

IMPROVING CHINA'S BANK REGULATION TO AVOID THE ASIAN BANK CONTAGION

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The People's Republic of China (PRC or China¹) must reform its bank regulations to avoid the systemic bank shocks that have seriously disrupted the economies and banking sectors in Indonesia, Korea, and Thailand. The failure of bank regulations in Indonesia, Thailand, and Korea to conform to international "best practices" is a direct cause of the Asian financial crisis (Crisis). China should bring its bank regulations in line with international "best practices", including prudential regulation of risk management and licensing and oversight of bank operations, in order to protect its banking sector from the Crisis.

The Crisis may be the most important and interesting law and economics story of the 1990s. The nations affected by the Crisis have a common history of inadequate regulation and government interference in the banking sector.² Structural reform, especially legal reform, is an important component of the International Monetary Fund's (IMF) strategy to restore economies

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1. Note that this article specifically excludes the banks in the Hong Kong Special Administrative Region of the People's Republic of China. Hong Kong banks are known to be well-run and efficiently regulated; only those banks inside the pre-1997 borders of the People's Republic of China are the focus of this article. Further, this article does not attempt to ascertain the effect of the Year 2000 (Y2K) computer bug on bank operations in the People's Republic of China or elsewhere in Asia. Y2K issues certainly would make an interesting law journal article, but are outside the scope of this article.

2. TIMOTHY LANE ET AL., IMF-SUPPORTED PROGRAM IN INDONESIA, KOREA, AND THAILAND: A PRELIMINARY ASSESSMENT 17 (1999) [hereinafter PRELIMINARY IMF REPORT]. The interference included promotion of the domestic economy through policy loans, guarantees for corporate debtors that obviated the need for adequate risk assessment, lax regulatory framework, implicit guarantees on bank liabilities, connected lending, and a lack of sound standards for sound banking operations. *Id.* at 19.

harmful by the Crisis.³ Insistence on structural reform has refocused attention on the activities of the Basle Committee on Banking Supervision (Basle Committee), especially their drafting of "Core Principles for Effective Banking Supervision" (Core Principles), detailing prudential regulation of banks that, by extension, would protect against Crisis-like systemic shocks. The Core Principles discuss the conditions for effective banking supervision, including the licensing, structure and prudential regulation of banks.

China's economic vitality, especially in its banking sector, is crucial for sustaining and furthering Asia's recovery from the Crisis. China is vulnerable to the same economic shocks that befell other Asian nations, but, remarkably, has not suffered the turbulence inflicted on Indonesia, Korea, and Thailand.⁴ Crisis-driven economic pressures bear on China, including a slowdown in exports, a decline in domestic demand, and rising unemployment.⁵ Insulating China from the systemic shocks that severely and adversely impacted Indonesia, Korea, and Thailand has yet to be meaningfully addressed. China's large state-owned bank sector and the attendant competitive distortions created by their access to low-cost capital and public sector guarantees necessitates ensuring a stable Chinese banking sector.⁶

This article argues that departure from international "best practices" such as the Core Principles contributed to Thailand's, Indonesia's, and Korea's plunge into the Crisis. Part II of this article is a general overview of the Crisis' history, beginning with the pressures that led to the devaluation of the Thai baht in July 1997. This article will also detail how China is vulnerable to the same banking shocks that befell Thailand, Indonesia, and Korea and should, therefore, quickly reform its banking sector to be more consistent with the Core Principles. Part III discusses each of the Core Principles in the context of the Crisis and provides strategic recommendations for China's banking system. This article concludes with general comments about China's economic structure and strategic recommendations to help China avoid the Crisis.

3. *Id.* at 32. Structural reform was necessitated by reform in other areas. For example, macroeconomic stabilization, fiscal policy, or exchange rate reform would be useless without structural reform. *Id.*

4. The Crisis has hit other states, including the Philippines and Malaysia. The author has selected Indonesia, Korea, and Thailand for analysis because of the severity of banking turbulence in each nation.

5. INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTLOOK AND INTERNATIONAL CAPITAL MARKETS INTERIM ASSESSMENT 78 (1998).

6. DAVID FOLKERTS-LANDAU & CARL-JOHAN LINDGREN, TOWARD A FRAMEWORK FOR FINANCIAL STABILITY 13 (1998) [hereinafter FRAMEWORK].

II. The Asian Financial Crisis

The July 1997 devaluation of the Thai baht is generally recognized as the Crisis' genesis. Pressure on the baht began to build in late 1996 and continued into 1997. This stemmed from Thailand's large current account deficit, the significant appreciation of Thailand's real effective interest rate, rising short-term foreign debt, a deteriorating fiscal balance, and other financial sector difficulties.⁷ The baht was freely floated on July 2, 1997, which was the result of increasing speculative attacks and concerns about the Bank of Thailand's reserve position. Immediately, the baht, which had been pegged at 25:1 U.S. dollar, depreciated by 20% relative to the U.S. dollar, and short-term interest rates sharply declined after a slight initial increase.⁸ The baht continued a steady depreciation until hitting a low in January 1998 as rollover of short-term debt declined and the Crisis began to spread.⁹ By this time, Thailand's stock market declined over 60%.¹⁰

Initial delay and poor communication regarding the goals of financial sector reform as well as instability in the Thai government adversely affected confidence in the Thai economy.¹¹ After hitting its January 1998 low, the baht began to appreciate in February 1998, the result of Thai government policy reactions to the Crisis; by May 1998, despite a deepening Thai recession, the baht had appreciated 35% relative to the U.S. dollar since the January

7. PRELIMINARY IMF REPORT, *supra* note 2, at 8.

8. *Id.* On August 20, 1997, the International Monetary Fund ("IMF") approved a three-year standby arrangement with Thailand in the amount of \$4 billion. Additional finances were pledged by the World Bank and Asian Development Bank in the aggregate amount of \$2.7 billion. The Asian Development Bank also provided extensive technical assistance. Financing support by Japan and other interest countries amounted to \$10 billion. These bilateral financing arrangements have been disbursed in parallel with purchases from the fund. The underlying adjustment program was aimed at restoring confidence, bringing about an orderly reduction in the current account deficit and limiting macro economic shocks like an increase in inflation. Growth was expected to decelerate sharply but remain positive. Key elements of the policy package included measures to restructure the financial sector, fiscal adjustment measures to bring fiscal balance back into surplus, and control of domestic credit. While macroeconomic policies were on track and nominal interest rates were raised, market confidence was adversely affected by delays in the implementation of financial sector forms, political uncertainty, and initial difficulties in communicating key aspects of the program. By the time of the October 17, 1997 review, there were also signs that the slowdown of economic activity would be more pronounced than anticipated. *Id.*

9. *Id.*

10. John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 KAN. J.L. & PUB. POL'Y 70 (1998) [hereinafter HEAD].

11. PRELIMINARY IMF REPORT, *supra* note 2, at 8. A new Thai government took office in mid-November 1997. *Id.*

1998 low.¹² This recovery proved to be short-lived as the baht weakened from June to July 1998, the result of slowing growth and other financial sector strains.¹³

The baht's floating increased pressure on the Indonesian rupiah, already under pressure due to the rapid rise in Indonesia's short-term private sector external debt and doubts over Indonesia's ability to maintain its currency peg.¹⁴ Following a July 11, 1997 widening of the intervention band, the rupiah was freely floated on August 14, 1997 and, by early October 1997, it depreciated by 30% relative to the U.S. dollar, which was then the largest depreciation in Asia.¹⁵ Tightened liquidity and exchange market intervention temporarily boosted the rupiah's exchange rate but the rupiah significantly depreciated during December 1997 and January 1998, the result of accelerating capital outflows.¹⁶ Indonesia's problems exacerbated the Suharto regime's corruptness and the lack of overseas confidence in the Indonesian banking sector.¹⁷ By January 1998, the Jakarta Stock Exchange lost 75% of its value.¹⁸ Economic and social dislocation caused severe civil unrest, that, in turn, caused the resignation of President Suharto on May 21, 1998. A paralyzed banking sector and rising economic dislocation caused the rupiah to hit an all-time low in mid-June 1998, a total depreciation of 85% relative to

12. *Id.* at 9. With weakening economic activity constraining revenues, additional fiscal measures were introduced to achieve the original fiscal target for fiscal year 1997-98. Reserve money and net domestic assets of the Bank of Thailand were to be kept below the original program limits, the indicative range for interest rates raised, and a specific timetable for financial sector restructuring was announced. The program was revised March 4, 1998, and monetary policy continued to focus on the exchange rate, with interest rates to be maintained high until evidence of the sustained stabilization emerged. Fiscal policy shifted to a more accommodating stance, allowing automatic stabilizers to take effect. In addition, the program included measures to strengthen the social safety net and broaden the scope of structural reforms to strengthen the core banking system and promote corporate restructuring. On June 10, 1998, the revised program was on track, but real gross domestic product was projected to decline by 4% to 5% in 1998 when inflation subdued, further adjustments were made to allow for an increase in the fiscal deficit target for fiscal year 1997-1998 from 2% to 3% of GDP. Monetary policy continued to focus on maintaining the stability of the baht. While the cautious reduction of interest rates since late March was viewed as consistent with exchange rate market developments, it was understood that interest rates would be raised again if necessary. *Id.* at 8-9.

13. *Id.* at 9.

14. *Id.* at 10. Indonesia's economic indicators were originally stronger than Thailand's. *Id.*

15. *Id.*

16. *Id.*

17. R. Carter Pate and Denise C. Andrews, *Turnaround Topics: The IMF Rescue: Asian Economies Propose Turnaround Plans to Obtain Financing*, 1999 ABI JNL. LEXIS 217, *2 (1998) [hereinafter Pate].

18. HEAD, *supra* note 10, at 70.

the U.S. dollar since August 1997.¹⁹ Market sentiment had improved by January 1999, and the rupiah appreciated significantly from its June 1998 low.²⁰

Until October 1997, the Crisis was localized in South Asia. Uncertainty in Hong Kong's foreign exchange and equity markets was transmitted across other markets, including those in Brazil, Russia, and Korea. A high level of short-term debt and moderate international reserves left Korea vulnerable to the Crisis, although Korea was unaffected until October 1997.²¹ Concerns over the soundness of financial institutions and *chaebol* operations compounded skepticism of Korea's economy.²² By late October 1997, Korean financial institutions were unable to weather credit withdrawals by international financial institutions because the Korean bank's assets were impaired due to the baht's depreciation.

By early December 1997, the Korean won depreciated 20% relative to the U.S. dollar since late October 1997.²³ In addition, the value of the Korean stock market fell two-thirds by December 1997.²⁴ Signs of stabilization began to emerge in January 1998 when the Korean government agreed with private banks to reschedule short-term debt. The won had appreciated some 20% since December 1997.²⁵ The won's appreciation continued through July 1997, despite a deepening recession and slowing output.²⁶

The Crisis amply illustrates how banking sector disturbances can ripple through an economy with devastating effects.²⁷ Several common factors in Indonesia, Korea, and Thailand created the Crisis, especially inadequate bank regulation. Despite increasing financial market globalization, bank regulation in Indonesia, Korea, and Thailand was inadequate.²⁸ Indonesia, Korea,

19. PRELIMINARY IMF REPORT, *supra* note 2, at 11.

20. *Id.* at 12.

21. *Id.* at 13.

22. *Id.*

23. *Id.*

24. HEAD, *supra* note 10, at 70.

25. PRELIMINARY IMF REPORT, *supra* note 2, at 13-14.

26. *Id.* at 14.

27. FRAMEWORK, *supra* note 6, at 5.

28. PRELIMINARY IMF REPORT, *supra* note 2, at 17. There was also a tradition of government guarantees, a heavy government role in credit allocation, as well as a large unhedged private short-term foreign currency debt in a setting wherein corporations were highly leveraged. In Korea and Thailand, the debt was intermediated through the banking system while Indonesia's debt was intermediated directly through corporations. Economic data in all three countries was inadequate for intermediaries to make informed decisions and contributed to the Crisis. *Id.* at 17-18. Typically, Bank regulators must mitigate five issues in order to prevent banking sector disturbances: (1) inadequate bank management leading to excessive risk taking;

and Thailand all had deep structural weaknesses in the banking system including implicit and explicit government guarantees of bank and corporate debt, government-directed loans, and connected lending that led to lax regulation of banks.²⁹ Pre-Crisis increases in capital inflows fueled rapid expansion of credit in domestic banks.³⁰ That, coupled with poor regulation, failed to minimize excessive risk-taking. This left many banking systems vulnerable to market and credit risk.³¹ As a result, the rupiah, won, and baht began to depreciate causing liquidity pressures, deterioration of bank asset quality, and doubt about the viability of each nation's bank sector.³² The result was a severe adverse impact on economic activity because of weakened financial strength.³³ Moody's Investors Service rated the financial strength of bank sectors before (June 1996) and after (May 1998) the Crisis: Indonesia slid from a D to an E, Korea fell from a D to an E+, and Thailand dropped from a D+ to an E+.³⁴ Interestingly, China remained a steady D, reflecting that the Crisis had yet to spread to China.³⁵

The IMF placed a premium on structural, especially legal, reform in Indonesia, Korea, and Thailand; a logical emphasis because banking systems have played a key role in the development of the Crisis.³⁶ The IMF believed its programs and government macroeconomic policies would have little chance of success and little credibility unless preceded or accompanied by significant bank sector reform and improvement in financial sector conditions.³⁷ For example, IMF packages for Indonesia, Korea, and

(2) inadequate information provided by banks; (3) implicit and explicit public sector guarantees; (4) ineffective bank regulatory environment; and (5) concentrated bank ownership and connected lending. FRAMEWORK, *supra* note 6, at 7. The Crisis has highlighted a need for sound regulatory structures in the banking sector to appropriately manage the types of risk that confront a bank. PRELIMINARY IMF REPORT, *supra* note 2, at 105. Inadequate regulation, coupled with other factors left Asian banks unable to effectively evaluate risk in its operations. *Id.*

29. *Id.* at 19. For example, Korea's average corporate debt/equity ratio was 395 while Thailand's was 450. *Id.* Moral hazard in the banking sector, created by actual or assumed public safety nets, encouraged banks to take on severe risks. *Id.*

30. CHARLES ADAMS ET AL., INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, PROSPECTS, AND KEY POLICY ISSUES 11 (1998) [hereinafter ADAMS].

31. *Id.*

32. *Id.* at 11-12.

33. *Id.* at 12. Local banking systems bore the brunt of money withdrawals from Asia, especially in the first half of 1998. Bank for International Settlement, *BIS Consolidated International Banking Statistics for end-June 1998* (visited Apr. 15, 1999) <<http://www.bis.org>>.

34. ADAMS, *supra* note 30, at 36.

35. *Id.*

36. PRELIMINARY IMF REPORT, *supra* note 2, at 110.

37. *Id.* at 110-11.

Thailand were conditioned on establishing and implementing effective banking sector exit strategies.³⁸

Indonesia, Korea, and Thailand are reviewing their bank regulations to conform with the Core Principles. The countries also seek to include financial institutions not previously subject to banking regulations.³⁹ The initial phase of reform focused on improving loan classification and provisioning standards, capital adequacy requirements, and foreign exposure limits.⁴⁰ For example, Indonesia, Korea, and Thailand have (1) shortened the time period for classifying loans as nonperforming, (2) increased loan loss provisions, (3) adopted international accounting standards, (4) improved financial disclosure, and (5) strengthened capital adequacy rules.⁴¹

The respective reform plans of Thailand, Korea, and Indonesia address the inadequacies of banking regulations.⁴² These nations want to make banking safe, transparent, and efficient, by overcoming such obstacles as a lack of accounting standards, lack of disclosure, and lax prudential regulation.⁴³ Each nation has created an autonomous restructuring agency, including Korea's Financial Supervisory Committee (FSC), Thailand's Financial Sector Restructuring Authority (FSRA), and the Indonesian Bank Restructuring Agency (IBRA).⁴⁴ Interestingly, in both Thailand and Indonesia, several months passed before the FSRA and IBRA were established, respectively, and a further six months passed until the legal aspects of their operations were solidified.

IBRA is an autonomous agency operating under the Ministry of Finance that supervises bank restructuring and acquires bank assets during restructuring.⁴⁵ IBRA was established in Feb-

38. HEAD, *supra* note 10, at 75.

39. PRELIMINARY IMF REPORT, *supra* note 2, at 109. In Korea, supervision of banks and nonbank financial institutions were unified at the beginning of the program, but different standards continue to apply to different types of institutions. *Id.* Revisions of prudential regulations address loan classification and capital adequacy standards, restrictions on foreign exchange and liquidity exposure, and rules on related party lending, and improvement of accounting standards and tightened disclosure requirements. *Id.* In addition, the Bank of Thailand segregated viable and nonviable financial institutions to maintain integrity of financial system; 58 finance institutions were suspended, leaving only 33 in place. Bank of Thailand, *Message from Minister of Finance* (visited April 1, 1999) <<http://www.bot.or.th/research/public/MOF/ter.htm>>.

40. PRELIMINARY IMF REPORT, *supra* note 2, at 108.

41. ADAMS, *supra* note 30, at 38.

42. Pate, *supra* note 17, at *7.

43. *Id.* at *9.

44. *Id.* at *9- *10.

