

**Monographic March 2005:  
Analysis of the Banking System**

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## 1.– The United States

### Analysis of the banking system: in excellent shape

The banking system has been one of the most solid pillars of the US economy in recent years, both due to results obtained as well as to its resistance in the recession in 2001 and the hesitant recovery that ensued.

The profound changes the sector underwent during the 90s and the intense transformation that is still taking place today have seen a huge jump from the serious crisis during the 80s and the beginning of the 90s to becoming one of the sectors of the economy that has generated least concern throughout the tumultuous times of late.

Nevertheless, it is worth remembering that the banking system in the United States is not as important as it is in Europe's continental economies or in Japan. The classic example of a market-based financial system means that the bank system is secondary with respect to the role of financial markets and even with regard to intermediaries such as retirement and investment funds, insurance companies etc. Therefore, banks maintain around a quarter of all financial assets, compared to half in Japan and two thirds in the largest European economies.

As far as classical indicators are concerned, stock market capitalisation stood at 130% of GDP at the end of 2004<sup>1</sup> compared to bank assets which represented around 78% of GDP. In bank-based financial systems

<sup>1</sup> This figure is, nevertheless, considerable lower than during the era of the "dot com bubble".

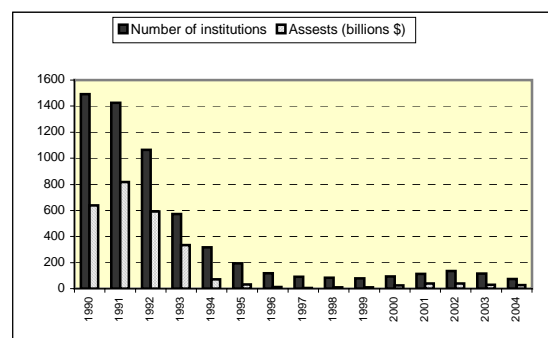
(Continental Europe or Japan), stock market capitalisation currently varies from half to three quarters of GDP, compared to a much higher percentage of bank assets, which doubles or trebles the amount mentioned for the stock market.

However, even though the banking system is smaller in size, relatively speaking with respect to other large developed economies, it is difficult to overestimate the importance of maintaining a strong and healthy banking sector, particularly in times of uncertainty.

#### a) Keys to the change

Both commercial banks and in particular saving institutions were in serious difficulty halfway through the 80s and the beginning of the 90s (made worse by the crisis in 1991). A poorly regulated system with an unusually low level of competition (in comparison to the norm in other sectors of the US economy) saw hundreds of banks with hundreds of billions of dollars in assets go into crisis during the above mentioned period (a good deal of which went bankrupt).

Figure 1: Banks in Trouble



Source: own elaboration with data from the Federal Deposit Insurance Company (FDIC)

In contrast, since halfway through the last decade and even during the recession, problems have been marginal and have mainly affected smaller banks (Figure 1).

The combination of several factors has brought about this improvement:

1) Changes in regulations:

- Adopting the Basel Agreement<sup>2</sup> meant reinforcing the solvency of US banks<sup>3</sup>.
- The Riegle-Neal Interstate Banking and Branching Efficiency Act, which in 1994 meant the disappearance of historical regulations that limited the interstate expansion of banks was especially important, together with other measures aimed at promoting competition (allowing banks to widen their spectrum of authorised activities, for example). By 1998, practically all States had adapted their regulations to the new law, giving rise to copious mergers and acquisitions across the country.

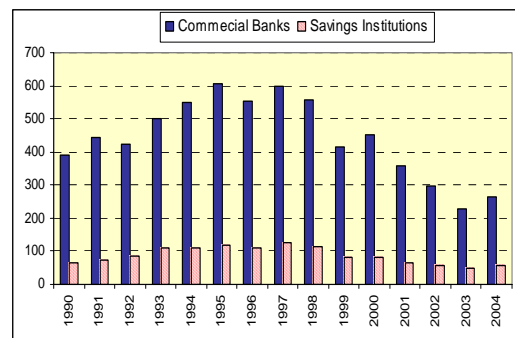
2) Banking consolidation: the series of mergers and acquisitions, which reached its peak halfway through the 90s (Figure 2) joined the disappearance of the least efficient banks in previous

<sup>2</sup> The Capital Agreement "Basel-1" was signed in 1988 by 11 developed countries with the aim of guaranteeing the solvency of its financial institutions. The improved, although more complex "Basel-2" Agreement should come into force in 2006.

<sup>3</sup> Specific regulations were even developed for institutions that were not initially subjected to this international agreement (due to their activity), in order to guarantee their solvency.

years. Organisation has improved as a result as has risk management. Furthermore, banks have widened their scope of activities in order to depend less on intermediation margins and have substituted – taking advantage of the housing boom – a considerable percentage of their loans to businesses for safer real estate loans.

Figure 2: Number of Mergers and Acquisitions



Source: own elaboration with data from the FDIC

3) Specifically, high technology companies in the United States, which particularly suffered the consequences of the past recession, use banks less as a source of external financing than companies in other sectors that better endured the crisis. This helped to strengthen the banking sector in that context.

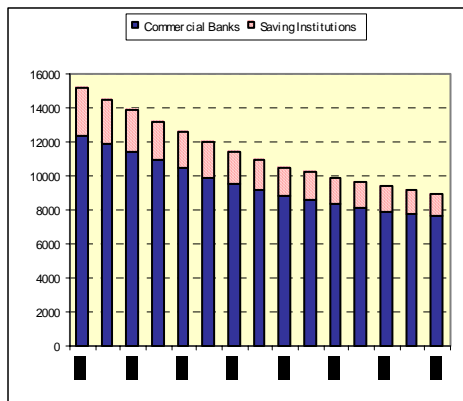
**b) Consolidation Results**

Bankruptcies stemming from the aforementioned crisis in the 80s and M&As favoured by the new legal framework resulted in a marked decrease in the number of institutions in a system that was extremely fragmented a decade and a half ago (Figure 3).

Despite this, there is still a large number of commercial banks and saving institutions in the US by international standards, and further

stages of consolidation are inevitable. In fact, broadly speaking, the interstate expansion of the largest banks has been rather slow and remains unfinished in the sense that it is always difficult to digest institutions with very different philosophies, lines of work, types of customers and procedures.

Figure 3: Number of Institutions in the Banking System



Source: own elaboration with data from the FDIC

Table 1: Bank Consolidation Process. Commercial Banks; institutions at the end of the year

Size of the institution	'90	'95	'00	'04
> 20bn.	16	28	45	53
10-20bn.	33	47	36	29
1-10bn.	32	34	30	35
	5	3	6	0
300mn - 1bn	62	65	74	10
	2	5	9	32
< 300mn	11	88	71	61
	22	00	19	03
	1			

Source: own elaboration with data from FRED II

There appears to be two large strata in the consolidation process over the past 15 years, as can be observed in Table 1. In this sense, medium-sized to large institutions merged or were absorbed by larger banks. The number of institutions with more than \$20bn in assets rose as a result, to the detriment of those in the next category down. Secondly, the smallest institutions have fallen considerably, in favour of those in the next category up (up to \$1bn in assets). Logically, the upward shift in medium-sized institutions has a two-fold result: firstly, consolidation and secondly, the inevitable increase of total assets in the system, parallel to growth in the economy.

In Table 2 at the end of this report displays the ranking of the main banks in the United States at the end of 2004. The ladder has been quite stable over the past three years, although the leadership has changed from the Bank of America to JP Morgan Chase, one of the four out of the top ten (three out of the top five) involved in large-scale M&As in the period dating from 2002 to 2004.

The ten large banks (which are not that big in comparison to their European and in particular Japanese counterparts, after correcting to take into account the size of the respective economies) account for around 39% of total assets in the system, eight points more than at the end of 2001. Finally, only three of them (JP Morgan Chase, Bank of New York and above all Citibank) display a significant amount of foreign assets.

*Foreign banking*, and European banking in particular, has taken advantage of the change in law to begin a slow but steady penetration into a banking system with less competition and

greater profit margins than their own domestic markets. Moreover, the enormous business opportunities, which can now be sought out in various states at the same time, have favoured a very intense process before the crisis in 2001 (and immediately afterwards and which is still continuing today in Europe) with particularly English banks, together with French, Dutch or German banks acquiring several medium-sized US institutions. This type of acquisition has diminished somewhat (as occurred in many other sectors) since 2002.

The overall weight of foreign banking is still modest, with 10% of total bank assets (slightly more than 8% when including savings banks). Foreign companies only have a share of nine of the 40 main institutions, of which three are minority. The most striking examples are the HSBC USA, number eight in the ranking, which is 100% owned by HSBC and Lasalle, which is 16th in the ranking of assets and is 100% owned by ABNAMro.

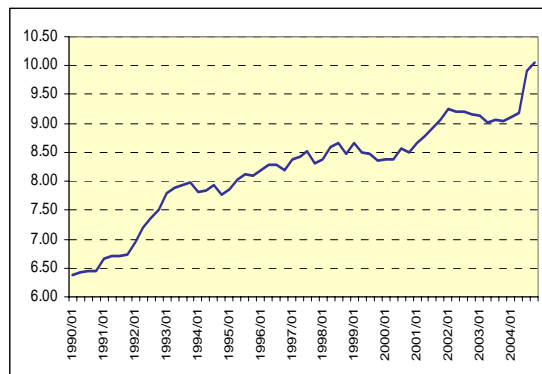
**c.- Some pointers**

The basic parameters that measure the health of the US banking system, as can be expected following the above information, display excellent results.

The capital adequacy of institutions, measured by the total capital to total assets ratio according to criteria from the Bank for International Settlements (BIS) (Basilea-1, 8% capital to risk ratio – BIS ratio is required) has improved noticeably since the beginning of the 90s (Figure 4). The steady climb of the BIS ratio from less than 6.5% to more than 10% shows how regulations have become tougher and the satisfactory response on behalf of institutions that are currently active.

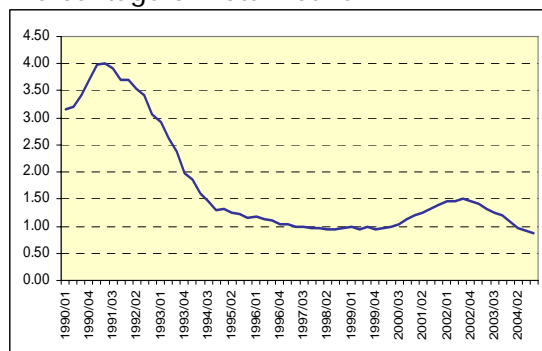
The steady decrease in the number of irretrievable loans is an equally good guarantee of the banking system's health. Bad loans have dropped to an all-time low of 1% of all live loans, barely suffering the recession (see Figure 5 where the percentage rose only slightly in 2001 and 2002) and far from the 4% observed a decade and a half earlier.

Figure 4: Total Capital to Total Assets Ratio (BIS ratio)



Source: own elaboration with data from FRED II

Figure 5: Irretrievable Loans as a Percentage of Total Loans



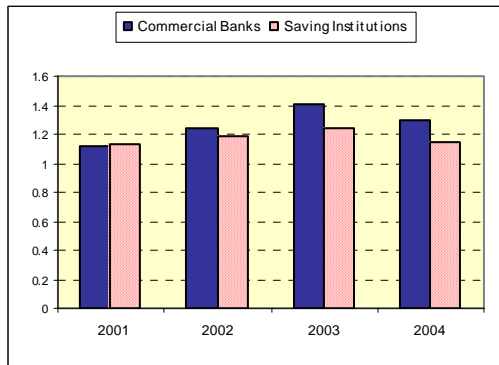
Source: own elaboration with data from FRED II

In addition to this, the US banking system's net result is, on average, one of the highest in the context of the Organisation of Economic Co-operation and Development (OECD), firmly

established above 1% of total average assets (Figure 6).

The modest competition referred to earlier in the report and the predominance of fixed mortgage rates (that protect the borrower from interest rate rises, but at the expense of paying interest rates that are considerable higher than those that can be obtained in many European countries), give US banks a more than respectable intermediation margin, above 3% of total average assets. Even if US banks had higher operating costs and less income outside the intermediation business than their counterparts in other developed countries – such as Spain – they still obtain an extremely satisfactory profit after tax. That final margin will probable tend to drop as competition increases.

Figure 7: Net Profit (percentage of Total Average Assets)



Source: own elaboration with data from FDIC

In order to conclude this brief review of the US bank system, here are some comments on the progress and situation of its credit structure. Table 3 shows how credit is distributed among large categories. Somewhat more than half the live credit is concentrated in the real estate business, 14% in consumption loans, nearly 20% in

commercial and industrial credit and a sixth corresponding to other categories such as securities, public sector, agriculture...).

