led to increased demand for long-term government bonds in the domestic bond market, used by Eurorand issuers as hedges for Eurorand exposure. Typically, Eurorand issues are swapped into other currencies, hedged by an offsetting acquisition of South African bonds.

Equity Market

The JSE, the sole licensed stock exchange in South Africa, initiated a broad restructuring program in 1995 which is expected to bring it into accordance with worldwide technical and regulatory standards by early 1999. In November 1995, membership was opened to foreign companies under new capital adequacy requirements applicable equally to domestic and foreign participants in the market. In 1996, the exchange introduced dual capacity (broker and dealer) trading, negotiated commissions, and introduced a new automated trading system. By early 1999, the JSE expects to have in place a fully-electronic scripless system of clearance and settlement. The JSE is promoting greater cooperation among regional stock exchanges to facilitate regional economic integration, cross-border investment, and foreign participation in the market.

At present, the JSE has 59 members, 11 of which are controlled by foreign companies. Merrill Lynch has purchased a controlling interest in a local securities firm. As of August 31, 1998, the JSE ranked number 21 worldwide in terms of total market capitalization, but remains less liquid than other major world exchanges due to the close-held ownership structure among large South African conglomerates and continued foreign exchange controls. Nevertheless, turnover rose by 77 percent in 1997, reflecting in part the rapid increase in foreign participation in the market. Foreign net purchases of South African equities have risen from R5.3 billion in 1996 (US$815 million) to R26.6 billion (US$4.1 billion) in 1997. Foreign ownership is estimated at 9 percent of total capitalization.

Corporate restructuring of South Africa's large conglomerates, sparked by increased global competition, deregulation, and a refocusing on core business activities, is gradually bringing South African corporate structures into closer conformity with international norms. This has resulted in a broadening of ownership, elimination of corporate "pyramids," restrictions on non-voting shares, enhanced disclosure standards, and greater liquidity in the market. The South African government is currently preparing legislation on competition policy, corporate disclosure, and information dissemination to shareholders. A new Insider Trading Act, based on international best practices, has recently been approved by Parliament. The FSB will be responsible for the administration of this Act.

Market Activity of the Johannesburg Stock Exchange

	1996	1997
New Capital Raised (US$ billions)	6.1	10.3
Value Traded (US$ billions)	25	42.5
Volume Traded (billion shares)	9.0	17.9
Number of Deals (million)	1.4	2.3
Liquidity (percent turnover)	10.9	16.9
Net Foreign Purchases (US$ billions)	1.1	5.4

Source: JSE, converted to US$ at year-end exchange rates.

Mutual Fund Market

South Africa's mutual fund industry has seen rapid growth in recent years. Total unit trust assets were R78.8 billion (US$13.4 billion) in end-June 1998, a 39 percent increase over end-June 1997. The number of mutual funds available reached 165 in end-June 1998. Equity funds represent approximately 70 percent of total assets. Under South African exchange controls, unit trusts can invest 15 percent of their total assets abroad subject to arranging matching capital inflows. Five percent of fund assets must be invested in local money market instruments. As of August 1, 1998, offshore collective investment schemes marketed in South Africa must be registered with the local regulatory authority. Registration criteria include: (1) the home regulatory environment must be at least of the same standing as that applicable locally; (2) the collective investment scheme must enter into a representative agreement or maintain a representative office in South Africa; (3) the risk profile of investments offered must not be significantly higher than that of similar local products; (4) investments offered must be permitted by local legislation; and (5) minimum advertising and information disclosure requirements must be respected.

Futures and Options Market

SAFEX began operations in 1990 under a license issued by the Registrar of Financial Markets which authorizes it to regulate the trading of futures and options as the only derivatives exchange in South Africa. The exchange offers financial and commodity futures as well as options contracts. All trading is conducted electronically. Daily trading volume has risen from 200 contracts in 1990 to roughly 40,000 contracts in 1997. Some 96 percent of futures and options traded through SAFEX are based on JSE equity index futures (the All-Share Financial, Mining Financial, and Industrial indices), with trading volume over twice the value of trades in underlying equities. Futures on individual equities are permitted. A rand/dollar futures contract was listed in 1997 with limited success due to continued foreign exchange controls and a well-developed forward market.

SAFEX offers membership in two classes, clearing and non-clearing members. Clearing members must be registered financial institutions in South Africa with a minimum net worth of R200 million (US$31 million) and provide a surety to the clearing house of R10 million (US$1.5 million). A non-clearing member must have an initial capital of at least R400,000 (US$62,500) and satisfy the executive committee that it has entered into a clearing agreement with a clearing member based on that member's careful evaluation of the non-clearing member's financial standing and integrity. To date, two U.S. companies hold non-clearing memberships in the exchange via local subsidiaries, J.P. Morgan and Merrill Lynch. The U.S. Commodity Futures Trading Commission has pending before it an application for a "no action" position to permit the offer and sale to U.S. customers of the All-Share Index (ALSI40) futures contract, which is based on the JSE's top 40 companies.

U.S. PRESENCE IN THE MARKET

U.S. participation in the South African securities industry is expanding rapidly. Since 1994, several U.S. securities companies have obtained memberships in the JSE, BESA, and SAFEX. Many U.S. firms are active in providing underwriting services and arranging asset swaps for South African government and non-government institutions. Most do not have permanent representation in South Africa, servicing the market out of U.S. or European offices. Financial advisory services, including privatization, corporate restructuring, mergers and acquisitions, and foreign placements (including asset swaps) have provided lucrative service-based business for U.S. bank and nonbank financial institutions.

Foreign investment in South African equity and debt instruments is not subject to foreign exchange regulation. U.S. investors, both individual and institutional, have increased their presence dramatically.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

As noted above, there are no legal prohibitions on foreigners operating in the South African securities industry. Financial services currently constitute the most rapidly expanding sector of the economy, with South Africa occupying an important position in the region. Industry and government are working closely together to bring the securities industry into full conformity with international "best practices" on the basis of national treatment for foreign participants and technological innovation, with South African authorities committed to a leadership role for the region in GATS negotiations. A major issue will be the ability of local authorities to phase out exchange controls expeditiously to achieve full integration with world financial markets and remove the inhibiting effects of capital restrictions on foreign participants in the securities industry.

Exchange Rates Used:

August 1998	6.50 R/US$		
June 1998	5.87 R/US$		
Average 1997	4.61 R/US$	Year-end 1997	4.87 R/US$
Average 1996	4.30 R/US$	Year-end 1996	4.68 R/US$

TAIWAN

BANKING

SUMMARY

As of 1997, 45 foreign banks were operating 71 branch offices in Taiwan. Although liberalization led to the establishment of 16 new banks in the 1990s, 13 state-owned banks still dominate Taiwan's banking sector. They account for more than 60 percent of assets and deposits of all deposit-taking institutions. Over the past four years, Taiwan has lifted most restrictions on entry as branches or as subsidiaries. Most restrictions on foreign banks' operations have also been removed although both domestic and foreign banks are subject to strict prudential requirements.

The deposit-taking sector is regulated by a number of agencies on a job-division basis. In principle, Taiwan's Central Bank of China (CBC) supervises bills finance companies, investment and trust companies, banks set up prior to 1990, and, with a few exceptions, foreign banks. The Ministry of Finance's (MOF) Bureau of Monetary Affairs (BMA) inspects banks established after 1990. The Central Deposit Insurance Corporation oversees all community financial institutions enrolled in the deposit insurance system.

At the end of 1997, 14 U.S. banks had 25 branches in Taiwan. They are allowed access to the market on the island either as subsidiaries or branches. However, none have entered as subsidiaries. These U.S. banks, generally focusing on wholesale banking, account for around 2 percent of deposits and loans. They are very active in the foreign exchange and credit card markets: one of them ranks among the top five in the bank-to-customer foreign exchange market and has a 14 percent share of the credit card market.

The financial crisis in East Asia has led to a drop in Taiwan's exports, resulting in a slowdown in the economy, a cash flow problem for some firms, and a consequent increase in the bank nonperforming loan ratio to about 4 percent. Nevertheless, both domestic and foreign banks have reported relatively good results. Before tax profits in the first quarter of 1998 more than doubled (over the same period in 1997) to NT$63 billion for domestic banks, and those for foreign banks shot up more than 50 percent to NT$3.89 billion. While domestic banks are expanding their operations, the picture for foreign banks is mixed; there is continued interest in expansion of retail banking but some foreign banks are reducing treasury operations as foreign exchange trading has become more restrictive.

DESCRIPTION OF THE MARKET

Structure of the Market

Taiwan has a relatively large financial sector. As of the end of 1997, a total of 471 financial institutions operated 5,696 deposit-taking offices throughout the island. On average, each office served 3,800 persons on the island. These financial institutions included 92 banks, 64 credit cooperative associations, 314 credit departments of farmers' and fishermen's associations, and one postal savings system.

There were also 23 non-deposit taking financial institutions operating 97 branches all over the island, including five investment and trust companies, four securities finance companies, and 14 bills finance companies.

Banks

The banking community is composed of 92 banks. There were 47 domestic banks at the end of 1997, slightly more than the 45 foreign banks. However, domestic banks operated 2,176 branches, far more than the 26 branches of foreign banks. Domestic banks accounted for 66 percent of total deposits and 84 percent of loans for the entire deposit-taking community, including community financial institutions. Foreign banks' share was only 2.4 percent of deposits, and 3.2 percent of loans.

Foreign bank presence in Taiwan has taken the form of either branch and representative offices. Foreign banks have not established subsidiary or joint venture banks, although Taiwan does not forbid such options. The number of foreign bank offices (branches and representative offices) in Taiwan increased from 82 at the end of 1994 to 101 at the end of March 1998. During this period, the number of foreign banks having branches in Taiwan rose from 37 to 46. The number of branches (i.e., head offices plus additional branches) of these foreign banks grew from 57 to 74. The number of representative offices climbed from 25 to 27.

Only banks are authorized to operate the full range of foreign exchange businesses, which is a strong point for foreign banks. Foreign banks also specialize in trade related financing. They occupy a market share of 28 percent in foreign exchange deposits, 30 percent in foreign exchange trading volume, and 43 percent in export Letters of Credit (L/C) notification.

The banking community is dominated by the public sector. At the end of 1997, only 13 of Taiwan's 47 domestic banks were owned or effectively controlled by government agencies. However, these 13 government-affiliated banks accounted for 61 percent of bank assets, 60 percent of bank deposits, and 63 percent of bank credit. The Bank of Taiwan (BOT), owned by the Taiwan Provincial Government (TPG), is the largest bank on the island. The BOT accounts for 11 percent of total deposits accepted by all domestic and foreign banks. It accounts for 10.9 percent of total loans extended by all domestic and foreign banks. No law or regulation grants preferential treatment. In addition to commercial banking services, CBC contracts with BOT to issue NT dollar notes.

A number of the banks owned by the authorities have been assigned special policy duties. The Cooperative Bank of Taiwan (CBT), also owned by the TPG, is the *de facto* central bank for community financial institutions. The CBT, Land Bank of Taiwan (LBT), owned by the TPG, and Farmers Bank of China (FBC), owned by MOF, provide services to the community financial institutions.

Export-Import Bank (EIB), like its counterparts in the United States and other developed nations, offers credits to promote trade. Trade credits offered by the EIB include medium and long-term loans and credit guarantees to finance exports of turnkey plants, capital goods, and technical services. It also offers overseas investment credit and export insurance. Unlike other banks, the EIB does not take deposits from its customers.

The Central Trust of China (CTC) is not only a bank but the largest insurance agency in Taiwan. It operates a civil service employee insurance program covering several hundreds of thousands of civil service employees. In addition, it is the major public sector foreign procurement agent.

Overseas Banking Network

Taiwan banks have been very aggressive in building overseas banking networks. Since 1994, the number of their overseas offices has expanded by 70 percent, from 69 units to 117 units by the end of 1997, including 21 subsidiaries, 60 branches, and 36 representative offices. This expansion has been most significant in Southeast Asia; Taiwan bank offices in ASEAN (the Association of Southeast Asian Nations) increased nearly fivefold, to 34 units at the end of 1997, compared with only seven units four years earlier. During the same period, Taiwan banks' offices in the United States rose from 21 to 25 units.

Community Financial Institutions

Taiwan has a very large number of small community financial institutions. At the end of 1997, they numbered 378. One out of every three deposit-taking offices (head and branch offices) is a community financial institution. However, they accounted for only 12 percent of total assets and 17 percent of deposits, and 12 percent of loans of the entire deposit-taking sector. Community financial institutions fall into two categories: credit cooperative associations and the credit departments of farmers' and fishermen's associations. In principle, they may take deposits from and extend loans to their members only. They are required to place mandatory deposit reserves with the Cooperative Bank of Taiwan (CBT). When they are in need of accommodations, they must go to the CBT, Farmers Bank, or Land Bank of Taiwan. They may not go to the other banks directly. No foreign membership is allowed in community banking institutions.

Postal Savings System (PSS)

The PSS is affiliated with the Directorate General of Posts, and operates the largest number of deposit-taking offices. Its 1,527 branches throughout Taiwan accept nearly 15 percent of deposits taken by all deposit-taking institutions. In principle, PSS only takes deposits, and may not offer any loans to its depositors. It is required to place its deposits with domestic and foreign banks.

Merger and Transformation

In 1988, Taiwan lifted a ban on establishment of new banks. As a result, 15 new banks were established in 1990 and 1991. The Taiwan authorities have also adopted a policy to encourage investment and trust companies, and credit cooperative associations (CCAs) to merge or transform into banks. A series of bank runs at community financial institutions in 1995 accelerated this process of merger and transformation. Over the past six years, two out of eight investment and trust companies have been reorganized into commercial banks, while another has merged with an existing bank. The remaining five trust and investment companies are planning to reorganize into commercial banks. Since January 1997, five CCAs have been reformed into commercial banks and another five merged with commercial banks. As a result, the number of CCAs has fallen from 74 in 1994 to 64 in 1997.

Prudential Requirements

Taiwan's authorities have established prudential requirements for banks. Ownership may exceed neither 5 percent for each shareholder nor 15 percent per shareholder plus relatives and corporate entities under their control. Banks are forbidden from offering unsecured loans to shareholders controlling more than 3 percent ownership or bank executives. In addition to other prudential requirements, banks must meet the Bank for International Settlements (BIS) capital adequacy requirement that capital must exceed 8 percent of risk-weighted assets.

ATMs and Credit Cards

Automatic teller machine (ATM) services are common in Taiwan. From 1994 to 1997, the number of ATMs increased 74 percent, to 11,606 units. ATM cards in circulation doubled to 32.6 million, close to one and a half ATM cards for every person on the island. During this four-year period, transactions via ATM cards more than doubled, reaching US$148 billion.

Credit card business also expanded substantially between 1994 and 1997. There were 7.8 million credit cards in circulation at the end of 1997, a nearly threefold rise over four years ago. In the four-year period, expenditure with credit cards also increased almost threefold, to US$11.5 billion. Domestic and foreign banks can set up and operate their own ATMs and ATM networks. There are no restrictions on the number of ATMs set up by either a domestic or foreign bank. Credit card issuing institutions may process credit card bills by themselves. They may join the bill processing systems of the National Credit Card Center or the Financial Information Center. Credit cards issued by U.S. banks account for 17.5 percent of total credit cards in circulation. Most large U.S. banks in Taiwan have set up their own processing centers.