45. BANK INDONESIA, 1998 ANNUAL REPORT (no page numbers in original) (1999) available at Bank Indonesia, *1998 Annual Report* (visited April 17, 1999) <<http://www.bi.go.id/intl/rep/index.html>> [hereinafter BI 1998 Annual Report].

ruary 1998, but amendments to Indonesia's banking laws endowing the IBRA with legal power were only passed in October 1998. However, IBRA's efficiency is compromised by doubts as to the adequacy of banking law amendments to endow IBRA with operational competence. In addition to IBRA, a credit supervision committee of senior members of the Ministry of Finance and Bank Indonesia oversee problem loans.⁴⁶

The FSRA rehabilitates suspended banks, assists bona fide depositors and creditors of suspended companies, and administers the liquidation process of suspended banks.⁴⁷ Importantly, the FSRA lacked legal power to help restructure Thailand's banking system for many months.⁴⁸ In addition to the FSRA, the Asset Management Corporation administers the banks' impaired assets by purchasing or receiving transfer during the restructuring process.⁴⁹

Two principles govern Korea's bank restructuring—(1) non-viable entities must be closed and (2) financial support will be provided to viable institutions for rehabilitation, conditioned on strong and complete self-rescue efforts and accountable loss sharing.⁵⁰ The FSC supervises and regulates financial institutions, and its Financial Restructuring Unit oversees the restructuring of Korea's banks.⁵¹ Since December 1997, FSC has had the authority to close insolvent banks and write down equity of banks to

IBRA was established by Presidential Decree No. 27 of 1998, dated January 26, 1998. BI reviews the banks and sends banks failing to meet BI's requirement to IBRA, pursuant to article 37 paragraph 2 of the Banking Act No. 7 of 1992. All information by banks is to be submitted to IBRA. IBRA's powers include: (1) requesting the bank comply with requirements on bank soundness; (2) requesting bank managers, shareholders, and owners to sign conditions to restructuring; (3) asking the bank to submit a restructuring plan; (4) investigating a bank undergoing a restructuring; (5) monitoring and securing certain bank assets; (6) calculating bank losses; or (7) requiring the bank to add capital, write off bad assets, or take any course to any party related with bank's restructured assets. To be placed in IBRA, a bank must have liquidity support less than 200% of paid-in capital, a capital adequacy ratio less than 5% and the bank must have failed to repay discount facility within 21 days after maturity date. *Id.*

46. Michael S. Bennett, *Banking Deregulation in Indonesia*, 16 U. PA. J. INT'L BUS. L. 443, 453 (1995) [hereinafter Bennett].

47. Emergency Decree on Financial Sector Restructuring, B.E. 2540, §7 (visited April 15, 1999) (*available at* <<http://www.bot.or.th/govnr/public/news/ae.htm>>).

48. PRELIMINARY IMF REPORT, *supra* note 2, at 107.

49. Emergency Decree on the Asset Management Corporation, B.E. 2540, §7 (visited April 15, 1999) (*available at* <<http://www.bot.or.th/govnr/public/news/be.htm>>).

50. Korean Ministry of Finance and Economy, *Progress Toward a Clean Bank Environment* (visited April 15, 1999) <http://www.mofe.go.kr/cgi-bin/e_mofe/body.txt?num=25&pos=29&menu=E_MINIS_ADDR>. [hereinafter Progress].

51. TOMÁS J. T. BALIÑO AND ANGEL UBIDE, THE KOREAN FINANCIAL CRISIS OF 1997- A STRATEGY OF FINANCIAL REFORM, 32 (International Monetary Fund Working Paper No. WP 99/28, 1999) [hereinafter Baliño].

absorb the losses.⁵² The FSC monitors all undercapitalized banks, as determined by FSC capital adequacy review, to ensure that troubled banks have reached minimum capital requirements by the end of April 1999⁵³ and banks strictly adhere to timetables for achieving a voluntary capital ratio of 10% by December 2000.⁵⁴ Five of eight nonviable banks (those with capital adequacy ratios less than 8%) were closed in June 1998.⁵⁵ The FSC promised that regulatory oversight would be consistent with the Core Principles by March 1999. The independence of the FSC will be enhanced by requiring that the FSC have the necessary authority to maintain the soundness of financial institutions, and a report is due in March 1999 to the Korean government regarding responsibilities and modes of operation in bank regulation.⁵⁶

China has not suffered the systemic problems that have plagued Indonesia, Korea, and Thailand. Despite pressure to devalue the renminbi, there is little devaluation risk because of the potential for political loss of face.⁵⁷ China's strong current account position, moderate foreign debt, and considerable international reserves protect China from the Crisis, although there are indications that the Chinese economy may be slowing.⁵⁸ Despite maintaining stability to the present, this article will show that China is at risk for succumbing to the Crisis.

The costs of the Crisis and banking sector restructuring are staggering. Banking sector restructuring will cost Thailand 3% of Gross Domestic Product (GDP); Indonesia, 1.5 % of GDP; and Korea, .75 %.⁵⁹ 1998 Real GDP is expected to fall by 7% in Ko-

52. Letter from Kyung-shik Lee, Governor, *Bank of Korea*, and Chang-Yuel Lim, Deputy Prime Minister and Minister, *Ministry of Finance and Economy*, to Michael Camdessus, Managing Director, *International Monetary Fund* 5 (Dec. 24, 1997) (available at <<http://www.imf.org/external/np/101/122497.htm>>).

53. The three banks, Cho Hung, KEB, and Chungbuk are to be feasible and credible by the end of March 1999; Peace Bank is to be capitalized by end-April 1999. Letter from Chol-Hwan Chon, Governor, *Bank of Korea*, and Kyu-sung Lee, Minister, *Ministry of Finance and Economy*, to Michael Camdessus, Managing Director, *International Monetary Fund* 4 (March 10, 1999) (available at <<http://www.imf.org/external/np/101/1999/031099.htm#memo>>) [hereinafter Korea March 10, 1999].

54. *Id.* at 4-5. The ratios are to improve to 6 % by March 1999 and 8% by March 2000. For regional banks without international operations that do not lend amounts greater than W5 billion to individual corporate borrowers, the timetable is 4% by March 1999, 6% by March 2000 and 8% by December 2000. *Id.*

55. Progress, *supra* note 50.

56. Korea March 10, 1999, *supra* note 53, at 10.

57. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: China* 18 (4th quarter 1998) [hereinafter EIU China I].

58. BANK FOR INTERNATIONAL SETTLEMENTS, 68TH ANNUAL REPORT 43 (1998) [hereinafter BIS II].

59. PRELIMINARY IMF REPORT, *supra* note 2, at 91. Banking sector restructuring involves closing non-viable banks and injecting public funds to recapitalize viable banks. Indonesia and Korea supported this restructuring directly through direct

rea, 8% in Thailand, and 15% in Indonesia.⁶⁰ The Crisis presents a clear and manifest danger to China's booming economy and, therefore, should be avoided at all costs.

III. Core Principles

The Basle Committee's drafting of the Core Principles was a defining step in the evolution of international "best practices" for banking regulation. Increasing internationalization and interdependence of global banking necessitate coordinated international regulation.⁶¹ The Basle Committee, created in 1975 by the central bank governors of eleven major nations,⁶² responded to a communiqué issued at the close of the June 1996 Lyon Group of Seven summit calling for international best standards and cooperation from banking systems.⁶³ The Basle Committee promotes prudent regulatory standards through suggested adherence to the Core Principles.⁶⁴ Importantly, the Core Principles were created with diverse input; the non-Group of Ten authorities involved in

budget expenditures; Thailand restructured its banks through its central bank, with little of its costs ever appearing on budget. *Id.* Costs to the Indonesian government for financial system restructuring include the capitalization of banks, the operational costs of the IBRA, payments to small depositors under a deposit insurance scheme, and compensation to the central bank for past support of failed banks; direct budgetary transfers and government guaranteed bonds were the main instruments of government support. *Id.* at 134. Indonesia is expected to issue Rp235 trillion worth of bonds, representing 25 % of GDP, in 1998 and 1999. Budgetary costs of servicing bonds and the operational costs of the IBRA for 1998 to 1999 1½ % of GDP. Full year costs are estimated to be about 2 % of GDP. In Korea, public funds are available to purchase bad loans from commercial and merchant banks, and honor commitments under the deposit insurance scheme. The system has been mostly financed through government guaranteed bonds or limited swaps of government assets for bank restructuring agency claims. Total costs of Korean bank restructuring are currently estimated at W75 trillion, representing 18% of GDP, including W65 trillion in government guaranteed bonds. The interest costs to the budget in 1998 are estimated at .8 % of GDP; this cost is expected to increase to 1½ to 2 % of GDP over the medium term as bond issues accelerate and prudential regulations are tightened. *Id.*

60. *Id.* at 45.

61. FRAMEWORK, *supra* note 6, at 47. International coordination is required for at least four reasons: (1) corporate structures across international borders can be used to escape regulation; (2) banks increasingly shift work to offshore tax havens; (3) in states with lesser developed accounting and legal frameworks, international banking can take advantage of such weaknesses; and (4) offshore activity can lead to outright fraud. *Id.*

62. *Id.* at 52. The Committee is now made of senior representatives of banking authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. *Id.* For an excellent view of the Basle Committee, see Lawrence L.C. Lee, *The Basle Accords as Soft Law: Strengthening International Banking Supervision*, 39 VA. J. INT'L L. 1 (1998).

63. FRAMEWORK, *supra* note 6, at 52.

64. *Id.*

the creation of the Core Principles included Chile, China, the Czech Republic, Hong Kong, Indonesia, Korea, Thailand, Mexico, Russia, Argentina, Brazil, Hungary, India, Malaysia, Poland, and Singapore.⁶⁵ The Core Principles are minimum regulatory standards that require some nations to change their legal framework.⁶⁶ If banks in Indonesia, Korea, and Thailand had adhered to the Core Principles, the Crisis could have been averted or minimized. The Chinese banks' adherence to Core Principles will be crucial in preventing the spread of the Crisis.

A. EFFECTIVE BANKING SECTOR REGULATION

Indonesia, Korea, and Thailand used a Gerschenkronian strategy to promote economic development. They created regulatory bodies that are significantly different from their Western counterparts.⁶⁷ Such a development strategy engenders two risks: (1) opportunities for corruption and (2) rent seeking undermining economic growth and misallocation of resources through government policies serving special interests.⁶⁸ The International Country Risk Guide (ICRG) index and the Business Environmental Risk Intelligence (BERI) index analyze institutional quality.⁶⁹ Between 1984 and 1995, Thailand's ICRG increased from 30.9 to 38.7, Indonesia's ICRG increased from 15.0 to 35.7, Korea's ICRG increased from 28.7 to 45.0, indicating a general decrease in regulatory quality.⁷⁰ Between 1972 and 1995, Indonesia's BERI increased from 6.6 to 7, and Korea's BERI actually decreased from 9.2 to 9.0, and Thailand's BERI was not measured until 1995, when it received an 8.4.⁷¹ Clearly, Indonesia, Korea, and Thailand all possessed weakening regulatory quality prior to the Crisis.

65. *Id.*

66. *Id.* at 52-53.

67. NICHOLAS CRAFTS, EAST ASIAN GROWTH BEFORE AND AFTER THE CRISIS 28 (International Monetary Fund Working Paper No. WP/98/137, 1998) [hereinafter CRAFTS]. The Gerschenkronian strategy first appeared in A. GERSCHENKRON, ECONOMIC BACKWARDNESS IN HISTORICAL PERSPECTIVE, 1962. The theory posits that initially less developed countries may rapidly catch up to their more developed colleagues if they take measures to promote development through institutional innovations and controlled capital markets. *Id.*

68. CRAFTS, *supra* note 67, at 28.

69. *Id.* at 31. BERI aggregates "bureaucratic delays", "nationalization potential", "contract enforceability", and "infrastructure quality" and has a maximum score of 16. ICRG aggregates "quality of the bureaucracy", "corruption in government", "rule of law", "expropriation risk", and "repudiation of contracts by the government" and has a maximum score of 50. *Id.*

70. *Id.*

71. *Id.* Further reinforcing the weakness in Korea's banking system, the real rate of return on capital declined rapidly-over 5 % per year on average- between 1966-1990. *Id.*

The first Core Principle details the preconditions necessary for effective banking sector regulation including an independent regulator and an effective legal system. Operationally, independent banking regulators with clear responsibilities and objectives backed by an effective legal framework most efficiently regulate a banking sector.⁷² The banking sectors in Indonesia, Thailand, and Korea each failed to create and maintain independent and effective banking regulators and regulations propelling each into the Crisis.

Bank regulators must have clear responsibilities and objectives, operational independence, adequate resources for effective oversight, and the ability and incentive to share information with regulators in other economic sectors.⁷³ Banking regulators require the necessary autonomy, tools, and direction to effectively carry out their mandate. Political influence, among other issues,

72. See, e.g., FRAMEWORK, *supra* note 6, at 41-46. In general, the objectives and purposes of the banking regulatory authority, as well as its autonomy, should be firmly spelled out and entrenched in law so as to resist outside pressures. A law covering banking regulators should have eight objectives: (1) Protect the regulator from undue political influences; (2) Provide authority for the issuance of prudential regulations and standards and to protect against undue outside influence regarding such regulations and standards; (3) Protect against undue influence and implementation of loan classification, provisioning rules, monitoring and inspection tasks; (4) Protect any proprietary information of regulated banks; (5) Protect regulators against personal liability in the discharge of their duties; (6) Ensure financial autonomy at the supervisory agency; (7) Ensure autonomy of the agency and its internal organization and procedures; and (8) create an appropriate system to ensure the accountability of the supervisory authority. An effective regulatory authority has at least the following eight powers: (1) Exclusive authority to license and withdraw licenses; (2) Authority to issue Prudential regulations and standards; (3) Authority to obtain periodic reports in the format and time period established by the regulator; (4) Authority to conduct on-site inspections; (5) Authority to take corrective actions in the form of administrative penalties; (6) Authority to take emergency action such as removal of management powers and imposition of conservatorship; (7) Authority to close and initiate a liquidation of banks; and (8) Authority over the bankruptcy of banks.

In addition, cooperation between supervisors in different financial sectors is necessary where there are corporate linkages between insurance, securities firms, and banks. *Id.* The Banking law itself should have four goals: (1) establish policies that only financially viable entities operate; (2) limit excessive risk taking; (3) establish appropriate accounting, valuation, and reporting rules; and (4) provide for effective corrective measures. *Id.* at 11. A lack of transparency in central bank independence and transparency can be welfare reducing. See TIMO T. VÄLILÄ, CREDIBILITY OF CENTRAL BANK INDEPENDENCE REVISITED (IMF Working Paper No. WP/99/2, 1999).

73. BASLE COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION Principle 1 (1997) [hereinafter Core Principles]. The autonomy issue is often linked with the location of the regulator's function; there are arguments for and against locating that function in a central bank. In many emerging markets, the central bank may be the best location to place regulatory functions because of the proximity to the central bank's other functions such as one of lender of last resort, overseer of the payment system, and collector of macro-financial data. See FRAMEWORK, *supra* note 6, at 12.

adversely impacts the ability of regulators to fulfill their charge. Importantly, banks in Korea, Indonesia, and Thailand have been subject to stringent regulation or pressure to lend to specific industries.⁷⁴

Public sector guarantees, including lender of last resort, deposit insurance, and exit policies, are important parts of the banking landscape, but change the outcome of market forces and, therefore, represent an example of government interference in the banking sector.⁷⁵ Although guarantees can undermine market discipline, they can foster confidence in and decrease the chances of failure in the banking system. However, implicit guarantees, such as the perception that governments will not allow bank failure, adversely affect bank sectors. The lack of explicit public sector guarantees coupled with implicit guarantees accelerated the failure of Indonesia's, Thailand's, and Korea's banking systems. Addressing the same issues in China are necessary to avoid the Crisis' spread.

Regulators require a legal system to reinforce effective banking sector regulation by enforcing compliance with law, safety, and soundness concerns.⁷⁶ Clear regulations place regu-

74. MORRIS GOLDSTEIN AND PHILIP TURNER, BANKING CRISES IN EMERGING ECONOMIES: ORIGINS AND POLICY OPTIONS 20 (Bank for International Settlements Economic Papers No. 46, 1996) [hereinafter GOLDSTEIN].

75. FRAMEWORK, *supra* note 6, at 27. Lender of last resort policies have three primary objectives: (1) protect the integrity of the payments system; (2) avoid runs that spill over from bank to bank which develops into a systemic crisis; and (3) preventing illiquidity at a specific bank from resulting in insolvency. "Best practices" for the use of lender of last resort policies include: (1) availability to the whole financial system and not just one bank; (2) lend speedily; (3) lend only for the short term; (4) lend at a penalty rate and lend only if the loan is collateralized; and (5) allow individual institutions to fail and close. Deposit insurance should protect small savers without encouraging moral hazard for larger institutions that weaken market discipline. Preferable deposit insurance systems are self-funded through uniform premiums and provide expeditious payments to insured depositors. Such a policy may enable smaller banks to compete against larger banks, in part due to the ending of the 'too-big-to-fail' concept. Such schemes must be adequately funded and give money speedily. All banks should be members of the deposit insurance system and co-insurance, either through co-payment or specified limits, is advisable. An effective exit policy is also necessary to illustrate the adverse impact of excessive risk taking. An effective exit policy requires an effective legal framework and supervisory authority; early intervention is desired. Rule-based exit policies are preferable and should differentiate between insolvent and undercapitalized-but-solvent banks. Preferably, banks would be closed before becoming deeply insolvent, thus limiting spillover to other financial institutions through major losses to creditors. Conservatorship could be a method of returning troubled banks to health. Once it is clear that a bank can't be restored, even through a conservatorship, it should be allowed to fail through rule-based failure procedures. Political interference is common where insolvent banks are involved; limits on the discretion of supervisors is preferable, along with a strong legal framework which, in turn requires accurate information. *Id.* at 27-31.

76. Core Principles, *supra* note 73, at Principle 1.

lated entities on notice and provide a clear basis for regulators' actions. Banking regulatory systems in Indonesia, Korea, and Thailand did not possess a significant degree of transparency, contributing to an inefficient and unhealthy banking system. Clear regulations may have averted or minimized the Crisis; clear regulations may yet help China avoid the fate of their Asian counterparts.

Six of the Twenty-Six Core Principles discuss a regulator's oversight of a bank's ongoing activities. Effective bank regulation requires the analysis of bank disclosures, collected through efficacious ongoing bank supervision.⁷⁷ Efficient regulation requires on and off-site supervision,⁷⁸ including regular contact with bank management and a thorough understanding of bank operations.⁷⁹ In addition to regulating on a consolidated basis, regulators should collect and analyze prudential reports and statistical information provided by the bank.⁸⁰ Regulators must be able to validate information provided by the bank's internal supervisors through direct examination or the use of external auditors.⁸¹ Further, bank regulators must be satisfied that each bank maintains adequate records drawn up in accordance with generally accepted accounting principles that present a true and fair view of the bank's financial condition.⁸²

77. FRAMEWORK, *supra* note 6, at 66.

78. Core Principles, *supra* note 73, at Principle 16. The extent of on-site work depends on a number of factors. In some states, on-site examination is undertaken by examiners and independent auditors while other states rely on a mix of on-site examinations and review of internal audits. FRAMEWORK, *supra* note 6, at 66.