While credit is evenly distributed across bodies of different sizes, quite the opposite can be said about foreign banking, with a tiny share of the real estate market<sup>4</sup>. In order to compensate for this, foreign banks are more involved in corporate financing and financial investment.

Table 3: Credit Structure (December 2004; % of total loans)

	Total banks	Large Banks	Foreign Banks
Businesses	18.78	18.11	36.82
Real Estate	52.32	51.00	4.67
Consumption	13.91	14.77	n.d.
Securities	4.59	3.66	33.08
Misc.	10.41	12.44	25.44

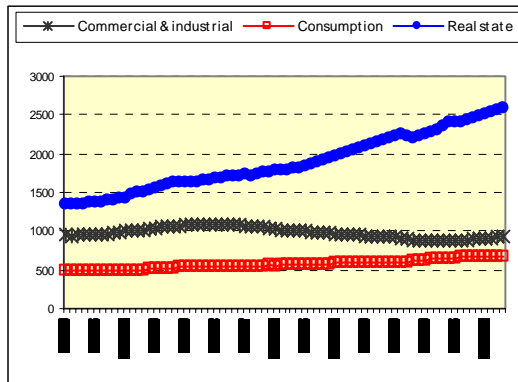
Source: own elaboration with data from the Federal Reserve System

Note: "Securities" refers to the percentage of loans given for financial investments

Figures 8 and 9 enable us to contemplate the significantly disparate progress of the three main credit categories.

<sup>4</sup>Consumer loans are not disaggregated in the case of foreign banking in the information consulted at the Federal Reserve.

Figure 8: Bank Credit (billions of dollars; seasonally adjusted data series)



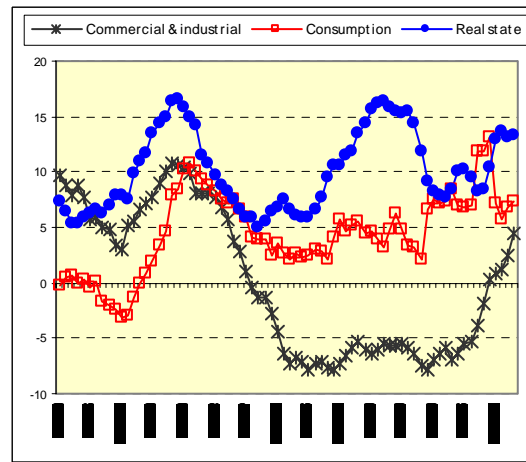
Source: own elaboration with data from FRED II

The amount of loans to businesses remains the same as five years ago, despite the particularly favourable conditions over this period. This is a consequence of three factors: firstly, the recession in 2001 and the logical downturn in investment, which lasted longer than usual due to geopolitical and economic uncertainty. In the second place, the exceptional conditions for issuing debt on financial markets with ample liquidity and eager for risk to raise their yields. The crash in spreads is a clear exponent of this situation. Finally, the considerable corporate profits obtained since the end of the recession has enabled more than a few businesses to invest without having to use external financing. As a result, loans to businesses have registered negative growth for three years in a row and only recently have they picked up slightly.

Meanwhile, consumer credit has risen by 36% over the past six years up to the beginning of 2005. Following a sluggish period, which was probably the result of the substantial growth rates recorded earlier and the relatively high

interest rates at the end of the 90's, the strength of the US consumer has called for bank financing which has risen consistently between 5% and 10% per annum since halfway through 2000.

Figure 9: Bank Loans (annual growth rates; seasonally adjusted series)



Source: own elaboration with data from FRED II

In keeping with the pattern observed in other countries (Spain, the United Kingdom, Australia), mortgage loans have multiplied as housing in recent years has become one of the mainstays of economic activity in the United States. Mortgage loans rose by 93% between 1999:1 and 2005:2, with an average growth rate (despite fluctuations that have nevertheless been compatible with increases that were always above 5%) in the vicinity of an annual 11%.

As has been highlighted in many forums, including several of the OCEI's monthly reports and in contrast to other countries that are also experiencing a real estate boom, in the United States the best part of mortgage loans (approximately 80%) have a fixed interest rate. This is a relief for household economies in light of the fact

that the cycle of interest rate rises is forecast to continue. On the contrary, one could anticipate problems for the institutions with most presence in this market. Nevertheless, the wide gap established between the average mortgage rate and the Fed Funds Rate (close to 500 basis points before the latter began its series of rises) and the system's high level of solvency and profitability<sup>5</sup> is no cause for concern in this area at present.

Vicente J. Pallardó.  
Valencia, March 2005.

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<sup>5</sup> Apart from the possibility of increasing the intermediation margin in other types of credit, taking advantage of the tougher monetary conditions.

Table 2: Main US Banks

Entidad	2004 Position	2001 Position	Consolidated Assets (2004; \$bn)	Household Assets (2004; \$bn)	Merger/Acquisition between 2001 and 2004
JP Morgan Chase	1	2	967.4	649.1	Yes
Bank of America	2	1	771.7	715.3	No
Citibank	3	3	694.5	300.0	No
Wachovia	4	4	390.0	367.8	Yes
Wells Fargo	5	8	366.3	364.7	Yes
Fleet	6	6	218.7	201.6	No
U.S.	7	13	194.4	194.1	Yes
HSBC USA	8	10	138.3	128.3	No
Suntrust	9	9	130.8	130.8	No
Bank of New York	10	14	92.1	68.5	No

Source: own elaboration with data from the Federal Reserve System

## 2.- Euro-zone

This monographic article devoted to the financial system in the Euro-zone will mainly focus on the fixed income market and in particular on the sovereign debt market, with a special mention for sub-national debt. Apart from explaining the various products on the market, we will look at agents' strategies and the latest innovations.

A financial system is defined as a group of institutions (markets and intermediaries) through which households, companies and Governments finance their operations and invest their savings.<sup>1</sup>

### 1) Financial Structure and Evolution

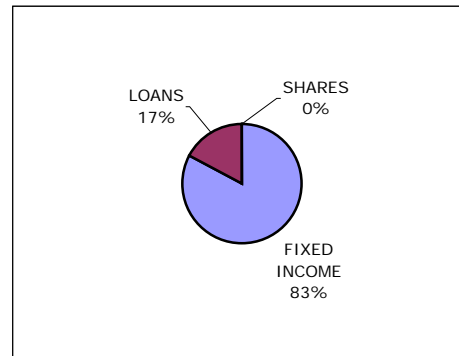
If the structure of the financial systems in the United States, Japan and the Euro-area were compared, we would find as many things in common as we would differences.

What all three systems have in common is that while financial institutions on the whole have a net position close to zero, household surpluses finance both Governments as well as non-financial institutions in their entirety.

In regard to the Euro-zone, governments are seen to use mainly treasury bonds and notes to obtain funding for their respective budgets. This is obviously a consequence of the considerable savings to be made in

terms of financing and due to the advantages of diversification.

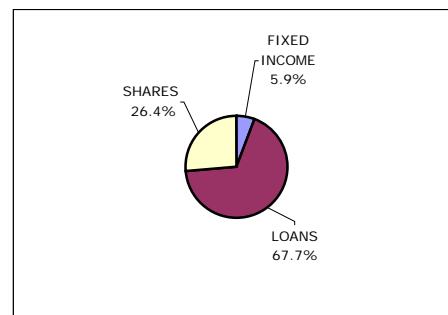
Figure 1: Sources of Government Funding in 2004



Source: ECB and own elaboration

However, the most striking difference is observed in corporate funding. While corporations in the Euro-zone mainly use the banking system for financing (67.7%), in the US quite the opposite occurs. Various factors can explain these differences. Inadequate capital valuation, subsidized credit operations indirectly offset by other banking services, the need to continually value bond portfolios in market prices, but not loans, and furthermore, the fact that companies are smaller in size could explain such differences.

Figure 2: Sources of Funding for Non-Financial Institutions in 2004



Source: ECB and own elaboration

<sup>1</sup> WP n° 230 May 2003 ECB. "The Euro Area: Financial System; Structure, integration and Policy Initiatives" by P. Hartmann, A. Maddaloni and S. Manganelli.

The birth of the Economic and Monetary Union prompted an authentic boom in the corporate bond market, which coincided with Universal Mobile Telecommunications System (UMTS) licence auctions, large Initial Public Offerings (IPOs) and corporate restructuring. Carnegie-Brown and King (2003) underline the fact that corporate bond issuance had been proportional to Merger and Acquisition (M&A) activity in the Euro-zone.

The strong increase in the market also resulted from an enlarged pool of investors, due to the disappearance of national currencies and a reduction in underwriting costs.

Growth in fixed corporate income has on average outpaced loans more than two-fold since 2000. The weighting of long term corporate funding, excluding capital extensions, is far greater than in the short term (69%).

As far as quoted shares are concerned, Euro-zone corporations use this method of funding less than in the United States due to the former having a greater proportion of Small and Medium-Sized Enterprises (SMEs).

Households, despite financing the rest of the system, are getting further and further into debt. While still far from the situation in the United States (80.3% of gross disposable income in 2001), borrowing is growing considerably. Buying a house represents the greatest proportion within the average structure of household borrowing.

Household saving patterns have also undergone changes over time. The general tendency was to invest in

increasingly sophisticated products that offered extra profitability, particularly considering the economic scenario of low real interest rates. This has led to new ways of investing savings being developed, outside of the traditional banking circuit. These include investment funds, insurance companies or retirement funds, as well as directly investing in bonds and stocks.

In this sense, European households clearly invest less in variable income than in the United States. This can be explained by the lack of incentives to seek out higher profitability expected in the long term due to having a greater degree of government protection.

Some products have been developed more than others, depending on the country and how savings are taxed, apart from the mentality of savers themselves. In France, for example, financial products from insurance companies are highly developed, besides people's savings accounts; retirement funds in the Netherlands; investment funds in Italy and Spain. There has also been a spectacular increase in direct investment on behalf of Italian households in corporate bond and emerging sovereign debt markets, which explains the current problems the country is experiencing.

In fact, capital in retirement funds, technical reserves in insurance companies and investment funds surpass total bank deposits belonging to non-financial corporations in the Euro-zone. Investment fund capital alone is approximately half of total deposits.

However, over recent years market circumstances have called the shots.

Falls in stock market listings have led to an increase in the proportion of deposits and fixed income at the expense of shares.

Table 1: Financial Investments on behalf of the Non-financial Sector

	1999	2004(3T)
DEPOSITS	35%	38%
FIXED INCOME	11%	12%
SHARES	21%	13%
FUNDS	13%	12%
TECH. INS. RES	21%	25%
TOTAL	100%	100%

Source: ECB and own elaboration

The high level of corporate and household financial disintermediation has made it impossible to completely finance bank assets with traditional deposits. This has forced many financial institutions to use new mechanisms in order to capture funds, such as issuing debt and promissory notes, loan securitization or Collateralized Debt Obligation (CDO), apart from various capital instruments.

Securitizing assets has been an important source of liquidity for the financial system, although it has also been used by Governments and corporations.

This market mushroomed by 70% between 1999 and 2003, but its proportion of total bond issuance remains at 4%. Mortgages are the most securitized assets (50%), followed by CDOs (26%), consumer credit or loans to SMEs, credit cards, etc.

Table 2: Banking System. Assets and Liabilities, Excluding Bank Financing and Fixed Income, in 2004

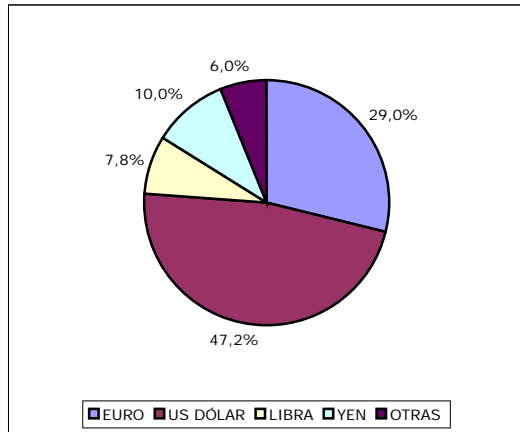
	BANK ASSETS	BANK LIABILITIES	FINANCING NEEDS
<b>TOTAL</b>	<b>10237.5</b>	<b>5416.1</b>	<b>-4821</b>
GOVT.	2315.5	288.2	-2027
LOANS	834.4		
FIXED INCOME	1481.1		
<b>CORPORATE</b>	<b>4185.7</b>	<b>1067.1</b>	<b>-3118</b>
LOANS	3104.2		
FIXED INCOME	447.5		
SHARES	634		
<b>HOUSEHOLDS</b>	<b>3736.3</b>	<b>4060.8</b>	<b>324</b>

Source: ECB and own elaboration

## 2) The Importance of the Euro as a Currency in Capital Markets and the Deepness of the Market

Internationalization of assets in euros has grown over recent years. From an investor's point of view, it is a good way of diversifying portfolios, including those of certain central banks, thereby increasing its value as a reserve currency. However, the euro still falls well short of the importance it should given the importance of the countries that make up the Economic and Monetary Union. From an issuer's point of view, many offshore institutions, such as US agencies, have frequently used the euro as their currency for financing their operations.