Foreign Exchange Trading

Taiwan has a relatively free foreign exchange market. Banks both domestic and foreign are all authorized to do foreign exchange business. They set their own buying and selling exchange rates. They may offer and trade in most financial derivatives, including forwards, swaps and options. Banks are required to obtain prior approval from the CBC before introducing new financial products to the market. Banks which intend to introduce products already present in the market need not obtain prior approval, but they must report them to the CBC for purpose of records. The size of the foreign exchange market has expanded substantially, and the trading volume totaled US$4.9 billion in December 1997, doubling its level of four years earlier. This total includes US$2.1 billion traded in the bank-customer market and US$2.8 billion at the interbank market.

Both foreign and domestic banks are subject to overbought and oversold positions which are set by the banks themselves and which must be reported to the CBC for the record. Trading in NT dollar-related derivatives may not exceed one-third of the position. Domestic and foreign banks may introduce new financial derivatives after prior approval is obtained from the CBC. Both domestic and foreign banks may introduce financial derivatives which already been approved by the CBC, although these banks must report the products introduction for the record.

To stabilize the foreign exchange market, due to the financial crisis in East Asia, the CBC partially closed the non-deliverable forward (NDF) market to domestic corporate entities in May of 1998. While the NDF market is still open to foreign institutional investors, the volume of trading has fallen dramatically. The CBC also has prohibited domestic and foreign banks from introducing new financial derivatives syndicated from two or more NT dollar related products. In addition, the CBC has stepped up monitoring over foreign exchange (FX) transactions and since July has required banks to instantly report by phone to the CBC any FX transaction exceeding US$5 million. Then, in mid-August, the CBC required an instant phone report for any FX transaction exceeding NT$1 million.

Offshore Banking Units (OBU)

A total of 72 OBUs were operating in Taiwan at the end of 1997, including 38 set up by domestic banks and 34 established by foreign banks. Their assets totaled US$39 billion at the end of 1997, up 46 percent from four years ago level.

The present requirement for foreign banks to set up an OBU is that they be among the top 500 worldwide in terms of assets. The CBC is considering further lowering the ranking criterion because no foreign bank without a commercial presence in Taiwan has ever set up an OBU. Treatment for foreign banks' OBUs is identical to that for domestic banks' OBUs. No restrictions are imposed on cross border activities of foreign and domestic banks' OBUs.

Regulatory Structure

In addition to internal controls, financial institutions are subject to regular and irregular examination. Authorities charged with banking examination include the Bank Examination Department (BED) under the CBC, the BMA under MOF, and the Central Deposit Insurance Corporation (CDIC). Supervisory responsibilities are shared among the three agencies as follows: BED supervises domestic banks (except the Changhwa Commercial Bank (CCB) and 16 new banks established after 1990, non-Asian foreign banks, bills finance companies (a company authorized to underwrite and issue commercial paper) and investment and trust companies (except Taiwan Development and Trust Corp. (TDTC) and China Development Corp. (CDC)) and business banks which do not participate in the deposit insurance program (except the Business Bank of Taiwan (BBT)). BMA oversees CCB, TDTC, CDC, BBT, the 16 post-1990 banks, and foreign banks from Asia. CDIC monitors credit cooperative associations, credit departments of farmers' and fishermen's associations, investment and trust companies, and business banks participating in the deposit insurance program. Taiwan sets no foreign ownership limit on bills finance companies. No foreign banks have ownership in such companies because banks are already permitted to do bills finance business, including issuing guarantees for commercial paper.

There are no restrictions on interest rates that banks can charge. A voluntary deposit insurance system covers 64 percent of foreign banks, 83 percent of domestic banks, and 88 percent of community financial institutions. The system guarantees up to NT$1 million per depositor.

Taiwan enacted the Money Laundering Prevention Law in April of 1997. The Ministry of Finance requires all financial institutions (including banks, trust and investment companies, postal savings system, insurance firms and jewelry stores) to report transactions (including deposits and withdrawals) of a person exceeding NT$1.5 million in a day to the Money Laundering Prevention Center. Banks and required institutions will be penalized for failure to record and report transactions suspected of money laundering.

U.S. PRESENCE IN THE MARKET

Fourteen U.S. banks operate 25 branch offices in Taiwan, an increase from 11 banks and 19 branches in 1994. They account for only 2.3 percent of bank deposits and 2 percent of bank loans. Most of them concentrate on wholesale banking. Although they account for only 3 percent of export letter of credit (L/C) loans and open only 6 percent of import L/Cs, these U.S. banks handle nearly one-fourth of the export L/C notification market. Since 1994, the number of U.S. representative offices declined from seven to three.

U.S. banks have been very active in the credit card business and foreign exchange trading, especially in the interbank market. Although it only operates nine offices around the island, Citibank is the largest foreign bank in Taiwan, and ranks among the top five in the bank-to-customer foreign exchange market; the other four are local banks. In addition, Citibank accounts for 14 percent of the credit card market here. It is one of a few foreign banks to achieve success in retail banking in Taiwan.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Taiwan has substantially liberalized the banking sector in the past four years. It has lifted a ban on foreign investment in local banks. Both domestic and foreign investors are subject to identical ownership limits, i.e., 5 percent per shareholder and 15 percent for all related groups. Establishment of Taiwan branches is no longer limited to the 500 largest banks in the world, if the bank's business transactions with Taiwan banks and enterprises have been large. A two-year waiting period requirement before establishment of additional branches has been dropped, as has a geographical restriction (under which foreign bank branches were limited to Taipei and Kaohsiung) and an annual quota for new branches (under which only three branches of foreign banks could be established a year). Also, the rule that foreigners may not exceed 10 percent of the entire staff of a bank office has been abolished.

The limit of 15 times local capital on a foreign bank's NT dollar deposits has been removed. Taiwan's authorities no longer forbid domestic and foreign banks from offering NT dollar credits secured by foreign exchange deposits as collateral. The authorities do not require all bank credits to be secured by collateral. Banks may, based on their best judgement, offer unsecured credit. Foreign currency credit is no longer limited to finance trade-related transactions. A restriction that commercial paper guaranteed by a foreign bank branch could not exceed ten times the bank's net worth has been lifted. These guarantees may be offered for commercial paper issued by individual persons. In addition, both domestic and foreign banks are permitted to underwrite and certify issuance of commercial paper.

In order to engage in certain transactions (e.g., perfecting a mortgage), Taiwan requires that a bank provide proof that the same privilege is available on a reciprocal basis to Taiwan institutions in the home jurisdiction of the foreign bank.

Taiwan's Ministry of the Interior (MOI) requires a foreign bank to produce a "certificate of reciprocity" issued by the government of its home country (or state in the United States) for its mortgage registration. Without such a certificate or statement, foreign banks are not permitted to process mortgage registrations at the land administration office. According to MOI, the requirement is based on the "Land Law" and the "Regulations Governing Acquisition of Land Rights by Foreigners." According to the MOI, 13 states have reciprocity arrangements with Taiwan, as follows: Ohio, Alaska, Tennessee, Florida, Massachusetts, New Jersey, Connecticut, Missouri, Delaware, California, Hawaii, Texas, Michigan and New York. For some U.S. banks with state charters, it has been difficult to obtain acceptable documentation of reciprocity.

In foreign exchange trading, the CBC has authorized banks to set their own overbought and oversold positions for internal control; the positions must be reported to CBC for record. CBC has replaced the foreign liability limit for a domestic and foreign bank with the foreign liability reserve requirement which CBC has not yet set. Capital funds borrowed from foreign sources are foreign liability, just like deposits which are a kind of on-shore liability. According to the CBC, a domestic and foreign bank must keep a required reserve for foreign liability, just like the required reserve that a bank must keep for deposits taken from customers. A domestic or foreign bank may introduce financial derivatives which have already been approved by CBC, although the bank must report the products' introduction to the CBC for record. The coverage of forward foreign exchange contracts has been expanded from a limited category of transactions to include all kinds of transactions which could be supported by documents.

Different standards are used to calculate the limits on lending to a single customer for domestic and foreign banks, but they generally favor foreign banks. For a foreign bank, total NT dollar loans for a single customer (a natural person or a corporate entity) may not exceed 10 percent of the bank's total lending portfolio or NT$1 billion, whichever is higher. For foreign banks, total foreign currency loans to a single customer may not exceed 25 percent of the net worth of the foreign bank's consolidated operations in Taiwan. So far, the lending of U.S. banks has not reached the ceiling, but the limits may become a constraint in the future as the scale of business of U.S. firms expands. For domestic banks, the limit on NT dollar loans is 3 percent of net worth for individuals and 15 percent of net worth for juridical persons (i.e., corporate entities). Loans with a term of over one year may not exceed the total fixed-term deposits of a bank, and residential construction loan exposure may not exceed 20 percent of savings deposits.

Foreign banks face difficulties in matching NT dollar loan and deposit maturities, due to the relatively underdeveloped interbank market, and the lack of longer-term debt instruments in the market. As Taiwan presses ahead with major infrastructure projects, such as independent power plants or the high speed rail project, which are have been or will be financed by medium and long term funds administered by the Council for Economic Planning and Development (CEPD), foreign banks have been effectively prevented from acting as arranger for loan facilities for these projects. CBC and CEPD insist that any arranger for these project loans using CEPD funds must meet onshore minimum net worth and total asset amount requirements (NT$20 billion and NT$100 billion, respectively), irrespective of the institution's global net worth or total assets. Although in principle exceptions to these criteria can be granted after special review by CEPD, the policy has imposed constraints on U.S. banks' ability to actively participate in the project financing market in Taiwan.

Taiwan's Financial System
December 31, 1997

Institution	Number of Firms	Domestic Branches	Assets (US$ millions)	Percent of Deposits
Domestic Banks	47	2,176	514,622	66.1
Foreign Banks	45	26	37,274	2.4
of which U.S. Banks	*14*	*10*	*15,288*	*1.4*
Credit Cooperatives	64	505	40,886	8
Credit Departments of Framers' & Fishermen's Associations	314	991	45,572	8.7
Postal Savings System	1	1,527	78,403	14.9
Investment & Trust Companies	5	61	14,434	n/a
Securities Finance Companies	4	2	7,781	n/a
Bills Finance Companies	14	34	50,967	n/a

TAIWAN

SECURITIES

SUMMARY

Securities in Taiwan are traded on a stock exchange or an over-the-counter (OTC) market. At the stock exchange, over 99 percent of trading is in equity shares. There are relatively few listed companies, but Taipei's very high turnover rate gives it the third largest annual trading volume in the world, second only to the stock exchanges in New York and London. Ninety-five percent of trading on the OTC market is in bonds, mostly issued by the public sector. Also traded on the OTC market are a few bonds issued by corporations or regional financial institutions, such as the Asian Development Bank (ADB). A futures exchange was established on July 21, 1998.

Over the past several years, many restrictions on foreign securities and futures firms seeking to operate in Taiwan have been lifted. Foreign firms may establish either branches or subsidiaries whose foreign ownership may reach 100 percent. However, U.S. securities firms have a limited presence, including two branches, five representative offices, and one subsidiary. One of Taiwan's 25 securities investment trust companies is 100 percent owned by a U.S. firm. Three of ten branches set up by foreign futures brokers come from the United States. Foreign investors' share of securities trading is very small, less than 2 percent.

Both U.S. (and other foreign) individual and institutional investors may engage in securities trading. Most restrictions on capital flows have been removed. However, foreign investors still face investment amount limits and foreign ownership limits.

DESCRIPTION OF THE MARKET

Taiwan has a stock exchange and an OTC market. The Taiwan Stock Exchange (TAIEX) is organized as a corporation, with 39 percent of the ownership held by state-run financial institutions and enterprises. The TAIEX is a venue for centralized securities trading. Equity shares of listed companies account for over 99 percent of total trading at the TAIEX. Beneficiary certificates of mutual funds, warrants, Taiwan Depositary Receipts (TDRs), and corporate bonds are also traded on the TAIEX. Government bonds are listed at the TAIEX, but no trading has been reported in the last three years.

Unlike the TAIEX, bonds account for 95 percent of trading on the OTC market. The OTC market is organized as a nonprofit institution, most of whose capital comes from the TAIEX, the Taiwan Securities Deposit Corporation, the Taipei Securities Firms Association, and the Kaohsiung Securities Firms Association. The four fund-contributors assign half of the trustees, while the government appoints the other half. Equity shares registered with the OTC market occupy the remaining 5 percent share. Repurchase agreements account for over 90 percent of the bond trading.

At the end of 1997, a total of 404 companies were listed on the TAIEX. The market value of their equity shares was US$297 billion. Despite the small number of listed companies (less than a quarter of that in Tokyo), trading volume, at US$1.3 trillion in 1997, ranked the third largest in the world, second only to the markets in New York and London, and 46 percent higher than the US$894 billion reported by the Tokyo Stock Exchange. The TAIEX's large trading volume is due to a very high turnover rate. On average, an equity share traded 368 times in 1997, compared with 66 times in New York, 44 times in London, and 33 times in Tokyo.

Also listed on the TAIEX at the end of 1997 were 7.5 billion beneficiary certificates belonging to 21 mutual funds and 164 million warrants belonging to seven issues.

Not many companies are listed on the OTC market. However, the number has increased tenfold in the past four years, from 11 at the beginning of 1994 to 114 at the end of 1997. The market value of registered equity shares increased 105 times, to US$31.5 billion. Trading volume on the OTC market in 1997 totaled US$1.5 trillion, nearly 50 percent greater than in 1996.

Outstanding bonds listed on the TAIEX and the OTC market at the end of 1997 included NT$1,034 billion (US$31.7 billion) of government bonds, NT$211.5 billion (US$6.5 billion) of corporate bonds, US$600 million of ADB bonds, ¥3 billion of ADB bonds, and NT$29.4 billion in NT dollar denominated bonds issued by the ADB, Central American Bank for Economic Integration, European Bank for Reconstruction and Development, Inter-American Development Bank, and Nordic Investment Bank.

Foreign companies listed on securities markets of 15 nations are permitted to list their equity shares and issue TDRs or corporate bonds on the TAIEX or the OTC market. However, as of January 1998, only one foreign company had issued TDRs on the TAIEX. No foreign company has ever listed equity shares or issued corporate bonds in Taiwan.

Taiwan companies are permitted to list their equity shares and issue Global Depositary Receipts (GDRs) or corporate bonds in any foreign securities market. As of the end of 1997, a total of 21 Taiwan companies had listed GDRs on major stock markets all over the world, including the New York Stock Exchange. Forty-five domestic firms have issued corporate bonds overseas, mostly in Europe. No Taiwan company has ever listed equity shares offshore.

Despite the Asian financial crisis, the TAIEX performed well in 1997 and 1998. The stock price index rose 18 percent in 1997 and another 11 percent in the first quarter of 1998. Trading volume in 1997 amounted to US$1,157 billion, nearly three times the level of the previous year. In the first quarter of 1998, trading volume rose by another 23 percent over the same period of 1997, to reach US$294 billion.

There were two million trading accounts on the TAIEX and 2.8 million accounts for trading on the OTC market at the end of 1997. Each investor may open more than one account. For instance, 160 foreign institutional investors have opened over seven thousand accounts for trading on the OTC market.

Individual investors dominate trading on both the TAIEX and the OTC market. In 1997, they accounted for 90.7 percent of trading at the TAIEX. The shares were only 7.6 percent for domestic institutional investors and 1.7 percent for qualified foreign institutional investors (QFIIs). Taiwan began to permit foreign individual persons and non-QFII foreign companies to trade in securities on the TAIEX and the OTC market in March 1996. The volume of trading by these non-QFII investors has been very small, although it has been increasing steadily.