79. Core Principles, *supra* note 73, at Principle 17. Banks should submit information updating their license application as well as periodic reports disclosing bank operations. Review of this information is an important part of effective bank regulation. It should be noted that banks should report on a consolidated basis. FRAMEWORK, *supra* note 6, at 66.

80. Core Principles, *supra* note 73, at Principle 20. Regulation on a consolidated basis allows regulators the ability to review banking and non-banking as well as domestic and foreign activities by the banking organization as a whole. Regulators should be aware of the bank structure as a whole before applying prudential regulations. FRAMEWORK, *supra* note 6, at 67. *See also* Core Principles, *supra* note 73, at Principle 18.

81. Core Principles, *supra* note 73, at Principle 19.

82. Core Principles, *supra* note 73, at Principle 21. To present a full and fair picture of a bank's financial condition, market-based valuation of assets and liabilities is best, but probably only practicable where markets are sufficiently liquid. Realistic valuations of assets and prudent recognition of income and expense are crucial factors to evaluating the financial data of banks. Bad information usually results in the overstatement of banks' performance. Reliable information is necessary for the effective functioning of market and regulatory discipline. It is essential to understand the true financial condition of a bank because bad information could lead to misdirection of lender-of-last resort assistance, and could increase the susceptibility of supervisors and courts to political interference. Records should include income statements and detailed information of loan losses and should evaluate banks profits (especially noninterest income) as well as risks. Market discipline is an

The Core Principles also address the bank regulator's formal powers. Bank regulators should have adequate powers and resources to bring about timely corrective action when banks fail to satisfy prudential requirements, commit regulatory violations, or where depositors are threatened in any way.⁸³

1. *Banking Sector Regulation: Indonesia*

Despite an active hand in the banking sector, the Indonesian government failed to create transparent regulations hindering the efficiency of the banking sector. Weak management, excessive credit concentration, moral hazards, inadequate and non-transparent information on the financial condition of banks, and ineffective supervision by Bank Indonesia (BI) all contributed to

effective tool; the market has as much a need for accurate financial information as supervisors. Market participants use similar qualitative and quantitative information as supervisors, such as annual (or more frequent) reports. If possible, it is important to use same accounting principles for all disclosures. Information should include audited financial statement and qualitative information as well as names and affiliations of insiders, and information about off-balance sheet items. Financial statements should include a general risk profile (credit, forex, market, liquidity risk, etc.) and risk tolerances of the bank and should also include information on earnings (income and expenses). Maintaining reliable information on the financial condition of banks is crucial for effective market discipline, regulatory oversight and corporate governance. There is a significant disincentive for accurate reporting of increases in a bank's financial condition because bad loans and other events cause the bank's financial position to deteriorate. The growth of derivative products and the ease of hiding 'bad' assets offshore, combined with the supervisor's inability to keep pace with financial innovation makes transparency difficult to achieve. In order to increase the transparency of banking, three items are needed: (1) realistic valuation of bank assets, (2) public disclosure, and (3) prudential reporting. Realistic appraisal of bank assets requires the adoption of generally accepted accounting principles (including consolidated reporting for corporate conglomerates), effective loan classification, provisioning, and income realization rules. Banks must have effective internal reporting and control procedures, especially regarding credit approval, classification, and recovery. Public disclosure requires that accurate information reach the marketplace, which is a prerequisite for effective market discipline. Integrity of data is under significant pressure when it is needed most: in times of financial stress. Prudential reporting requires banks to report information to supervisors that, due to its sensitivity, they would not report to the public; It should be generally accepted that bank supervisors be able to request all relevant data with proper notice. FRAMEWORK, *supra* note 6, at 67-69.

83. Core Principles, *supra* note 73, at Principle 22. These corrective measures should allow for a timely graduated formal or informal response to any potential threat to the nation's banking system. Corrective measures have the best chance for success when they are part of a comprehensive program developed in conjunction with the bank. Regulators should be able to restrict the current activities of the bank and any future activities, including acquisitions or distributions. Also, banking regulators should have the power to forbid a specific individual from becoming involved with any bank. In the most extreme case, the regulator should have the power to liquidate the bank. FRAMEWORK, *supra* note 6, at 69.

the Crisis.⁸⁴ Further, a lack of political stability created discontinuity in policy-making and implementation.⁸⁵ Enforcing rules, enhancing the skills of bank regulators, and re-evaluating the organizational structure of banking supervision are goals of post-Crisis reform.⁸⁶ BI seeks to bring Indonesian bank regulations more in line with the Core Principles.⁸⁷

The Indonesian government used state-owned banks for economic development, which led to questionable actions such as "memo lending"—lending on the basis of a government recommendation.⁸⁸ Before the Crisis, self-regulation resulted in abuse of authority and left the bank sector fragile and vulnerable to external shocks.⁸⁹ The Indonesian government's interest in banks is waning; within five years the government will be divested of its interest in any Indonesian bank and regulators' discretion will be limited to ensuring that the banks are run properly and efficiently.⁹⁰

The Banking Law, enacted in 1992, is the principal law governing Indonesia's bank sector. The 1992 legislation addresses the perception that the previous 1967 Banking Law created an insufficient legal framework for Indonesia's banking system.⁹¹ The post-1988 time period saw a liberalization of the banking sector. For example the 1992 law specifically sought to decrease the number of banks and clarified the licensing procedure.⁹² The liberalization process has been uneven; for example, the number of scandals involving Indonesian banks and regulators has increased since 1988.⁹³

84. Bank Indonesia, *The Most Current Banking Developments* (visited April 17, 1999) <<http://www.bi.go.id/intl/policies/bankingcurrent.htm>> [hereinafter BI Current Developments].

85. BANK OF THAILAND, *BANK OF THAILAND ECONOMIC FOCUS: FOCUS ON THE THAI CRISIS 22* (1998) [hereinafter BOT FOCUS].

86. See BI Current Developments, *supra* note 84.

87. *Id.*

88. Bennett, *supra* note 46, at 458. It should be noted that Suharto's family had large interests in Indonesia's financial sector. See also HEAD, *supra* note 10, at 72-73.

89. Dr. Syahirl Sabirin, "Recent Developments in the Indonesian Economy", Address at Banque de France (Mar. 1999) [hereinafter Sabirin].

90. *Id.*

91. See Bennett, *supra* note 46, at 450.

92. *Id.* The new banking law also sought to improve governmental control over bank lending and capital adequacy policies and to emphasize professionalism among bank directors. *Id.*

93. *Id.* An excellent example is the 1994 scandal involving Bank Pemangungan Indonesia ("Bapindo"). Between 1989-1991, Bapindo generated some U.S.\$430 million in loans in the form of letters of credit to the Golden Key business group. Not only were these loans not covered by adequate collateral, but they contained a unique clause that allowed the letters to be drawn upon prior to the shipment of goods for which the letter was issued. Predictably, the letters were cashed and no equipment was ever delivered. Then-President Suharto's youngest son had an interest in Gold Key at the time the loans were issued, although he denied any knowl-

The Ministry of Finance and BI are the primary regulators of Indonesia's banking sector. The former oversees all of Indonesia's finance sector, including bank licensing, in consultation with BI; the latter is the central bank which oversees the daily administration of the banking sector.⁹⁴ BI, established as a central bank in 1953, is a state institution tasked by the President to carry out monetary and banking policies. BI's governor is a member of the President's cabinet.⁹⁵ BI is empowered to license, regulate, supervise, and impose sanctions on parties in the Indonesian bank sector.⁹⁶ Before the Crisis, BI was unable to effectively regulate because of its inability to keep up with the rapid progress and increasing complexity of a banking system, enabling banks to overlook prudential regulations.⁹⁷ Weak law enforcement contributed to BI's inadequate regulation and poor corrective measures.⁹⁸

BI's credibility was compromised because of a lack of transparency and independence.⁹⁹ As a result of the Crisis, BI will consistently implement legal lending limits and make such review more transparent.¹⁰⁰ Post-Crisis, BI will improve its transparency and disclosure of banks' financial status to enable public regulation of banking performance.¹⁰¹ To enhance transparency, BI will disclose support and policy for every regulation.¹⁰² For ex-

edge of the problem. In the process of the Bapindo investigation, the then-Minister of Finance, Mar'ie Muhammed, discovered that the total value of bad loans issued by state-owned banks amounted to 21.2% of combined loan portfolio, an increase, inclusive of doubtful loans, of 360% since 1990. Much of the increase seems to have been due to politically-connected lending and collusion between bankers and borrowers. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: Indonesia*, 21-23 (2nd quarter 1994).

94. *Id.* at 452-453. Bank Indonesia is a successor to Bank Negara, the central bank until 1968. Unlike the latter, Bank Indonesia is not allowed to conduct commercial banking activities. *Id.* at 455. Bank Indonesia implements policies of prudential banking, as well as empowering banks to self regulate. Bank Indonesia, *The History of Bank Indonesia*, (visited April 17, 1999) <<http://www.bi.go.id/intl/about/index.html>> [hereinafter History of BI].

95. See *History of BI*, *supra* note 93.

96. See Bank Indonesia, *Banking Policies in Indonesia* (visited April 17, 1999) <<http://www.bi.go.id/intl/policies/bankingpolicy/htm>> [hereinafter BI Policies].

97. BI 1998 Annual Report, *supra* note 45.

98. *Id.*

99. Dr. Syahril Sabirin, "Bank Indonesia Meets the Challenge of Independence", Address at Batch of Course for Senior Staff and Leadership of Bank Indonesia (1998), available at Bank Indonesia, *Speeches by the Governor* (visited April 17, 1999) <<http://www.bi.go.id/intl/speeches/kapitaselekt.htm>> [hereinafter Challenge]. The lack of transparency in the government decision-making in Indonesia's banking sector contributed to the outbreak of crisis in Indonesia. HEAD, *supra* note 10, at 72

100. BI 1998 Annual Report, *supra* note 45.

101. See BI Current Developments, *supra* note 84.

102. BI 1998 Annual Report, *supra* note 45.

ample, a new draft of BI's constitution requires periodic policy statements on monetary and regulatory issues, geared to improving BI's transparency.¹⁰³

BI's lack of independence contributed to the Crisis and independence should be increased.¹⁰⁴ The new draft of the BI constitution focuses on bank regulation, the relationship between BI and the government, and the limits of BI's responsibilities.¹⁰⁵ The draft constitution would ensure BI's independence by more explicitly defining it as a state institution with duties and responsibilities stipulated by law.¹⁰⁶ BI's new draft constitution also holds that BI's Board of Directors will be assigned for a long period, ensuring devotion of sufficient time to BI, and their dismissal will be defined by law.¹⁰⁷ In response to the perception that BI's ill-defined role created structural weakness in Indonesia's bank sector, the draft constitution will provide for BI's functional independence and exclusive authority in monetary stability and banking regulation.¹⁰⁸

Indonesia's improvement of bank legal infrastructure includes reviewing a new draft of bankruptcy law and creating a deposit insurance institution.¹⁰⁹ However, these measures are not as important for BI's independence and the transparency in BI's rulemaking. Similarly, China's bank regulator, the People's Bank of China (PBC), lacks operational independence and transparent operations placing it at the same risk as BI. China should institute needed reforms to avoid the regulatory issues that plague Indonesia.

Implicit government guarantees, created by a lack of transparency in BI's operations, adversely affected Indonesia's banking sector. In addition, a lack of an exit mechanism and no explicit deposit insurance helped create an implicit guarantee.¹¹⁰ BI's implicit guarantee that no bank would be allowed to fail, ostensibly to prevent a systemic banking crisis, created moral hazards on behalf of bank managers which lead to risky lend-

103. Challenge, *supra* note 99.

104. *Id.* See also Letter from Ginandjar Kartasasmita, State Coordinating Minister for Economy, Finance, and Industry, *Government of Indonesia*, to Michael Camdessus, Managing Director, *International Monetary Fund* (Nov. 13, 1998) available at <<http://www.imf.org>> [hereinafter Indonesia Nov. 13 letter].

105. Challenge, *supra* note 99.

106. *Id.*

107. *Id.*

108. *Id.* According to its current constitution, Bank Indonesia not only has monetary and regulatory authority, it has the duty to encourage economic growth and create job opportunities. Interestingly, the reformers are contemplating creating a regulatory entity totally independent of Bank Indonesia for banking supervision. *Id.*

109. BI 1998 Annual Report, *supra* note 45.

110. *Id.*

ing.¹¹¹ Before the Crisis, Indonesia did not have an explicit bank guarantee structure. This compounded the risks of implicit guarantees. Today, guaranteeing deposits is a cornerstone of Indonesian policy that ensures that reform does not affect the safety of deposits; it is a significant part of the government's ongoing effort to establish a safe, efficient, and competitive banking system.¹¹² As the Crisis started, Indonesia did not create a formal deposit insurance system but, instead, promised compensation only to small depositors in Indonesian banks that were closed at the beginning of bank restructuring.¹¹³ Indonesia's deposit guarantee was not widely publicized, and after several waves of runs on deposits, Indonesia introduced a comprehensive scheme covering all bank depositors for a period of two years.¹¹⁴

In terms of regulating banks' ongoing operations, BI's evaluations use a system comparing capital, asset quality, management competence, earnings, and liquidity (CAMEL). Using CAMEL, a bank is awarded a score between 0 and 100 and is rated sound, fairly sound, poor, or unsound.¹¹⁵ Despite this structure, BI's bank supervision and enforcement departments required strengthening.¹¹⁶ Weak law enforcement and a lack of complete information regarding the financial condition of regulated banks hampered the effectiveness of the examination system.¹¹⁷ As a first step, BI now requires all banks to prepare and submit audited financial statements.¹¹⁸ Further, BI will improve its surveillance of capital adequacy and bank liquidity by requiring monthly reports.¹¹⁹ Additionally, BI's oversight will be made easier by more consolidated regulation of banks, their parent, subsidiaries, and affiliates.¹²⁰

111. *Id.*

112. Bank Indonesia, *Government of Indonesia Announces Sweeping Reforms of the Bank System* (visited Apr. 17, 1999) <<http://www.bi.go.id/intl/press/sweeping.html>>.

113. PRELIMINARY IMF REPORT, *supra* note 2, at 108. The guaranty covers deposits up to equivalent of US\$5,000, which covers 90% of depositors but only 20% of the deposit base of closed institutions. *Id.*

114. *Id.*

115. Bennett, *supra* note 46, at 453 n.53.

116. Letter from Ginandjar Kartasasmita, State Coordinating Minister for Economy, Finance, and Industry, *Government of Indonesia*, to Michael Camdessus, Managing Director, *International Monetary Fund* (June 24, 1998) available at <<http://www.imf.org>> [hereinafter Indonesia June 24 letter].

117. See BI Current Developments, *supra* note 84.

118. Indonesia June 24 letter, *supra* note 116.

119. BI 1998 Annual Report, *supra* note 45.

120. *Id.*

2. Banking Sector Regulation: Korea

Korea's banking sector has been the Achilles' heel of the Korean economy.¹²¹ Weak regulatory oversight allowed banks to incur excessive risk without building a capital base to withstand shock.¹²² Before the Crisis, Korean bank regulation contained a dichotomy: banks were regulated by the Bank of Korea's (BOK) Office of Bank Supervision (OBS) and nonbank financial institutions (NBFIs) that were largely unregulated. The lack of unified regulations coupled with weak regulation created regulatory arbitrage which lead to the development of risky practices critical to the Crisis' development.¹²³

Traditionally, the Korean government used the banking sector to facilitate industrial policy initiatives that, coupled with the economic power of the *chaebols*, dominated credit allocation and obviated banks' prudential evaluation and monitoring of loans.¹²⁴ In spite of financial market liberalization and government deregulation, the explicit or implicit Korean government interventions did not stop, and the influence of the *chaebols* did not decline.¹²⁵ As with Indonesia, regulators' lack of independence and transparency were causal factors in the Crisis.¹²⁶

The Bank of Korea Act and the Banking Act underpin the Korean banking system. The Ministry of Finance and Economy establishes and revises laws relating to financial policies and licensing of certain financial institutions; the financial supervisory function recently has been transferred to the Financial Supervisory Committee (FSC).¹²⁷ The BOK's main responsibilities are price stability and bank supervision.¹²⁸ Prior to the establishment of the FSC, the OBS was tasked with day-to-day banking

121. Eduardo Borensztein and Jong-Wha Lee, CREDIT ALLOCATION AND FINANCIAL CRISIS IN KOREA 3 (International Monetary Fund Working Paper No. WP/99/20, 1999) [hereinafter Borensztein].

122. Baliño, *supra* note 51, at 21.

123. *Id.* at 16, 19.

124. Borensztein, *supra* note 121, at 3.

125. *Id.*

126. Letter from Kyung-shik Lee, Governor, *Bank of Korea*, and Chang-Yuel Lim, Deputy Prime Minister and Minister of Finance and Economy, *Republic of Korea*, to Michael Camdessus, Managing Director, *International Monetary Fund* (Dec. 3, 1997) (available at <<http://www.imf.org/external/np/101120397.htm#memo>>).

127. Korean Ministry of Finance and Economy, *Historical Background of the Ministry of Finance and Economy*, (visited Apr. 17, 1999) <http://www.mofe.go.kr/ENGLISH/e_oa.html>.

128. Bank of Korea Act of 1950, Act No. 138, § 3, (1950), (as amended by Law No. 5491 of December 31, 1997) [hereinafter Bank of Korea Act]. The central purpose of Bank of Korea is price stability through efficient monetary and credit policies. *Id.*

sector oversight.¹²⁹ The BOK's Governor, appointed by the President on deliberation of State Council, is limited to two four-year terms and may be dismissed by the Minister of Finance and Economy if she or he violates the Bank of Korea Act, is convicted in a criminal case, or is declared bankrupt or mentally or physically incompetent.¹³⁰ The OBS had the power to waive the regulations, facilitating forbearance and making enforcement nontransparent.¹³¹

The BOK supervises reserve requirements¹³² and minimum ratios to be maintained by each banking institution.¹³³ Consistent with the Core Principles, the BOK's executive officers and bank employees are public officials for purposes of the Criminal Act.¹³⁴ The Superintendent of the OBS can request that a bank punish an employee if the employee violates the Bank of Korea Act, violates the bank's articles of association, fabricates reports to the OBS, interferes with an OBS inspection, or neglects to carry out other OBS disciplinary requests.¹³⁵ If a bank intentionally violates the Bank of Korea Act, the BOK's Monetary Board Operating Committee may advise the general bank shareholders meeting of such violation¹³⁶ and may, if such violations continue, suspend the bank's business operations or cancel its business license.¹³⁷

However, pre-crisis, the BOK was not an independent entity. The Ministry of Finance and Economy exercised the strongest voice on the BOK's operations committee.¹³⁸ The Minister of Finance and Economy has oversight over the BOK's Monetary Board Operating Committee and could override, with a two-thirds vote, any final decision to be made by the Monetary Board.¹³⁹ Further, the Ministry of Finance and Economy closely regulated the banking industry through detailed guidance of BOK under which the government rewarded companies with "approved" economic development strategies and punished

129. Bank of Korea Act § 28. *See also* Baliño, *supra* note 51, at 9.

130. Bank of Korea Act § 114.

131. Baliño, *supra* note 51, at 19.

132. Bank of Korea Act § 56.

133. Bank of Korea Act § 57. If reserves are under a minimum ratio, BOK fine is 1% of average shortage, if ratio is low for 2 ½ months, can prohibit new loans, investments or paying out dividends until reserve requirements are fulfilled for one month or more, stricter penalties for one year or more. Bank of Korea Act § 60.