Figure 3: International Bonds and Notes in 1999

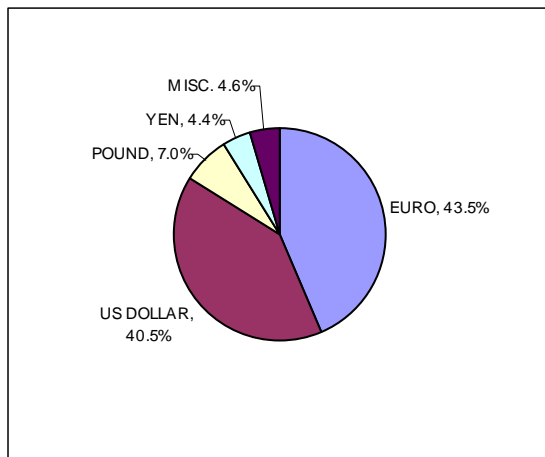


Source: BIS

Factors such as the appreciation of the euro and possible arbitrage in the foreign exchange swap market are behind the increasing use of the European currency.

In fact, when the euro came into being, not only did it increase its market share as a currency for international bonds and commercial paper, but has become the main currency for international for the denomination of international bonds and commercial paper.

Figure 4: International Bonds and Notes in 2003



Source: BIS

Supremacy in the bond market has changed hands. The number of bonds in dollars represented 47.2% of the market in 1999 compared to 29% in euros. However, in 2003 the Euro has taken over with 43.5% and according to available information the trend continues. In the third quarter of 2004, issues in euros accounted for more than 50% compared to the 32.6% share of bonds in dollars.

Paper issued in euros is even much more widely used in the commercial Eurobond market. The percentage of paper in euros now stands between 48% and 49% compared to 27% in dollars, when the first year of the euro saw issues in dollars prevail with more than 50%.

Finally, the US market is deeper due to the fact that it more readily accepts low issue ratings.

Table 3: Issues and Rating (Excluding Governments)

	EURO-ZONE	USA
AAA	23.0%	38.5%
AA	32.1%	18.2%
A	39.3%	28.0%
BBB	4.4%	7.9%
BB	0.4%	4.5%
B	0.7%	2.5%
CCC & INF	0.1%	0.4%

Source: Bondware, CDC-Ixis CM and own elaboration

### 3) Innovations on behalf of Central Governments

Central Governments lead issuing action in the euro fixed income market with 44% in 2004. Long term paper represents 90%, most of which has a fixed rate.

Sovereign debt issues are expected to reach €606.8bn in 2005. The country to most tap the market for funds is expected to be Italy, with almost a third of total issuance.

It is important to highlight that the entry of the euro has seen Euro-zone sovereign debt spreads narrow appreciably over this period. This can be explained by the following factors: some countries, such as Spain, have improved their ratings; exchange risk has vanished; effort has been made to improve issue liquidity – every 1% increase in issue size generates savings of 0.7bp<sup>2</sup>; issue characteristics have become more homogeneous.

In the following section, we will look at Central Government management innovation.

### **3.1. Creation of Specialised Public Debt Agencies**

The creation of specialised debt management agencies has become more widespread of late in the Euro-zone. However, there are very important national treasuries such as Spain and Italy, which do not have them. The existence of debt agencies, nevertheless, does not necessarily mean debt is managed satisfactorily.

Ireland and Portugal were the first two countries to create an agency, even before the euro came into being. Ireland's decision was due to the need for highly specialised human resources from the private sector (generally from the banking sector), who could

contribute to management both in terms of tapping the capital market as well as in financial risk management itself – interest and foreign exchange. In Ireland, the agency even subcontracted important services from the international banking sector in the field of risk management.

Agencies establish their management objectives/variables, which are quantified in order to verify management effectiveness. Minimising debt servicing is one common objective, normally in the long term, by using portfolio duration optimisation as a target. Due not only to diversification, but also to the need to generate price references at different points in the interest rate curve, National Treasuries lack the flexibility to completely determine the duration of issues in the aim of adjusting to target duration. In order to achieve this, some treasuries adjusted duration by means of interest rate swaps. France's treasury agency (AFT) had to suspend interest rate swaps some time ago due to price distortions in the market in view of the considerable amounts contracted.

### **3.2. Changes in Issuer Strategies**

Before the arrival of the euro, national treasuries had little competition in their respective currencies and used auctions to launch domestic bonds. Some countries, such as Italy or Spain, issued international bonds as a complement, although not on a regular basis.

Once the third stage of the Economic and Monetary Union had begun, national barriers disappeared, thereby creating a much wider and deeper market with strong competition among

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<sup>2</sup> WP 369 "Sovereign risk premium in the European Government Market". K. Bernoth and others. ECB June 2004.

the various agents, issuers, investors and intermediaries.

For investors, the disappearance of exchange rates completely changed security risk credit/premium analysis, in search of extra yields for their respective portfolios.

For intermediaries, fixed commission on syndicated operations dropped sharply and issuers were even offered subsidies in order to gain ground in league tables.

For sovereign debt issuers' previous strategy underwent clear changes with differences in terms of the country's size or debt stock itself.

The breadth of the market came with the need to considerable increase issue size.

As far as sovereign public debt was concerned, issue size rose substantially due to the need to increase secondary market liquidity as a way of reducing the liquidity premium and to increase competitiveness, the war between the largest countries' treasuries to become benchmarks for the rest of issuers and the fact that assets had to be eligible to be listed in the super liquid public debt market Euro-MTS, heir of Italy's Montetitoli. Issue size was initially around €6bn when launched by a syndicate, which grew further due to the incorporation of fungible tranches (1,000-2,000 in the case of Spain or 5,000-9,000 in the case of Germany) with identical characteristics. Launching fungible issues and repurchasing or on the contrary auctioning has enabled issue size to expand<sup>3</sup>.

Smaller countries concentrated on offering less payments and less issues less frequently to meet the minimum requisites in order to be eligible for the Euro-MTS. A sovereign debt issue must have €5bn in outstanding size on the date of the last auction or €3bn in outstanding size and the commitment to reach the minimum within the next 180 days in order to be accepted by this market.

The issuing procedure also changed. Generally speaking, large countries continued to issue using the auction procedure, except for the launch of a new note duration or design or in the case of Italy. Small countries combined the syndication at the beginning of a new issue together with auctions in later tranches.

These procedures have different objectives. Auctions guarantee better prices, while syndication, without necessarily having to renounce the best price, can distribute paper well across the pool of investors, although more working time must be invested: road-shows with investors, pre-marketing, bookbuilding, etc.

As far as issues in currencies other than the euro are concerned, Italy and Spain to a lesser extent have issued in foreign currencies. In Italy's case, a programme of Euro Medium Term Notes (EMTN) was used.

<sup>3</sup> Issue size examples (in €Mn) are:

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ESP OBL 6% 08	14,600
GER BUND 5% 12	27,000

### 3.3. New Products on the Market

Three new products, all of which were created by France's Treasury are worth highlighting: the inflation indexed bond, the TEC-10 index and more recently the 50-year bond.

Before the arrival of the EMU, France's Treasury Department, following on from the United Kingdom and Sweden in Europe, launched its first bond indexed to France's harmonised inflation rate, without tobacco, which was later completed with another bond with a different maturity. The birth of the euro saw the French treasury launch another issue of bonds, but this time indexed to European harmonised inflation without tobacco. Much later on, Italy became the second Euro-zone government to issue European inflation indexed bonds.

France, both in terms of number of issues (8) as well as size led Euro-zone issuing activity, albeit a modest amount in relation to its total debt (8.5%).

Indexed debt is expected to rise by €55bn in 2005, much more than the previous year. Moreover, Germany will foreseeably make its debut on the inflation market, as parliamentary authorisation has been given to this end.

Issuing this type of bonds has, among others, the following advantages:

- You give a market reference to the inflation forecast which leads to a market of inflation derivatives allowing agents with inflation risk to be managed.
- You satisfy a strong demand on behalf of the insurance sector to mitigate the risks they take on.

- You generate real self-discipline in public finances, even though the proportion with respect to the rest of bonds is very small.

The second innovation was the TEC-10 index, which is a bond that pays a 10-year interest rate on each coupon. In other words, the coupon is indexed to the 10-year interest rate.

However, the latest great innovation is the first 50-year bond in euros by means syndication. The market was avid for long term paper, particularly considering the reform of retirement funds in the Netherlands, which requires a closer relationship between the life of an asset and the obligations of liabilities, together with those that will be introduced in other countries. The operation was well received by the market and great diversity was observed among investors and countries. Nevertheless, the proportion corresponding to retirement funds and insurance companies only reached 22%.

### 4) A New Emerging Market: Regional and Local Debt

Europe has become more and more politically and administratively decentralised over the past few years which is still incomplete and which has affected the more centralised countries such as France and Italy.

At this very moment, a proposal for significant constitutional reform is being discussed in the Italian parliament, which aims among other things, to give more power to regions and attempts to go beyond the reform passed in 2001.

This process involves passing over responsibility in expenditure on education, health, the environment, public works, etc. and the approval of new models of financing.

New spending competences and the inadequate financing of regional bodies – centrifuging Central Government deficits to Regional Governments – has led to a significant rise in debt, which in most countries can only deal with investment expenses – complying with the golden rule.

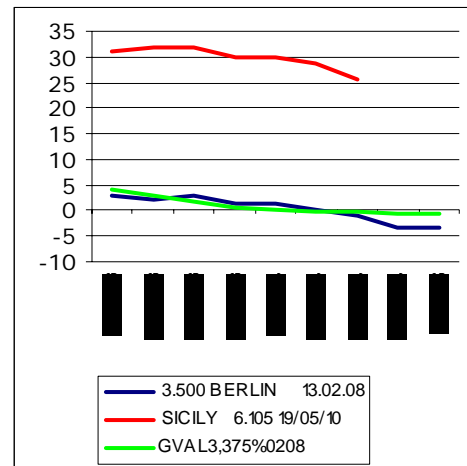
Regional and local debt is 16.8% of total public debt. German regions as a whole tap the market the most with nearly 83% of total regional and local European debt.

While Central Government debt is managed mainly in treasury bonds and notes, regional and local bodies make much more use of loans. The percentage of loans and bonds differs across countries. While in Spain bonds represent 50% of debt, in Italy the figure is only 10%.

Individual needs are in many cases behind this: Schuldscheine loans - widely used by German Landers – and the development of collateralised bonds with public loans or securitisations themselves.

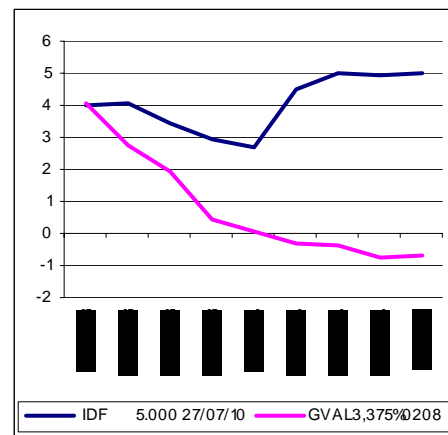
Nevertheless, there is a tendency towards increasingly using bonds and notes rather than loans. In Spain this is due to differences in terms of capital consumption between a bond and a loan. In Germany it is due to the strong need for financing, while in Italy it is due to the lack of competition in the banking market, longer maturities and changes in regulations.

Figure 5: Regional Debt Secondary Market



Source: Reuters and own elaboration

Figure 6: Regional Debt Secondary Market



Source: Reuters and own elaboration

In regard to secondary market spread of similar issues in Figures 2.5 and 2.6, we can see that better rating does not always imply better spread. This is the case with Ile de France AAA, when compared to Generalitat Valenciana A3. The French region consumes 20% of bank capital, while Valencia's bank capital consumption is 0%. Moreover, Berlin and Generalitat Valenciana are both rated A3 and both have 0% bank capital consumption. However, Berlin displays a debt/current revenue ratio of

260% and Generalitat Valenciana's is in the vicinity of 70%. Berlin spread is also somewhat lower than Valencia's. The possible reason for this is the strong reputation of the robust system of guarantees in Germany's regional model.