On the OTC market, domestic institutional investors accounted for 22 percent of trading in registered equity shares in 1997. The share for foreign institutional investors was 2.4 percent. While smaller than on the TAIEX, the share of individual persons was still very high, at over 75 percent.

Taiwan investors are permitted to trade in securities listed on all stock exchanges of foreign nations, except the People's Republic of China (PRC). Trading may go through either of two channels, including a nondiscretionary foreign exchange trust program. Under this program, securities investment consultant companies may provide a client with consulting services. The client then enters into a "nondiscretionary trust agreement" with a bank that will convert the local currency into foreign currency for investment in designated foreign securities through a foreign broker. Trading in securities listed on foreign stock exchanges may also be done through domestic securities firms and branches of foreign securities companies which have membership at those foreign markets.

Taiwan first permitted offshore futures trading in 1993. By the end of 1997, a total of 184 futures products listed on 40 futures exchanges in 17 nations could be traded through 22 domestic brokers, who were required to submit trading bids to branches of ten foreign futures brokers for transmission to foreign futures markets. In August 1997, Taiwan permitted domestic investors to trade in offshore Taiwan stock price index futures; the main vehicle for this trading was a contract introduced by the Singapore International Monetary Exchange (SIMEX).

The Taiwan International Mercantile Exchange started operation on July 21, 1998. Initially, only stock price index futures were available for trading. Foreign investors are permitted to trade, though a foreign investor's trading volume may not exceed 30 percent of total inward remitted capital.

Institutional Investors

Insurance companies, banks, retirement funds, securities investment trust companies, and investment firms are major institutional investors. State-owned banks, the Postal Savings System, and such state-controlled funds as the Civil Service Retirement Program and the Labor Retirement Program have also been influential market players, and were organized into a stock market stabilization force by the authorities during the period of cross-strait tensions and PRC missile tests in early 1996. Trading by officially-controlled entities successfully stabilized the stock market during this period.

Taiwan's securities markets were opened to QFIIs in December 1990. QFII requirements have been relaxed many times since then. As of May 1998, a QFII must obtain approval from the Taiwan Securities and Futures Exchange Commission (TSFC), and must be (1) one of the top 1,000 non-communist banks, or (2) an insurance company with US$300 million or more in assets, or (3) a fund manager with at least US$200 million in assets, or (4) a securities company with net worth of US$100 million or more, or previous experience with Taiwan securities. As of the end of the 1997, a total of 346 foreign institutional investors had been approved to trade securities in Taiwan. Net of outward remittances, they had brought in investment funds totaling US$8.7 billion, of which 84 percent was kept in the form of equity shares, with the remaining 16 percent mainly in bank deposits and commercial paper.

In March of 1996, foreign individual investors and foreign companies other than QFIIs were permitted to trade in securities on the TAIEX and the OTC market. However, the maximum allowed portfolio investment is less for foreign individual investors and non-QFII foreign companies than for QFIIs. Investments by foreign persons are subject to limits on annual remittances, as well as various restrictions on the types and amounts of instruments in which they may invest. A total of 327 investors under this category were trading in equity shares by the end of 1997. Their inward remittances, net of outward remittances, totaled US$1 billion.

Regulation

The TSFC is the official regulatory agency under the jurisdiction of the Ministry of Finance. The TSFC chairman ranks just below a Vice Minister. The TSFC has eight divisions that oversee securities issuance, securities firms regulation, securities trading, futures trading, market regulation, inspection, and auditing.

The TAIEX and the Over-The-Counter Trading Center (OTCTC) are both self-regulating entities. The TAIEX is responsible for preliminary review of all listing applications, clearing and settlement, and examining operations and financial conditions of securities brokers and dealers.

Before floating equity shares or corporate bonds on the OTC market, companies are required to register with the OTCTC. Public bonds and bonds issued by ADB and other regional financial institutions are automatically listed on the TAIEX and the OTC market upon issuance.

U.S. PRESENCE IN THE MARKET

The U.S. presence in Taiwan's securities market is small. Of the 14 foreign securities companies operating branches in Taiwan, two come from the United States. One of them engages only in securities trading on the U.S. stock exchange on behalf of local clients. The other engages in brokerage, dealer, and underwriter services in addition to securities trading on the New York Stock Exchange. Five of the 14 representative offices of foreign securities companies are U.S. firms. These representative offices seek business for their offices outside Taiwan, chiefly underwriting the issuance of corporate bonds and GDRs by Taiwan companies. In addition, one U.S. firm operates a subsidiary on the island. Among Taiwan's 25 securities investment trust companies, one is 100 percent owned by a U.S. firm, while others have some U.S. ownership. U.S. firms have also established securities investment counseling firms to promote the sale of offshore funds in Taiwan.

U.S. firms also have a presence in the offshore futures brokerage business. Ten foreign firms have set up branches for futures brokerage: three of these are from the United States. No U.S. firms held ownership in the 21 local futures brokerage firms by the end of May of 1998. However, one U.S. firm is organizing a subsidiary whose ownership will be over 90 percent held by the U.S. company. According to TSFC, many of about 500 overseas mutual funds approved by TSFC for local investors to trade through non-discretionary foreign exchange trusts for investment in foreign securities are U.S. mutual funds.

Foreign institutional investors' share of securities trading was only 1.7 percent in 1997. TSFC cannot identify trading by U.S. institutional investors. Only a handful of Taiwan's 115 securities investment consultant companies have U.S. investment.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There has been significant liberalization of the securities sector in the past four years. The one-year waiting period to upgrade a representative office to a branch was dropped. Almost all foreign ownership restrictions have been abolished; U.S. firms may now create 100 percent owned subsidiaries, and they may now engage freely in joint ventures. Foreigners are allowed to establish 100 percent foreign-owned securities investment and trust companies (SITCs). However, if a foreign firm or individual invests in an SITC, that investment must be more than nominal. In March of 1996, TSFC set a minimum foreign ownership limit of 20 percent for foreign banks, insurance companies, and fund managers in an SITC. The purpose of this minimum ownership limit is to encourage foreign participation in the local market.

The limits on foreign ownership in futures brokerage firms were lifted in late 1996.

Foreign and domestic firms face the same capital requirements and, after establishment, may provide essentially the same services (including brokerage, dealing, underwriting, and securities financing). Both local and U.S. securities firms may provide brokerage services in foreign securities for local investors. The foreign securities markets on which both domestic and foreign securities firms may broker securities trading have expanded to include any stock exchange in the world, other than those in the PRC.

Most restrictions on repatriation of capital and earnings by foreign institutional investors have been removed.

U.S. securities firms continue to face discriminatory treatment in several areas, however. U.S. (and other foreign) qualified institutional investors are subject to a US$600 million investment limit per investor, which was raised from US$400 million in December 1996. The US$7.5 billion limit on aggregate foreign investment in the TAIEX was replaced by the foreign ownership limits in listed firms in 1995. Limits on foreign ownership in a listed company remain, although these ceilings have been raised several times over the past four years. As of October 1, 1998, these limits were 15 percent for an individual foreign investor and 30 percent for all foreign investors combined. Taiwan authorities have committed in their offer on financial services for their WTO accession to removing these ceilings by 2000.

Foreign individuals and foreign companies other than QFIIs now may trade in and hold equity and debt instruments listed on the TAIEX and the OTC market. However, they are subject to outstanding investment fund limits of US$5 million for each foreign individual and US$50 million for each non-QFII foreign company, which correspond to remaining capital flow restrictions.

In June 1997, Taiwan allowed domestic companies to list their stocks on any foreign stock markets. Meanwhile, Taiwan permitted foreign companies listed on stock markets of 15 nations (including the United States) to list their equity shares, TDRs, and corporate bonds on the TAIEX or the OTC market. It also permitted foreign companies not listed on the 15 designated markets to issue corporate bonds in Taiwan if they have a minimum credit rating of A (by Standard and Poor's or Moody's). In January 1998, the first TDR was issued by a foreign company. However, no corporate bonds have as yet been issued by foreign companies.

Despite the many positive measures undertaken by the Taiwan authorities, the overall environment for securities firms operating in Taiwan remains restrictive. Capital and exchange controls still in effect for large sums impede the range of operations, as do limitations on foreign institutional investors. Issues of securities by foreign issuers remain scarce due to stringent listing requirements. Marketing and sale of foreign mutual funds is heavily regulated and restricted. Although foreign firms may invest in or own securities firms in Taiwan, Taiwan law still forbids foreign individuals from being licensed as dealers, traders, brokers or underwriters.

In the past four years, Taiwan has fulfilled most of its commitments included in the GATS schedule negotiated as part of its accession to the WTO. These commitments have been designed principally to open markets to foreign investors. To some extent, Taiwan has gone beyond its GATS commitments. Foreign ownership limits on SITCs, securities investment consultant companies, and others have been lifted. Taiwanese securities authorities have allowed more foreign institutional investors to enter the market. Securities firms are not restricted to brokering, dealing, and underwriting. They may offer securities financing and other services. For underwriting of foreign listings by Taiwanese companies, foreign securities firms are no longer required to enter into an underwriting cooperation contract with a local underwriter. At present, Taiwan still maintains two limits on foreign ownership of a listed company, i.e., 15 percent for a single foreign investor and 30 percent for all foreign investors. Nevertheless, Taiwan is committed to removing these two limits by the year 2000. Taiwan currently bans foreign individuals from being licensed as dealers, traders, brokers or underwriters. Both foreign individual investors and foreign institutional investors are subject to investment fund limits which have been raised from time to time. As of yet, however, Taiwanese authorities have no timetable to abolish them.

Foreign institutional investors are no longer subject to capital flow restrictions. Non-deliverable forward (NDF) contracts have been opened to foreign institutional investors to hedge their foreign exchange risk but since the onset of the Asian financial crisis, the Central Bank of China has applied administrative controls to reduce the NDF positions of banks. Except for the restriction on NDF contracts, the Asian crisis has not led to any new barrier to market openness.

Trading Volume in Taiwan's Securities Market
(NT$ billions)

	1996	1997
Taiwan Stock Exchange	13,142.1	37,763.4
Equities	*12,907.6*	*37,241.2*
Beneficiary Certificates	*224.5*	*500.5*
Warrants	*0.0*	*2.0*
Convertible Corporate Bonds	*10.0*	*19.8*
OTC Market	28,741.0	42,682.9
Equities	*453.5*	*1,310.7*
Government Bonds	*28,287.5*	*40,372.2*
TOTAL	41,883.1	80,446.3
US$ (billions)	1,525.2	2,805.4

Notes: Exchange rates against the U.S. dollar are NT$27.46 in 1996 and NT$28.67 in 1997.

THAILAND

BANKING

SUMMARY

Over the past two years, the operations of Thai financial institutions were adversely impacted by several factors, ranging from a sharp deceleration in economic growth, a cautious monetary policy stance to safeguard economic and foreign-exchange stability, the Baht devaluation in mid-1997, political uncertainty, and regional financial turmoil. These factors resulted in tight Baht liquidity and rising levels of nonperforming loans. The Asian financial crisis caused a further tightening of banks' liquidity and exacerbated their asset quality and foreign debt problems. In order to restore confidence, banks had to improve their operations in step with the more stringent prudential regulations, such as required increased provision for non-performing loans (NPLs) and higher capital requirements. However, some medium and small sized Thai banks could not meet the more stringent provisions and re-capitalization requirements in the last quarter of 1997. Re-capitalization was extremely difficult amidst the sluggish stock market.

The Ministry of Finance has broad responsibility for financial sector policies, while the Bank of Thailand (BOT), the central bank, is more directly involved in bank supervision. In recent years, the Thai financial market grew rapidly but was poorly regulated and mismanaged. Now, under its IMF program, the government is attempting to bring financial sector practices in line with international standards by year-end 2000.

The Thai financial system will be fundamentally altered in the aftermath of the 1997 financial crisis. The government has absorbed large losses from the failure of most of the country's finance companies and a number of intervened banks. The government closed 56 of 91 finance companies in 1997 and assumed control of 12 finance companies and five of the smaller banks in 1998. By mid-1999, many observers expect that a combination of foreign investors and the Thai government will end up in control of a majority of the Thai financial system. However, the BOT plans to restructure and privatize, merge or close the six intervened banks, which are severely undercapitalized and have a large proportion of NPLs. By mid-1998, tightened BIS standards and stricter loan loss provisioning had improved transparency in the banking sector.

As of September 1998, there were 37 commercial banks in Thailand – 16 domestic and 21 foreign, including three U.S. banks. Since 1994, one domestic banking license and seven foreign full-branch licenses have been issued. In addition, there are 43 representative offices of foreign banks in Thailand, of which three are from the United States. The BOT has also issued 52 licenses to operate offshore banking units called Bangkok International Banking Facilities (BIBFs), of which 48 are in operation, including six American institutions.

Commercial bank assets totaled US$157.9 billion as of year-end 1997. Domestic Thai banks account for about 81 percent of commercial bank assets (compared to 91.5 percent in 1996), and foreign banks controlled the remaining 19 percent. The share of U.S. banking operations in Thailand is approximately 2.9 percent.

There are restrictions on foreign share ownership in locally incorporated banks, although these were relaxed in November 1997. To facilitate the re-capitalization of the financial sector, the BOT increased the level of permissible foreign ownership in domestic financial institutions and removed some tax disincentives. The June 1997 Emergency Decree Amending the Commercial Banking Act empowered the Minister of Finance to raise the 25 percent ceiling on foreign ownership of domestic banks on a case-by-case basis. In November the BOT announced that foreign investors would be allowed to hold more than 49 percent of the shares in existing financial institutions for a period of 10 years without the approval of the Ministry of Finance. After 10 years, foreign investors will not be forced to sell their shares but may not purchase any additional shares, until the amount of foreign shareholding falls to 49 percent of total shares.

There are also several restrictions on the expansion of foreign bank activities. A foreign bank is prohibited from opening more than three branches. In addition, the minimum BIS capital adequacy ratio requirement and legal lending limit for branches of foreign banks operating in Thailand are based on the locally held capital in the branch instead of the consolidated capital of the parent bank. The limit on the number of expatriate management personnel also hampers foreign banks' expansion and could restrict their scope of operations. Foreign banks are required to maintain minimum capital funds of Bt125 million (about US$3.1 million) invested in low-yielding government securities and other eligible papers (including state-owned enterprise and FIDF bonds) and foreign currencies.

On August 14, 1998, the Ministry of Finance and the BOT announced a financial sector restructuring program. The program makes available on a voluntary basis to banks and finance companies Tier 1 and Tier 2 capital, subject to certain conditions. Changes to the structure of the financial sector were also announced. When implemented, these changes will affect the number of banks and finance companies. The plan also calls for the privatization of all state owned banks and finance companies. Some regulatory and legal changes are also contemplated.

DESCRIPTION OF THE MARKET

Structure of the Market

There are now 37 commercial banks operating in Thailand – domestic banks (including a new state bank - Radhanasin Bank or RAB which operated in February 1998) and 21 full licensed branches of foreign banks. Since 1994, seven foreign banks have received full branch licenses, while only one additional domestic bank license has been issued. As of year-end 1997, commercial bank assets totaled US$157.9 billion. Locally incorporated Thai banks accounted for 81 percent of commercial bank assets; foreign banks controlled the remaining 19 percent.