134. Bank of Korea Act § 112-2.

135. Bank of Korea Act § 114-2.

136. Bank of Korea Act § 115.

137. Bank of Korea Act § 116.

138. ASIAN BANKING LAW MANUAL, KOREA 48 (1994) [hereinafter ABL Korea].

139. Bank of Korea Act § 39.

those without.¹⁴⁰ The Ministry of Finance and Economy's "policy loans" and oversight over certain parts of the BOK weakened the BOK's ability to effectively and efficiently regulate Korea's banking system. The policy loans continued despite August 1993 regulations ordering their reduction.¹⁴¹

In connection with the IMF package, Korea will provide for more central bank independence, consolidate and strengthen banking regulation consistent with international best practices, conduct external audits, close or restructure questionable financial institutions, and increase foreign entry into the Korean banking sector.¹⁴² December 1997 legislation significantly strengthened the independence of the BOK, consolidated all regulatory oversight in the FSC, and merged all deposit insurance companies into the Korea Deposit Insurance Corporation.¹⁴³ At the same time, Korea issued clear standards for bank regulation and the relationship between the FSC and other government entities.¹⁴⁴

Korea had a "too close" relationship among banks, government, and business. Until recently, the Korean government controlled the selection of top management of major city banks. The Ministry of Finance and Economy's close relationship with *chaebols* created the perception among the banks at the *chaebols'* center that the *chaebol* were above reproach. *Chaebol*-connected NBFIs were largely unregulated, providing ample opportunity for regulatory arbitrage and risky practices. NBFIs were under the authority of the Ministry of Finance and Economy, although on-site NBFIs inspections were conducted by the OBS.¹⁴⁵ China's banking system, like Korea's, is marked by a large number of "policy loans" and a close relationship among the banks, government, and state-owned enterprises (SOEs).

There was a general perception in Indonesia's, Korea's, and Thailand's banking sectors that deposits were covered by implicit government guarantees.¹⁴⁶ Banks were not allowed to fail in Korea, which, along with asymmetric information, implicit guarantees, and weak balance sheets, created a serious risk of financial crisis by fostering moral hazard.¹⁴⁷ Korea's banking sector

140. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: South Korea 24* (1997-8).

141. ABL Korea, *supra* note 138, at 48.

142. HEAD, *supra* note 10, at 73-74.

143. Baliño, *supra* note 51, at 31.

144. *Id.* at 33.

145. *Id.* at 16.

146. PRELIMINARY IMF REPORT, *supra* note 2, at 107.

147. CRAFTS, *supra* note 67, at 32.

needed systematic exit procedures to include objective criteria for the BOK to cause a bank to exit.¹⁴⁸

Before the Crisis, only Korea had a formal deposit insurance system as an explicit guarantee. Deposit insurance was created in 1996, but there were not enough funds to absorb Crisis problems.¹⁴⁹ Korea's deposit insurance scheme, effective January 1997, was funded by low premiums paid by banks and insured the depositor up to W20 million; weak regulatory oversight rendered this ineffective.¹⁵⁰ As the Asian financial crisis broke, Korea and Thailand announced improvements to deposit guarantees in order to calm depositors and avoid widespread bank runs.¹⁵¹ The programs in Korea and Thailand minimized the risk of moral hazard by creating strict time limits and replacement by the funded, and caps were formulated in order to prevent weak banks from bidding up deposit rates.¹⁵²

In 1995, the OBS created a reporting system based on a CAMEL framework, designed to give early warning of problems; however, weak regulatory oversight rendered this ineffective.¹⁵³ Post-Crisis, the FSC will monitor capital ratios and CAMEL; if capital adequacy falls below 8% or if CAMEL falls to three or worse, a commercial bank will be exposed to enforcement procedures.¹⁵⁴ Supervisory inspections can result in banks being required to increase capital because of deterioration in asset quality or the strengthening of supervisory rules.¹⁵⁵

The FSC will, on a consolidated basis, oversee merchant banks and other financial institutions with the same standards applying to those entities as to commercial banks; specialized and development banks will still be under the Ministry of Finance and Economy's control, with the inspection process delegated to the FSC.¹⁵⁶ FSC ongoing regulation will be on a more consolidated basis.¹⁵⁷ The FSC will also oversee improvements on enhancing risk management and continuing identification and resolution of nonperforming loans.¹⁵⁸ If a bank's plans are not

148. "Principles in Financial Reform" Address by Chol-Hwan Chon, Governor, the Bank of Korea at Financial Times Conference (1998) available at (visited April 17, 1999) <http://www.bok.or.kr/cgi-bin/nph-hwp2html/data/eng9/UP/ft_korea.hwp.19980428165449> [hereinafter Korean Principles].

149. *Id.*

150. Baliño, *supra* note 51, at 17.

151. PRELIMINARY IMF REPORT, *supra* note 2, at 107.

152. *Id.*

153. Baliño, *supra* note 51, at 17.

154. Korea March 10, 1999 letter, *supra* note 53, at 6.

155. *Id.*

156. Baliño, *supra* note 51, at 42.

157. *Id.*

158. Korea March 10, 1999, *supra* note 53, at 5.

fulfilled, the bank will be subject to the FSA's Prompt Corrective Action procedures.¹⁵⁹

Korean banks must continue to comply with periodic inspections by the OBS,¹⁶⁰ which supervises and makes periodic examinations of banks under the purview of the Banking Act, and can require the submission of a report. Examinations are to be yearly without any prior notice; the OBS may require submission of bank documents.¹⁶¹ Banks must publish consolidated balance sheets showing profits and losses within three months of the end of the fiscal (calendar) year.¹⁶² Korean regulators have an array of punitive powers—bribes are to be punished by not less than five years in jail and a W30 million fine;¹⁶³ unlicensed banks subject to three years in jail and up to a W20 million fine.¹⁶⁴ If a bank officer or manager violates reserve requirements, if a bank's capital stock is inadequate, or if a bank fails to accumulate surplus, invests in long-term debt, owns real estate or engages in other prohibited activities, makes false announcements, or falsifies reports, the bank official is subject to up to one year in jail and a W10 million fine.¹⁶⁵ Banks are also subject to punitive measures if they violate the Banking Act.¹⁶⁶ If a bank officer intentionally violates the Banking Act, the BOK can order his or her suspension or can ask a shareholders meeting to dismiss such officer.¹⁶⁷

3. *Banking Sector Regulation: Thailand*

The Commercial Banking Act (1962), as amended, and the Bank of Thailand Act (1942) established the Bank of Thailand (BOT) to govern Thai bank operations. Thai banking regulation was largely ineffective because of the political power of banks and finance companies.¹⁶⁸ Further, BOT lacked regulatory skill and relied on politicians instead of technocrats, although training and recruitment are accelerating as a result of the Crisis.¹⁶⁹ Reg-

159. *Id.*

160. Korean Banking Act, No. 139, § 32 (1950) (as amended through Act No. 5257 of January 13, 1997) [hereinafter Korean Banking Act].

161. Bank of Korea Act § 30. Examination fees paid by banks. Bank of Korea Act § 34.

162. Korean Banking Act § 35.

163. Korean Banking Act § 38.

164. Korean Banking Act § 38-2.

165. Korean Banking Act § 38-3.

166. Korean Banking Act § 39.

167. Korean Banking Act § 40.

168. HEAD, *supra* note 10, at 71.

169. Letter from Tarrin Nimmanahaeminda, Minister of Finance, *Kingdom of Thailand*, and M.R. Chatu Mongol Sonakul, Governor, *Bank of Thailand*, to Michael Camdessus, Managing Director, *International Monetary Fund* (visited Aug. 25, 1998) (available at <<http://www.imf.org>>) [hereinafter Thailand Aug. 25 letter].

ulatory independence, procedures, authority, and transparency needed to be improved before the Crisis.¹⁷⁰ Post-Crisis, the regulatory framework as a whole will be brought in line with international "best practices" by 2000.¹⁷¹

BOT, under the supervision of the Ministry of Finance, supervises Thai commercial banks and is governed by an 11-member Board.¹⁷² Among other responsibilities, BOT regulates deposit insurance rates, interest rates and fees, and rules for lending or borrowing money.¹⁷³ BOT has significant oversight powers, such as removal of bank officers, and new appointment of officers subject to BOT approval, or, if the bank fails to take action within the provided 30-day window, BOT may fire and replace such officers.¹⁷⁴

Despite these powers, BOT has significant shortcomings in several important areas. BOT needs a litigation department specifically tasked to litigate and to secure more accurate results in less time.¹⁷⁵ BOT should have a more market-oriented regulatory approach in order to have a closer relationship and better understanding of banking business.¹⁷⁶ Also, BOT should engage in employee exchanges with banks to foster BOT employees' knowledge.¹⁷⁷

In addition, BOT's relationship with the Ministry of Finance is often uncertain, leading to doubts about BOT's independence. BOT's independence was marred in a 1996-7 scandal that forced the resignation of two BOT governors and other high-ranking

170. Letter from Tarrin Nimmanahaeminda, Minister of Finance, *Kingdom of Thailand*, and Chaiyawat Wibulswasdi, Governor, *Bank of Thailand*, to Michael Camdessus, Managing Director, *International Monetary Fund* (visited Feb. 24 1998) (available at <<http://www.imf.org>>) [hereinafter Thailand Feb. 24 letter].

171. Letter from Tarrin Nimmanahaeminda, Minister of Finance, *Kingdom of Thailand*, and Chaiyawat Wibulswasdi, Governor, *Bank of Thailand*, to Michael Camdessus, Managing Director, *International Monetary Fund* (visited Nov. 25 1997) (available at <<http://www.imf.org>>) [hereinafter Thailand Nov. 25 letter].

172. Apisith John Sutham, *The Asian Financial Crisis and the Deregulation and Liberalization of Thailand's Financial Services Sector: Barbarians at the Gate*, 21 *FORDHAM INT'L L.J.* 1890, 1911-12 (1998) [hereinafter Sutham]. The Board includes appointees by the King on the advice of the cabinet and the cabinet on the advice of the Ministry of Finance. *Id.*

173. *Id.* at 1913.

174. Emergency Decree Amending the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business, B.E. 2522 (No.4) B.E. 2540 §3 (available at <<http://www.bot.or.th/govnr/public/news/ee.htm>>); See also Emergency Decree Amending the Commercial Banking Act B.E. 2505 (No. 3) B.E. 2540 §4 (available at <<http://www.bot.or.th/govnr/public/news/de.htm>>).

175. M.R. Chatu Mongol Sonakol, Bank of Thailand, *Thoughts on the Bank of Thailand by the Governor of the Bank of Thailand M.R.* (visited April 15, 1999) <<http://www.bot.or.th/govnr/public/news2541/OtherNews/concept-e.html>> [hereinafter Thoughts].

176. *Id.*

177. *Id.*

BOT officials.¹⁷⁸ The often adversarial relationship between the Ministry of Finance and BOT not only negatively impacts BOT's independence, but also adversely impacts BOT's transparency. The Ministry of Finance has powers over the banking system as well ensuring that commercial banks do not reduce capital without authorization, hold shares in other domestic commercial banks, or commit any act that may impair the economy.¹⁷⁹ The Minister of Finance should, in the future, oversee compliance with laws, but allow BOT sufficient autonomy to enforce bank regulation— action that should improve transparency.¹⁸⁰

Like Thailand, China's bank regulators appear inexperienced and ineffective, given the political power of some Chinese state-owned banks. Further, the relationship between the PBC and China's Ministry of Finance should be clarified by fostering the PBC's independence and transparency.

Implicit government guarantees for the Thai banking sector were aggravated by a lack of an explicit government deposit guarantee. The Thai government has agreed to introduce a deposit insurance system during the IMF program period.¹⁸¹ Banks are to remit to the BOT's Fund Management Committee money at a prescribed rate, not to exceed .5% of total deposits, borrowings, or funds of a bank at the end of six-month periods; additional .5% contributions will be required where the fund extends insurance to creditors of financial institutions.¹⁸² The fund is empowered to lend money without collateral in accordance with terms and conditions approved by the Minister of Finance, guarantee bills, provide assistance to entities that sustain losses, and perform other actions incidental to the operation of the fund.¹⁸³

Thai bank regulators inspected banks under their purview, although the efficacy of those inspections was questionable. Examination procedures were generally effective, but require a universal examination standard, better post-examination follow-up, improved procedure, and training through an institute for exam-

178. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: Thailand* 30 (1997-8).

179. Sutham, *supra* note 172, at 1912-3. Thai banks may not grant any credit or guarantee the debt of directors or certain related persons, accept their own shares or the shares of another commercial bank as security, hold fixed property except for offices and foreclosed property, hold a greater than 10% equity interest in any company, pay money to directors outside of their salary, or sell property to any director without the consent of the Bank of Thailand.

180. Thoughts, *supra* note 175.

181. Thailand Nov. 25 letter, *supra* note 171.

182. Emergency Decree Amending the Bank of Thailand Act, B.E. 2485 (No. 2) B.E. 2540 §3 (*available at* <<http://www.bot.or.th/govnr/public/news/ce.htm>>).

183. *Id.* §4. The fund may also purchase or hold shares of financial institutions, borrow money, make investments with the oversight of the Fund Management Committee, hold deposits, and acquire and dispose of property. *Id.*

iners.¹⁸⁴ Complementing the inspection process, Thai regulators had the power to close down insolvent intermediaries.¹⁸⁵ Post-Crisis, BOT will strengthen its on-site examinations of asset portfolios of all institutions to ensure that intermediaries are viable.¹⁸⁶ Also post-Crisis, the bankruptcy law will be amended to allow reorganization instead of liquidation for banks and increase out-of-court workouts, enhancing Thai banks' exit strategy.¹⁸⁷

4. *Banking Sector Regulation: China*

An efficient Chinese financial market depends on establishing an effective banking regulatory regime.¹⁸⁸ The Law of the People's Republic of China (PRC) on the People's Bank of China and the Central Banking Law of the PRC, the first national Chinese banking laws, regulate Chinese banking operations and provide a framework for banking system development.¹⁸⁹ Despite the legal framework, political interference in banking operations is a significant problem for the Chinese banking system. Further, the PBC seems to lack the ability to promulgate regulations on an independent and efficient basis.

Until the 1978 economic reforms, the Chinese banking system was comprised of the PBC acting as both the central bank and sole commercial bank.¹⁹⁰ The PBC, formed in 1948 as the central bank following the merger of the North China Bank, Beihei Bank, and the Farmer's Bank of Northwest,¹⁹¹ makes and implements national monetary policy, supervises and administers financial institutions, and issues and maintains the stability of the renminbi.¹⁹² The PBC supervises and controls banks and finan-

184. Thoughts, *supra* note 175.

185. JOSEPH BISIGNANO, *PRECARIOUS CREDIT EQUILIBRIA: REFLECTIONS ON THE ASIAN FINANCIAL CRISIS* 9 (Bank for Int'l Settlement Working Papers No.64, 1999). [hereinafter BISIGNANO].

186. Thailand Feb. 24 letter, *supra* note 170.

187. BOT FOCUS, *supra* note 85, at 31.

188. Lawrence L.C. Lee, *Adoption and Application of a 'Soft-Law' Banking Supervisory Framework Based on the Current Basle Accords to the Chinese Economic Area*, 16 WIS. INT'L L.J. 687, 702 (1998) [hereinafter Lee II].

189. Andrew Xuefeng Qian, *Transforming China's Traditional Banking Systems Under the New National Banking Laws*, 25 GA. J. INT'L & COMP. L. 479, (1996) [hereinafter Qian].

190. ASIAN BANKING LAW MANUAL, CHINA 3 (1994).

191. I.A. TOKLEY AND TINA RAVN, *BANKING LAW IN CHINA*, 9 n.2 (1997) [hereinafter TOKLEY].

192. Law of the People's Republic of China on the People's Bank of China §§ 2,7 (effective from March 18, 1995) [hereinafter PBC Law]. PBC has eleven functions: 1) formulate and implement monetary policies, 2) issue and control circulation of renminbi, 3) examine, approve, supervise, and control financial institutions, 4) supervise and control the financial market, 5) promulgate ordinances, regulations, and rules concerning financial supervision and control and banking operations, 6) hold

cial institutions by approving the establishment, alteration, scope of business, and termination of a bank.¹⁹³ In addition to supervising state-owned banks, the PBC supervises the granting of deposits and loans, accounts settlement, bad debts, and business affairs of a bank.¹⁹⁴ The PBC has a broad range of operational functions, such as a lender of last resort for the Chinese banking system by making commercial loans to banks;¹⁹⁵ organizing and supervising the interbank market;¹⁹⁶ and stipulating repayment schedules and rates of interest granted by commercial banks.¹⁹⁷

The PBC controls foreign exchange transactions through supervision of the State Administration of Exchange Control.¹⁹⁸ Also, the PBC represents the PRC in international dealings, including the Basle Committee.¹⁹⁹ The PBC conducts licensing examinations,²⁰⁰ audits bank operations,²⁰¹ and may demand submission of financial statements within three months of the end of a fiscal year.²⁰² Additionally, the PBC compiles statistics on the banking industry for government use.²⁰³ The PBC, which cannot act as a guarantor,²⁰⁴ must control its budget and provide accounting records to the State Council.²⁰⁵ Profits earned by the

and operate state foreign exchange and bullion reserves, 7) manage State treasury, 8) maintain normal payment and settlement system, 9) statistics, analysis, and forecasting for the banking industry, 10) engage in international financial activities as central bank of State, and 11) other functions assigned by State Council. *Id.* PBC is permitted under the PBC law to use a number of different instruments to influence monetary policy, including reserve funds to be deposited by commercial banks with the PBC (PBC Law § 22(1)), base interest rates fixed by the PBC (PBC Law § 22(2)), rediscount for banking institutions which have opened accounts with PBC (PBC Law § 22(3)), provision of loans to commercial banks (PBC Law § 22(4)), dealing in State or other government bonds (PBC Law § 22(5)), and any other monetary policy instruments as specified by the State Council (PBC Law § 22(6)).