Total issuance is expected to reach €45bn in 2005, of which €37bn will be placed on the market by German Landers. Spanish and Italian regions will issue a total of €4bn each.

#### **4.1. Regional and Local Government Market Strategies**

In this sector there is no common strategy for approaching the market. It obviously depends on how much paper is needed, but also on legal determinants and the philosophy of the issuers themselves.

German Landers generally use the strategy of regularly tapping the market by means of large issues which enable them to achieve competitive financing costs and widespread distribution among both European and international investors. Syndication is fundamentally used when calling on the market for financing. A build up is provided with road-shows, paper pre-placing – book-building – with guaranteed issues or with the pot system, where investors bid directly through a programme on the internet. Moreover, the most active Landers manage their bonds through EMTN programmes. It is striking that some Landers have issued Islamic Eurobonds with the aim of enlarging their pool of investors.

Apart from individual issues, some Landers carry out joint issues called Lander-Jumbo, which do not stop them

from issuing individually. Twenty joint issues have been launched to date, most of which were carried out by the same Landers. The last issue was worth €1.5bn.

In Italy, regions, provinces and towns also tap the market with international paper (EMTN) aiming to make it easier to attract international investors. The potentiality of the EMTN is not used to carry out private placements with the objective of reducing the financing costs of public issues, as they are legally obliged to issue long-lasting paper and even to carry out issues with the French Amortization system. This is highly unusual in the market and obviously penalises them. Nevertheless, in light of the lack of competition in Italy's capital market, the cost of issues and the yield obtained is much better. Generally speaking, issue size is small in relation to what the market actually demands.

Few names appear on the market in France due to the small size of operations, the creation of bonds with public loan guarantees (obligacions foncieres) and the strong presence of French banks in the region, offering long term loans with coverage. Ile de France stands out as a regional issuer, placing both short and long term paper on the market with programmes of commercial paper and EMTN.

Finally, Spanish regions frequently tap the market, together with the Madrid and Barcelona City Councils, which have on occasions sought out funding on the market.

To sum up, Spanish regional issuers can be divided into three groups according to their strategy:

- a) Regions that do not have a strong need for funding and issue generally long term debt but not on a regular basis: Castilla y Leon, Castilla La Mancha, Galicia, Murcia, Aragón and the Canary Islands.
- b) Regions that have a long term financing strategy with diverse products, using a regular auction system similar to that used by the Spanish Treasury and more focused on the domestic market: Catalonia and Andalusia.
- c) The region that has a long term financing strategy with a more international vision and with varied products – commercial europaper and short term promissory notes; and the programme of EMTN for public issues and private placements: Valencia.

Valencia, April 6 2005  
Nicolás Jannone

### 3.- Spain

#### Introduction

The lengthy process of modernisation and adaptation to international patterns that the Spanish financial system has undergone, began in 1962 with the "*Ley de Bases*" (Base Law in Spanish). This was the first serious attempt to rationalise the banking system (breaking the status quo, specialising, nationalising and the remodelling of the Bank of Spain, changes in monetary policy, etc.). The second important step in this process was taken in 1977 with the reform passed by Enrique Fuentes Quintana. This reform meant further changes in monetary policy, putting banks on a level with savings banks, liberalising competition in assets and liabilities within the capital market, access to foreign banking, etc.

The third stage of the process came with Spain's incorporation into the European Communities in 1986. This meant the financial system had to be suitably adjusted. The main milestone was the approval of the single financial market in 1993, which completely deregulated internal and external financial flows and eliminated all exchange rate controls.

Finally, the last key event in this process was the passing of the euro in 1994 and all the necessary changes made to ensure the effectiveness of its coming into being: central bank independence in 1994, "*ley paraguas*" (umbrella law in Spanish) concerning the introduction of the euro in 1998, the creation of the European Central Bank and the European System of Central Banks, as well as the definition of new monetary policy within the Euro-

zone and in 2002 the euro was put into circulation.

It is not easy to summarise the basic features of the Spanish Financial System in a few lines, let alone to compare it to other systems that have different regulations and statistical records. In order to achieve this, how a financial system meets its basic objective within an economy is used as a starting point. In other words, the channelling of net savings from surplus spending units to deficit spending units in the most efficient manner.

#### 1. The Weight of Financial Assets

The first issue that must be taken into account is just how developed the financial system in Spain is. In order to obtain this information, the weight of total financial assets issued by the system (with the aim of capturing the country's disposable savings) is related to GDP and then compared to the same ratio for the United States and Japan. The result can be observed in Table 1.

It is verified that the Spanish Financial System is significantly developed, falling only slightly behind the USA and somewhat further away from Japan. Spain's total financial assets are eight times the country's GDP.

#### 2. Economic Agents

The second feature worth highlighting is the role and importance of each and every economic agent into which the economy of each country is divided (households and non-profitmaking organisations serving households (NPISH), non-financial institutions, the public sector, financial institutions and the foreign sector).

Table 2 could not be more representative of the structure of the economies analysed. It is no surprise whatsoever, for example, that Japan's level of accumulated financial assets in relation to GDP (1172%) is well and truly above that of the United States (911%), as Japan's savings rate has been one of the highest in the world for decades. Even Spain (827%) is catching up to the United States, with a lower savings rate than Japan, although higher than in the US. It is also no surprise that public sector liabilities are growing uninterruptedly in Japan (172% of GDP) as a result of the country's enormous and persisting deficit in the public sector, comfortably surpassing the USA (66%) and Spain (57%).

Another feature is the role of households and NPISH, the genuine accumulators of financial assets in the three countries under study. The ratios available reveal that despite the enormous amount of borrowing on behalf of US households and their low savings rate, they have more financial assets in terms of GDP and their net financial standing could not be healthier (217% of GDP), even better than Japanese households (211%). Spain's case differs considerably. Neither are the levels of income per capita comparable nor has Spain's access to development had a long history either. In fact, quite the opposite. Taking this into account, it is no surprise that the level of accumulated financial assets on behalf of Spanish households is comparatively lower (156% of GDP). At the same time, financial liabilities have grown (70%) and households' net financial standing has stagnated (86%) as a result of the marked increase in

household borrowing (most of which is used for buying a house).

Non-financial institutions always emerge as the greatest demanders of financial resources and their net financial position is markedly negative. In this case, it must be remembered that all trading companies issue securities (shares) which are underwritten by the rest of agents or by other companies and that all of these securities (as in the rest of cases) are liabilities for the issuer (trading companies) and assets for underwriters. In the following section, the weight of shares and the amount of bank debt taken on by companies will be looked at for Spain.

The importance of the External Sector in all three economies is an interesting reference point. It seems logical that in a medium-sized and increasingly open economy such as Spain's, the external sector would have greater weight, and this is in fact the case. It is also on the cards that an economy such as Japan's, with substantial and constant current account surpluses, has over time accumulated a considerable stock of financial assets with respect to the exterior (which appear as liabilities in cash flow accounting) and above all that the country's net balance, its international financial position, is significant (36% of GDP). In contrast, Spain, with a long history of current account deficits and being a net importer of capital displays a balance in which the external sector has accumulated a considerable quota of Spanish financial assets (154% of GDP), which is not offset by foreign assets purchased by the country's economic agents (114%) despite the increase in this type of acquisition in

recent years. As a result, the net position of the Spanish economy reflects this deterioration and the net external accumulation of Spanish financial assets on behalf of foreign agents (39%).

Finally, Table 2 also shows the enormous weight that the financial system has in Japan. This is measured by the amount of financial assets purchased or issued by financial institutions (589% or 587% of GDP respectively), easily surpassing the United States (395% compared to 421%). In the case of Spain, despite significant growth over recent years and marked internationalisation, the weight of the financial system remains considerably lower (290% and 286%) when compared to the other two countries under consideration. One aspect worth highlighting is the substantial deficit in the net position of US financial institutions, which contrasts with the surplus in the other two economies. There are several reasons for this, but all we have to do is consider that US dollars issued by the Federal Reserve and accumulated by the rest of countries in their reserves total \$43bn.

### 3. Financial Assets

The next step consists in analysing the weight of the various financial assets issued by the system in the case of Spain. Tables 3 and 4 summarise the main financial assets, distinguishing their ownership according to the different agents considered.

In Table 3, the structure of financial assets in Spain can be clearly appreciated and summarised in five large sections:

- The various types of deposits are still the system's main financial assets. Almost a quarter (24%) of all financial assets are comprised of cash and cash deposits by instalment (to a lesser extent in foreign currencies) and are mainly owned by households. Deposits are still the main financial assets for Spanish households, accounting for 40% of their total wealth.
- The second group of assets are listed and non-listed shares directly underwritten by economic agents, representing almost another quarter (23%) of total financial assets in the system. In this case, the ownership of these assets is more widely spread, although the majority are owned by non-financial institutions. Non-financial institutions hold 38% of all listed and non-listed shares. The companies themselves are the ones who create and purchase other companies. Households own 20% of these assets; a further 23% is in the hands of non-residents (foreign sector), 15% in the financial sector and the rest (4%) in the public sector.
- The third set of assets covers short and long term loans, which represent 20% of all assets. This is the logical contrast to deposits and the way financial institutions directly carry out their work as intermediaries. The fact that long term loans are more important can be appreciated

(86% of the total), together with how the weight of the demand for these loans (liabilities) is shared by companies (49%) and households (39%). Companies corner the best part of short term loans in order to satisfy their operating needs, while households opt *en masse* for long term borrowing, in accordance with their needs which mainly stem from the desire to buy a house (mortgage loans). The foreign sector's share of these assets is also surprisingly high. The Spanish economy's financing needs and the single currency are giving these assets a boost. Spanish banks and companies are borrowing more and more euros from banks outside the Euro-zone to see to the growing demand for loans that are used to finance domestic activity and investment.

- The fourth category is made up of miscellaneous securities, which include, among others, all public and private fixed yield securities (public and private bonds, commercial paper, notes etc.). The weight of this group with respect to the total is quite considerable (15% of all financial assets in the system). The public sector is the main issuer of bonds (liabilities) in this group with 38% of the total, but the foreign sector once again has obtained a significant and increasingly large share in recent years. The reasons for this are similar to those in the previous section.

Spanish banks are borrowing from abroad to capture funds in order to finance their operating needs. This logically results in a significant number of securities or programmes emerging in foreign markets, along with the loans which were discussed in the previous section. In the same vein, financial institutions use securitised tools in their lending operations when operating in markets abroad. Both the tendencies can be appreciated in Table 3: the weight of the foreign sector in liabilities and assets and the importance of the intermediation on behalf of financial institutions in this area.

- The rest of assets are very heterogeneous (reserves, trade credit, investment funds, retirement funds, life insurance and miscellaneous insurance policies and assets). Trade credit is the most significant entry (10%), given by companies (from both within the country and also, albeit to a lesser extent, from abroad) to other companies and, to a lesser extent, to households. The second group covers everything related to insurance (life, pensions, etc.) which only represents 3.4% of all the assets in the system. At least these assets are seen to be held by households. Finally, with a 3.5% weighting, investment funds offer households an investment alternative to directly underwriting securities.

#### 4. Spanish Households

In this section the differences that exist among the asset portfolios held by economic agents in one country and another are compared. In this case, and to avoid drawing out this article, the structure of financial assets owned by Spanish households will be compared to that of US households. Table 5 displays some of the fundamental differences.

- The amount of financial assets accumulated by US households doubles that owned by Spanish households in terms of both countries' respective GDP. This is logical when considering that the United States has enjoyed a higher Standard of living and, above all else, an advantage in terms of income per capita for a long time. As US GDP per capita is also higher than in Spain, this can only result in US households having greater financial wealth than their Spanish counterparts. While Spain averaged €30,000 in financial assets per capita, the figure in the US was three times this amount (€100,162).
- In the same line, in accordance with Spain's lower level of income per capita and shorter history of being "well off", Spanish households display a strong preference for liquid assets. Cash and deposits of all kinds account for 40% of the financial assets owned by Spanish households, whereas US households barely devote 13% of their portfolios to this type of asset. The marked bank intermediation in Spain, particularly in relation to the USA, plays a leading role when it comes to explaining these results.
- The financial asset "par excellence" for US households are retirement funds, which account for 26% of their entire portfolio. As far as Spain is concerned, this asset has not yet taken off, despite marked growth. Spanish households devote 6% of their portfolio to these assets, which results in a marked difference per capita. While Americans hold more than €26,000 per capita, Spaniards barely reach €1,860, fourteen times less. Various causes concur in these results and not everything can be blamed on the income per capita gap and the need to diversify assets, which is indispensable when studying countries where the levels of holdings are so different. The fact that there are various social security systems undoubtedly plays an important role when it comes to understanding the mentality of US households and the concentration of their savings in this group of assets, to which we must add personal funds, which are covered in the next section and which represent a further €2,600 per capital.
- Another obvious difference between both portfolios lies in the low level of bank intermediation in the United States. Some 43% of US households' financial wealth is channelled directly to securities

and listed and non-listed shares, compared to 29.4% in the case of Spanish households. On a per capita basis, the gap worsens considerably. In comparison to the €43,152 per capita in assets of this type owned by US households, Spanish households barely reach a fifth of that figure with €8,837 per capita in their portfolios.