Commercial banks also dominate deposit taking in Thailand. As of year-end 1997, domestic and foreign commercial banks held about 90 percent of all the deposits of deposit-taking institutions, up from two-thirds in 1992. The suspect conditions of many of the country's finance companies led to a surge in deposit transfers from finance companies to commercial banks during the second half of 1997.

Most commercial banking activities are dominated by the largest six locally incorporated banks: Bangkok Bank (BBL), Thai Farmers Bank (TFB), Krung Thai Bank (KTB), Siam Commercial Bank (SCB), Bank of Ayudhya (BAY), and Thai Military Bank (TMB). These banks accounted for a combined 61 percent and 78 percent of commercial banking sector loans and deposits, respectively, as of year-end 1997.

By September 1998, six smaller domestic banks and twelve finance companies had been nationalized. The BOT ordered sweeping management changes and write-downs of the capital in these banks. The Financial Institution Development Fund (FIDF), the central bank's financial arm, provided recapitalization through debt-to-equity swaps. As a result, the FIDF controls virtually 100 percent of the equity in these banks. The government has agreed with the IMF to develop a strategy to re-privatize or otherwise restructure the intervened banks.

After the lifting of the 25 percent foreign ownership limit, two small local banks attracted foreign investors. In March 1998, Thai Danu Bank (TDB) became the first commercial bank to sell a majority stake to a foreign investor, with the Development Bank of Singapore taking a 50.1 percent stake. Bank of Asia (BOA) sold a 75 percent stake to Dutch banking giant ABN AMRO.

Other banking institutions in Thailand include seven specialized financial institutions. Four are public sector banks – the Government Saving Bank (GSB) for small saving deposits, the Bank for Agriculture and Agricultural Cooperative (BAAC) for farm credits, the Government Housing Bank (GHB) for medium and low income housing mortgages, and the Export-Import Bank of Thailand (TEXIM). The other three specialized financial institutions include the Industrial Finance Corporation of Thailand (IFCT), the Small Industries Finance Corporation (SIFC), and the Small Industries Credit Guarantee Corporation (SICGC). The specialized financial institutions held a combined 15 percent of the financial system's assets as of year-end 1997.

There are also numerous nonbank financial institutions, particularly finance companies, life insurance companies, and savings and agricultural cooperatives. In early 1997, there were 91 finance companies which had provided the majority of home mortgages, car loans and loans to small businesses. Fifty-six finance companies are currently under liquidation, and their assets are being auctioned through the supervision of the Financial Sector Restructuring Authorities (FRA).

Over the past two years, the operations of financial institutions were buffeted by many factors, ranging from a sharp deceleration in economic growth, a cautious monetary policy stance to safeguard economic and foreign-exchange stability, the Baht devaluation in mid-1997, political uncertainty, and regional financial turmoil. These resulted in tight Baht liquidity and rising levels of nonperforming loans. The Asian financial crisis magnified the problems of Thai banks. The loss of domestic and foreign investor confidence caused runs on some banks and exacerbated their foreign debt problem. In order to restore confidence, banks had to improve their operations in step with the more stringent prudential regulations such as required increased provision for NPLs. However, some medium and small-sized Thai banks could not meet the more stringent provisions and re-capitalization requirements in the last quarter of 1997. Re-capitalization was extremely difficult amidst the sluggish stock market, while there was little success in negotiating with overseas investors due to unresolved NPLs. The NPL and foreign debt problems were the major reasons for the downgrading of Thai banks' foreign debts by international credit rating agencies several times in 1997. In mid-1998, an increasing number of Thai companies elected not to service current bank debt. As a result, Thai banks are facing a continued rising trend in nonperforming loans.

There is only one type of full banking license available to both foreign and locally incorporated banks. However, both locally incorporated and foreign banks are permitted to operate offshore banking units under the Bangkok International Banking Facility (BIBF). By year-end 1997, 52 banks (including 6 U.S. banks) had been issued BIBF licenses, compared with 47 (including 6 U.S.) as of year-end 1994. The offshore banking units are limited in their operations as follows: (1) Acceptance of deposits and borrowing of funds must come from sources outside Thailand; (2) Repayments of deposits or borrowed funds or interest thereof, or draw down of loans by borrowers of the BIBFs for international lending, must be transacted outside the country (or out-out transactions); and (3) Each disbursement from BIBFs for domestic lending must be at least US$500,000 for export-related activities or US$2 million for other types of activities, or the equivalent in other currencies at market exchange rates (or out-in transactions). In June 1998 the BOT authorized BIBFs to issue letters of credit and extend credit in the form of trust receipts in foreign currencies.

In 1954, a Thai bank opened its first overseas commercial branch. At the end of 1997, Thai commercial banks were operating 54 overseas branches, 36 of which were in Asia. At the end of 1997, Thai banks operated three agencies and five branches in the United States.

On August 14, 1998, the Ministry of Finance and the BOT announced a financial sector restructuring program. The program makes available on a voluntary basis to banks and finance companies Tier 1 and Tier 2 capital, subject to certain conditions. Changes to the structure of the financial sector were also announced. When implemented, these changes will affect the number of banks and finance companies. The plan also calls for the privatization of all state owned banks and finance companies. Some regulatory and legal changes are also contemplated.

Banking Regulation

Commercial banks in Thailand are governed by the Commercial Banking Acts of 1962 and 1979, amended in 1985 and 1992. According to the Commercial Bank Acts, the Ministry of Finance has broad responsibility for financial sector policies, while the BOT is more involved in day-to-day supervision of banks. Licenses are issued by the Ministry of Finance. Numerous changes to the role of the BOT were being considered in mid-1998, including removing bank supervision to an independent agency.

Finance companies in Thailand are governed by the 1979 Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business and subsequent amendments. Responsibilities for licensing and regulating finance companies are divided among the Ministry of Finance and the BOT in the same manner as for banks.

There is no formal government or private sector deposit insurance in Thailand. The Ministry of Finance provides financial assistance and managerial experience to troubled banks through the FIDF. However, Thai authorities, under the IMF program, will have to finalize a plan for the introduction of a deposit insurance scheme to replace the current blanket guarantee in the medium term by the end of 1998. As part of the IMF program, the government has guaranteed all depositors and creditors of the currently open financial institutions. Holders of promissory notes from the closed finance companies can exchange those notes for certificates of deposit issued by Krung Thai Bank or Krung Thai Thanakit.

Thailand's financial liberalization without adequate regulation contributed greatly to the current downturn in both financial and capital markets. Substantial inflows of foreign capital mounted in 1993 when the BIBFs were introduced, resulting in accelerating investment and consumption as borrowers were afforded access to foreign loans at costs lower than for domestic borrowing. However, most of the foreign currency loans were short-term, while the funds were re-lent at longer terms in Baht or tied to domestic projects which would generate only long-term returns in Baht. Although the BIBF facilities were initially intended to fund imports for Indochina, the hard currency financing soon attracted Thai entrepreneurs who did not hedge their exposure assuming the Baht would remain pegged to the dollar. The effect of these flows was soon reflected in aggregate statistics. Total private credits extended by commercial banks (including BIBFs) and finance companies climbed and in 1995 accounted for 85 percent of total credit outstanding extended by all financial institutions in Thailand. The current account deficit surged to 8 percent of GDP in 1995-96. The debt/export ratio rose significantly to 121.2 percent in 1996 from an average of 109 percent in the period of 1991-95.

Extensive forward commitments in defense of the Baht gradually exhausted available foreign reserves, resulting in an effective float of the currency on July 2, 1997. Subsequent depreciation triggered a sharp economic decline and exposed substantial weaknesses in the financial sector.

Under its agreement with the International Monetary Fund (IMF), the Thai government intends to bring the financial sector into line with international standards by the end of 2000. Effective January 1, 1999, financial institutions are required to cease accruing interest income on any account where interest payments have not been received for three months (instead of six months). Effective July 1, 1998, banks are required to classify loans for which payments have not been made for three consecutive months as NPLs. New provisioning for such non-performing loans is to range between 20 percent and 100 percent depending on loan classification using primarily qualitative criteria. In addition, 1 percent and 2 percent provisioning will be required for ordinary and "special mention" loans (those delinquent less than three months), respectively. Originally, financial institutions are allowed to fully meet the requirements by year 2000. However, under the financial sector restructuring package announced on August 14, 1998, the central bank will provide capital through an exchange of ten-year government bonds to domestic banks and finance companies under certain conditions. One of the conditions requires that institutions must advance year-end 2000 loan classification and provisioning rules before applying for the Tier 1 capital scheme, which will be made available in the form of tradable 10-year government bonds for institutions' preferred shares.

The financial sector restructuring will require substantial funds. To encourage private recapitalization efforts, the authorities removed some tax disincentives and relaxed regulations which limited foreign ownership of Thai financial institutions to 25 percent.

U.S. PRESENCE IN THE MARKET

Foreign banks may establish full-licensed branches or representative offices in Thailand. Besides obtaining full-branch license from the Ministry of Finance, foreign banks (including U.S.) can take over local banks. In November 1996, seven international banks operating the BIBF program were upgraded to full-branch business, although none were from the United States.

There are three U.S. banks with full branches: Citibank, Chase Manhattan Bank, and Bank of America. At the end of 1997, American banks accounted for 2.9 percent of Thailand's commercial banking assets, compared to 1.8 percent in 1996. All three have received licenses to operate offshore banking units under the BIBF program. Three other American banks – American Express Bank, Bank of New York, and Bankers Trust – also have received licenses to operate BIBF units. An additional three U.S. banks (Union Bank of California, CoreStates Bank, and the First National Bank of Boston) maintain representative offices in Thailand. CoreStatesBank's representative office will be officially changed to First Union Bank in November 1998.

In spite of the branch restrictions, some U.S. banks such as Citibank have diversified their businesses into retail banking due to adequate manpower. Expansion in credit card business is their main strategy to increase their customer base in Thailand. Citibank has the largest deposit base of any foreign bank. However, U.S. and other foreign banks remain relatively small players in traditional deposit taking and lending business relative to domestic Thai banks. Most foreign banks focus on wholesale businesses rather than retail business, in large part due to branching limitations. During the past four years, foreign banks such as Bank of America have played an important role in capital markets activities (especially capital raising through syndicated loans or Yankee bonds for local large corporations), investment banking (merger and acquisition activities) and risk management.

Prior to the financial crisis, the main foreign competitors of U.S. banks in terms of technology were banks from European countries. However, Thai banks with foreign bank partners, such as Bank of Asia and ABN AMRO, are now viewed as competitors because of the amalgamation of technological know-how and branch networks.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks are subject to a number of restrictions on expansion. A foreign bank is limited to three branches, a modest improvement from only one in 1994. Two of these branches must be outside Bangkok and adjacent provinces if the foreign bank does not have a Provincial International Banking Facility (PIBF) license. (If a commercial bank is authorized to operate International Banking Facilities (IBFs) in Bangkok, it is known as a BIBF; if an authorized bank established an IBF in a province, it is known as a PIBF.) Currently, none of the foreign full-license banks has more than one branch. An offsite standalone ATM is considered an additional branch. Several foreign banks have applied to the BOT to open additional full branches, but no approvals have been granted to date.

The government can require that foreign banks desiring to establish full licensed branches first open a representative office and apply for a BIBF license. Eligible applicants must be of reputable and accredited standing and be registered in a country with high supervisory standards. Although the BOT will establish a minimum capital fund requirement for each round, the effective minimum is understood to be Bt500 million (US$12.4 million).

The number of expatriate management personnel is limited to six persons, which also hampers foreign banks' expansion and could restrict their scope of operations. Foreign banks that operate BIBF affiliates, however, are allowed to have two additional expatriate personnel. Foreign representative offices can have no more than two expatriate management personnel. Foreign bankers say that the quotas have not been an impediment and that the BOT has been flexible and willing to authorize additional expatriates on a case-by-case basis.

Foreign banks are required to maintain minimum capital funds of Bt125 million (about US$3.1 million) invested in low yielding government securities and other eligible papers. This counts towards fulfillment of capital to risk ratios. All banks (foreign and domestic) are required to keep an equivalent of 8.5 percent of their risk assets invested in low-yielding government securities, other eligible papers, real estate assets (not more than 20 percent of the capital funds) or deposited at the central bank.

There are also restrictions on foreign share ownership in domestic banks, although the BOT recently increased the level of permissible foreign ownership in domestic financial institutions in November 1997 to facilitate the re-capitalization of the financial sector. Before this date, foreign investors could not takeover local banks but could purchase bank shares up to a 25 percent ceiling. In addition, each local bank typically allowed foreign participation less than the legal limit. The 25 percent legal ceiling on foreign ownership was raised to 49 percent in November 1997. The BOT announced that foreign investors with sound financial status and high potential to help increase the management efficiency of domestic financial institutions shall be allowed to hold more than 49 percent of the shares in existing financial institutions for a period of 10 years, with the approval of the Ministry of Finance. After 10 years, foreign investors will not be forced to sell their shares but may not purchase any additional shares, until the amount of foreign shareholding falls to within 49 percent of total shares. The authorities reserve the right not to allow a foreign bank that has more than 49 percent stake in a Thai bank to have an additional full branch in Thailand.

A foreign bank seeking approval to acquire a shareholding in a Thai bank must have sound financial status and possess high potential to help increase the managerial efficiency of the underlying institution. "Sound financial status" is understood to entail assets of at least Bt1,000 million (US$24.8 million).

Foreign banks can now participate in domestic ATM networks. In 1997, foreign banks were allowed to install ATMs at their branch premises, and foreign banks with full-branch licenses are able to pool existing ATM networks with Thai banks with a certain fee requirement per transaction. Tokyo-Mitsubishi and Hong Kong & Shanghai have already made such arrangements. There is no report of US banks participating in the pooling scheme.

The BIS capital adequacy ratio and legal lending limit for branches of foreign banks operating in Thailand are based on the locally held capital in the branch instead of the consolidated capital of the parent bank. The BOT requires all commercial banks operating in Thailand (including foreign banks) to limit their lending transactions to 25 percent of their first tier capital base (or local capital base for foreign banks) for a single borrower for risk management purposes. Foreign banks see this as a barrier due to their significantly smaller local capital base compared to domestic banks. In late 1997, foreign banks petitioned for a relaxation of the regulation. The Thai central bank has not yet responded.

Fourteen Thai banks (all but Radhanasin and the Bangkok Bank of Commerce) belong to the Thai Bankers Association (TBA), which presents banks' views to the government on financial issues and has cooperated in the drafting of banking legislation. All 21 foreign incorporated banks and some foreign representative offices are members of the Foreign Bankers Association (FBA), whose functions are similar to those of the TBA.

Thailand's GATS commitments largely reflect the current regulatory environment. The major exception occurs in practice, but is not formalized in regulation. A foreign bank which purchases a majority share in a local bank (for example, ABN AMRO's purchase of Bank of Asia) will be allowed to continue operating that bank under the rules pertaining to domestic banks.