193. TOKLEY, *supra* note 191, at 46.

194. *Id.* at 47-48.

195. *Id.* at 45.

196. *Id.*

197. *Id.* at 46.

198. *Id.* at 15. Yuan is still not convertible. Originally supposed to be so in 2010, but it may occur sooner. *Id.* at 24. However, some banks in the Pudong section of Shanghai have been allowed to operate on a converted yuan basis as part of an experiment, seen as a move to increase foreign exchange reserves. PRC needs a better interbank market with free flow of foreign exchange and flexible market interest rates before convertibility would be a reality. *Id.*

199. *Id.* at 40.

200. PBC Law §31.

201. PBC Law §32. The Commercial Banking Law of the People's Republic of China §62 (*Effective from July 1, 1995*) [hereinafter PRC Commercial Banking Law].

202. PBC Law *supra* note 191 at §33; PRC Commercial Banking Law § 5.

203. PBC Law *supra* note 191 at §34.

204. TOKLEY, *supra* note 191, at 46.

205. *Id.* at 48. Art. 37

PBC are sent to the treasury, but can be treated as a reserve; PBC's losses are covered by the state.²⁰⁶

Commercial banks must seek PBC approval for various actions, from a name change to a change in registered capital.²⁰⁷ The PBC requires Commercial banks to keep a reserve.²⁰⁸ The PBC makes commercial banks qualify their debt and assets.²⁰⁹ The PBC may take control of a bank if the bank has a "credibility" crisis.²¹⁰ Upon takeover, the PBC's goal would be to resume normal bank business activity.²¹¹ Any bank dissolution plans are to be submitted to the PBC, with a schedule for repaying obligations.²¹² In extreme cases, the PBC may liquidate a bank whose license has been revoked.²¹³

Despite the detail in the People's Bank of China law, several issues are unanswered and could adversely affect development of China's banking system. For example, jurisdictional lines between financial authorities are unclear,²¹⁴ especially regarding potential conflicts between the PBC and the State Council Securities Commission over securities regulation.²¹⁵ Further, the PBC administers banks through administrative guidelines, not banking regulation.²¹⁶ For example, the PBC does not have independent authority to establish loan classification and provisioning methodologies.²¹⁷ Detailed rules and regulations implemented under both the People's Bank of China law and Commercial Banking law are still needed.²¹⁸ Despite 1993 reforms that attempted to make the PBC less like a socialist central bank by making operations more transparent, the lack of detailed guidance has fostered a general disregard for the PBC, as evidenced by the rise of gray markets for raising capital.²¹⁹ In addition, there are no laws on

206. *Id.*

207. PRC Commercial Banking Law, *supra* note 200 at § 24. Other powers include, 3) change in address of either branch or home office, 4) adjustment of scope of business, 5) change in 10% shareholders, 6) amendments to articles of association, 7) other matters specified by PBC. *Id.*

208. *Id.* at § 32.

209. TOKLEY, *supra* note 191, at 38.

210. PRC Commercial Banking Law, *supra* note 200 at § 64.

211. *Id.* Management powers to be assumed by entity taking control. *Id.* at § 66. Control is to last only 2 years. *Id.* at § 67.

212. PRC Commercial Banking Law § 69.

213. PRC Commercial Banking Law § 70.

214. Lee II, *supra* note 188, at 707-708.

215. Qian, *supra* note 189 at 487. Regulation of foreign or Chinese joint venture banks not clear either, although presumption that PBC governs. *Id.*

216. Lee II, *supra* note 188, at 728.

217. THE WORLD BANK, THE CHINESE ECONOMY: FIGHTING INFLATION, DEEPENING REFORMS 47 (1996) [hereinafter WORLD BANK I].

218. *Id.* at 47-48.

219. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: China* 38 (1997-8) [hereinafter EIU China II].

NBFIs, and weak regulatory oversight of both commercial banks and NBFIs has created the possibility of failures that could be transmitted across the entire Chinese banking system.²²⁰

The PBC reports to the Standing Committee of the National People's Congress on the supervision and administration of financial activities.²²¹ The PBC's Governor is nominated by the Premier of State Council, subject to the approval of the National People's Congress.²²² The PBC law forbids political interference at any level.²²³ However, the reality is that PBC provincial branches are under dual administration from the local government and Beijing, engendering significant political interference²²⁴ and causing political factors to outweigh credit analysis.²²⁵ As a result of political interference, many state-owned banks are technically insolvent, and the non-performing loan rate may be as high as 20%, creating the risk of a shock that the Chinese banking system could not withstand.²²⁶

The Chinese government uses banks for central planning of the PRC's economy and is unwilling to lose control.²²⁷ PBC's lending policy is consistent with government policy, giving the government the ability to manage the banking sector.²²⁸ However, this control may be waning. The national interbank market started on January 1, 1996, with market operations beginning April 1, 1996; the interbank market consists of 54 primary dealers, 19 banks and 35 short-term fundraising centers. The PBC has significant power in the interbank market by placing a now-expired upper limit on Chibor rates, which is still observed indicating that interest rates are not entirely market-driven because the State Council decides savings and deposit rates.²²⁹ Banks still look to the PBC for short-term money issues because PBC's interest and discount rates are better than interbank rates.²³⁰

Inspections and regulation of ongoing bank operations are weakened by the relative lack of skill possessed by PBC officials. Because China is relatively new at market banking, it has yet to develop a critical mass of educated and experienced bank regulators. Specifically, Chinese regulators seem to lack a complete appreciation of market banking operations and how regulation

220. WORLD BANK I, *supra* note 217, at 36.

221. PBC Law, *supra* note 191, at §6.

222. PBC Law, *Id.* at §9.

223. PBC Law, *Id.* at §7.

224. Qian, *supra* note 189 at 486. See also EIU China I, *supra* note 57, at 30.

225. Lee II, *supra* note 188, at 706.

226. EIU China I, *supra* note 57, at 30.

227. TOKLEY, *supra* note 191, at 11. Primarily to sustain growth of SOEs. *Id.*

228. *Id.* at 23.

229. *Id.* at 27

230. *Id.*

affects banking sector development and business. The lack of regulatory skill adversely affects transparency of the PBC's operations as well as their effectiveness. The PBC should undertake intensive training of regulators so to avoid scandals that have plagued Thai, Korean, and Indonesian banking systems.²³¹

5. *Chinese Banking Sector Regulation:
Strategic Recommendations*

Based on the lessons of Indonesia, Korea, and Thailand, China should:

1. Make Chinese banking regulations more consistent with the Core Principles.
2. Add the following language at the end of Article 3 of the People's Bank of China law: "The aim of banking supervision is to regulate in an independent and transparent manner. Banking regulation shall be consistent with the Core Principles and, thereby, will promote economic growth."
3. End the influence of the State Council in the PBC's operations. In Article 7 of the People's Bank of China Law, strike "under the leadership of the State Council". Also, in Article 7's discussion of the PBC's freedom from government interference, the "local" should be replaced with "any local or national". Given the State Council's political nature, its interference adversely impacts the transparency and effectiveness of the PBC's operations. It may be appropriate, however, for the PBC to report to the National People's Congress (NPC), but the NPC's oversight should be strictly limited to protecting from abuse of power, gross negligence and similar concerns.
4. Ensure that the PBC's governor and deputy governors, appointed pursuant to Article 9 of the People's Bank of China law, are more technocrats than politicians with little economic experience. A reduction in the State Council's power may also be appropriate here.
5. End the informal practice of dual oversight of the PBC by regional and national political entities.
6. Amend the People's Bank of China law to provide legal immunity for PBC officials in the discharge of their duties, absent gross negligence or intentional misconduct.
7. Amend the People's Bank of China law to clarify under what circumstances PBC officials may be terminated.
8. Endow the PBC with specific legal authority to independently promulgate regulations under both the People's Bank of China Law and the Commercial Banking Law.

231. *Id.* at 38-39.

9. In rulemaking, make the PBC disclose all relevant information, including the policy behind the rule as well as the rule's legal basis. Such action will improve PBC's transparency. Also, China should amend Article 40 of the People's Bank of China law to provide that the PBC's yearly operations report should be publicly disseminated.
10. Clarify whether the PBC or the State Council Securities Commission has authority over the securities markets. The PBC should not have any oversight over China's securities markets and should focus just on banking regulation.
11. Clarify exit procedures for Chinese banks to avoid the inadvertent creation of an implicit guarantee that Chinese banks cannot fail.
12. Establish an effective deposit guaranty system, despite Article 32 of the Commercial Bank law, without engendering too much moral hazard.
13. Foster the interbank market to reduce government influence in the banking sector.
14. Create objective standards for bank inspections pursuant to Article 32 of the People's Bank of China law, notwithstanding Articles 47-48 of the Administrative Regulations Governing Financial Institutions—promulgated August 9, 1994 by the PBC.
15. Attract and develop a critical mass of highly trained regulators, perhaps through international exchanges, to better inspect and more efficiently regulate the Chinese banking system.
16. Enure that Article 36 of the People's Bank of China law creates an audit system consistent with internationally accepted auditing and accounting principles.

B. LICENSING AND STRUCTURE

The second through fifth Core Principles suggest minimum standards for the licensing and structure of banks. Sound licensing and structure requirements are an entry policy inducing banks to operate in a safe and prudential manner, by minimizing informational asymmetries between regulators and the regulated and fostering competition in the banking sector.²³² Thorough, transparent, objective, and sound licensing policies are essential for an efficient and effective entry policy.²³³ Entry restrictions in

232. See, e.g., FRAMEWORK, *supra* note 6, at 32-36.

233. *Id.* Entry policies must strike a balance between fostering competition by encouraging entry and maintaining supervisory effectiveness by limiting entry. In general, the licensing process should ensure that a prospective bank, with suitably qualified owners, be properly organized, professionally managed, financially viable, and potentially profitable. Licensing regulations should require a thorough assess-

Indonesia, Korea, and Thailand were sometimes preferred to high capital standards because they gave more discretion to the government.²³⁴ However, ineffective entry policies in Indonesia, Korea, and Thailand failed to minimize informational asymmetries, contributing to the Crisis. The Crisis may have been averted or minimized if an entry policy had leveled the playing field between regulators and the regulated. Upgrading China's banking sector entry policy is crucial to minimizing the "Crisis risk" facing China.

The Core Principles' first entry policy is a standard definition of those activities a "bank" may undertake,²³⁵ to be enforced through a licensing process overseen by a central regulator who uses objective standards in reviewing applications requiring the disclosure of the entity's organization, management, and operating plan.²³⁶ Importantly, NBFIs, which perform functions similar to a bank, were laxly regulated in Indonesia, Korea, and Thailand; this was common in most APEC states, despite the IMF's 1992 warning.²³⁷

After granting an initial license, the regulator must be able to review a bank's transfer of control to a third party²³⁸ and a bank's acquisitions to ensure that the bank is not exposed to un-

ment of management, owners, business plan, and capitalization of the applicant; this information, in turn, requires disclosure of the knowledge, experience, and judgement of the applicant. The licensing process should verify: (1) Initial capital is sufficient; (2) Major shareholders and management are suitable for their offices; (3) Corporate structure is transparent; (4) The bank's organizational structure is adequate; and (5) The bank is adequately supervised in its home country, if any, and the establishment of the branch is approved by the home county supervisor. In the licensing process, bank regulators should be able to request at least five types of banking information: (1) decision-making process and competency of bank management; (2) the risks undertaken by the banks; (3) present and future earnings and profitability; (4) capital adequacy; and (5) banks' liquidity. Generally, this information includes detailed ownership information on the bank, cross-holdings involving related entities, whether directors and officers satisfy the "fit and proper test" (which requires information about the identity, experience, qualifications, personal financial status, honesty and integrity of such individuals as verified by law enforcement agencies, etc.). Also included is information about the business strategy and operations policy of the bank. FRAMEWORK, *supra* note 6, at 32-36.

234. BISIGNANO, *supra* note 185, at 9.

235. Core Principles, *supra* note 73, at Principle 2. Such is to prevent banks from using depositors' money to take risks outside the scope of traditional banking, to limit conflicts of interest, and concentrations of financial power. Excessive diversity of activities by a bank can also create difficulties in consolidating accounts and exercising effective supervision. Limiting banks to certain well-defined financial activities allows matters to have the necessary expertise to manage ongoing operations, as well as allowing the regulators to exercise their expertise. FRAMEWORK, *supra* note 6, at 39-40.

236. Core Principles, *supra* note 73, at Principle 3.

237. BISIGNANO, *supra* note 185, at 27.

238. Core Principles, *supra* note 73, at Principle 4.

due risk through corporate relationships.²³⁹ Close relationships between corporate entities and banks create connected lending risks and other risks for the bank's ongoing operations. In Indonesia, Thailand, and especially Korea, close bank-corporate relationships created significant risk ultimately culminating in the Crisis. China's banking sector is marked by close relationships between state-owned enterprises and banks creating similar risks.

1. *Licensing and Structure: Indonesia*

Under Indonesian law, a "bank" is defined as a unit that mobilizes funds from the public in the form of deposits, and channels such funds back to the public through loans.²⁴⁰ A commercial bank receives deposits, generates loans, provides payment services, and engages in securities transactions and may be owned by the central or a regional government, a cooperative, or private limited liability company.²⁴¹ A smallholder rural credit bank receives only time deposits, savings, or other similar types of deposits and may be owned by a regional government, cooperative, private limited liability company, or other entity specified by regulation.²⁴² As a result of Crisis-driven banking sector restructuring, banks will be restructured into international banks, national banks, regional banks, and rural banks with different capital requirements and scope of activities.²⁴³

The Indonesian banking system had rapid entry and growth, the result of liberalizing reforms like 1988's PAKTO that actually exacerbated regulatory deficiencies.²⁴⁴ Indonesian commercial banks were not limited to demand deposits, savings, and time deposits but were allowed to market securities, such as certificates of deposits, equities, and bonds as a result of heightened competition in the Indonesian banking sector brought about by deregulation through the early 1990s.²⁴⁵ Tighter competition, in turn, caused banks to become involved in certain high-risk activities,

239. Core Principles, *supra* note 73, at Principle 5.

240. DARRELL R. JOHNSON, *Indonesia* in COM. LAWS OF EAST ASIA 204 (Alan Gutterman & Robert Brown eds., 1997).

241. *Id.*

242. *Id.*

243. BI 1998 Annual Report, *supra* note 45.

244. BISIGNANO, *supra* note 185, at 12-13. PATKO allowed the establishment of new private banks, with paid-in capital of 10 billion rupiah Bennett, *supra* note 46 at 461. In 1994, new licenses curtailed by government. ROBERT DEKLE AND MAHMOOD PRADHAM, FINANCIAL LIBERALIZATION AND MONEY DEMAND IN ASEAN COUNTRIES: IMPLICATIONS FOR MONETARY POLICY 6 (IMFund Working Paper WP/97/36, 1997) [hereinafter DEKLE].

245. Bank of Thailand, *The Banking Industry Facing the 21st Century* by J. Soedradjad Djiwandono, (visited April 16, 1999) <<http://www.bi.go.id/intl/speeches/century.htm>> [hereinafter 21st Century].

such as property loans.²⁴⁶ Indonesian regulators were not entirely blind to the issue as new capital adequacy rules and restrictions on banks in equity markets were promulgated in the early 1990s.²⁴⁷

NBFIs were a significant part of the Indonesian banking system. Lax NBFi regulation provided ample opportunity for regulatory arbitrage among banks, NBFIs, and corporations. Weak regulation created weak NBFIs, exposing the whole Indonesian bank system to significant risk. The NBFi issue was resolved with 1992 reforms that abolished NBFIs, allowing them to be reestablished as commercial banks.²⁴⁸

In addition to the broad definition of "bank" in Indonesian law, the bank licensing process, pre-Crisis, required improvements.²⁴⁹ Indonesian regulators failed to ensure that the banks' business plans were workable, or that management was "fit and proper."²⁵⁰ In 1995, Indonesia announced that certain persons involved in a wide range of financial misdeeds would not be allowed to establish or manage a bank.²⁵¹ However, politics adversely affected the effectiveness of this regulation.²⁵² Also in 1995, Indonesia started imposing requirements on their banks. This included submission of a corporate plan, access to related-party loan information, augmentation of lending standards, and the creation of an internal audit system.²⁵³ As a result of the Crisis, Indonesia will tighten procedures for the establishment of new banks, including raising minimum capital requirements.²⁵⁴ Crisis-bred reforms also seek to upgrade management competence through the licensing process and enhance self-regulatory banking.²⁵⁵

Indonesia attempted to proactively regulate connected lending. Lending limits were 20% of bank capital to one person, 50% to a related group of parties, and 5% to a bank director.²⁵⁶ Pre-Crisis, corporations were allowed to own shares in a bank up to

246. *Id.*

247. DEKLE, *supra* note 244, at 7.

248. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: Indonesia* 41-2 (1997-8) [hereinafter EIU Indonesia I].

249. Indonesia Nov. 13 letter, *supra* note 104.

250. Dr. Syahrial Sabirin, Governor of Bank Indonesia, "Efforts to Save Indonesian Banks", Address at the Indonesian Executive Circle (April 7, 1999).

251. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report Indonesia* 16 (2nd quarter 1995).

252. *Id.* at 16-7.

253. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: Indonesia* 28 (1st quarter 1995) [hereinafter EIU Indonesia II].

254. BI 1998 Annual Report, *supra* note 45.

255. *Id.*

256. Bennett, *supra* note 46, at 462.

the corporation's net worth; foreign ownership of traded shares of a domestic commercial bank was not allowed to exceed 49%.