- In order to discover how important life insurance is in Spain, rather than looking into the weight that Spanish households give these policies, we must look into the specific characteristics of this type of policy, which is on the borderline between life insurance and retirement funds. Therefore, a large percentage of this epigraph should be included in that of retirement funds in order to suitably evaluate the comparison between the two countries.
- Liabilities deserve a special mention. Much has been written, and rightly so, about the high level of borrowing on behalf of US households. Well, when comparing the overall weight, Spanish households are seen to have borrowed less than US households in terms of GDP. However, it is also true that while Spanish households own less than a third of the assets per capita owned by US households, in terms of liabilities, Spanish households have accumulated almost half the amount of their US counterparts. Therefore,

Spanish households are, relatively speaking, more in debt per capita than US households.

- The result is clearly visible in the balance per capita of the financial position of the two households. While US households have €70,986 per capita, Spanish households barely reach €16,628, less than a quarter.
- In short, there are significant discrepancies in the structure of assets, which stem to a great extent from the degree of intermediation on behalf of the system and from the determinants of the economic system.

## 5. Structural Indicators

The best way to conclude this brief overview is to analyse some financial structural indicators for the three largest economic regions and to compare them to those for Spain in order to extract the differences and similarities of our financial system. Table 6 includes a set of indicators corresponding to 2003.

- The first difference, apart from that stemming from the income per capita gap, consists in the current situation of the public sector and its inevitable impact on the financial system. Japan's persisting and substantial deficit is affecting not only economic policy itself, by reducing the leeway of fiscal policy (in a liquidity trap and being absolutely incapable of using monetary policy), but also the

supply of financial assets on behalf of the rest of economic agents, to a great extent alleviated by the high savings rate in both the economy and Japanese households. The US case scenario and that of the Euro-zone are not comparable as far as the size of the public sector is concerned or the overall impact it has on their respective economies. Perhaps the situation in the US is much more serious in light of the low savings rate in the economy itself. The direct result is the emergence of a foreign deficit (twin deficit) brought about by the need to fall back on foreign savings to see to excessive expenditure fuelled by the tremendous fiscal deficit. The Spanish economy with its balanced budget stands out in this scenario. The public sector is generating a considerable savings rate which means it can finance its investments without having to fall back on financial markets. The result of these tendencies can be appreciated in the weight of financial assets issued by the public sector. In Japan, it has reached the considerable figure of 141% of GDP, while in Spain it stood at 50% in 2003.

- The second important feature of the structure of financial markets lies in the importance of direct markets in comparison to intermediated markets, which is captured and summarised by the weight that stock market capitalisation has with respect to GDP in each of the regions

under study. As pointed out in previous sections of this article, the most disintermediated economy in terms of the banking sector, the US economy, is the one that has the highest level of stock market capitalisation, followed at a considerable distance by Japan and even further behind by the Euro-zone. Other variables certainly have an influence when it comes to explaining these results (business size and internationalisation, lack of businesses in the market, etc.), but the development of direct markets undoubtedly has a lot to do with it. Spain's position in this sense is intermediate, near Japan. The internationalisation of Spain's businesses is largely responsible for these results.

- The third feature worth highlighting is the logical compensation for the above point. In other words, the importance of intermediated financing. Both bank loans and bank deposits in the Euro-zone register considerably higher percentages than in the US. The same occurs in the case of Japan, where the banking system has considerable weight, as has already been indicated. However, the highest percentages are observed in the Spanish economy. The level of bank intermediation in Spain is the highest of all the regions under study. It is also worth underlining the fact that the imbalance between loans and deposits that is forcing Spanish banks to intermediate with other

countries in the Euro-zone and to capture savings that they cannot obtain in Spain, at the expense of the marked increase in the amount of assets held by non-residents (foreign sector) referred to earlier in this article.

- Another difference can be found in both private and public-sector bond markets. In a country that makes little use of intermediation such as the US, it is no surprise that bond markets reach such high figures, despite public debt stock in terms of GDP being low (as previously commented). Businesses are those that participate in these markets directly, without having to go to banks. The same, but to a much lesser extent, could be said about Japanese bond markets, where the weight is logically carried by the public sector. The weight of private debt is even lower in the Euro-zone and has reached very low figures in the case of Spain. The strong bank intermediation outlined in the previous section is offset by businesses' extraordinary lack of access through fixed yield markets to direct private savings, the

lowest of the four regions under consideration.

- Finally, the weight of the various monetary aggregates in GDP must be highlighted. Logically, this indicator is affected by the weight of deposits in each economy and how they are accounted for and calculated. Nevertheless, the Spanish economy is seen to be significantly similar to the Euro-zone economy and data is difficult to compare to the rest of economies.

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*(\*) This article expresses the author's personal opinion and not necessarily that of the Instituto de Crédito Oficial.*

Valencia, 24 February 2005

## APPENDIX

Table 1: Financial System Development

	Total Financial Assets	Nominal GDP	FA/GDP Ratio
USA 2004 (€bn)	87.868 <sup>1</sup>	9.637	910,7
Japan 2004 (€bn)	41.939 <sup>1</sup>	3.581	1171,5
Spain 2004 (b€n)	6.604 <sup>2</sup>	799	826,9

(1) The conversion into euros was based on the average exchange rate in 2004 (1.244 dollars and 140.96 yen to the euro)

(2) Data corresponding to Quarter III, 2004

Source: Federal Reserve, Bank of Japan and the Bank of Spain

Table 2: Weight of the Various Economic Agents

	USA		Japan		Spain <sup>1</sup>	
	€bn	%GDP	€bn	%GDP	€bn	%GDP
<b>Total Financial Assets</b>	<b>87.768</b>	<b>911</b>	<b>41.939</b>	<b>1172</b>	<b>6.604</b>	<b>827</b>
- Households and NPISH	29.549	307	10.442	292	1.290	156
- Non-Financial Institutions	10.562	110	5.276	147	1.426	172
- Government Bodies	2.129	22	3.342	93	218	26
- Foreign Sector	7.466	77	1.805	50	1.270	154
- Financial Institutions	38.062	395	21.074	589	2.400	290
<b>Total Financial Liabilities</b>	<b>85.635</b>	<b>889</b>	<b>41.912</b>	<b>1170</b>	<b>6.604</b>	<b>827</b>
- Households and NPISH	8.607	89	2.887	81	575	70
- Non-Financial Institutions	24.904	258	8.770	245	2.247	272
- Government Bodies	6.323	66	6.160	172	473	57
- Foreign Sector	5.257	55	3.088	83	945	114
- Financial Institutions	40.543	421	21.007	587	2.364	286
<b>Net Financial Position</b>						
- Households and NPISH	20.942	217	7.555	211	715	86
- Non-Financial Institutions	-14.342	-149	-3.494	-98	-821	-99
- Government Bodies	-5.337	-55	-2.818	-79	-255	-31
- Foreign Sector	2.209	23	-1.283	-36	325	39
- Financial Institutions	-2.481	-26	67	2	36	4

(1) Data corresponds to quarter III, 2004

(2) The conversion to euros was based on the average exchange rate in 2004 (1.244 dollars and 140.96 yen to the euro)

Source: Federal Reserve, Bank of Japan and Bank of Spain

Table 3: Financial Assets<sup>1</sup> (Millions of Euros)

	Households and NPISH	Non- Financial Institutions	Public Sector	Resto of the World	Financial Sector	All Sectors
<b>Total Financial Assets</b>	<b>1,290,290</b>	<b>1,426,025</b>	<b>217,836</b>	<b>1,270,088</b>	<b>2,399,982</b>	<b>6,604,221</b>
- Reserves				-5,938	5,938	0
- Cash and demand deposits	147,810	88,704	38,282	8,372	23,425	306,593
- Other deposits	376,754	51,120	29,794	326,155	468,380	1,252,203
- Miscellaneous securities	35,285	30,937	17,903	336,630	539,814	960,569
- Short term loans		417		20,900	166,370	187,687
- Long term loans		46,858	33,168	170,123	877,137	1,127,286
- Trade Credit	30,408	560,016		46,357		636,781
- Shares	105,623	155,766	4	141,531	104,983	507,907
- Non-listed shares and misc.	209,075	434,928	57,461	214,567	122,435	1,038,466
- Investment funds	165,091	20,145	320	7,507	40,874	233,937
- Life insurance	99,586					99,586
- Retirement Funds	80,016					80,016
- Misc. Insurance reserves	19,928	19,773			12,251	51,952
- Miscellaneous assets	20,715	17,363	40,904	3,884	38,375	121,241
<b>Total Financial Liabilities</b>	<b>574,694</b>	<b>2,247,408</b>	<b>472,728</b>	<b>945,318</b>	<b>2,364,072</b>	<b>6,604,220</b>
- Cash and demand deposits			2,519	6,904	297,150	306,573
- Miscellaneous deposits				181,501	1,070,702	1,252,203
- Miscellaneous securities		13,077	367,780	302,195	277,517	960,569
- Short term loans	26,819	135,788	6,348	15,151	3,580	187,686
- Long term loans	480,158	507,542	65,288	63,835	10,463	1,127,286
- Trade credit	42,729	523,787	14,276	55,987		636,779
- Shares		301,068		72,582	134,258	507,908
- Non-listed shares		731,126		244,022	63,319	1,038,467
- Investment funds					233,936	233,936
- Life insurance					99,586	99,586
- Retirement funds		1,045			78,971	80,016
- Miscellaneous Insurance reserves				3,067	48,885	51,952
- Miscellaneous liabilities	24,987	33,975	16,517	75	45,686	121,240
<b>Net Financial Position</b>	<b>715,596</b>	<b>-821,383</b>	<b>-254,892</b>	<b>324,770</b>	<b>35,910</b>	<b>1</b>

(1) Data corresponds to quarter III, 2004

Source: Bank of Spain

Table 4: Relative Weight of Financial Assets<sup>1</sup>

	Households and NPISH	Non- Financial Institutions	Public Sector	Resto f the World	Financial Sector	All Sectors
<b>Total Financial Assets</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>
- Reserves				-0.47	0.25	
- Cash and demand deposits	11.46	6.22	17.57	0.66	0.98	4.64
- Miscellaneous deposits	29.20	3.58	13.68	25.68	19.52	18.96
- Miscellaneous securities	2.73	2.17	8.22	26.50	22.49	14.54
- Short term loans		0.03		1.65	6.93	2.84
- Long term loans		3.29	15.23	13.39	36.55	17.07
- Trade credit	2.36	39.27		3.65	0.00	9.64
- Shares	8.19	10.92		11.14	4.37	7.69
- Non-listed shares and miscellaneous	16.20	30.50	26.38	16.89	5.10	15.72
- Investment funds	12.79	1.41	0.15	0.59	1.70	3.54
- Life insurance	7.72					1.51
- Retirement funds	6.20					1.21
- Miscellaneous insurance reserves	154	1.39			0.51	0.79
- Miscellaneous assets	1.61	1.22	18.78	0.31	1.60	1.84
<b>Total Financial Liabilities</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>
- Cash and demand deposits			0.53	0.73	12.57	4.64
- Miscellaneous deposits				19.20	45.29	18.96
- Miscellaneous securities		0.58	77.80	31.97	11.74	14.54
- Short term loans	4.67	6.04	1.34	1.60	0.15	2.84
- Long term loans	83.55	22.58	13.81	6.75	0.44	17.07
- Trade credit	7.44	23.31	3.02	5.92		9.64
- Shares		13.40		7.68	5.68	7.69
- Non-listed shares		32.53		25.81	2.68	15.72
- Investment funds					9.90	3.54
- Life insurance		0.00			4.21	1.51
- Retirement funds		0.05			3.34	1.21
- Miscellaneous insurance reserves			0.00	0.32	2.07	0.79
- Miscellaneous liabilities	4.35	1.51	3.49	0.01	1.93	1.84

(1) Data corresponds to Quarter III, 2004.