Deposits of Domestic Commercial Banks in Thailand
Year-end 1997

Bank	Deposits (US$ millions)	Market Share (percent)
1. Bangkok Bank	20,032	23.2
2. Thai Farmers Bank	12,452	14.4
3. Krung Thai Bank	12,275	14.2
4. Siam Commercial Bank	11,830	13.7
5. Bank of Ayudhya	8,234	9.5
6. Thai Military Bank	5,451	6.3
7. Siam City Bank	3,346	3.9
8. First Bangkok City Bank	2,785	3.2
9. Bangkok Bank of Commerce	2,103	2.4
10. Thai Danu Bank	1,902	2.2
11. Bangkok Metropolitan Bank	1,702	2.0
12. Bank of Asia	1,695	2.0
13. Union Bank of Bangkok	1,024	1.2
14. Nakornthon Bank	990	1.2
15. Laem Thong Bank	563	0.7
16. Radhanasin Bank	Operating in February 1998	-
TOTAL	86,383	100.0

Exchange Rate: 47.25 Bt/US$

Deposits of Domestic Commercial Banks in Thailand
Year-end 1997

Bank	Deposits (US$ millions) Forex = Bt47.25/US$	Market Share (percent)
1. Bangkok Bank	20,032	23.2
2. Thai Farmers Bank	12,452	14.4
3. Krung Thai Bank	12,275	14.2
4. Siam Commercial Bank	11,830	13.7
5. Bank of Ayudhya	8,234	9.5
6. Thai Military Bank	5,451	6.3
7. Siam City Bank	3,346	3.9
8. First Bangkok City Bank	2,785	3.2
9. Bangkok Bank of Commerce	2,103	2.4
10. Thai Danu Bank	1,902	2.2
11. Bangkok Metropolitan Bank	1,702	2.0
12. Bank of Asia	1,695	2.0
13. Union Bank of Bangkok	1,024	1.2
14. Nakornthon Bank	990	1.2
15. Laem Thong Bank	563	0.7
16. Radhanasin Bank	Operating in February 1998	-
TOTAL	86,383	100.0

Credits of Domestic Commercial Banks in Thailand
Year-end 1997

Bank	Credits (US$ millions) Forex = Bt47.25/US$	Market Share (percent)
1. Bangkok Bank	21,511	21.7
2. Thai Farmers Bank	12,333	12.4
3. Krung Thai Bank	13,821	13.9
4. Siam Commercial Bank	11,636	11.7
5. Bank of Ayudhya	8,373	8.4
6. Thai Military Bank	6,236	6.3
7. Siam City Bank	4,841	4.9
8. First Bangkok City Bank	5,854	5.9
9. Bangkok Bank of Commerce	2,845	2.9
10. Thai Danu Bank	2,375	2.4
11. Bangkok Metropolitan Bank	3,372	3.4
12. Bank of Asia	2,771	2.8
13. Union Bank of Bangkok	1,198	1.2
14. Nakornthon Bank	1,235	1.2
15. Laem Thong Bank	883	0.9
16. Radhanasin Bank	Operating on February 1998	-
TOTAL	99,285	100.0

Deposits of Foreign Commercial Banks in Thailand*
Year-end 1997

Bank	Deposits (US$ millions) Forex = Bt47.25/US$	Market Share (percent)
1. Citibank	892	22.6
2. Bank of Tokyo-Mitsubishi	648	16.4
3. Hong Kong & Shanghai	434	11.0
4. Sakura Bank	427	10.8
5. Standard Chartered Bank	382	9.7
6. Deutshe Bank (Asia)	289	7.3
7. Credit Agricole Indosuez	152	3.8
8. Bank of America	143	3.6
9. ABN AMRO Bank	116	2.9
10. Intl. Comm. Bank of China	72	1.8
11. Chase Manhattan Bank	57	1.4
12. Bharat Overseas Bank	49	1.2
13. Oversea Chinese Banking Corp.	27	0.7
14. Sime Bank Berhad	9	0.2
15. Dresdner Bank AG.[1]	16	0.4
16. The Industrial Bank of Japan[1]	82	2.1
17. The Sumitomo Bank[1]	119	3.0
18. The Bank of China[1]	13	0.3
19. The Dai-Ichi Kangyo Bank[1]	27	0.7
20. Banque Nationale de Paris[1]	1	0.0
21. Bank of Nova Scotia** [1]	0	0.0
TOTAL	3,955	100.0

*Note : * Excluding BIBF operation, ** Scheduled to operate on July 2, 1998*

1] New full-branch licenses

Credits of Foreign Commercial Banks in Thailand
Year-end 1997

Bank	Credits (US$ millions) Forex = Bt47.25/US$	Market Share (percent)
1. Citibank	1,496	6.9
2. Bank of Tokyo-Mitsubishi	3,909	18.1
3. Hong Kong & Shanghai	1,203	5.6
4. Sakura Bank	2,538	11.8
5. Standard Chartered Bank	646	3.0
6. Deutshe Bank (Asia)	615	2.8
7. Credit Agricole Indosuez	450	2.1
8. Bank of America	620	2.9
9. ABN AMRO Bank	432	2.0
10. Intl. Comm. Bank of China	114	0.5
11. Chase Manhattan Bank	899	4.2
12. Bharat Overseas Bank	28	0.1
13. Oversea Chinese Banking Corp.	182	0.8
14. Sime Bank Berhad	27	0.1
15. Dresdner Bank AG.[1]	315	1.5
16. The Industrial Bank of Japan[1]	1,543	7.2
17. The Sumitomo Bank[1]	3,440	15.9
18. The Bank of China[1]	76	0.4
19. The Dai-Ichi Kangyo Bank[1]	2,545	11.8
20. Banque Nationale de Paris[1]	370	1.7
21. Bank of Nova Scotia** [1]	135	0.6
TOTAL	21,582	100.0

*Note : * Excluding BIBF operation, ** Scheduled to operate on July 2, 1998*
1/ New full-branch licenses

Assets of Foreign Commercial Banks in Thailand
Year-end 1997

Bank	Assets (US$ millions) Forex = Bt47.25/US$	Market Share (percent)
1. Citibank	2,530	8.3
2. Bank of Tokyo-Mitsubishi	4,553	15.0
3. Hong Kong & Shanghai	1,808	5.9
4. Sakura Bank	3,366	11.1
5. Standard Chartered Bank	1,127	3.7
6. Deutshe Bank (Asia)	1,071	3.5
7. Credit Agricole Indosuez	705	2.3
8. Bank of America	912	3.0
9. ABN AMRO Bank	818	2.7
10. Intl. Comm. Bank of China	163	0.5
11. Chase Manhattan Bank	1,071	3.5
12. Bharat Overseas Bank	66	0.2
13. Oversea Chinese Banking Corp.	206	0.7
14. Sime Bank Berhad	46	0.2
15. Dresdner Bank AG.[1]	780	2.6
16. The Industrial Bank of Japan[1]	2,730	9.0
17. The Sumitomo Bank[1]	3,980	13.1
18. The Bank of China[1]	166	0.5
19. The Dai-Ichi Kangyo Bank[1]	3,476	11.4
20. Banque Nationale de Paris[1]	580	1.9
21. Bank of Nova Scotia** [1]	283	0.9
TOTAL	30,436	100.0

*Note : * Excluding BIBF operation, ** Scheduled to operate on July 2, 1998*
1] New full-branch licenses

Numbers of Operating Commercial banks and BIBFs

	1995	1996	1997
Thai commercial banks	15	15	15
- number of branches *(excluding headquarters)*	2,957	3,138	3,284
Foreign full-branch banks	14	14	21
BIBFs			
- Thai commercial banks operating BIBFs	12	12	12
- Foreign full-branches operating BIBFs			
BIBF	11	11	17
PIBF	5	10	10
- Foreign operating BIBFs			
BIBF	20	19	19
PIBF	20	20	20

Note : BIBF = Bangkok International Banking Facilities, PIBF = Provincial International Banking Facilities

THAILAND

SECURITIES

SUMMARY

Thailand's capital market has gradually increased in importance since the April 30, 1975 establishment of the Securities Exchange of Thailand (old SET). Rapid growth in the Thai economy in the 1980s fostered the development of the domestic equity market. In order to increase supervisory efficiency, the Thai government established the Securities and Exchange Commission (SEC) on May 16, 1992, and the old SET was reformulated as the Stock Exchange of Thailand (SET). The SET is the secondary equity market and is largely self-regulated for day-to-day operations.

The Thai capital market was one of the fastest growing in the region during 1980s. However, it has been battered by the 1997 economic and financial crisis. Between January 1997 and mid-1998, the SET lost two thirds of its value, and declined still further in dollar terms due to the depreciation of the baht. Various measures were then introduced to shore up the market, including financial liberalization.

Following the 1997 financial crisis, foreign ownership limits for securities firms were relaxed. At least 13 firms have been purchased by foreign interests, including several by American firms.

DESCRIPTION OF THE MARKET

Regulatory Structure

Thailand passed the Securities and Exchange Act of 1992 (SEA), repealing the 1974 Act and establishing the Securities and Exchange Commission (SEC) as the sole regulatory authority for the Thai capital market. Specifically, the SEA empowered the SEC to supervise all securities companies including sub-brokerage firms. (A sub-broker is a firm that is licensed by the SEC to conduct securities business but does not have a seat on the SET and therefore cannot execute its own trades.) The SEC supervises and approves all primary securities issues. In addition, the SEC also plays an important policy role in supervising secondary markets (i.e., equity and bond exchanges). Previously, such regulatory authority was shared between several agencies and the old Securities Exchange of Thailand.

Pursuant to the SEA of 1992, corporate issuers of equity-related securities and debt instruments must receive approval and file "extensive financial information" with the SEC. This includes draft prospectuses and regular financial statements. Listed companies, and those intending to make public offerings, must report without delay: (1) serious damage to the company; (2) the interruption or suspension of operations; (3) changes in corporate objectives or lines of business; (4) contractual changes in company operation or management; (5) involvement in a takeover bid (as defined by Section 247 of the SEA); and (6) any event that will have a bearing on the rights of securities holders or which will affect investment decisions or the prices of securities.

The Act defines securities to include treasury bills, bonds, bills, shares, debentures, unit trusts, share warrants, debenture warrants, unit trust warrants, and other instruments as specified by the SEC. Government securities and bonds with principal and interest guaranteed by the Finance Ministry, however, are exempted from the approval and filing process. The SEC intends to further upgrade information disclosure requirements on the Thai capital market to comply with international standards.

Under the 1992 Act, the old SET was restructured as a nonprofit organization to serve as the main secondary market for trading securities including ordinary shares, preferred shares, unit trusts, warrants, debentures, and convertible debentures. The official name was changed to the Stock Exchange of Thailand. The SET's operations are financed by listing, membership, and securities registration fees.

The SET is self-regulated to some extent and is overseen by a board composed of 11 persons. Five are appointed by the SEC. Five others are selected by the members of the SET. The president is appointed by the 10 other board members. The SET has broad powers to enforce accounting standards and disclosure rules but not legal issues related to unfair trading practices. Major rules adopted by the SET must receive prior approval from the SEC.

In addition, the SEA provides a more open and flexible legal framework for new securities issues. Securities listed on the SET are ineligible to be traded on any other exchange. On November 14, 1995, the Bangkok Stock Dealing Center (BSDC) – or the organized OTC market – was established to bolster the liquidity of securities which are offered to the public but are unqualified to be traded on the main SET. At the end of 1997, there were only three securities registered for trading in the BSDC.

The Debt Markets

A major component of debt markets is the commercial paper or B/E (bill of exchange) market, in which B/Es are typically issued on a bearer (non-registered) discount basis. The commercial paper market was probably the most active debt market from 1992-96. However, trade volumes have declined sharply because of deteriorating credit quality.

Thailand's bond market dates from 1933 when the Finance Ministry issued the first government bond. During its initial stage, the market was dominated by government bonds which were normally issued to finance infrastructure projects. Corporate bonds became more common after 1992 when the SEA eased regulatory impediments. Corporations had previously mobilized funds through loans and overdrafts from financial institutions and through the equity market.

Despite helpful provisions in the SEA, Thailand's bond market developed relatively slowly due to the absence of a secondary market for debt instruments. Hence, in 1994, a dealer's network serving as the central channel for all bond trading was established under the name of the Bond Dealers Club (BDC). The introduction of the BDC has led to significant market development for bond trading. The issuance of domestic bonds grew 140 percent from Bt215 billion (US$8.5 billion) in 1992 to Bt526 billion (US$16.8 billion) in 1997. Moreover, the year-end value of registered bonds with the BDC rose from 29 issues worth Bt32.5 billion (US$1.3 billion) in 1994 to 131 issues worth about Bt170 billion (US$5.4 billion) in1997.

The Thailand Rating Information Service (TRIS) was also formed around the same time to support the bond market infrastructure. However, it did not gain wide acceptance by sophisticated investors.

Thailand considers development of the bond market to be a strategic element in the overall development of its financial system. In April 1998, with the approval of the SEC, the BDC was restructured and transformed into the Thai Bond Dealing Center (Thai BDC) to cover Thailand's secondary market for bond-trading. The expansion was intended to improve market efficiency through higher standards and upgraded facilities. Like the SEC, the Thai BDC is self-regulated but subject to SEC oversight. It is governed by a Board of Directors and the Executive Boards. The Thai BDC's widely-used trading system is called BONDNET (an electronic screen trading system), which was originally developed by the Bond Dealers Club.

Bond trading in the secondary market remains at relatively low volumes, as the supply of good quality bonds is limited. As the Thai government ran a sizable budget surplus every year from 1988 until 1996, government bonds are scarce. Guaranteed state-enterprise bonds, albeit relatively common, are not widely traded. Instead, they are held by financial institutions as part of their reserve requirements. Consequently, government (and state-enterprise) bonds rarely trade in the secondary market. This in turn has led to difficulty in determining medium and long-term pricing benchmarks for both issuers and investors in corporate debt.

In addition, during the economic and financial turmoil after the Baht devaluation in mid-1997, many foreign rating agencies downgraded Thai sovereign debt as well as specific corporate issues. These downgrades resulted in a higher risk premium, making it more expensive for Thailand to mobilize foreign-currency denominated capital. As of July 1998, the yield spread of Thai long-term overseas debt was more than 400 basis points above U.S. Treasuries. This contrasts with the 90 basis point spread for Thailand's April 1997 US$600 million Yankee Bond issue. By the end of August 1998 the spread had increased to 800 basis points above U.S. Treasuries, although it had declined to 650 basis points by early October.

The Equity Market

Securities trading in Thailand has a relatively short history. Companies began acting as intermediaries for securities transactions in 1953, but volumes were negligible. In 1962, several Thai entrepreneurs and their foreign partners formed the Bangkok Stock Exchange. There were few listings and very little trading on that market. After several years of study by the Bank of Thailand and the Finance Ministry, the Securities and Exchange Act of 1974 was enacted and the old SET began operations on April 30, 1975.

In its early years, the old SET, like its predecessor, also saw little trading. Spurts of trading activity were based on short-term speculation. However, beginning in 1986, securities trading on the old SET gathered momentum. The rapid growth and development of the Thai economy, foreign investor interest, and the government's financial liberalization policies provided momentum for the growth of the old SET and its successor, the SET. By 1996, trading volume had grown to 20 billion shares, worth Bt1,303 billion (US$52 billion).

However, in 1997 the equity market collapsed, battered by the economic and financial crisis. In the primary market, the number of new corporate securities issues declined substantially. New corporate domestic issues fell from Bt174.2 billion (US$6.9 billion) in 1996 to Bt81.7 billion (US$2.6 billion) in 1997, or 53 percent in Baht terms. New corporate issues abroad dropped from Bt113.9 billion (US$4.5 billion) in 1996 to Bt32.2 billion (US$1.0 billion) in 1997, or 72 percent in Baht terms. In the secondary market, the SET lost half of its value falling from the year's open of 803.13 points to below 400 points and continued its downward trend through the first half of 1998. (By July1998 the SET fell to 258.) During 1997, the SET's market capitalization slumped by 56 percent to Bt1,133.3 billion (US$36.1).