Indonesian bank regulators underestimated the riskiness of many loans, bank portfolios, and bank business plans. The end result was a very low capital base and an excessive number of institutions unable to institute necessary reforms.²⁵⁷ In addition, the riskiness of Indonesian bank loans was probably underestimated by bank managers. Pre-Crisis, the quality of bank management was low but now will be better regulated by comprehensive questionnaires issued by BI.²⁵⁸ Complementing the questionnaires, restructuring is encouraging Indonesian banks to merge, formulate better business development strategy, and bring greater professionalism into bank management.²⁵⁹

2. *Licensing and Structure: Korea*

Before the Crisis, the Korean banking system was comprised of NBFIs, commercial banks, and specialized or development banks. Lax regulation of NBFIs, and *chaebol* connections to commercial banks adversely impacted the efficiency and transparency of the Korean banking system, possibly hastening the Crisis.

NBFIs, comprised 30% of total financial system assets in December 1997, and included investment institutions, savings institutions, and insurance companies.²⁶⁰ Trust accounts, operated by commercial banks, also were also considered a NBFIs and, as with NBFIs in general, were not regulated as strictly as commercial banks, especially in key areas such as loan loss provisioning rules or reserve requirements.²⁶¹ The market share of NBFIs bank deposits increased to 68% in 1996 from 29% in 1980 as NBFIs began to replace the informal loan market.²⁶² NBFIs typically had strong links with *chaebols* and *chaebol* investors because NBFIs financed *chaebol* activity by intermediating notes and paper, allowing *chaebols* to circumvent restrictions on commercial bank lending.²⁶³ NBFIs were largely unregulated, creating large off-balance sheet exposures by *chaebols* to such NBFIs, exacerbating connected-lending issues discussed elsewhere in this

257. See Sabirin, *supra* note 89.

258. See BI Policies, *supra* note 96.

259. 21st Century, *supra* note 245.

260. Baliño, *supra* note 51, at 10. Investment institutions, in turn, included merchant banks, investment trust companies, and securities companies. *Id.*

261. *Id.* at 9. By the end of 1997, trust accounts amounted to about 40% of total commercial bank assets. Trust banks were popular in part because banks could charge higher interest rates than in commercial accounts. *Id.*

262. Borensztein, *supra* note 121, at 11

263. Baliño, *supra* note 51, at 7-10.

article.²⁶⁴ As a result of the Crisis, consolidated supervision of all banking entities, including NBFIs, will be introduced in 1999 to manage the full range of banking risks.²⁶⁵ By June 30, 1999, the FSC will complete an evaluation of the adequacy of NBFIs prudential regulations, and by September 30, 1999, NBFIs will be regulated according to international best practices for commercial banks, ending regulatory arbitrage.²⁶⁶

Commercial banking is defined as lending from demand deposit for a period not to exceed one year or lending between one and three years with the BOK's approval.²⁶⁷ Korean banks may not acquire shares, debentures, or negotiable instruments with periods exceeding three years in excess of equity capital.²⁶⁸ Specialized and development banks, created to provide funds for specific economic sectors, comprised 17% of the financial system assets before the Crisis.²⁶⁹ These banks were overseen by the Ministry of Finance and Economy until April 1998 and were not subject to the same prudential requirements as commercial banks.²⁷⁰

Banks are legal entities under the provisions of the Commercial Act or other relevant acts applicable to such financial institutions.²⁷¹ A "bank" lends funds acquired through deposit, or issuance of negotiable or debt instruments.²⁷² Only a "bank" may create a checking deposit.²⁷³

New banks must be approved and licensed by the BOK's Monetary Committee.²⁷⁴ Bank officers must be authorized by the BOK's Monetary Board upon recommendation of the Supervisor of the OBS.²⁷⁵ Banks need BOK authorization to merge, amend articles of association, discontinue banking business, re-

264. *Id.*

265. Letter from Chol-Hwan Chon, Governor, *Bank of Korea*, and Kyu-sung Lee, Minister of Finance and Economy, *Republic of Korea*, to Michael Camdessus, Managing Director, *International Monetary Fund* (May 2, 1998) [hereinafter Korea May 2 letter].

266. Korea March 10, 1999 letter, *supra* note 53, at 7.

267. Korean Banking Act § 20.

268. Korean Banking Act § 22.

269. Baliño, *supra* note 51, at 9. There are four specialized banks: one each for fisheries, livestock, and agriculture as well as the Industrial Bank of Korea. There are three development banks: Korean Development Bank, Korea Export-Import Bank, and the Long-Term Credit Bank. Funding for these banks primarily comes from deposits (specialized banks) and government guaranteed bonds (development banks). *Id.* at 9-10.

270. *Id.* at 10.

271. Korean Banking Act, *supra* note 159 at § 2.

272. Korean Banking Act, *supra* note 159 at § 3.

273. Korean Banking Act, *supra* note 159 at § 6.

274. ABL Korea, *supra* note 138, at 50.

275. Korean Banking Act, *supra* note 159 at § 9.

duce capital stock, or open or close certain branches.²⁷⁶ Bank licenses are assured after confirmation of proposed capital, personal integrity of promoters, and contribution of the bank to the public interest.²⁷⁷ Bank officers cannot have been bankrupt, imprisoned, nor received a severe sentence under Korean banking law. Further, a bank officer cannot have been removed from an institution by disciplinary action. A bank officer shall be well-educated, experienced, and unlikely to harm the public interest.²⁷⁸

Members of a bank's Board of Directors cannot be an institutional investor, a person of bad credit, an affiliated enterprise, the government, or a person with a greater than 15% share ownership of the bank.²⁷⁹ Pre-Crisis, no individual was allowed to own more than 8% of the voting stock of a nation-wide commercial bank or 15% of a local bank.

3. *Licensing and Structure: Thailand*

Thailand's banking system is overbanked because the growth of credit far outpaced the growth of equity between 1991 and 1997.²⁸⁰ Commercial banking is defined as the granting of credit, buying and selling bills of exchange or any other negotiable instrument, buying or selling foreign exchange,²⁸¹ or lending to and taking deposits from corporations and the public.²⁸² Since the late 1980s, Thai banks have been allowed to trade securities and underwrite debt instruments.²⁸³ All Thai banks must be licensed by the Ministry of Finance and be in the form of a limited public company subject to certain ownership and reserve requirements.²⁸⁴ Despite this already broad definition of a bank's activity, Thailand may be expanding the scope of banks' operations,²⁸⁵ despite the fact that Thailand's banking licensing requirements, before the Crisis, should have been stricter.²⁸⁶

276. *Id.*

277. Korean Banking Act, *supra* note 159 at § 12.

278. Korean Banking Act § 14.

279. Korean Banking Act § 14-3.

280. BOT FOCUS, *supra* note 85, at 20. The growth of credit doubled as compared to the growth in equity.

281. BENTLEY J. ANDERSON, *Thailand*, in COM. LAWS OF EAST ASIA 587 (Alan Gutterman and Robert Brown, eds., 1997) [hereinafter ANDERSON].

282. Sutham, *supra* note 172, at 1912.

283. DEKLE, *supra* note 244, at 6.

284. ANDERSON, *supra* note 281, at 587. Must have 250 shareholders who are natural persons and no more than 5% ownership in any one person. Minimum 5% kept in cash reserves. *Id.*

285. Bank of Thailand, *Executive Summary: The Bank of Thailand's Financial System Development Plan Phase III: 1996-1998* (visited April 16, 1999) <at <http://www.bot.or.th/govnr/public/plan/plane.htm>>.

286. Thailand Nov. 25 letter, *supra* note 171.

Thai commercial banks are prohibited from employing persons who have been declared bankrupt, been imprisoned or fired for dishonesty, or removed from a bank position at the suggestion of the Ministry of Finance.²⁸⁷ Thai commercial banks are barred from providing a guaranty to a bank director and cannot hold more than 10% of the shares of a limited liability company, including a related entity.²⁸⁸ Despite these regulations, the “fit and proper” rules and licensing requirements needed improvement.²⁸⁹ New, more effective guidelines on fit and proper review of bank board members, managers, and owners were issued just after the Crisis broke in Thailand.²⁹⁰

Pre-Crisis, a bank was required to have at least 250 individual shareholders who, in the aggregate, own at least 50% of the outstanding shares. An individual shareholder may not own more than 5% of the bank shares. Thai shareholders must own at least 75% of a bank's shares. Commercial banks are not allowed to grant credit and provide guarantees on behalf of any of their directors. No commercial bank may purchase or hold more than 10% of the outstanding shares of a limited liability company or any shares in another commercial bank. These regulations left Thai banks with weak management. As a result of the Crisis, every effort will be made to hire well-qualified bank managers, especially those with international experience.²⁹¹

4. *Licensing and Structure: China*

Commercial bank is a new term in the PRC. The four largest commercial banks are the four policy banks—the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, and the People's Construction Bank of China. These four banks, along with nine other banks, account for about 80% of the total assets in the Chinese banking system.²⁹² Commercial banks are under the supervision of the PBC²⁹³ and are encouraged to rely on the principles of self-operation, self-restraint, self risk management, and self-responsibility for profits and losses.²⁹⁴

287. Sutham, *supra* note 172, at 1920-21.

288. ANDERSON, *supra* note 281, at 588.

289. Thailand Feb. 24 letter, *supra* note 170.

290. Thailand Nov. 25 letter, *supra* note 171.

291. Korea March 10, 1999 letter, *supra* note 53, at 6.

292. Qian, *supra* note 189 at 488.

293. PRC Commercial Banking Law, *supra* note 200 at § 10.

294. PRC Commercial Banking Law, *supra* note 200 at §4.

Commercial banks may take deposits from the public, grant loans, and handle settlements.²⁹⁵ There are five requirements to establishing a commercial bank: (1) articles of association must conform with the Commercial Banking Law and Company Law; (2) the applicant must have the minimum amount of registered capital; (3) the applicant must have senior management experience and knowledge relevant to their positions; (4) the applicant must have sound organization and management structure; and (5) the applicant must have operational facilities in conformity with relevant requirements.²⁹⁶ Appropriate documentation evidencing the foregoing must be filed with the PBC.²⁹⁷ Banks may establish branches inside or outside the PRC, as approved by the PBC, with a branch to be allocated funds not more than 60% of "head office" capital.²⁹⁸

Chinese commercial banks must have a minimum registered capital of RMB1 billion, an urban cooperative credit union must have minimum registered capital of RMB100 million, and a rural cooperative credit union must have registered capital of RMB50 million.²⁹⁹ Chinese commercial banking must observe a legally

295. PRC Commercial Banking Law, *supra* note 200 at § 2. Article 3 lists 13 activities 'commercial banks' may undertake: 1) taking deposits from the public, 2) granting short-, medium-, and long-term notes, 3) conducting domestic and overseas settlements, 4) handle discounting of negotiable instruments, 5) issuing financial bonds, 6) acting as agent for the issuance, honoring, and underwriting of government bonds, 7) buying and selling government bonds, 8) engaging in interbank lending, 9) buying and selling foreign exchange on its own behalf or as agent, 10) providing letter of credit services and guarantees, 11) acting as agent for receipt and payment of money and acting as an insurance agent, 12) providing safe deposit box services, and 13) any other business approved by the People's Bank of China. Activities are to be specified in the bank's articles of association to be submitted to the People's Bank of China. PRC Commercial Banking Law § 3.

296. *Id.* at § 12. Article 14 details the application that must be made: a written application with the name, location, and registered capital of applicant, feasibility study report, and other documentation as requested by PBC. PRC Commercial Banking Law § 14. Article 15 states that after an application is approved, a bank must provide: 1) draft articles of association, 2) credentials of senior management, 3) investment verification certificate, 4) list of shareholders and breakdown of capital contributions of each, 5) supporting documents showing creditworthiness of ten % shareholders, if any, 6) management policies and plans, 7) information on operation premises and facilities, and 8) other documentation as required by PBC. PRC Commercial Banking Law § 15.

297. PRC Commercial Banking Law § 14.

298. PRC Commercial Banking Law § 19. Article 20 lists the documents required to apply for a banking branch: 1) written application with information on name, operating funds, location and scope of business of both proposed branch and head office, 2) past two years' financial and accounting reports, 3) credential of senior management of proposed office, 4) management policies and plans, 5) information on business site and operational facilities of such site, and 6) any other documentation to be requested by PBC. PRC Commercial Banking Law § 20.

299. PRC Commercial Banking Law §§ 12, 13.

mandated debt-equity ratio.³⁰⁰ Further, Chinese commercial banks may not own property for their own account, engage in a stock business, engage in trust investment,³⁰¹ or loan any credit to its staff or directors.³⁰² Despite these restrictions, undisciplined banking operations are a significant source of trouble in China, leading to many unreported financial scandals.³⁰³

None of the following may serve as bank management: (1) persons convicted of corruption, bribery, conversion of property, or disruption of social and economic order or persons deprived of political rights for committing a crime; (2) directors or managers of entities subject to personal liability for mismanagement that led to bankruptcy; (3) representatives of companies or enterprises that have had their business licenses revoked for breaking the law; or (4) persons with heavy individual debts that have not been settled on maturity.³⁰⁴ These standards are appropriate for screening out unqualified persons from bank management. However, these standards may be applied in a manner that screens out otherwise qualified persons from bank management. Inefficient screening may exacerbate the aforementioned problem in creating a critical mass of educated and experienced Chinese bank managers. The end result could be China not having enough educated bank managers or regulators.³⁰⁵

5. *Licensing and Structure: Strategic Recommendations*

Based on the experience of Indonesia, Korea, and Thailand, China should:

1. Amend Article 3 of the Commercial Bank law to better separate insurance and underwriting functions from traditional "bank" functions such as accepting deposits and generating loans.
2. Pursuant to Article 12 of the Commercial Bank law, better definitions of the professional knowledge and specialized work experience a bank manager should possess; better definition of the "fit and proper" test in this context, notwithstanding Article 8 of the Administrative Regulations Governing Financial Institutions.

300. PRC Commercial Banking Law §39.

301. PRC Commercial Banking Law §43.

302. PRESTON M. TORBERT AND JIA ZHAO, *China*, in COMMERCIAL LAWS OF EAST ASIA 310 (Alan Gutterman & Robert Brown, eds., 1997).

303. Qian, *supra* note 189, at 492.

304. PRC Commercial Banking Law § 27.

305. Todd Kenneth Ramey, Comment, *China: Socialism Embraces Capitalism? An Oxymoron for the Turn of the Century* 20 Hous. J. INT'L L. 451, 486 (1998) [hereinafter Ramey].

3. Create exchange programs with the myriad foreign banks, especially in Shanghai and Shenzhen, so that Chinese bank managers can gain knowledge and experience.
4. Issue regulations to better define the types of operational facilities a bank should possess.
5. Limit commercial banks' discretion in creating internal accounting and operating systems by requiring that those systems meet internationally accepted standards.
6. Amend Article 7 of the Administrative Regulations Governing Financial Institutions to limit the government's discretion in the creation of a commercial bank.

C. PRUDENTIAL REGULATIONS AND REQUIREMENTS

Before the Crisis, banking sector policies placed little weight on proper accounting and auditing, prudential regulations, or credit ratings.³⁰⁶ Effective auditing requirements and prudential regulations are necessary to create transparency in a banking sector making regulations more effective. Effective prudential regulations, including proper accounting rules and credit ratings, could have minimized the risk of the Crisis, and could have alerted regulators to avert or minimize adversity. China must adopt effective prudential banking regulations to insulate its banking sector from the Crisis' systemic banking shocks.

The next group of ten Core Principles provides standards for regulators to develop and utilize prudential regulations to effectively manage risk.³⁰⁷ A bank's internal controls can ensure capital adequacy and minimize market, transfer, and credit risk, and, by extension, secure the health of a banking system.³⁰⁸ Indonesia's, Korea's, and Thailand's regulatory systems failed to detect and manage risk, leading to the collapse of the banking sector. Prudential risk management is a significant concern for China's banking system and merits modification.

Prudent minimum capital requirements for banks should reflect the types and level of a bank's risk.³⁰⁹ Minimum capital ratios can reduce the risk of loss to a bank's creditors and shareholders and provide prima facie evidence of a bank's health.³¹⁰ The Basle Accord provides for minimum capital re-

306. CRAFTS, *supra* note 67, at 32, speaking specifically of Korea.

307. Prudential regulation in the banking sector seeks four goals: (1) Establishing procedures that allow only financially viable banks to operate; (2) Limit excessive risk taking by owners and managers of banks; (3) Establishing appropriate accounting, reporting and valuation rules; and (4) Provide for corrective measures and restrictions on activities of weak institutions. FRAMEWORK, *supra* note 6, at 11.

308. See, e.g., FRAMEWORK, *supra* note 6, at 19-27 and 36-41.

309. Core Principles, *supra* note 73, at Principle 6.

310. FRAMEWORK, *supra* note 6, at 61-62.

quirements for internationally active banks.³¹¹ Indonesian, Korean, and Thai banks often fell below the Basle-recommended minimum capital requirements, compromising their ability to withstand Crisis turbulence.

Several practices help banks and regulators effectively monitor the lending function and prevent an increase in credit risk that jeopardizes the bank's ongoing operations such as sound policies, principles, and practices for loan generation (especially to related parties³¹² or a single party³¹³) and oversight for banks' ongoing management, outside investments,³¹⁴ asset quality, adequacy of loan loss provisions, and loan banks' loss reserves.³¹⁵ Connected lending—lending to the banks' owners or related businesses—entails the risk of loss of objectivity in credit risk assessment.³¹⁶ For example, connected lending between Korea's banks and *chaebol* and Indonesia's banks and Suharto-connected corporations exposed those banks to significant credit risk. Similarly, the close connection between China's banks and SOEs exposes China to significant credit risk.

311. Core Principles, *supra* note 73, at Principle 6. Bank soundness can be interpreted through bank capital ratios, as defined through Tier I and Tier II by the Basle Committee on Banking Supervision. Proper definition and effective reporting are essential. *Id.* The Accord sets minimum capital ratio requirements for internationally active banks of 4% of Tier one capital and 8% of total capital (Tiers one plus two), applied to banks on a consolidated basis. *Id.*

312. Core Principles, *supra* note 73, at Principle 10. Related party loans should be made only on an arm's-length basis with the credit amount strictly monitored; loan terms should be the same for related and unrelated parties. Regulators and internal bank supervisors should consider hard limits on the amount of credit extended to related parties, collateralization of such loans, or outright rejection of such loans. FRAMEWORK, *supra* note 6, at 63.