Source: Bank of Spain.

Table 5: Household Portfolio Structure  
(billions of Euros)

	USA <sup>3</sup>			SPAIN		
	Total	% Total	Per <sup>2</sup> capita	Total <sup>1</sup>	% Total	Per <sup>2</sup> capita
<b>Total Financial Assets</b>	<b>29.548</b>	<b>100</b>	<b>100.162</b>	<b>1.290</b>	<b>100</b>	<b>30.000</b>
- Cash and demand deposits	328	1.1	1.112	148	11.5	3.442
- Miscellaneous deposits	3531	12.0	11.969	377	29.2	8.767
- Miscellaneous securities	2540	8.6	8.610	65	5.0	1.512
- Shares	5423	18.4	18.383	106	8.2	2.465
- Non-listed shares	4767	16.1	16.159	209	16.2	4.860
- Investment funds	2871	9.7	9.732	165	12.8	3.837
- Life insurance	891	3.0	3.020	100	7.7	2.326
- Retirement funds	7748	26.2	26.264	80	6.2	1.860
- Personal funds and misc. reserves	771	2.6	2.614	20	1.5	465
- Miscellaneous assets	859	2.9	2.912	21	1.6	488
<b>Total Financial Liabilities</b>	<b>8.607</b>	<b>100</b>	<b>29.176</b>	<b>575</b>	<b>100</b>	<b>13.372</b>
- Loans	8251	95.9	27.959	507	88.2	11.791
- Miscellaneous liabilities	356	4.1	1.207	68	11.8	1.581
<b>Net Financial Position</b>	<b>20.941</b>		<b>70.986</b>	<b>715</b>		<b>16.628</b>

(1) Data corresponds to Quarter III, 2004

(2) Estimated population in 2004

(3) Conversion based on average exchange rate for 2004 (1.244 dollars/euro)

Source: Federal Reserve and Bank of Spain

Table 6: Structural Indicators of the Financial System (2003)

	Euro-zone	USA	Japan	Spain
GDP (PPP)	7.3	9.9	3.2	0.86
GDP (PPP) per capita (1,000s of Euros)	23.5	34.1	29.2	20.0
Gross savings rate (% of GDP)	20.3	13.5	26.3	22.7
Public sector balance (% of GDP)	-2.7	-4.6	-7.9	+0.4
Public sector debt stock (% of PIB)	70.7	47.7	141.3	50.7
Stock market capitalisation (% of PIB)	49.3	108.1	75.0	63.7
Companies listed on the stock exchange	6,271 <sup>5</sup>	6,586 <sup>5</sup>	2,153 <sup>5</sup>	223 <sup>1</sup>
Bank credit (% of GDP)	108.8	63.1	95.9	125.6
Bank deposits (% of GDP)	86.2	49.3	118.5	141.3
Bond market balance (% of GDP)	119.2	165.7	196.9	62.9 <sup>2</sup>
M 1 (% of GDP)	36.6	13.1	25.8 <sup>3</sup>	23.3
M 3 (% of GDP)	84.2	89.9	143.7 <sup>4</sup>	81.5

(1) Total number of companies listed excluding closed-end investment companies

(2) Bond market in account entries total balances

(3) Monetary base

(4) Monetary base + total deposits

(5) Data refers to 2002

Source: European Central Bank (2004), The Monetary Policy of the EBC. Web Sites: Bank of Japan, Federal Reserve Bank of Saint Louis, Bank of Spain and the Comisión Nacional del Mercado de Valores (National Stock Exchange Commission).

## 4.- Germany

### Banking System

The first issue to be dealt with in reference to the banking system is to quantify the relative importance of the intermediation it carries out. In the table below the banking system is seen to finance almost three times the GDP of the German economy and tends upward except during tough economic periods. Total deposits register a much lower figure and currently stand at just over double GDP. This score is not that high and suggests that when Germans save, they tend to do so by means of less traditional financial products than in other countries. As was the case with loans, the economic crisis reduced this variable's importance in relation to GDP, but deposits began to recover in 2004.

Table 1: Loans and Deposits (% of GDP)

	Loans	Deposits
2000	277.18	198.81
2001	282.38	203.10
2002	281.75	202.31
2003	281.24	200.54
2004	284.48	201.35

Source: Bundesbank

As the German economy is traditionally oriented towards exporting, it would be interesting to see whether the country's banking system displays that same orientation. In order to achieve this, the previous variables have been separated according to whether they affect residents or non-residents. The result can be observed in the table below, where German banking is seen to clearly share that inclination. Figures show that operations with non-residents accounted for a large amount

total loans and deposits (24.5% and 20.8% respectively) in 2004. Furthermore, although non-resident deposits have decreased since 2000 when 22.3% belonged to this group, the percentage of loans has not stopped growing since 2000 when a figure of 17.4% was observed. Therefore, while the German banking system has obtained more resources from residents in recent years, which is no surprise in light of the high savings rate, banking assets are clearly aimed at capturing customers abroad, due to the increasingly difficult situation within the country's borders due to the economic crisis<sup>1</sup>.

Table 2: Loans and Deposits: Residents and Non-Residents (% of GDP)

	Residents		Non-residents	
	Loans	Deposits	Loans	Deposits
2000	228.73	154.43	48.45	44.38
2001	226.14	156.17	56.24	46.93
2002	222.49	158.02	59.27	44.29
2003	218.00	158.35	63.24	42.20
2004	214.75	159.36	69.73	41.98

Source: Bundesbank

The following table confirms the fact that a slump in banking activity affects both operations between banks and also operations with households and businesses, as total loans as a percentage of GDP drop by between 6% and 7% from the starting value whichever way it is measured.

<sup>1</sup> Figures are not available, but it would be interesting to see how much of this reorientation abroad has been carried out at the same time as the enlargement of the European Union to include Eastern European Countries, which have historically close-knit relationships with Germany.

Table 3: Loans to Non-Bank Residents (% of GDP)

	Total	Total – Nego. Sec.	Households and Businesses
2000	148.0	131.2	117.6
2001	145.3	130.4	117.0
2002	142.2	127.6	114.4
2003	140.8	126.0	113.3
2004	137.8	121.5	110.1

Source: Bundesbank

Another important additional issue is whether the degree of bank concentration has increased in recent years. To this effect, the following table presents the total number of banks, by category. Notice that this number has dropped considerably over the past five years from 2,740 in 2000 to 2,147 in 2004, a decrease of almost 22%. Over the same period of time, foreign banks operating in Germany saw their number fall to a lot lesser extent. This could be explained by the disappearance of banks due to the economic crisis and also as a reflection of bank concentration. Without further information, the decrease seems too large to have occurred without a process of bank concentration.

In addition to this, all types of banks have seen their number reduce over the last few years, although this decrease is much more pronounced (practically double) in the case of cooperatives, which provides further confirmation that a strong concentration has taken place in Germany's banking sector<sup>2</sup>.

<sup>2</sup> The state guarantee for lander-owned banks (Landesbanken) disappears next July. These banks should, therefore, redirect their activity towards more profitable sectors than those traditionally focused on.

Table 4: German Banking Structure (N° of banks)

	Bank	Land	Savings Banks	Coop	Misc.	Total	Ext.
'00	294	13	562	1796	75	2740	382
'01	279	13	537	1621	71	2521	416
'02	273	14	520	1491	67	2365	405
'03	261	13	491	1395	66	2226	381
'04	252	12	477	1338	68	2147	373

Source: Bundesbank

The following table is consistent with our previous conclusions: the percentage of banks with €1bn turnover or less has dropped, especially within the category of banks with less than €100mn in turnover. Meanwhile, the percentage of banks with greater turnover has increased appreciably from slightly less than 20% of the total in 2000, to more than 26% in 2004<sup>3</sup>.

Table 5: German Banking Concentration (% of total N° of banks)

	Turnover in millions of €			
	Less than 100	100- 1,000	1,000- 5,000	More than 5,000
2000	25.9	53.8	15.4	4.9
2001	22.8	54.5	17.4	5.3
2002	20.3	55.6	18.5	5.7
2003	19.5	55.2	19.5	5.8
2004	18.3	55.4	20.2	6.1

Source: Bundesbank

In conclusion, it is worth pointing out that fragmentation is considered to be one of the factors that makes the German banking system different. However, this feature is being corrected to a great extent by this process of bank concentration. Another characteristic of the behaviour of the German banking sector that stands out,

<sup>3</sup> Together with the consolidation, German banks have also begun to carry out important restructuring which involves cutting back on staff significantly, especially abroad.

according to specialists, is its close-knit relationship with industry, both for tradition and historical reasons and also for a clear desire to operate as an industrial bank in the traditional sense of the term.

Antonio Cutanda  
Valencia, 6 Abril 2005

## 5- France

The important financial intermediation work carried out by French banks can be appreciated in the next table, which shows how both total loans approved and also deposits received treble GDP in 2003. In addition to this, both variables have, as expected, a slightly upward trend that is only bucked or curbed in 2002. It is worth pointing out that both loans and deposits, (particularly the latter) register very high totals with respect to other economies. The fact that the figure for deposits is larger in relative terms could be a sign that France rejects untraditional financial products more. Similarly, it is striking that deposits have been able to increase so much (by more than 14% over the period dating from 1999 to 2003) at a time when consumption was growing strongly.

Table 1: Assets, Loans & Deposits (% of GDP)

	Assets	Loans	Deposits
1999	597.03	273.41	263.30
2000	592.53	288.36	261.13
2001	647.07	296.45	277.77
2002	612.95	293.35	279.39
2003	614.29	296.76	301.56

Source: Bank of France

Table 2 shows how French banking activity abroad, in terms of loans to businesses and corporate bodies, is relatively intense, although its proportion of total business has dropped considerably from 19% to 16% in barely a year. This restructuring, although very pronounced, is not unusual in light of the relatively healthy situation of French domestic demand in recent years. Banks have, therefore, no particular reason to orient their business towards foreign markets such

as Germany as domestic economic activity has been satisfactory.

Table 2: Loans to Businesses and Corporate Bodies (% of total loans)

	To residents	To non-residents
Feb 04	0.81	0.19
Mar 04	0.81	0.19
Abr 04	0.81	0.19
May 04	0.82	0.18
Jun 04	0.83	0.17
Jul 04	0.83	0.17
Aug 04	0.83	0.17
Sep 04	0.83	0.17
Oct 04	0.83	0.17
Nov 04	0.84	0.16
Dec 04	0.84	0.16
Jan 05	0.84	0.16

Source: Bank of France

France's healthy economic situation is reflected by the almost 20% increase in household loans between 1999 and 2004 that can be observed in Table 3. Compare this to the minimal (and varied) progress made over the same period by non-share security portfolios. Therefore, the French banking system does not appear to have needed to resort to assets outside of its normal line of work, which is none other than intermediation, for the same reasons mentioned above.

Table 3: Some Asset Entries (% of GDP)

	Total	Household Loans	Non-share securities
1999	273.41	129.36	13.36
2000	288.36	131.68	11.63
2001	296.45	134.78	15.11
2002	293.35	138.37	12.68
2003	296.76	147.26	13.39
2004	302.67	153.39	13.69

Source: Bank of France

In the case of the French bank system, the total number of banks is not available, but the number of windows. By using this variable to analyse the

structure of the banking system, commercial banking is seen to corner 40% of the total, while savings banks and rural banks and cooperatives respectively account for more than 17% and 33%. Only rural banks and cooperatives have lost ground with respect to the rest.

Table 4: Structure of the French Banking System (% of total cashier windows)

	Banks	Local Banks	Peoples Banks	Rural Banks & Coops.	Savings Banks
1984	39.88		6.12	37.46	16.54
1985	39.61	0.17	6.08	37.07	17.06
1986	39.55	0.18	6.12	37.14	17.01
1987	39.56	0.19	6.17	37.13	16.96
1988	39.81	0.25	6.24	36.94	16.76
1989	39.63	0.28	6.28	36.94	16.86
1990	40.13	0.29	6.29	36.55	16.74
1991	40.37	0.30	6.32	36.23	16.78
1992	40.68	0.31	6.32	35.83	16.86
1993	40.95	0.30	6.37	35.66	16.72
1994	41.07	0.30	6.51	35.33	16.78
1995	41.20	0.30	6.60	35.25	16.65
1996	40.84	0.30	6.82	35.45	16.59
1997	40.51	0.31	7.02	35.57	16.58
1998	39.87	0.33	7.20	36.01	16.58
1999	39.72	0.33	7.39	35.98	16.59
2000	39.52	0.32	7.74	35.71	16.71
2001	39.16	0.30	7.89	35.19	17.46
2002	39.16	0.30	8.11	35.04	17.39
2003	40.37	0.30	8.63	33.06	17.64

Source: Bank of France

Although a clear measure of bank concentration is not available, in the case of commercial banking, which accounts for 40% of the total as we saw earlier, we can examine the proportion of assets, loans approved and deposits received with respect to the number of institutions. Figures see all the variables under consideration rise, although this cannot be taken as a clear sign that banking concentration has increased in view of the fact that this could be explained by an increase in business stemming from more intense economic activity. Nevertheless, banking concentration, if

this has occurred, must not have been very significant.