The first signs of the impending equity market crisis appeared midway through 1996 as pressure grew from speculative attacks on the Thai Baht and weakening economic fundamentals. On July 2, 1997, the flotation of the Baht did help boost the stock market, but only for a short period of time. The Baht quickly suffered an unexpectedly sharp depreciation against major currencies. Liquidity soon became tight, partly resulting from the suspension and closure of two-thirds of Thailand's finance companies. Many businesses, including companies listed on the SET, had to shut down. The deepening regional crisis has caused both local and international investors to lose confidence and pull out of the Thai equity market.

Authorities tried various measures in 1997 to bolster investor confidence, but to little avail. One step required listed companies to establish their own audit committees to ensure greater transparency and credibility in their operations. The SET also restructured brokerage fees from fixed to negotiable rates depending on the type of service and client. Another measure was the expansion of price movement limits, from 10 to 30 percent of the previous closing price, but with an added circuit breaker system. Other measures included the introduction of short selling and the replacement of margin loans by a credit balance system. In addition, the SET tried to help alleviate cost burdens of listed companies and member firms through fee reductions.

At the end of 1997, the SET had 431 listed companies, a decrease of 23 firms from 1996. The total number of listed securities was 529, of which there were common stocks, preferred stocks, debentures, convertible debentures, unit trusts, and warrants. However, common stocks account for nearly all of the SET's market capitalization and turnover.

Under the SEA, securities businesses are defined as securities brokers, securities dealers, investment advisors, securities underwriters, mutual fund managers, and private fund managers. Each type of securities business requires a separate license with approval from the Finance Ministry upon the recommendation of the SEC. A securities license is granted only to a juristic person, not an individual.

In general, the term "securities company" refers to a company obtaining all or any of the four types of license (brokering, dealing, advisory, or underwriting). Securities business can be undertaken by either finance-cum-securities companies or pure securities companies. Nonetheless, by year-end 1999, all finance-cum-securities companies will be required to separate their securities business from their finance business. Commercial banks and pure finance companies are allowed to engage in securities business only to the extent of dealing in or underwriting debt instruments. The SEC is empowered to supervise financial institutions (commercial banks and finance companies) only for their activities related to securities business.

As of January 1998, Thailand had 45 securities companies, of which 23 were pure securities companies, and 22 conducted both securities and finance activities. Of these 45 companies, 41 companies had brokerage licenses, 43 had securities dealing licenses, 39 had investment advisory licenses, and 41 had securities underwriting licenses. In addition, there were 11 commercial banks, one finance company, and eight foreign banks with dealing or underwriting debt instrument licenses.

A mutual fund management license is granted only to separate mutual fund management companies. At present, there are 14 mutual fund management companies. Both closed-end and open-end funds are allowed to offer shares to the public.

Derivatives

Authorities have almost completed arrangements for financial futures and options trading. The SEC completed drafting the Derivatives Market Act in May 1997. The main objectives of the draft Act are to create legal certainty for derivative contracts, and to provide for a regulatory framework for a derivatives market. The draft bill has received cabinet approval and is now before the Juridical Council. However, in mid-1997, the SEC also gave *de facto* approval to a domestic OTC derivatives market by permitting securities companies to deal in financial derivatives. Thus far, underlying issues include only financial products (such as securities, currencies, gold, financial indices, securities indices, and interest rates) and crude oil. Agricultural products, however, are excluded as they fall under the jurisdiction of the Commerce Ministry. The SEC has also approved a derivatives training fund by securities companies, short-selling in the cash market, and securities lending.

Cross-Border Capital Movements

Repatriation of investment funds, dividends, profits, and loan repayments can be made freely, net of all taxes. Commercial banks are authorized to sell foreign exchange for remittance abroad without limit. Thai residents can invest in foreign securities subject to prior approval from the Bank of Thailand.

Thailand also has a Foreign ("Alien") Board, which amounts to a separate listing of 83 stocks as of mid-1998. This Alien Board was designed to reflect legal limits on foreign holdings in specific Thai enterprises (i.e., if only 25 percent foreign equity was allowed in a given enterprise, 25 percent of the shares would be traded on the Alien Board, and thus available to foreigners). These shares have generally traded at higher prices than shares in the same enterprise which were reserved for Thais.

Individuals are exempt from capital gains taxes and pay a 10 percent tax on dividends and a 15 percent tax on interest income. Juristic persons pay a 15 percent withholding tax on capital gains and interest income, and 10 percent tax on dividends. Foreign investors from any country with a tax treaty with Thailand receive specified tax benefits. The U.S.-Thai bilateral tax treaty went into effect in 1997.

U.S. PRESENCE IN THE MARKET

Until recently, U.S. securities firms did not have a significant direct presence in Thailand, relying on representative offices and several minority holdings in domestic finance/securities companies. Nevertheless, U.S. firms have been active in underwriting offshore debt and equity issued by Thai companies over the past several years and have been involved in underwriting and managing both offshore and domestic mutual funds. U.S. portfolio investors have been active participants in Thailand's equity market.

Of late, U.S. securities firms have become more involved in advising on financial restructuring (including debt and management restructuring) for listed companies and on privatization. In September 1998, Morgan Stanley Dean Witter was selected to advise the Bank of Thailand on the privatization of two nationalized banks (Siam City Bank and Bangkok Metropolitan Bank). J.P. Morgan advised the Thai government on its Yankee Bond issue of April 1997, while Morgan Stanley Dean Witter advised Bangkok Bank on its latest share sale. Merrill Lynch has purchased 51 percent of a Thai securities firm, and the new entry is registered as Merrill Lynch Phatra Securities. Through their ownership of majority stakes of Thai securities firms, U.S. and other foreign firms are now able to control seats on the SET. Goldman Sachs has been a long-term business partner of Thai Farmers Bank and advised on the bank's latest share offering. Lehman Brothers is advising the Financial Sector Restructuring Authority (FRA) on the sale of the core assets of the 56 closed finance companies and recently acquired 99 percent of Peregrine Nithi Securities. American International Group has also purchased a controlling interest in Bangkok Investments.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The current financial crisis has caused the government to ease restrictions on foreign ownership of securities firms. Before the crisis, existing regulations imposed a 25 percent ceiling on foreign ownership of commercial banks, finance companies, and credit foncier firms. Foreign equity participation in finance-cum-securities companies was also restricted to 25 percent. Purchases of shares by foreigners on the SET were limited accordingly. Beginning in 1997, on a case-by-case basis, the Thai government allowed foreign ownership in those financial institutions to exceed the 25 percent ceiling and to exceed 50 percent for a maximum period of 10 years.

Executives at U.S. securities firms confirm that restrictions have eased noticeably since the onset of the financial crisis. While exceptions to the former rules limiting foreign ownership of securities companies to 25 percent are considered on a "case-by-case" basis, U.S. firms report that approvals seem routine. On May 16, 1998, an Executive Decree was issued to allow foreigners to have majority stakes in Thai securities businesses. Foreign purchasers must invest no less than Bt500 million (US$11.8 million). This rule also applies to domestic mutual funds.

Thailand's current regime governing the participation of foreign securities companies goes beyond its December 1997 GATS offer on financial services.

Statistical Highlights of the Stock Exchange of Thailand

		1994	1995	1996	1997
CORPORATE SECURITIES					
Total Turnover - Volume	(millions of shares)	23,051.9	20,875.0	19,359.1	29,902.4
- Value	(Baht billions)	2,113.9	1,535.0	1,303.1	929.6
Daily Average Turnover Value	(Baht billions)	8.63	6.24	5.34	3.76
Turnover by Type					
Ordinary Shares	(Baht billions)	2,036.6	1,464.5	1,205.3	831.0
Preferred Shares	(Baht billions)	1.38	0.0005	0.0002	-
Unit Trusts	(Baht billions)	23.33	9.69	8.37	5.72
Debentures	(Baht billions)	0.54	0.09	-	-
Convertible Debentures	(Baht billions)	0.01	-	-	-
Warrants	(Baht billions)	52.05	60.68	89.51	92.86
Newly Listed Companies					
Number		43	28	40	5
Subscription Value	(Baht billions)	47.37	37.18	25.19	2.79
Number of Companies		389	416	454	431
Number of Securities		494	538	579	529
Ordinary Shares		389	416	454	431
Preferred Shares		9	9	9	8
Unit Trusts		61	69	71	58
Debentures		11	11	5	2
Convertible Debentures		3	1	1	1
Warrants		21	32	39	29

		1994	1995	1996	1997
Total Capitalization					
Par Value	(Baht billions)	421.03	519.91	611.5	609.13
Market Value	(Baht billions)	3,300.75	3,564.57	2,559.58	1,133.34
GOVERNMENT SECURITIES					
Yearly Total Turnover - Volume	(millions of units)	-	-	-	-
- Value	(Baht billions)	-	-	-	-
Number of Quoted Issues		48	35	22	13
Total Capitalization (Par Value)	(Baht billions)	62.33	42.91	17.99	13.8
MARKET STATISTICS					
SET Index		1,360.09	1,280.81	831.57	372.69
SET 50 Index[1]		-	-	61.28	25.98
Market Dividend Yield	(%)	1.86	2.25	3.5	6.04
Market P/E Ratio[2]		19.51	19.75	11.97	6.59
Capital Mobilized by Listed Companies[3]	(Baht billions)	75.88	94.75	95.72	51

Source: Stock Exchange of Thailand

[1] The SET launched SET Index since June 17, 1996
[2] The SET requires listed company to recognize the operation result of its associated company on the basis of Equity Method since January 1, 1994.
[3] Total new capital raised during the year by equity issues.

Size of Financial Markets
Baht billions

	1994	1995	1996	1997
Bank loans	3,430.5	4,230.5	4,825.1	5,983.6
Equities (market capitalization)	3,300.8	3,564.6	2,559.6	1,133.3
Debt (domestic)	339.0	424.4	519.3	545.3
GDP (current price)	3,634.8	4,194.6	4,689.6	n/a
GDP growth rate (percent)	8.9	8.7	5.5	-0.4

Source: Bank of Thailand

Thailand's Outstanding Domestic Debt Instruments
Baht billions

	1994	1995	1996	1997
Government	62.5	43	18	13.8
State enterprise	190.4	238.3	278.4	293.2
- Guaranteed	159.8	208.7	239.7	247.2
- Non-guaranteed	30.6	29.6	38.7	46
Corporate	86.1	133.6	182.4	187.7
Others	-	9.5	40.5	50.6
Total	339	424.4	519.3	545.3

Source: Bank of Thailand, The Securities and Exchange Commission

Issuance of Debt Instruments
Baht billions

	1994	1995	1996	1997
Domestic	59,804	47,529	43,135	12,492
of which				
Secured	3,500	5,500	10,700	-
Unsecured	31,928	30,329	29,695	7,318
With warrant	19,286	3,500	-	0.1
Convertible	5,090	8,200	2,740	250
Short-term	-	-	-	4,924
Offshore	50,246	39,206	89,721	28,429
of which				
Secured	-	3,112	6,048	5,442
Unsecured	26,214	28,162	45,883	20,467
With warrant	1,608	-	-	-
Convertible	22,424	7,932	37,790	2,520
TOTAL	110,050	86,735	132,856	40,922

Source: The Securities and Exchange Commission

Net Investment in Thai Equity Securities, by Country

	Baht billions		Percent Share	
	1996	**1997**	**1996**	**1997**
1. Singapore	5.34	9.4	8.85	8.33
2. Hong Kong	4.54	12.43	7.52	11.02
3. European Union	5.34	10.02	8.85	8.88
4. Japan	16.07	45.44	26.62	40.27
5. Taiwan	3.38	3.94	5.6	3.49
6. Switzerland	1.32	3.46	2.19	3.07
7. Australia	0.86	3.74	1.43	3.31
8. Malaysia	0.47	0.39	0.78	0.35
9. Canada	0.03	0.06	0.05	0.05
10. USA	12.32	22.43	20.41	19.88
11. Others	10.68	1.52	17.7	1.35
Total	60.35	112.83	100	100

Source: Bank of Thailand

Circuit Breaker System

SET Index Falls from Preceding Day's Close	Trading Stops for
100 points	1:00 hour
150 points (another 50 points)	1:30 hour
200 points (another 50 points)	Remainder of the trading day

Source: Stock Exchange of Thailand

New Commission Rate Structure	
Member's Client	Commission Rate
Sub-Broker	Fully Negotiable
Foreign Broker	Negotiable, but not less than 0.3%
Foreign Client	Negotiable, but not less than 0.5%

Source: Stock Exchange of Thailand.

Exchange Rates Used:

1992	25.399 Baht/US$
1993	25.319 Baht/US$
1994	25.149 Baht/US$
1995	24.914 Baht/US$
1996	25.342 Baht/US$
1997	31.364 Baht/US$
June 1998	42.364 Baht/US$

VENEZUELA

BANKING

SUMMARY

The Venezuelan banking sector continues to recover from a serious financial crisis in 1994 and 1995, which affected more than 50 percent of the deposit base and is estimated to have cost the country between 15 percent and 18 percent of GDP. The crisis was the result of an economic recession, along with deregulation, lax bank supervision, directed lending, and poor credit practices. In response, the bank supervisory authorities have taken steps to stabilize the banking sector. For example, new banking legislation strengthened the supervisory authority of the Superintendency of Banks (SUDEBAN), although the Financial Emergency Law – passed during the collapse of the financial system – remains in effect and restricts SUDEBAN from acting as a fully independent entity. Significant foreign penetration into Venezuela is also credited with helping to restore confidence in the banking sector. However, the banking sector presently is under renewed pressure because of an economic slowdown in 1998, in large part due to depressed oil prices, coupled with soaring interest rates since the beginning of 1998. Although major banks are expected to weather the financial turmoil and economic contraction, banks' asset quality and earnings are exhibiting a deteriorating trend.

The market share of assets and deposits in the Venezuelan financial system is highly concentrated, with 39 commercial and universal banks accounting for 87.4 percent of financial sector assets as of March 31, 1998. The system remains segmented with specialized and legally distinct financial subsectors. A new banking law, which became effective in 1994, opened the banking sector to foreign investment. Until January 1994, other than representative offices, foreign banks were only allowed to establish through a joint venture, in which they could a hold a maximum of 20 percent ownership interest. The banking law also lifted onerous operating restrictions on established foreign banks that prevented them from expanding or offering a competitive range of services. Foreign banks control almost 50 percent of the banking system's assets (up from 3 percent in 1993), a reflection of the government's massive bank reprivatization effort in 1996-97.

Foreign banks perceive Venezuela as an attractive market because of the country's low banking penetration (gross loans represent only 14 percent of GDP) relative to other Latin economies of similar size, and the opportunities associated with the investments taking place in the oil and petrochemical sectors. Additionally, the relatively small size of the banking system is an impediment to locally incorporated banks as their lending capacity is insufficient to meet the needs of large industrial customers. The latter represents a business opportunity for most foreign banks.