313. Core Principles, *supra* note 73, at Principle 9. Such exposures are capped by limits as expressed by a percentage of bank capital. In general, 25% of bank capital should be the limit for lending to a single party or a single set of related parties without the bank's obtaining approval from a regulatory authority. As a practical matter, however, smaller banks may not have the ability to diversify and may exceed this 25% limit. Exposures to a single party over 10% should be reported, at the least, to the bank's supervisors and banking regulators. FRAMEWORK, *supra* note 6, at 63.

314. Core Principles, *supra* note 73, at Principle 7. Prudent lending and underwriting standards are required to manage and minimize credit risk. An effective management information system, including the financial condition or borrowers, is crucial to manage and minimize credit risk. FRAMEWORK, *supra* note 6, at 62.

315. Core Principles, *supra* note 73, at Principle 8. Such policies need to be reviewed regularly and implemented consistently. In appropriate circumstances, regulators should be empowered to require that a bank strengthen its lending practices, credit-granting standards, and financial strength. Contingent risks and guarantees should be frequently reviewed. FRAMEWORK, *supra* note 6, at 63.

316. GOLDSTEIN, *supra* note 74, at 20. This has contributed to banking problems in Indonesia and Thailand. *Id.* at 21. Korea had rules limiting exposure to 15% of capital; Indonesia was 20% for a group and 10% for an individual; Thailand was 25% of capital. *Id.* at 22.

Banks should also have adequate policies to identify and control country and transfer risk,³¹⁷ market risk,³¹⁸ interest rate risk, liquidity risk, and operational risk.³¹⁹ Transparent qualitative risk information aids both bank self-regulation and a regulator's effective and efficient regulation. Indonesia, Thailand, and Korea did not require banks to seek a credit rating that would enhance public knowledge.³²⁰

The Core Principles' final prudential requirement suggests that banks create and maintain effective internal controls on organizational structure, accounting procedures, segregation in certain areas, and safeguarding of assets.³²¹ Effective internal controls and professional standards minimize operational and reputational risk and may forestall insolvency.³²² Internal controls in Indonesian, Korean, and Thai banks were inadequate to recognize or thwart the burgeoning Crisis; internal controls in Chinese banks should be revised to prevent China from suffering a similar fate.

In general, capital ratios were kept too low in Crisis countries to provide an adequate cushion in the event of trouble.³²³ Most banks in developing areas do not have higher capital adequacy ratios despite the higher risk environment they encounter.³²⁴ Low capital adequacy ratios aggravated poor surveillance

317. Core Principles, *supra* note 73, at Principle 11. Country risk refers to the economic, social, and political risk attendant any foreign loan or investment. Transfer risk arises when the obligation is denominated in currency that is not the same as the bank's home currency. Risk evaluation should include on- and off- balance sheet data and their sensitivities to future events. FRAMEWORK, *supra* note 6, at 60.

318. Core Principles, *supra* note 73, at Principle 12. Market risk refers to the risk of loss in on- and off-balance sheet positions arising from a change in prices; one element of market risk is foreign exchange risk. FRAMEWORK, *supra* note 6, at 60-1.

319. Core Principles, *supra* note 73, at Principle 13. Interest rate risk refers to the bank's exposure to adverse movements in interest rates, affecting both a bank's earnings and a bank's assets. Interest rate risk includes repricing risk, yield curve risk, basis risk, and optionality. Liquidity risk is created by a bank's inability to weather decreases in liabilities or fund increases in assets and can, in an extreme case, lead to a bank's insolvency. Operational risk stems from a breakdown in a bank's internal controls or corporate governance. Other risks include legal risk, such as an increase in liabilities or decrease in assets because of poor legal advice, and reputational risk arising from operational failures. FRAMEWORK, *supra* note 6, at 61.

320. BANK FOR INTERNATIONAL SETTLEMENTS, 67TH ANNUAL REPORT 116 (1997) [hereinafter BIS I].

321. Core Principles, *supra* note 73, at Principle 14. For example, audit rules should include internationally accepted accounting rules, and should include accrual and consolidation. Banks should also have high ethical and professional standards preventing the bank from being used by criminal elements. Core Principles, *supra* note 73, at Principle 15.

322. FRAMEWORK, *supra* note 6, at 65.

323. BIS II, *supra* note 58, at 17.

324. GOLDSTEIN, *supra* note 74, at 27.

of the banking sector. More allowance should be made for risks, because the net interest margin is not larger than operating costs; China's margin was 0.8% of assets in 1995-96; Indonesia's also was 0.8% in 1995-96; Korea's was 0.2% in 1995-96; Thailand's was 1.7% in 1995-96.³²⁵ Delayed evolution of prudential standards and supervision after liberalization³²⁶ explains why newly liberalized banks do not develop good risk assessment.³²⁷ This problem is especially critical in assessing interest rate risk.³²⁸ Also, long-standing fixed or pegged exchange rates distort exchange rate risk perception.³²⁹

Other prudential issues included low reserve requirements, as a percentage of loans to the nongovernment sector. In 1995, Korea's reserve percentage was 7.9%, Indonesia's was 1.1%, and Thailand's was 1.4%.³³⁰ Such low percentages limited credit, but fostered risky lending practices. Also, in a number of Asia Pacific Economic Cooperation (APEC) countries, loans were classified as nonperforming only after being in arrears for six months or more with bank management setting the criteria, distorting "true" nonperforming loans.³³¹ Such practices compounded the risk of nonperforming loans.

Low loan loss reserves and high percentages of nonperforming loans illustrate the risks confronting a banking system. Loan loss reserves (average 1990-4) and percentage of non-performing loans (average 1990-5) for Crisis states were, Korea 1.5% reserve and 1% nonperforming loans; Indonesia 2.6% and 11.2%; and Thailand 1.7% and 7.6%.³³² All of the foregoing were aggravated by the loss of accounting transparency, causing the bank to base its soundness on faulty numbers.³³³

1. Prudential Regulations and Requirements: Indonesia

Before the Crisis, violations of prudential regulations by Indonesian banks were widespread, especially with regard to liquidity and capital adequacy ratio.³³⁴ Indonesian banks suffered from high credit risk generated by four questionable lending policies: (1) little investigation into prospective borrowers; (2) unsecured lending, especially without inquiring whether the loan

325. BIS II, *supra* note 58, at 118-119.

326. BISIGNANO, *supra* note 185, at 18.

327. BIS II, *supra* note 58, at 118.

328. *Id.* at 120.

329. *Id.* at 124.

330. GOLDSTEIN, *supra* note 74, at 39-40.

331. *Id.* at 23.

332. *Id.* at 48.

333. BISIGNANO, *supra* note 185, at 15.

334. BI 1998 Annual Report, *supra* note 45.

can be repaid; (3) failing to monitor or restrict the borrower's use of loan proceeds; and (4) "memo lending", lending on the basis of a written request from a politically well-connected individual.³³⁵ As a result of the Crisis, minimum capital requirements are to be increased, regulation of productive asset quality is to be improved, and the lending function is to be enhanced.³³⁶

As the Crisis worsened, violations in statutory reserve requirement, loan to deposit ratio, net open position, capital adequacy ratio, and legal lending limit increased.³³⁷ Loan to deposit ratio increased from 79.6% to 83.2%, causing 40 banks (compared to 11 in 1996) to violate the law.³³⁸ Cumulative capital adequacy ratio for all Indonesian banks dropped from 12.2% to 4.3% during 1998.³³⁹

Minimum statutory reserve for Indonesian commercial banks is equal to 5% of third-party funds, while liquidity maintenance is determined by the individual bank.³⁴⁰ The 5% requirement was drafted in early 1996, an increase from 3%.³⁴¹ Many Indonesian banks still violate the statutory reserve requirements or have negative balances on BI demand deposits.³⁴² Poor liquidity management caused banks to violate statutory reserve requirements when pressure mounted on the banking system and the rupiah.³⁴³ Minimum capital requirements were set so low that, after the 1980s deregulation, many banks were undercapitalized. For new private banks, the capitalization requirement was about US\$5 million.³⁴⁴

Productive asset quality is monitored by comparing ratios or reserves.³⁴⁵ As a result of the Crisis, BI raised minimum requirements for bank capital, improved regulation of productive asset quality and provision of allowance for productive asset amortization, and enhanced transparency and access of information on financial reports to the public.³⁴⁶ More new regulations on capital adequacy ratio, connected lending, and publication of financial statements were to have been issued in December 1998.³⁴⁷

335. Bennett, *supra* note 46, at 447. Memo lending is especially endemic to state owned banks. *Id.*

336. BI 1998 Annual Report, *supra* note 45.

337. *Id.*

338. *Id.*

339. *Id.*

340. BI Policies, *supra* note 96.

341. EIU Indonesia I, *supra* note 248, at 42.

342. See BI Current Developments, *supra* note 84.

343. BI 1998 Annual Report, *supra* note 45.

344. Bennett, *supra* note 46, at 448.

345. BI Policies, *supra* note 96.

346. See BI Current Developments, *supra* note 84.

347. Indonesia Nov. 13 letter, *supra* note 104.

Before the Crisis, Indonesian commercial banks were required to satisfy the capital adequacy ratios for banks appointed foreign exchange banks.³⁴⁸ Minimum risk weighted capital ratio was to be increased to 7% by March 1993 and 8%, the Basle Accord-recommended level, by December 1993.³⁴⁹ These goals, spurred on by 1991 reforms, were soon relaxed either by extending dates or lowering amounts.³⁵⁰ By 1994, 93% of Indonesian banks met the 8% capital adequacy ratio, but bad debt remained a significant issue.³⁵¹ Post-crisis, greater emphasis is placed on Indonesian banks meeting the minimum capital requirement of 8% of risk-weighted assets, escalating to 10% in September 1999, and 12% after October 2000.³⁵²

Indonesian banks are typically set up within a corporate conglomeration, causing significant related-party lending issues.³⁵³ Distributions of funds by an Indonesian bank are done at that bank's own risk; the bank is obligated to consider sound credit principles in making any distribution. BI requires any lending bank to ask a potential credit applicant to submit tax returns and other financial information. Sizable connected lending increased exposure to non-performing loans.³⁵⁴ By 1991, non-performing loans amounted to 5.9% of total loan portfolios, a 50% increase from 1990.³⁵⁵ The connected lending issue was exacerbated by Indonesian banks' leaving non-performing loans on their books to inflate their asset base.³⁵⁶ In 1994, Indonesia considered, but did not adopt, a proposal that banks would have to write down loans that had not been serviced for three consecutive years.³⁵⁷ In 1997, BI forbade commercial banks from extending credit to real estate developers because of the large problem of connected lending to real estate entities.³⁵⁸

Pre-Crisis, Indonesia classified loans as either current, substandard, doubtful, or lost. A current loan was a loan with no arrears in principal or interest over one month. A substandard loan was a loan with principal in arrears between one month and two months, three months and six months, and six months and 12

348. BI Policies, *supra* note 96.

349. Bennett, *supra* note 46, at 467.

350. *Id.* at 469.

351. EIU Indonesia II, *supra* note 253, at 28.

352. BI Policies, *supra* note 96.

353. Bennett, *supra* note 46, at 448.

354. BI 1998 Annual Report, *supra* note 45.

355. Bennett, *supra* note 46, at 464-465. The loans were the result of memo lending and intragroup lending. *Id.* at 465.

356. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: Indonesia 24* (3rd quarter 1994) [hereinafter EIU Indonesia III].

357. *Id.*

358. See BI Current Developments, *supra* note 84.

months for credit with installment periods of less than one month, monthly/bi-monthly/quarterly, and four months or more, respectively. Interest was in arrears between one month and three months or between three months and six months for credit with installment periods of less than one month and one month or more, respectively. A doubtful loan was a loan that did not meet the criteria for current or substandard but was considered collectable with collateral value exceeding 75% of the debt or, if the loan was considered uncollectable, the collateral value exceeded 100% of the debt. A lost loan was a loan that did not meet any other classification, or was doubtful but there had been no remedial action within 21 months of being classified as being doubtful.³⁵⁹

Clearly, new prudential regulations on loan classification and loan loss provisioning were needed.³⁶⁰ Pre-Crisis, required loan loss reserves for current loans were 0.5%, 3% for substandard loans after deducting collateral (10% after December 1996), and 100% for loss loans, after deducting collateral. Post-Crisis, loans will be reclassified as either performing, less performing, doubtful, and nonperforming.³⁶¹ Loan loss issues will be helped by BI's divestiture of interests in private banks and making loan loss provisions fully tax-deductible.³⁶²

Liquidity, capital asset ratios, and connected lending problems were compounded by low bank managerial skill that caused weakened productive asset quality and increasing credit exposure.³⁶³ Poor internal management was multiplied by weak internal information systems.³⁶⁴ A lack of transparent information on a bank's condition hampered BI's ability to effectively and efficiently regulate Indonesian banks.³⁶⁵ Poor management and internal controls wreaked havoc on Indonesia's self-regulatory system rendering it ineffective, especially with regard to credit concentration.³⁶⁶

In late September 1995, Indonesia encouraged corporate borrowers to obtain a stock exchange license, which requires regular published audited accounts.³⁶⁷ At the same time, regulation

359. KALPANA KOCHHAR, ET AL., THE EAST ASIAN CRISIS: MACROECONOMIC DEVELOPMENTS AND POLICY LESSONS 40-42 (International Monetary Fund Working Paper No. WP/98/128, 1998) [hereinafter KOCHHAR].

360. Indonesia Nov. 13 letter, *supra* note 104.

361. BI Policies, *supra* note 96.

362. Indonesia June 24 letter, *supra* note 116.

363. BI 1998 Annual Report, *supra* note 45.

364. *Id.*

365. *Id.*

366. *Id.*

367. ECONOMIST INTELLIGENCE UNIT, *EIU Country Report: Indonesia* 16 (4th quarter 1995).

sought to encourage bank mergers by increasing the capital required for a foreign exchange license.³⁶⁸ These actions sought to increase transparency in a bank's operations. Despite this, banks are not going to be required to submit monthly reports on capital adequacy and bank liquidity position, and banks will train bank supervisors to better understand risk management.³⁶⁹

Indonesian accounting principles compounded violations of prudential principles, although the Indonesian government has attempted to rectify the situation. For example, as a result of the Bapindo controversy, the Indonesian government considered bringing in the Institute of Internal Auditors to establish internationally accepted principles for accounting and auditing.³⁷⁰

Indonesia's structural reform strategy, revealed on March 13, 1999, includes closing certain banks, allowing other banks to continue operations while temporarily being taken over by the government, announcing which banks need recapitalization, and announcing which banks will continue independent operations.³⁷¹ Indonesian banks with a capital adequacy ratio of 4% or more will be allowed to continue operation without recapitalization.³⁷² A banks' continuing operations are subject to BI review of their business plan, the fit and proper test, and examinations of the sources of capital injections; first round assessments were conducted by April 21, 1999, and then will be conducted every six months subsequent.³⁷³ Banks with a capital adequacy ratio between minus 25% and positive 4% will be allowed to continue to operate by joining recapitalization programs with others taken over by the government.³⁷⁴ Thirty-eight deeply insolvent banks were closed down, with the owners required to repay their debts and the government guaranteeing deposits.³⁷⁵

Indonesian banks are generally obligated to reduce risk by adhering to maximum legal lending limits, as detailed by BI. The limits ensure that banks do not lend money to corporate affiliates in excess of certain amounts. These limits apply to the granting of credit facilities, the grant of guarantee facilities, the purchase of commercial paper, and other similar credits. In general, the maximum legal lending limit for a borrower not associated with

368. *Id.*

369. See BI Current Developments, *supra* note 84.

370. EIU Indonesia III, *supra* note 356, at 23.

371. Bank Indonesia, *Steps Toward Restructuring the National Banking System* (visited Apr. 14, 1999) <<http://www.bi.go.id/intl/press/press31-100.html>>.

372. *Id.*

373. *Id.*

374. *Id.*

375. *Id.*

the bank is 20% of the bank's capital; affiliated persons are limited to 10% of the bank's capital. A borrower may be a group of borrowers, which means an association of entities in terms of ownership, management, and/or financial relationship.

2. Prudential Regulations and Requirements: Korea

Despite deregulation in the 1980s, Korea's banking sector continues to be the focus of significant government attention and influence.³⁷⁶ Government influence caused Korean bank regulators to avoid adoption of prudential regulations, leaving Korea's banking sector exposed to external shocks.³⁷⁷ Through the period ending in 1996, there is a negative correlation between the allocated credit and profit rate, indicating that Korean banks have allocated resources to less profitable sectors.³⁷⁸ *Chaebol*-dominated industrial structures and politically well-connected firms obtained disproportionate access to bank credit.³⁷⁹ Profitability of investment did not play an important role in the allocation of credit; the previous year's profit rate has a negative effect on the current year's credit flow, implying that credit was allocated preferentially to economic sectors with poor economic performance.³⁸⁰ The FSC will bring Korean prudential regulation more in line with the Core Principles.³⁸¹

As a result of the Crisis, Korea pledged to (1) set a timetable for all banks to meet or exceed the Basle standard on capital adequacy; (2) strengthen accounting standards to be consistent with international practice (3) require large banks to be audited by internationally recognized accounting firms; (4) require banks to publish twice yearly key data on loans, capital, and ownership; and (5) pass legislation consolidating banking sector regulation.³⁸² Korean bank sector reform rests on the premise that responsibility for the Crisis rests with bad management and bank shareholders should bear the loss.³⁸³

In 1997, just before the outbreak of the Crisis, several large *chaebols*, including Hanbo Steel and Kia Motors, went bankrupt, causing nonperforming loans to rise to 7% of GDP which increased the pressure on the existing structural inadequacies of

376. Borensztein, *supra* note 121, at 18.

377. *Id.*

378. *Id.* at 21.

379. *Id.* at 24.

380. *Id.*

381. Baliño, *supra* note 51, at 43.

382. International Monetary Fund, *Republic of Korea: IMF Standby Arrangement* (visited Apr. 5, 1999) <<http://www.imf.org/external/np/oth/korea.htm>>.