Table 5: Structure of the French Banking System (measured by commercial banks)

	Assets	Loans	Deposits
1999	5.65	2.59	1.95
2000	5.93	2.88	1.98
2001	6.73	3.08	2.69
2002	6.84	3.27	2.26
2003	7.35	3.55	2.57

Source: Bank of France

Antonio Cutanda  
Valencia, 6 April 2005

## 6.- United Kingdom

### Financial Sector Analysis

The financial sector plays a vital role in the economy, matching savers to borrowers, helping to manage risk, and providing firms and individuals with the means to make and receive payments. Since the paper by King and Levine (1993), there is widespread academic agreement that a highly developed financial system stimulates a country's economic growth. For example, Leahy et al. (2001) estimate that a 10% increase in the equity market capitalisation of an OECD country over GDP (*ceteris paribus*) increases GDP per capita in that economy by 3.3% in the long term<sup>1</sup>.

One difficult aspect about examining the financial sector is that it tends to operate worldwide. This is particularly the case in the United Kingdom, as the City of London is one of the most important financial centres in the world in terms of capital market operations (shares, bonds...), insurance and foreign exchange.

The financial sector represented 5.3% of the United Kingdom's added value in 2003 and this figure climbs to 9.5% if services such as corporate consulting, accounting and legal support are included.

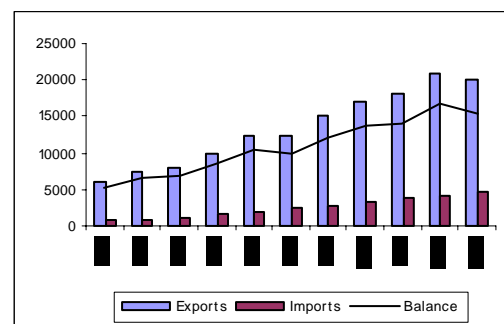
Furthermore, the financial system employs one million people distributed all over the country, with the exception of the high concentration in London.

<sup>1</sup> King, R. and Levine, R. (1993): "Finance and Growth: Schumpeter must be right", *Quarterly Journal of Economics*, 108.  
Leahy et al. (2001): "Contributions of financial systems to growth of OCDE economies" (OECD WP 280).

Some 317,000 people were estimated to be directly linked to financial activity in the City in 2003, almost 6% of London employment<sup>2</sup>.

Financial services produced exports to the value of £20bn in 2003, 23% of all exports in the services sector and 7.2% of total exports of goods and services as a whole. The insurance sector alone accounted for a third of this figure. The growing surplus in the balance sheet of financial services shows that the United Kingdom has a strong comparative advantage in this sector.

Figure 1: UK Trade in Financial Services



Source: ONS

The financial sector also boosts growth in labour productivity in the UK. Productivity per hour in this sector rose by 3.6% each year over the period dating from 1997 to 2001, compared to an annual 2% growth registered by the British economy as a whole. This is reflected by earnings. According to the Labour Force Survey in the last quarter of 2004, the average wage in the financial sector in the UK was £525 per week, compared to £378 per week in

<sup>2</sup> The City of London accounted for 41% of all activity carried out by European financial centres in 2004. The Edinburgh-Glasgow cluster and Leeds are the other two large financial centres in the UK.

the rest of industries as a whole – 40% higher

In this overview of the financial system in the United Kingdom we will firstly describe the various markets and their players through the three core functions mentioned earlier: financial intermediation, risk pooling and management and facilitating payments. Following this, the banking sector will be dealt with in more detail. Institutional changes in terms of the regulation of the financial system since 1997 will also be analysed. Finally, the current situation of monetary, stock market, bank credit and risk indicators will be examined, as well as bank solvency.

### Britain's Financial System: the Players<sup>3</sup>

As far as financial intermediation is concerned, the banking sector (banks and building societies) has historically been the main vehicle used to channel savings to financing households and companies.

Securities or financial assets (shares or bonds) have also been used to finance investment projects more directly of late, registering spectacular growth rates. Between 1990 and 2003, for example, the bond market in the United Kingdom has multiplied four-fold, double that of the world market. Corporate bonds account for 80% of that growth. The United Kingdom manages 60% of the international

primary market and 70% of the secondary market.

Finally, corporations have also used private funding (private equity, or in special cases venture capital for SMEs) to finance their activities, thereby not having to hit the stock or bond markets for capital. This financial instrument is used to both create and expand companies, generally by means of management buy-out or buy-in strategies, which run high risks in the hope of obtaining an equally high return. The United Kingdom cornered almost 50% of this market in Europe in 2003 and this type of funding has produced very good results to date. Over the period dating from 1999-2004, those companies financed by private investors have seen their output rise by 23%, more than double the figure recorded by the companies listed on FTSE100. Employment also grew markedly in these companies (20% on average per year) in comparison to companies in the private sector in the UK (0.6% on average).

Risk pooling and management is mainly carried out by the insurance sector, investment funds, derivatives and similar instruments. The United Kingdom is the third largest market in the world in investment fund management behind the United States and Japan, handling a total of £2.8 trillion pounds in 2003, equivalent to 8% of total funds managed worldwide. The United Kingdom has recently acted as a portal to the European market for numerous US investment funds and hedge funds.

Britain's insurance sector is also the third largest in the world behind the United States and Japan in terms of business with £152.7bn in 2003 (8.4% of the sum for the world as a whole).

<sup>3</sup> This section is based on Chapter 2 of HM Treasury (2005): "The UK financial services sector: Rising to the challenges and opportunities of globalisation", [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

London is the world leader in insurance and reinsurance related to international trade. The city's most representative company in this sector, Lloyd's of London, was capable of insuring up to £13.7bn in 2003.

In recent times, other risk management instruments have emerged, such as commodity markets or derivatives that attempt to hedge risk exposure in basic goods markets (due to price fluctuations caused for example by bad weather) or in the foreign exchange market. The UK, through Euronext.Liffe, has become the world leader in over-the-counter derivatives, managing up to 45% of total business between 1995 and 2004. Other markets of a similar nature based in London include London Metal Exchange (LME), the Equity Derivative Exchange (LDX) and the International Petroleum Exchange (IPE). London is also the top-ranked hedge fund manager in Europe, cornering more than 70% of total turnover in 2004.

The third core function of the financial system is that of facilitating payments and money management. Domestically, retail banks play a key role in supplying money transmission services such as cheques, debit and credit card systems, cashpoints and e-banking. On an international scale, different currencies also require a system for making and receiving payments and the United Kingdom has one of the largest Real Time Gross Settlements (RTGS) systems in the world: CHAPS, which operates domestically in sterling and euros.

Finally, foreign exchange markets are crucial when it comes to cross-border trade or investment. Foreign exchange annual daily turnover has grown from \$590bn in 1989 to \$1,880bn in 2004.

The United Kingdom is still the most important financial centre in the world as far as foreign exchange is concerned, with more than 30% of total global turnover 2004.

Table 1: Main Financial Centres' Share of the World Market (%)

	London	NY	Tokyo	Paris	Frankfurt	Misc.
<b>Cross-border bank lending (March 2004)</b>	20	9	8	8	11	44
<b>Exchange Rate (April 2004)</b>	31	19	8	3	5	34
<b>Derivatives</b>						
- exchange rate (2003)	6	26	2	3	12	51
- over-the-counter (April 2004)	43	24	3	10	3	17
<b>Secondary International Bond Market (2003)</b>	70	d.u.	d.u.	d.u.	d.u.	d.u.
<b>Hedge funds (June 2004)</b>	14	74	1	1	0	10

Source: London Stock Exchange (2004).

Note: d.u. = data unavailable

Table 1 shows London's importance as a financial centre in relation to New York, Tokyo, Paris and Frankfurt. London holds 70% of the secondary bond market; 40% of the derivatives market; 30% of the foreign exchange market; and 20% of the cross-border bank lending market. London surpasses New York in all cases<sup>4</sup>.

### Significant Institutional Changes Since 1997

The features of the new system for regulating financial services, which came into force in the United Kingdom in 1997, are as follows:

The Financial Services Authority (FSA) was created in 1997 as a regulating body that was independent of the Bank of England and the Government. Its functions are outlined in the Financial

<sup>4</sup> London School of Economics (2004): "London's Place in the UK Economy", Corporation of London.

Services and Markets Act 2000 (FSMA), which came into force in December 2001. The tripartite agreement between the FSA, the BoE and the British Treasury specifies each institution's powers with regard to financial stability (liquidity and solvency).

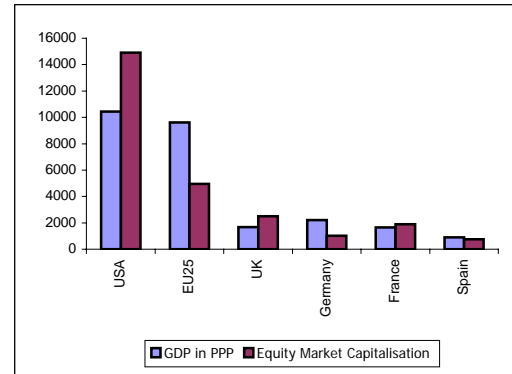
The 1998 Bank of England Act, which invested the Monetary Policy Committee with independence, came into force in 1999. At the same time, the BoE monitors the banking system to guarantee the stability of the financial system, in collaboration with the FSA and the Treasury. Finally, public-sector debt management is taken over by the UK Debt Management Office (DMO), which is independent of the Treasury and has been in operation since 1998. However, the responsibility of the Exchequer cash management was not conferred to the DMO until April 2000.

In conclusion, three institutions share the responsibility of safeguarding the stability of the UK financial system: the FSA, the BoE and the Treasury.

### Stock Market Development

One of the most significant features of the British economy is its high level of equity market capitalisation with respect to GDP. In 2003, this ratio stood at around 150%, in line with the USA and well above the average of the EU25, which stood around 50%.

Figure 2: Equity Market Capitalisation (2003, billions of dollars)

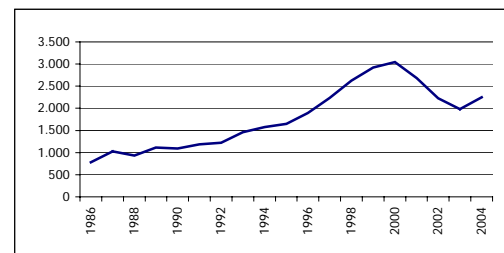


Source: Morgan Stanley

The high ratio can partly be explained by differences between British and Continental financial culture: the banking sector is used less for financing, public sector and family businesses are less prominent and private pensions are more developed. As a result, shares account for up to 70% of investment portfolios in the United Kingdom, in comparison to Germany, France and Italy with 20%.

In regard to the current scenario on the stock market, 2004 witnessed a slow recovery. The FTSE index went from 2217 in January 2004 to 2422 in January 2005, up by 8%, which was lower than in the United States (12%), and Italy (15%), in line with France and Germany and slightly higher than in Japan (7%).

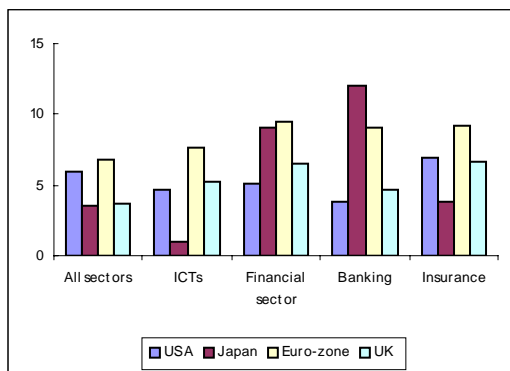
Figure 3: FTSE-all Index, 1986-2004



Source: Thomson Financial Datastream

As far as recent developments by sector are concerned, results have been very favourable since October 2004 in all stock markets, both in the banking sector and also in the insurance sector. The exception to the rule was reinsurance in the UK, whose performance has dropped noticeably (6.6% between October 2004 and January 2005).