Although foreign banks maintain an important presence in Venezuela, Citibank is the only U.S. bank with banking operations in Venezuela other than a representative office. At the end of March 1998, Citibank held 2.6 percent of universal and commercial bank total assets, and operated through seven

branches. Chase Manhattan and the Bank of America National Trust & Savings Association have received permission to open branches. There are no differences in the licensing requirements and permissible activities for locally-incorporated and foreign banks. However, the local capital of the branch rather than the consolidated capital of the parent bank is used to compute the branch's legal lending limit and other capital driven thresholds, in effect eliminating many of the benefits of establishing in branch form.

DESCRIPTION OF THE MARKET

The Venezuelan banking sector continues to recover from a serious financial crisis in 1994 and 1995, which affected more than 50 percent of the deposit base and is estimated to have cost the country between 15 percent and 18 percent of GDP. The crisis was the result of an economic recession, along with deregulation, lax bank supervision, directed lending, and poor credit practices. In response, the bank supervisory authorities have taken steps to stabilize the banking sector. For example, new banking legislation strengthened the supervisory authority of SUDEBAN. SUDEBAN can now require greater disclosure and higher levels of capitalization. In 1997, the requirement that banks offer farm loans at preferential rates was eliminated, as was the obligation of commercial banks to set aside a portion of their portfolio for agricultural loans. Significant foreign penetration into Venezuela is also credited for helping to restore confidence in the banking sector. However, the banking sector presently is under renewed pressure because of an economic slowdown in 1998, in large part due to depressed oil prices, coupled with soaring interest rates since the beginning of 1998.

Although major banks are expected to weather the financial turmoil and economic contraction, asset quality and earnings are deteriorating. Past due loans rose to 4 percent of total loans in September 1998, twice the level in 1997. Problem restructurings have increased and it is suspected that banks are easing terms on existing performing loans to preserve asset quality. Furthermore, rapid growth in 1997 may mask asset quality problems because these loans are still unseasoned. Total financial system assets increased by 49 percent from US$15.5 billion at the end of 1996 to US$23.1 billion at the end of 1997. Loan growth during this period was in excess of 100 percent.

The Venezuelan financial system, in theory, is highly segmented with specialized and legally distinct financial subsectors. These include universal and commercial banks, mortgage banks, investment banks, leasing companies, money market funds, capitalization companies, and the National System of Savings and Loan Associations. However, Venezuela's financial system is highly concentrated in terms of market share of banking sector assets. As shown in Table I, the universal and commercial banking sector comprised 39 institutions (compared to 47 commercial banks that existed in 1994), which accounted for 87.4 percent of financial sector assets as of March 31, 1998.

Table 1 – Principal Components of the Venezuelan Financial System
March 1998
(bolivars billions)

	Number	Assets	Percent of Total Assets
Universal Banks	11	6,523.1	53.8
Commercial Banks	28	4077	33.6
Savings & Loan Associations	21	872.8	7.2
Investment Banks	15	414.1	3.4
Leasing Companies	12	121.5	1
Mortgage Banks	5	91.0	0.8
Money Market Funds and Capitalization Companies	13	25.1	0.2
TOTAL	105	12124.6	100

The seven largest banks (Provincial, Mercantil, Banco de Venezuela, Union, Industrial de Venezuela, Corpbanca and Caribe) held 63.5 percent of universal and commercial bank assets as of December 31, 1997. Banco Provincial, the country's largest bank, held a 20 percent share. Foreign banks control almost 50 percent of the banking system's assets (up from 3 percent in 1993). Before 1994, the Banking Law did not allow the operation of foreign banks in Venezuela (with the grandfathered exceptions of Citibank, Extebandes, Tequendama Do Brasil and Ganadero). The new banking law, which became effective in 1994, opened the banking sector to foreign investment. The Venezuelan banking crisis (1994-95) entailed the intervention, closure, or nationalization of 19 banks which together held 55 percent of total banking system deposits at year-end 1993. Most of the state-owned banks that were nationalized in 1994-95 and privatized in 1996-97 were purchased by foreign banks. As a result, the sector moved from almost no foreign participation to almost 50 percent of the banking system's assets (Refer to Table II).

Table II – Percentage of Banking Sector Market Share Held by Foreign Banks

	Year-end 1993	Year-end 1997	March 31, 1998
Total Assets	1	41	46.5
Citibank (U.S.)	0.5	2.3	2.7
Total Loans	0.4	40.2	46.3
Citibank (U.S.)	0.3	3.4	3.2
Total Deposits	0.9	40.6	45.9
Citibank (U.S.)	0.5	2	2.5

Table III provides information on the major foreign bank presence in the Venezuelan banking system. As shown in Table III, Santander and BBV from Spain maintain the most important presence and account for 26.1 percent of banking sector assets. They conduct a full range of financial operations.

Table III – Major Foreign Bank Presence in the Venezuelan Banking System
March 31, 1998
(bolivars billions)

Bank	Owner	Ownership Stake	Assets
Banco Provincial	BBV (Spain)	49%	2,153.6
Banco de Venezuela	Santander (Spain)	95%	1,011.4
Corp Banca	Infisa (Chile)	94%	487.5
Banco del Caribe	Nova Scotia (Canada)	25%	382.5
Citibank	Citicorp (USA)	100%	279.0
Banco Fivenez	Banco Popular (Ecuador)	65%	222.2
Banco Republica	Da Vivienda (Colombia)	100%	119.4

The Venezuelan government owns Banco Industrial de Venezuela (BIV), which provides long-term developmental finance for projects that are high political priorities. The government also owns two regional institutions that play an inconsequential role in the market, and a new bank created in 1997

(Banco de Comercio Exterior - Bancoex) to finance and promote non-oil exports. These state-owned banks held only a combined 7.2 percent of universal and commercial bank total assets at the end of 1997.

Concentration of banking sector assets is likely to continue as additional consolidation in the number of banks takes place through closures and mergers. Some economic analysts expect that industry consolidation could reduce the number of universal and commercial banks in Venezuela by half due to large investments in technology and improvement of operating efficiency. In particular, many smaller domestic banks want to consolidate in order to obtain greater efficiency and the critical mass to compete with the larger foreign owned banks.

There is also a trend toward universal banking in Venezuela's banking sector. Such entities can perform all of the activities permitted to specialized financial entities. The conversion of many financial groups to universal banks reflected their desire to take advantage of economies of scale. Universal banks are also able to increase the size of their loan portfolio's based on the banks' larger consolidated assets. Banco Provincial was the first commercial bank authorized to operate as a universal bank on November 26, 1996. Since late 1996, eleven banks have received authorization to become universal banks, including five foreign financial institutions: Banco Provincial (BBV, Spain), Banco de Venezuela (Santander, Spain), Banco Fivenez (Ecuador), Banco Republica (Columbia), and Citibank (U.S.). ABN AMRO Bank, N.V., Venezuelan branch, received authorization to become a universal bank in August 1998, but has not yet started to operate as a universal bank. Previously, most large and medium-sized banks belonged to a financial group which controlled entities in all major financial subsectors. A typical financial group was comprised of a commercial bank, a leasing company, a mortgage bank, a credit card company, and offshore affiliates. Banco Venezolano de Credito did not choose to become a universal bank because it was not willing to consolidate with its financial group's liquid assets funds.

Foreign banks perceive Venezuela as an attractive market because of the country's low banking penetration (gross loans represent only 14 percent of GDP) relative to other Latin economies of similar size, and the opportunities associated with the investments taking place in the oil and petrochemical sectors. Additionally, the relative small size of the banking system is an impediment to locally incorporated banks as their lending capacity is insufficient to meet the needs of large industrial customers. The latter represents a business opportunity for most foreign banks. The foreign banks have injected new capital, instituted their own banking cultures, improved systems and internal controls, and introduced new technology to the banking sector. As a result, bank competition has increased significantly and banks have invested heavily to upgrade their systems.

Regulatory Structure

The 1994 banking law was supposed to have made SUDEBAN an independent agency and expanded its regulatory role to include other financial institutions besides banks. SUDEBAN's regulatory powers have been strengthened. For example, reporting requirements have been tightened to improve monitoring of offshore operations and activities within financial groups. Consolidated financial statements prepared for a banking group must include their locally-incorporated and overseas branches, subsidiaries and any related entities constituting a decision unit or activity. However, SUDEBAN must obtain prior approval from the central bank and the Superior Council of the Superintendency of Banks (comprised of the Minister of Finance, Bank Superintendent, central Bank President, and the President of the Deposit Insurance Agency) to intervene in or take over the operations of a troubled bank or financial institution. Moreover, SUDEBAN must obtain approval of the Financial Emergency Board (JEF) established by the Financial Emergency Law. The JEF is headed by the Minister of Finance and includes as members the President of the central bank, the President of the Deposit Guaranty Fund (FOGADE), and the Superintendent of Banks. The JEF has broad powers to take measures to address a financial crisis. For example, the JEF has the power to freeze and subsequently expropriate properties which back loans or investments of failing financial institutions. This ties SUDEBAN's hands to some extent, e.g., the ability to issue regulations or force more rapid industry consolidation. In the near term, it is unlikely that the Emergency Law will be repealed.

FOGADE gained responsibility for bank interventions and liquidations under the 1994 law. It provides deposit insurance up to a maximum of 4 million bolivars. To fund the insurance program, banks pay a fee at the end of each semester, currently set at 1 percent of total deposits. FOGADE also can provide monetary assistance to financial institutions to reestablish liquidity and solvency and can liquidate financial institutions. By early 1998, FOGADE had successfully privatized three banks (Consolidado, Republica and Venezuela) which had been intervened by the Venezuelan government during the 1994-95 financial crisis. FOGADE is funded through a variety of sources including government revenues, profits from its operations, bond issuances, and payments by financial institutions. In addition, the central bank can make loans directly to FOGADE.

Venezuelan banks are required to comply with the BIS risk based capital ratios. There are no significant differences in the calculation of these ratios from the BIS standards.

U.S. PRESENCE IN THE MARKET

Citibank Venezuela, founded in 1917, is still the only U.S. bank with a banking presence in Venezuela other than a representative office. At the end of March 1998, Citibank held 2.6 percent of universal and commercial bank total assets, and currently operates seven Venezuelan branches. Chase Manhattan received permission in April 1998 to open a commercial bank, but plans to maintain a single office and continue focusing on corporate customers. The Bank of America National Trust & Savings Association (San Francisco, California) received permission on August 4, 1998, to open a branch in Venezuela to operate as a commercial bank.

Non-U.S. foreign banks maintain an important presence in Venezuela. The foreign presence in the Venezuelan financial sector increased substantially in 1997, accounting for 48 percent of total banking sector assets at year-end. Five foreign financial institutions have universal bank licenses: Banco Provincial (BBV, Spain), Banco de Venezuela (Santander, Spain), Banco Fivenez (Ecuador), Banco Republica (Columbia), and Citibank (U.S.). ABN AMRO Bank, N.V., Venezuelan branch, received authorization to become a universal bank on August 11, 1998, but has not yet started to operate as a universal bank. As of June 1998, 73 foreign banks maintained representative offices in Venezuela; twelve were U.S. institutions and included Bank of America, Bankers Trust, J.P. Morgan, and Bank of New York. These banks provide a variety of financial services, including arranging medium and long-term dollar financing, clearing wire transfers, servicing corporate clients, and arranging debt-equity swaps.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The 1994 Banking Law removed the entry barriers to foreign banks that provide reciprocal access to Venezuelan banks. Until January 1994, other than representative offices, foreign banks were only allowed to establish through a joint venture, in which they could a hold a maximum of 20 percent ownership interest. Foreign banks may now enter the Venezuelan market in one of three ways: acquisition of shares in existing commercial banks or other financial institutions, creation of a new bank or other financial institution wholly owned by foreign banks or investors, or establishment of a branch of a foreign bank or financial institution. Moreover, the country has lifted the onerous operating restrictions on established foreign banks, which prevented them from expanding or offering a competitive range of services.

There are no differences in the licensing requirements and permissible activities for locally-incorporated and foreign banks. In addition to retail and corporate banking, foreign banks can issue credit cards, participate in ATM networks, and engage in fund management and trading dollar-denominated public sector debt instruments with local and foreign clients.

There are no branching restrictions on foreign banks. They are not restricted from establishing ATMs. However, the local capital of the branch rather than the consolidated capital of the parent bank is used to compute the branch's legal lending limit and other capital driven thresholds, in effect eliminating many of the benefits of establishing in branch form.

Under the 1994 banking law, banks can engage in securities activities; in practice, however, foreign banks participate through separately established securities firms. Capital requirements are less onerous if an institution establishes a separate securities firm. Applications for entry into the Venezuelan financial system are submitted to SUDEBAN.

VENEZUELA – BANKING

Venezuela's current banking regime is reflected in its GATS offer for banking services. There are no measures in force which are more liberal than its commitments made in the GATS, and there are no planned liberalization measures that go beyond the GATS commitments. The only barrier with respect to "national treatment" and market access which remains to be addressed is a provision in the banking law by which the Venezuelan government can take into account "economic and financial conditions, general and local" and insist on reciprocity when deciding on an application for entry. However, the Venezuelan government has not used these powers to date against U.S. firms.

VENEZUELA

SECURITIES

SUMMARY

Trading of securities in Venezuela is thin and highly concentrated. The Caracas Stock Exchange IBC Index has fallen sharply since September 1997 due to the Asian financial crisis, the decline in international oil prices, and uncertainty about the results of the national elections scheduled for December 1998. The National Securities Commission (Comisión Nacional de Valores, or CNV), under the Ministry of Finance, is the chief regulatory agency of the local stock exchanges. The proposed reform of The Capital Markets Law was approved by the Chamber of Deputies in 1997 but awaits ratification by the Senate. Banks may engage in a full range of securities activities under the 1994 Banking Law, although their participation has typically been indirect through the securities firms that they own. Foreign banks and securities firms are allowed to engage in fund management activities, subject to authorization from the CNV. There are no impediments to the introduction of new financial products although some transactions may require prior approval from the Superintendency of Banks.

DESCRIPTION OF THE MARKET

Caracas Stock Exchange

The Caracas Stock Exchange (CSE) is a privately owned corporation that has been in operation since 1947. A second regional exchange was opened in Maracaibo in 1986, but trading volume on the Maracaibo Exchange is less than 5 percent of the trading volume handled by the CSE. An Electronic Stock Exchange (SET) began operations in mid-1995. Membership in local capital markets is open to both individuals and legal entities.

Trading is thin and highly concentrated. After declining as a percentage of GDP for five successive years, capitalization of the CSE doubled in 1996, increasing from US$4.3 billion to US$10 billion. At the end of 1997, the total amount in trades on the CSE reached a record level of US$5.6 billion, representing an 84 percent increase over the previous year. The IBC Index closed at 3,893.88 at the end of September 1998, a decrease of 55 percent from year-end 1997. The IBC Index reached its 1998 low of 2,904.02 at the end of August after declining consecutively throughout the year (with the exception of March). The market has been affected by the impact of the Asian financial crisis, the decline in international oil prices, and uncertainty about the results of the national elections scheduled for December 1998. Higher local interest rates have also lured some investors out of equities and into the fixed income market. The index was modified on August 28, 1997 to make it more representative of the companies now being traded in the CSE. The national telephone company CANTV is one of the new companies included in the index as a result of privatization.

The CSE began trading stock index futures and dollar-bolivar exchange rate futures in September 1998.