383. Korean Principles, *supra* note 148.

the banking sector.³⁸⁴ The Korean loan classification system was backward-looking because it was based on payment history and availability of collateral whereas forward-looking policies would focus on the ability to repay.³⁸⁵

Pre-Crisis, loans were classified as normal, precautionary, substandard, doubtful, and lost. A normal loan had no delays in debt service longer than three months. A precautionary loan had payment that was in arrears three to six months. A substandard loan had arrears for six months or more but was covered adequately by collateral. A doubtful loan had arrears for six months or more that was not covered adequately by collateral, but was not yet considered a lost loan. A lost loan was a doubtful loan for which collection was not expected.³⁸⁶ Nonperforming loans, as defined by the BOK, were in arrears for six months or more, not the standard of three months.³⁸⁷ The total amount of troubled loans by March 1998 was W118 Trillion, about 28% of GDP, of which W68 trillion were classified as substandard or worse.³⁸⁸

Before the Crisis, Korean banks were to set up loan loss provisions equal to 100% of expected losses; such losses were not expected to be greater than 2% of total loans. Any loan loss reserves in excess of 2% of total loans were not tax-deductible.³⁸⁹ However, loan loss provisions in Korean commercial banks were only 0.5% in March 1997.³⁹⁰ Compounding this issue, in 1995, doubtful loan provisioning requirements had been lowered from 100% to 75% of expected losses.³⁹¹ Also, provisioning rules for securities and accounting standards fell short of international best practices.³⁹² Securities were carried at acquisition cost and were only marked to the market when the market cost was below acquisition cost for three consecutive years, or when the book value was considered substandard.³⁹³

As a result of the Crisis, market to market accounting for traded securities and derivative positions was introduced January 1, 1999.³⁹⁴ New loan classification rules will focus on the ability to repay, not solely on past performance, with the FSC oversee-

384. Pate, *supra* note 17, at *3.

385. Baliño, *supra* note 51, at 17.

386. KOCHHAR, *supra* note 359, at 40-42.

387. *Id.*

388. *Id.* at 40.

389. *Id.* at 17. This lack of tax deductibility led most banks to just provision as if only 2%, no more, of their loans would be loss loans. *Id.*

390. *Id.* at 25.

391. *Id.* at 28.

392. *Id.* at 17.

393. *Id.*

394. Korea May 2 letter, *supra* note 265.

ing the new definitions on a trial basis.³⁹⁵ Loans past due 90 days are to be classified substandard or lower effective January 1, 1999.³⁹⁶ Further deductions from Tier II capital for nonperforming loans were adopted.³⁹⁷ Loss provision on "normal" loans may be increased from 0.5% to 1%, which would be included in Tier II capital.³⁹⁸

A 1992 bank reform plan made the Bank for International Settlement capital adequacy ratios compulsory for Korean banks, with the goal of banks maintaining an 8% ratio by the end of 1995. The reform plan also required Korean banks to maintain a liquid capital ratio at least equal to 7.25% of risk weighted assets.³⁹⁹ Prior to this 1992 reform, bank's aggregate equity capital was to equal at least 5% of outstanding liabilities.⁴⁰⁰ By 1993, three of the top seven domestic banks in Korea still did not meet the 7.25% requirement.⁴⁰¹ Weak regulatory oversight rendered the 1992 plan ineffective and⁴⁰² by the outbreak of the Crisis, 14 of 26 commercial banks had capital adequacy of less than 8%, and two were technically insolvent.⁴⁰³

Korean bank reserves must equal 10% of outstanding liabilities, unless revised by the BOK's Monetary Board.⁴⁰⁴ Required reserves, the ratio of reserve requirements to deposit liabilities, may not exceed 50% except in times of pronounced monetary expansion, may set reserves equal to 100%, and are to be held in form of deposits with the BOK.⁴⁰⁵ A Commercial bank's capital stock is to equal W100 billion, with a lesser amount for local institutions.⁴⁰⁶ Korean banks are to accumulate 10% of net profits until reserves equal capital stock.⁴⁰⁷

Banks lacked adequate internal liquidity management controls and policies were not sufficiently stringent, especially for foreign exchange.⁴⁰⁸ The history of government involvement in the Korean banking system left banks with limited skills in credit analysis, risk management and poor loan loss provisioning.⁴⁰⁹

395. Korea March 10, 1999 letter, *supra* note 53, at 10.

396. Korea May 2 letter, *supra* note 265.

397. Baliño, *supra* note 51, at 43.

398. Korea May 2 letter, *supra* note 265.

399. ABL Korea, *supra* note 138, at 53.

400. Baliño, *supra* note 51, at 17.

401. *Id.* at 54.

402. *Id.*

403. *Id.* at 30.

404. Korean Banking Act § 15.

405. Bank of Korea, *About the Bank* (visited Apr. 15, 1999) <http://www.bok.or.kr/kobank/owa/act12?i_lp=eng&I_top=english>.

406. Korean Banking Act § 16.

407. *Id.*

408. Baliño, *supra* note 51, at 19.

409. *Id.* at 20.

The close connection among government, banks, and *chaebols* resulted in many bad investments, including banks financing projects without conducting risk or profitability analysis.⁴¹⁰ Legislation in 1991 set credit exposure limits for single borrowers at 20% of the bank's equity capital for loans and 40% for guarantees, with a three year phase-in and a generous grandfather clause.⁴¹¹ Concentration of risk and large exposure regulations were lax, even after revision in the 1991 legislation.⁴¹² Limits on lending to large conglomerates were set bank by bank under a basket control system under which the shares of loans to the top 5 and 30 business groups over the total loans of the bank should not exceed the limits set by the OBS; the limits were tightened in August 1997 to 45% of equity capital for commercial banks, still very lax in comparison to other OECD countries.⁴¹³ Crisis-bred reforms now require that connected lending be limited to 25% of equity capital by 2001.⁴¹⁴

Before the Crisis, Korean accounting standards did not require consolidated statements encompassing the parent banks and subsidiaries.⁴¹⁵ Today, auditing is reviewed to ensure that it is consistent with international best practices.⁴¹⁶

3. Prudential Regulations and Requirements: Thailand

Thailand's domestic banks, lacking prudent regulation, invested in risky, nonproductive assets, including property.⁴¹⁷ Loan loss provisioning, loan classification, and capital adequacy rules were not consistent with international best practices.⁴¹⁸ Banks did not accurately value underlying collateral and were less than vigilant in monitoring and taking appropriate action once loans started to not perform.⁴¹⁹ A lack of transparency in banking regulation, no required disclosure, and a perception that the BOT would not let a bank fail combined with a *laissez-faire* attitude to banks' development of proper credit risk analysis created a fragile bank structure.⁴²⁰

Thailand's loan classification and provisioning lagged behind other Asian systems. Uncollected interest could accrue for 12

410. Borensztein, *supra* note 121, at 8.

411. Baliño, *supra* note 51, at 19.

412. *Id.*

413. *Id.*

414. *Id.* at 44.

415. *Id.* at 17.

416. Korea March 10, 1999 letter, *supra* note 53, at 10. Merchant Banks and Investment Trust Companies are to be brought consistent with U.S. GAAP. *Id.*

417. Pate, *supra* note 17, at *1.

418. Thailand Feb. 24 letter, *supra* note 170.

419. BOT FOCUS, *supra* note 85, at 14.

420. *Id.* at 21.

months and banks rarely provisioned above the required minimum.⁴²¹ By virtue of Crisis-required reforms, recognition of accrued interest has been shortened from twelve to six months and will be shortened to three months.⁴²² Banks were first required to release information on nonperforming loans in June 1997.⁴²³ Since the beginning of the Crisis, a more realistic loan classification system and provisioning are seen as a means to help banks' capital base.

Pre-Crisis, Thai banks were required to allocate 0.5% of deposits, borrowings, and other funds outstanding at the end of the previous year to the Financial Institutions Development Fund; such funds could be augmented by BOT reserves.

New BOT regulations require loan classification and qualitative review at the end of each calendar quarter to determine the minimum levels of loan loss reserves.⁴²⁴ Also, there is full tax deductibility for loan loss provisioning effective 1997.⁴²⁵ Further, provisioning will be made on all loans more than six months overdue and, effective as of January 1, 1998, no accrual of interest on nonperforming loans is allowed.⁴²⁶ Loan classification and provisioning rules are expected to be in line with international standards by 2000.⁴²⁷

Nonperforming Thai bank loans will be classified three ways: substandard, doubtful, and noncollectable.⁴²⁸ Noncollectable loans now require 100% provisioning, and doubtful loans require 50% provisioning, while substandard loans require 20% provisioning.⁴²⁹ Substandard loans are three to six months in arrears plus other qualitative concerns; doubtful loans are one year past due or otherwise below substandard.⁴³⁰ Since March 31, 1998 performing loans may be classified as pass or special mention.⁴³¹ Pass loans require 1% provisioning and special mention

421. *Id.* at 22.

422. Bank of Thailand, *Message from Minister of Finance* (visited Apr. 14, 1999) <<http://www.bot.or.th/research/public/MOF/ter.htm>>.

423. BOT Focus, *supra* note 85, at 21.

424. Sutham, *supra* note 172, at 1919.

425. Thailand Nov. 25 letter, *supra* note 171.

426. *Id.*

427. *Id.*

428. Sutham, *supra* note 172, at 1916. Substandard are loans that are in arrears but there are reasonable grounds to believe the loan will be repaid. Doubtful loans are unsecured loans whose repayment is uncertain. Non-collectible loans are those where there has already been an unsuccessful attempt at recovery and recovery is not expected. *Id.* at n. 106.

429. *Id.* at 1917.

430. *Id.* at 1919.

431. *Id.* at 1918. Pass loans show no sign of default and are unlikely to cause the bank any loss while special mention loans show no sign of default but they are a sign

loans require 2% provisioning. These new regulations are expected to come into force by December 31, 2000.

Before September 8, 1997, Thai commercial banks had to maintain liquid assets of 7%; post-Crisis, such banks must maintain liquid assets equal to 6% of domestic deposits, to be made of cash (2.5%), non-interest bearing deposits with the BOT (2.0%), and certain unencumbered securities.⁴³²

Pre-Crisis, Thai bank capital was required to equal at least 20% of contingent liabilities, and banks were required to maintain a ratio of capital to risk weighted assets of at least 7.5%. On June 5, 1992, BOT implemented the Bank for International Settlements capital adequacy framework, replacing a system under which capital adequacy was measured relative to the bank's assets, liabilities, and contingent liabilities.⁴³³ By the end of 1994, required minimum capital ratios were increased to 8% of which 5.5% must be Tier I capital. As of November 20, 1996, BOT required Thai banks to maintain 8.5% capital to risk weighted assets ratio.⁴³⁴ Also, effective as of July 26, 1996, single person exposure was limited to 25% for Tier I capital.⁴³⁵

Thai accounting standards were not consistent with international best practices by December 31, 1998.⁴³⁶ Before the Crisis, no audit committee supervised bank operations; effective May 1998, banks are expected to have an audit committee.⁴³⁷

4. Prudential Regulations and Requirements: China

The history of government dominance over the Chinese banking system has left the bank sector very fragile. Chinese banks are operated more like an administrative agency than a commercial enterprise; banks operate in the red with significant government subsidies.⁴³⁸ Some 70% of Chinese bank loans go to the state sector, producing only 34% of total output.⁴³⁹ In the PRC, there are low loan rejection rates and high bad loan

of weakness which, if left uncorrected, could adversely impact the ability to collect the loan. *Id.*

432. *Id.* at 1914.

433. *Id.*

434. Thailand Aug. 25 letter, *supra* note 169.

435. Sutham, *supra* note 172, at 1920.

436. Letter from Tarrin Nimmanahaeminda, Minister of Finance, *Kingdom of Thailand*, and M.R. Chatu Mongol Sonakul, Governor, *Bank of Thailand*, to Michael Camdessus, Managing Director, *International Monetary Fund* (May 26, 1998).

437. *Id.*

438. Qian, *supra* note 189 at 479.

439. Ramey, *supra* note 305, at 483.

rates,⁴⁴⁰ despite the requirement that commercial banks conduct a searching inquiry of the borrower's purpose, collateral, and ability to repay.⁴⁴¹

State-directed lending has made about 20-30% of loans nonperforming, weakening the ability of banks to effectively perform a credit analysis.⁴⁴² Forty percent of SOEs lose money. The government has said that money losers should merge, be acquired, or go bankrupt.⁴⁴³ Bankruptcy law is an issue; the pace of reform is slow because the government fears unrest, but it is possible that the central government will follow the lead of the provinces and provide for the recovery of debt and enforcement of security.⁴⁴⁴ Loan recovery is also a problem because the government protects defaulting SOEs, although the government is now encouraging more effective loan recovery programs.⁴⁴⁵

Under the government's credit plan, the money supply is dictated by the central government; under previous requirements, 13% of savings deposits were to be set aside as reserves and additional excess reserved with the PBC, although these reserve rates were recently cut.⁴⁴⁶

SOEs have to provide details regarding bank loans, and their debts must be verified by bankers for SOEs to obtain a license. Without a license, no loan may be created for the SOE. This policy is seen as giving the banks expertise in evaluating loan applications.⁴⁴⁷ Despite the foregoing, the Chinese banking system needs a uniform risk-based loan portfolio classification system, modern accounting methods, new financial reporting requirements, and a renewed focus on accounts to determine bank's overall position.⁴⁴⁸

The Chinese government is attempting to address the bad debt issue. Three policy banks—State Import and Export Bank, State Development Bank, and State Agricultural Bank—were created in 1986 in an attempt to separate out bad debt owed by SOEs.⁴⁴⁹ These specialized banks will primarily do policy lend-

440. David Eu, *Hong Kong and China: The 1997 Transition: Note: Financial Reforms and Corporate Governance in China*, 34 COLUM. J. TRANSNAT'L L. 469, 491 (1996) [hereinafter Eu].

441. PRC Commercial Banking Law § 35.

442. BIS I, *supra* note 320, at 113.

443. TOKLEY, *supra* note 191, at 28.

444. *Id.* at 26.

445. *Id.* at 25.

446. *Id.* at 27-28.

447. *Id.* at 29.

448. WORLD BANK I, *supra* note 217, at 33.

449. Lee II, *supra* note 188, at 706.

ing.⁴⁵⁰ However, specialized banks must be encouraged to use more market analysis in reviewing loan generation.⁴⁵¹

The PRC is attempting to upgrade its accounting regulations. The accounting standards draft has four goals: (1) fulfill specific requirements under the People's Bank of China Law; (2) ensure international acceptance of PBC regulatory system; (3) ensure clarity for regulations, and (4) combine international best practices with several aspects of the Chinese banking system.⁴⁵² New accounting standards are not enough to ensure the stability of the Chinese bank system.

Chinese management systems need to upgrade to include: (1) audit portfolios; (2) risk-based and bad debt provisioning; (3) assess capital adequacy; (4) international standards for capital adequacy; (5) sound loan approval and review and asset-liability management; and (6) a management training program.⁴⁵³ Commercial banks lack key management processes (planning, budgeting, and reporting), have no familiarity with asset and liability management techniques, possess substandard information system standards, and suffer from a lack of management autonomy and from conflicts of interest.⁴⁵⁴ The decentralized branch systems of Chinese banks have high operating costs, an oversized workforce, and staff who are unfamiliar with financial concepts and methods.⁴⁵⁵

As stated above, Chinese banks' capital reserves are far below the international standards and credit allocation is problematic.⁴⁵⁶ In granting loans, banks must ensure that their capital adequacy ratio is 8 or greater, the loan to deposit ratio should be 75%; the circulating asset balance to circulating liability balance ratio should not be greater than 25%; and no more than 10% of loans should be given to one person.⁴⁵⁷

5. *Prudential Regulations: Strategic Recommendations*

Based on Indonesia's, Korea's, and Thailand's experiences, China should:

1. Require that Chinese commercial banks exceed the 8% Bank for International Settlements capital adequacy ratio. Given the Chinese market, 10% to 12% capital adequacy ratio may be appropriate.

450. EIU China II, *supra* note 219, at 38.

451. Eu, *supra* note 444, at 489.

452. WORLD BANK I, *supra* note 217, at 33.

453. *Id.* at 48.

454. *Id.* at 34.

455. *Id.* at 34.

456. Lee II, *supra* note 188, at 706.

457. PRC Commercial Banking Law § 39.

2. Adopt international best practices for loan classification and loan loss provisioning.
3. Actively reduce the amount of nonperforming loans.
4. Adopt international accounting practices, and solicit help in the implementation and operation of such international accounting practices.
5. As stated in Section 3.2.5, *supra*, create a critical mass of bank managers through international exchanges.
6. Focus on developing effective internal bank management systems, so that liquidity management, asset performance, and other issues may be directly overseen by bank managers.
7. Limit connected lending to not more than 10% to related parties, *in the aggregate*.
8. Wean Chinese companies off the policy loans provided by specialized banks and allow market forces to dictate credit allocation, despite the risk of dislocation.
9. Ensure that Chinese banks maintain liquidity consistent with international best practices.

IV. Conclusion

The Chinese economy is at a crossroads between liberalization and quicker development and central control and stagnation. The former choice will help foster Asia's recovery from the Crisis as well as ensure China's continued development into the next millennium. The latter choice not only jeopardizes China's economy, but the global economy as well. A liberalized, expanding economy requires efficient bank regulation so banks and regulators can better manage operational risk. Traditionally, due to histories of government domination of banking sectors, newly liberalized bank sectors have difficulty managing the market-based risks confronting them. Indonesia, Korea, and Thailand all failed to effectively manage the risks confronting their banking sectors, contributing to the Crisis. These banking systems failed to live up to the Core Principles, international best practices standards for banking regulation in several crucial areas such as licensing and oversight, regulatory transparency and efficiency, and effective ongoing risk management.

China has the opportunity to learn from the mistakes committed in Indonesia, Korea, and Thailand. China should avoid a "too-close" relationship between government regulators and banks as occurred in each of Indonesia, Korea and Thailand. Also, China needs to separate better the political and regulatory functions of the PBC. Further, China should increase the independence, transparency, efficiency and quality of bank regulation; Indonesia, Thailand, and Korea did not have independent

or transparent bank regulators, detracting from regulators' ability to judge and react to the Crisis. Lastly, China should ensure that its bank regulations generally conform to the Core Principles. Reform of Chinese bank regulations is crucial to protect China from a systemic shock that could lead to devaluation of the renminbi, a renewed Crisis, and a new round of global financial concerns.