Stock and Bond Markets

Trade in shares accounted for US$3.9 billion during 1997, representing a 220 percent increase over 1996. A total of 225,546 trades were made, for a daily average of 917 trades. In rights, the total amount traded was US$2.3 million. Global Depositary Shares (GDSs), which are instruments negotiated in dollars, went from US$5.4 million in 1996 to US$20.1 million in 1997. In the fixed income market, trades in Public Bonds increased by 29 percent, from US$110.1 million in 1996 to US$143.7 million in 1997. Trades in Brady Bonds amounted to US$1.4 billion, around 12 percent less than in the previous year. Several companies made public offerings of shares during 1997, proceeding through sales on the primary market, allotments to their shareholders in payment of dividends, or through capital subscriptions.

Market Regulation

The Capital Market Law of 1975 regulates the public offering of shares and other medium- and long-term securities, except public debt bonds and credits. The CNV, under the Ministry of Finance, is the chief regulatory agency of the local stock exchanges. The CNV is also the futures regulator. Like most securities commissions around the world, the CNV has no legal capacity of its own to impose criminal sanctions for violations of legal regulatory statutes. A proposed reform to the Capital Markets Law was approved by the Chamber of Deputies in 1997 and only remains to be discussed and ratified by the Senate. This new law would strengthen the regulatory environment that governs Venezuela's equity markets. It would provide new regulations for intermediaries, establish new conditions for public offerings, and make regulations more flexible for small firms that wish to issue stocks.

U.S. PRESENCE IN THE MARKET

U.S. presence in Venezuela's capital market is modest. Citicorp purchased a seat on the CSE in 1988 for its local brokerage house, Citibank. Bankers Trust is also a member of the CSE. Additionally, as of June 1998, 11 other U.S. commercial or investment banks had representative offices in Venezuela. Other U.S. commercial and investment banks participate indirectly in the local capital market, either by using offshore or local Venezuelan firms as intermediaries. Activities include consulting, investment advising, underwriting, and trading dollar-denominated public sector debt instruments with local and foreign clients.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Banks may engage in a full range of securities activities under the 1994 Banking Law, but their participation is typically indirect through the securities firms that they own. Foreign banks and securities firms are also allowed to engage in fund management activities, subject to authorization from the CNV. There are no impediments to the introduction of new financial products. Some transactions, however, may require prior approval from the superintendency of Banks. Foreign corporations located in Venezuela may issue stocks, bonds, or commercial paper on the domestic market, provided they comply with the regulations established by the CNV and the provisions of capital markets legislation. Residents of Venezuela may access offshore securities markets for fund-raising purposes, but have very limited access to offshore securities markets for investment purposes. Nonresidents may invest in Venezuelan securities, subject to some restrictions in certain sectors of the economy.

The most significant remaining barrier to market entry is Article 11 of the Venezuelan Banking Law, which allows the Bank Superintendency to consider economic and financial conditions when deciding on an application for entry into the financial (including securities) sector by a foreign entity. However, there have been no reported cases of foreign entities being refused market access. The law was not even invoked during the 1994-95 financial crisis. Foreign entities are afforded national treatment once granted permission to enter the market.

No legal or regulatory changes are required to implement Venezuela's GATS offer. The offer reflects current laws governing Venezuela's financial sector.

VIETNAM

BANKING

SUMMARY

Vietnam is attempting to develop the basic infrastructure to support a modern banking system and financial markets. Over the past two years the government has initiated projects to modernize the interbank payments system, adopt international accounting standards, and allow independent audits of major Vietnamese banks. However, the use of banking services by the general public remains limited, and most retail transactions are in cash.

The banking sector is regulated by the State Bank of Vietnam, a ministerial-level agency. Although a number of small joint-stock banks have been formed, four state-owned banks still dominate domestic banking activity. Three U.S. banks have established branches or representative offices in Vietnam, and one U.S. bank has pending an application to open a branch.

In 1997, foreign-bank branches and joint-venture banks accounted for almost 20 percent of the Vietnamese market's total mobilized capital, and their share of lending in Hanoi and Ho Chi Minh City increased from 14 percent in 1994 to about 50 percent in 1997. However, foreign banks remain restricted in their ability to provide a full range of services and to expand operations in local currency.

DESCRIPTION OF THE MARKET

Market Structure

As of mid-1998, approximately 82 banks were operating branches and representative offices in Vietnam, including 4 state-owned banks, 4 joint-venture banks, 52 joint-stock banks, 24 foreign-bank branches, and 68 foreign-bank representative offices. In addition, there are many microfinance organizations, including People's Credit Funds, the Bank for the Poor, and savings and credit groups under the Women's Union.

The four state-owned banks – the Vietnam Bank of Foreign Trade (Vietcombank), the Vietnam Industrial and Commercial Bank (Incombank), the Bank for Agriculture and Rural Development, and the Vietnam Investment Bank – still dominate domestic banking activity, providing an estimated 70-80 percent of all lending. Formed with the four state-owned banks, the joint-venture banks are the VID Public Bank (Malaysia), Indovina Bank (Indonesia), Firstvina Bank (South Korea), and Vinasiam (Thailand).

The first foreign bank in Vietnam, the Banque Française du Commerce Extérieur (BFCE), opened a representative office in 1989. Several other European and Asian banks followed rapidly. In 1992, foreign banks were allowed to open full commercial branches with required local operating capital of US$15 million. Foreign banks now provide a variety of traditional services, such as correspondent banking, cash management, international payments, and foreign exchange services. In 1997, according to information from the State Bank, foreign-bank branches and joint-venture banks accounted for almost 20 percent of the Vietnamese market's total mobilized capital, and their share of lending in Hanoi and Ho Chi Minh City increased from 14 percent in 1994 to about 50 percent in 1997.

Despite the growing number of banks, over 50 percent of local business transactions are conducted outside the banking system. (The figure would probably be higher if commodity exports and government transactions were excluded.) Furthermore, many cash transactions in Vietnam take place in dollars. The financial intermediation of domestic savings has been made difficult by managed interest rates, which do not reflect market rates. Other problems include lingering distrust of the domestic currency (due to hyper-inflation and scandals) and the lack of basic infrastructure to support a modern banking system. These problems have resulted in very little medium-term and long-term capital being made available for private-sector businesses. For example, paper checks are still not widely used, in part because they expire within fifteen days of issuance. However, the Vietnamese government is in the process of creating a national payments, clearing and settlement system.

Vietnam's banking system also suffers from a lack of consumer confidence. The Vietnamese public keeps an estimated 45-50 percent of the broad money supply in cash and gold. Less than 5 percent of the general population has a bank account. However, Automated Teller Machines (ATMs) are now available in Hanoi and Ho Chi Minh City. Electronic banking is still limited but is becoming more widespread.

Regulatory Structure

The State Bank of Vietnam is both Vietnam's central bank and its financial regulatory agency. It supervises all of the state-owned, joint-venture, joint-stock, and foreign banks operating in the country. The State Bank has offices with bank examiners in 53 provinces and its Banking Supervision Department employs about 500 staff nationwide. The newly-appointed Governor serves concurrently as Deputy Prime Minister with responsibility for economic issues. The First Deputy Governor manages day-to-day operations of the State Bank.

The success of economic reforms in stimulating growth over the past ten years has placed new demands on Vietnam's financial sector, which formerly operated largely in isolation from international standards and practices. A depressed real estate market, combined with a number of improperly-issued loans in 1996-97, has led to widespread recognition of the need for re-evaluating the regulatory policies and management practices that govern Vietnamese banking. The World Bank and the Asian Development Bank, among others, are providing training and other assistance to modernize the banking system.

U.S. PRESENCE IN THE MARKET

Following the lifting of the U.S. trade embargo in 1994, three U.S. banks opened offices in Vietnam. At present, four U.S. banks and financial institutions operate in Vietnam, two with branches (Bank of America, Citibank) and three with representative offices (American Express, Chase Manhattan, and Bank of America).

In October 1997, after a wait of three years following its application, Citibank received permission to open a branch in Ho Chi Minh City. (It already had a branch in Hanoi.) The new branch opened in January 1998. Bank of America also operates two branches in Vietnam. Chase, which has a representative office in Hanoi, applied to open a Ho Chi Minh City branch in October 1997. (It has yet to receive approval.)

Several Vietnamese state-owned and joint-stock banks have active correspondent relationships with U.S. banks. The most significant part of U.S. bank operations is project and trade finance, primarily for foreign corporate clients.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The financial services sector is similar to other service sectors in Vietnam in that the ability to establish an entity is not subject to consistent and transparent criteria. Generally, a quota is imposed on the number of licenses that may be issued in a particular period. Even if a foreign firm is permitted to establish an entity, that entity is subject to additional restrictions beyond those that apply to Vietnamese enterprises. In the banking sector, the following specific issues are of concern to foreign banks.

The "Ordinance on Banks, Credit Cooperatives, and Financial Companies" (the Ordinance) provides that foreign financial institutions may be established upon application to and if permitted by the State Bank. The Ordinance specifies the contents of the application form, which provides background information about the applicant to the State Bank. It does not contain any detailed criteria that a foreign financial institution must satisfy in order to be permitted to establish operations in Vietnam.

U.S. and other foreign banks seeking to enter the banking sector can do so through a joint venture with a Vietnamese bank or through the establishment of a branch or representative office. Foreign branches and representative offices are subject to differences in treatment or scope of permissible activities as compared to joint-venture banks.

Under present law, the treatment of a foreign branch versus a foreign subsidiary is not significantly different. The current advantage of a branch structure is that its regulatory capital is based on the parent organization's capital (however, the parent is responsible for branch losses). The regulatory capital of a foreign subsidiary is limited to its own capital.

The current policy of the State Bank is to limit the number of foreign financial institutions that may establish branches in Vietnam. For at least the last 18 months, there has been a *de facto* moratorium on the issuance of new bank licenses. Therefore, regardless of the corporate structure of U.S. financial institutions, it has not been possible for another U.S. bank to establish a branch in Vietnam.

According to State Bank officials, approvals of additional foreign bank operations are on hold due to a pending overhaul of the Vietnamese banking system. The State Bank also indicated in January 1998 that it would not issue new branch or representative office licenses for foreign banks during 1998 and that it would suspend the issuance of licenses for foreign joint-venture banks for 2-3 years. These officials expressed concerns that Vietnamese banks might not be able to compete successfully with U.S. and other foreign banks and, therefore, they have limited the range of services open to foreign banks.

Aside from the moratorium mentioned above, Vietnam has no explicit restriction on the number of branches of foreign banks. Each branch must be individually approved by the State Bank and, to date, no foreign bank has been permitted to open more than two branches. All foreign banks have chosen to locate in Hanoi and/or Ho Chi Minh City, the two largest cities in Vietnam.

As mentioned above, foreign banks are regulated under the "Ordinance on Banks, Credit Cooperatives and Financial Companies" (the Ordinance) dated May 23, 1990. They are also regulated under "Decree No. 189/HDBT" (the Decree) dated June 15, 1991. These documents provide procedures for establishing foreign-bank operations and list the types of services a foreign-bank branch or joint-venture bank may offer.

Articles 6 through 12 of the Decree set forth conditions and procedures for obtaining a banking license and opening a bank. Articles 13 and 14 of the Decree describe the operations a foreign-bank branch or joint-venture bank may perform.

According to Article 13 of the Decree and the terms of its banking license issued by the State Bank of Vietnam, a foreign-bank branch or joint-venture bank may perform some or all of the following foreign currency operations: foreign currency deposits, foreign currency lending, foreign currency investment, purchase and sale of bonds in foreign currency, import and export finance, issuance of foreign currency guarantees, conversion of foreign currency, purchase and sale of foreign currency for its own or its clients' accounts, and "other operations that the State Bank may authorize."

Under Article 14 of the Decree and again according to the terms of its license, a foreign-bank branch or joint-venture bank may carry out some or all of the following operations in Vietnamese currency: short, medium, and long-term deposits; short, medium, and long-term loans; bond dealing; payment operations; and "other operations that the State Bank may authorize." The State Bank may limit a foreign or joint-venture bank's Vietnamese currency resources.

While the licenses granted to foreign-bank branches permit these branches to conduct transactions in foreign currency and in Vietnamese dong, apparently the state-owned banks have an informal policy of refusing to lend dong to foreign-bank branches. Interest rates for borrowing dong on the interbank market approach the ceiling rate at which banks are allowed to lend. In effect, this condition makes it impossible for foreign banks to lend Vietnamese dong profitably. Furthermore, foreign banks are restricted in their ability to take deposits from non-borrowing customers, and they may not offer savings accounts.

Foreign-bank branches are prohibited from accepting U.S. dollar deposits in cash from organizations. Therefore, although a large amount of cash is floating through the underground economy in Vietnam, no mechanism allows this cash to be deposited in foreign-bank branches.

Vietnamese enterprises, including state-owned enterprises and foreign enterprises, are prohibited from opening more than one foreign-exchange bank account. The state-owned banks have emphasized to state-owned enterprises the importance of such enterprises maintaining their links with the state-owned banks. In effect, this policy obliges state-owned enterprises to close their accounts with foreign-bank branches and restricts them from opening new accounts with foreign banks.

Different regulations and limits apply to foreign-bank branches and domestic credit institutions regarding long and short positions in foreign currencies. The allowed percentages of capital differ for foreign-bank branches and all other domestic credit institutions, with foreign-bank branches subject to a 15 percent limit and all other domestic credit institutions subject to a 30 percent limit. In addition, the calculation of regulatory capital is not transparent for the state-owned banks and, therefore, these regulations are enforced only against foreign-bank branches and joint-stock banks.

Unlike domestic banks, foreign banks are not permitted to take security interests in land or land-use rights. This prohibition effectively eliminates mortgage-based financing, and severely undermines asset securitization and project financing, by foreign banks. Moreover, the ability of foreign-bank branches to take security interests in other property, including accounts receivable and inventory, is unclear and inconsistent under ambiguous regulations (particularly if that property is owned by state-owned enterprises).

VIETNAM – BANKING

In an attempt to regulate the banking industry more comprehensively, the National Assembly last year passed two new laws. One law governs banks and credit institutions and the other law outlines the responsibilities of the State Bank. Both new laws took effect on October 1, 1998.

The new "Law on Credit Institutions" defines the forms of foreign involvement in Vietnam's banking sector and the conditions and procedures for license applications. Both are little changed from existing law and regulation. The new law emphasizes the dominant position of the state sector, suggesting that state-owned enterprises and state-owned credit institutions will continue to be protected and favored. However, the new laws do not specify restrictions on foreign bank activities.

The ultimate effects of the new law on foreign banks in Vietnam will depend on implementing regulations now being prepared. For example, regulatory authorities apparently considered basing the legal lending limit of a foreign-bank branch on the capital of the branch rather than the capital of the parent, as the policy has been in the past (although there are conflicting views on this issue). The lending limit is scheduled to increase from 10 percent to 15 percent under the new law. Because most foreign-bank branches have no more than US$20-30 million in capital, this provision would have limited the maximum loan to a single customer to US$3-4.5 million in October 1998. Lending capped at this level may not be efficient and may not permit foreign-bank branches to adequately service their clients. However, the State Bank recently announced that capital will be based on the parent bank. State Bank officials have stated that Vietnam eventually will have uniform regulations for both foreign and domestic banks.

The new Decree 63, Decision 173, and Circular 08, which relate to the de-dollarizing of the Vietnamese economy, require the conversion of 80 percent of non-exempt dollars to dong within 15 days. Foreign banks must bear the onerous and costly expense of policing the conversion. In addition, while the economy is being de-dollarized, foreign banks still have difficulty funding themselves in dong in order to make local currency loans.