Figure 4: Annually Adjusted Percentage Change in Main Stock Markets (Oct. 2004-Jan. 2005)



Note: USA (Wilshire 5000), Japan (Nikkei 225), Euro-zone (DJ EURO STOXX) and UK (FTSE 100)

Source: Thomson Financial Datastream

### Banking Sector Structure and Development

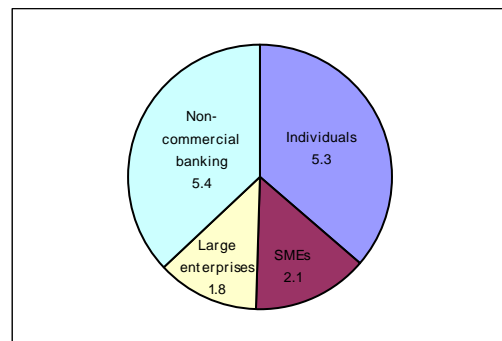
The banking sector (banks and building societies) plays a fundamental role in the economy as part of the money transfer system. This activity is carried out through services provided to individual customers (current accounts, personal loans, mortgages and savings accounts), small businesses (current accounts, credit/loans and savings accounts) and to large enterprises. More than 60% of banks' business was accounted for by these "typical" bank services in 1998.

Banks and building societies are the main players in the British banking system. In 1999 four banks carried out most of the banking activity: Lloyds/TSB, Natwest, Barclays and HSBC.

New entities have gradually emerged since 1989 (21 between 1995 and 2000), many of which are specialised in one or several bank services<sup>5</sup>.

In regard to the type of banking service, the personal accounts, credit cards and personal loans market was dominated by banks, while building societies enjoyed a greater presence in the business of mortgages and savings accounts (Table 2).

Figure 8: UK Banking Business Composition by source of income in 1998 (billions of pounds)



Source: Banking Review 2000

Over the period dating from 1997-2003, British banks have staged three important mergers and acquisitions. In March 2000, the Royal Bank of Scotland acquired NatWest and not long

<sup>5</sup> On the one hand, it is worth highlighting the presence of supermarkets and large department stores such as Marks & Spencer, Tesco Personal Finance, Sainsbury's Bank, Safeway, Virgin and Littlewoods, and on the other hand, e-banking (Smile, Egg, Goldfish).

afterwards Barclays bought Woolwich. In September 2001, Halifax and the Bank of Scotland merged under the new name of HBOS. At the end of 2003, the seven largest banks in the United Kingdom according to total assets were Abbey National, Barclays, HBOS, HSBC, Lloyds, Royal Bank of Scotland and Standard Chartered.

Table 2: Presence in Banking Services by type of bank in 1999

	Current a/c	Credit card	Personal loan	Mortgage	Savings a/c
Big Four	68	61	46	17	19
Building Societies	18	7	17	67	69
Other banks	13	17	16	5	5
Entries	0	13	5	0	1
Misc.	1	2	19	11	6

Note: The Big Four are Lloyds/TSB, Natwest, Barclays and HSBC.  
Source: Banking Review 2000

Table 3: Equity Market Capitalisation on 31 December 2004

Name	Capitalisation	Origin
1 Citygroup	183301	USA
2 Bank of America	139139	USA
3 HSBC	138175	UK
4 JP Morgan Chase	101877	USA
5 Royal Bank of Scotland	78559	UK
6 Wells Fargo	77083	USA
7 UBS	69539	Switzerland
8 Wachovia Corp	61836	USA
9 B. Santander	57102	Spain
10 Barclays	53630	UK
11 Mitsubishi Tokyo	48503	Japan
12 BNP Paribas	47155	France
13 HBOS	46628	UK
14 BBVA	44251	Spain
15 Muzuho Financial	44080	Japan
16 US Bancorp	42870	USA
17 Credit Suisse	37513	Switzerland
18 Lloyds TSB	37222	UK
19 Deutsche Bank	35535	Germany
20 ABN Amor	33189	Holland

## Financial Stability in 2004

The Bank of England described the last six months of 2004 as a "relatively benign period" in its Overview of Financial Stability: Threats and Resilience, published in December 2004. Credit losses have been small and new provisions have declined. Nor have there been significant pressures on liquidity or solvency from the international or domestic financial system. In general, asset prices have been less volatile in recent months. Moreover, yield curves suggest that abrupt rises in borrowers' interest payments are not expected in forthcoming months.

Francisco Requena  
Valencia, april 4, 2005

## 7.- Japan

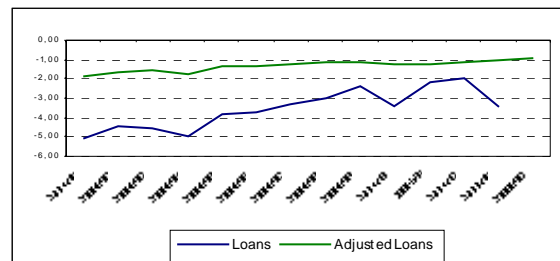
### The Role of Banks

Japan's financial sector has traditionally been dominated by banks, both on a national scale in the case of large institutions and at a local level in the case of smaller entities. Although this situation has been under threat in recent years due to the difficulties banks have had, the current financial system in Japan is still dominated by banks. In this environment, unlike the United States, stock markets list a relatively small number of large enterprises, which contrasts with the size of the Japanese economy and the buoyancy of its manufacturing industry. Moreover, markets have been traditionally pushed into the background even by large corporations. This is due to the fact that the industrial conglomerates the latter form a part of usually have a main banking institution that is in charge of satisfying their financial requirements. In addition to this, the bank is often the main shareholder, making the rest of shareholders irrelevant when it comes to making decisions. And that is not all. The stability of the system was made complete by means of close-knit relationships between the banking sector and political oligarchies. This reached a point where a political retirement automatically led to the beginning of high level career in a bank.

The banking crisis in the 1990s changed the traditional make-up of the Japanese financial system in two ways. Firstly, banks focused on recovering

their regular large clients<sup>1</sup>, in the hope of conserving the value of their original assets rather than searching for new business areas in which to finance new business ventures. Secondly, the best part of small enterprises suffered marked credit restrictions that increased their propensity to finance themselves with internal funds, also due to the poor reputation of some regional banks. Finally, the sluggishness of the Japanese economy, in view of the lack of a solution to the banking crisis, reinforced a situation where credit restrictions became even more widespread. Despite some banks overcoming a great deal of their credit problems in recent years, the sector as a whole continues to display negative growth in bank loans and this has been the case now for 85 months in a row (Figure 1).

Figure 1: Bank Loans



Source: Bank of Japan

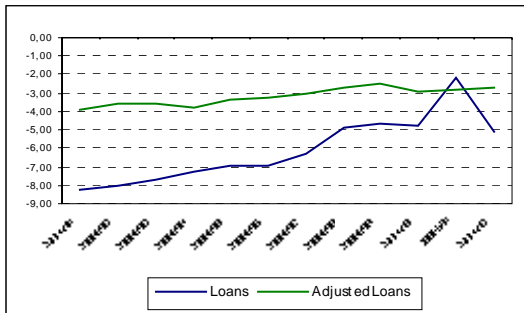
Note: annual growth rates. "Loans" include nominal loans. "Adjusted Loans" contemplate loan securitizations, loan write-offs and loan transfers to government agencies through the Japanese National Railways Settlement Corporation (JNRSC).

The breakdown of Loans given by the banking sector according to the size of the institution shows the differences in

<sup>1</sup> See Caballero, R. et al. (2003), "Zombie lending and repressed restructuring", Universidad de California, San Diego.

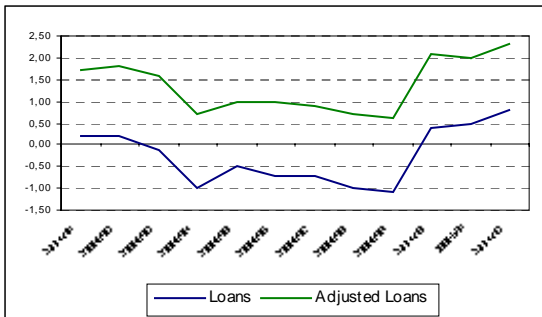
how the different end to the crisis in the 90s has marked different patterns in credit decisions, where loans given by the main regional banks figure prominently.

Figure 2: Bank Loans: Large National Banks



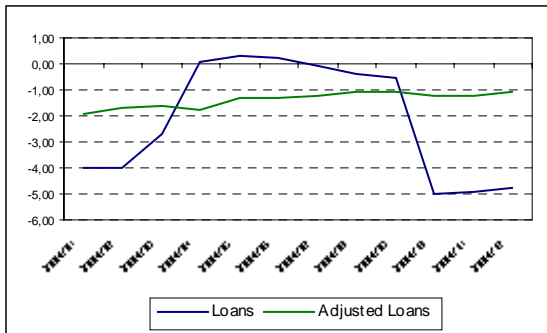
Source: Bank of Japan  
Note: see explanation below Figure 1

Figure 3: Bank Loans: Large Regional Banks



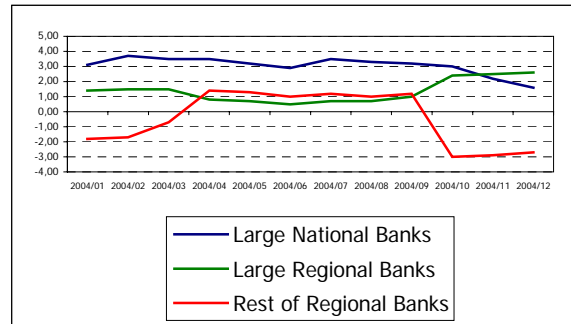
Source: Bank of Japan  
Note: see explanation below Figure 1

Figure 4: Bank Loans: Small Regional Banks



Source: Bank of Japan  
Note: see explanation below Figure 1

Figure 5: Bank Deposits



Source: Bank of Japan  
Note: annual growth rates in deposits and deposit certificates

Loan patterns over the last part of 2004, just when the slowdown in the economy was becoming evident, suggest that only large regional banks have given more loans when their customers most needed them. These banks also moved into first place in terms of deposits. On the other hand, the rest of banks are seemingly concentrating on selling off assets, thereby magnifying the negative effect of the slowdown.

In addition to the existing problems in channelling funds to enterprises, which stem from many Japanese banks specialising in the evaluation of assets and their swift sale, rather than developing interbank relations and overcoming friction and borrowing requirements during economic slowdowns is due to the fact that the largest savings institution in the country and in fact in the world does not give loans. This institution is Japan Post, which only operates in savings deposits and insurance assets. Funds captured by this institution (almost three trillion euros) by means of its enormous network of offices (24,700 branches: almost ten times more than those belonging to the seven largest national banks put together), which the government guarantees and tax exemptions that it enjoys also contribute to, significantly distorts the allocation of

resources to corporate ventures. Moreover, Japan Post is the main purchaser of government bonds and the largest holder of government debt, with a total of 10 trillion euros (a quarter of the total). Using this as a basis, the government has announced a plan to privatise the institution in the aim of improving the efficiency of resource allocation in the long term. Nevertheless, political pressure has forced the government to allow a period of transition, which will be at least a decade long, during which time the institution will continue to offer savings and insurance services.

### Financial Sector: Additional Peculiarities

Alongside the previous comments concerning the banking sector, we can examine some of the additional peculiarities of Japan's financial system by means of the asset pricing model, focusing on government bonds and corporate debt issued by companies. According to this model, the optimum behaviour of a representative investor with relative risk aversion  $\rho$  gives the following pricing equation:

$$E_t(r_{i,t+1}) - r_0 = \theta_{mt} (E_t(r_{m,t+1}) - r_0)$$

with

$$\begin{aligned} \theta_{mt} &= \alpha \beta_{mt} + (1 - \alpha) \gamma_{mt} \\ \beta_{mt} &= \text{cov}(r_{i,t+1}, r_{m,t+1}) / \sigma_m^2 \\ \gamma_{mt} &= \text{cov}(r_{i,t+1}, \sigma_m^2) / (\sigma_m^3 a_m) \\ \alpha &= 1 / (1 - (1 + \rho) \sigma_m a_m / 2) \end{aligned}$$

where  $E_t$  is the mathematical hope adjusted to available information over period  $t$ ,  $r_{i,t+1}$  is the return on the  $i$ -th risky asset in  $t+1$ ,  $r_0$  is the return on the risk-free asset,  $r_{m,t+1}$  is the market return in  $t+1$ ,  $\alpha$  is the

capitalisation weight of  $i$ -th asset holdings,  $\beta_{mt}$  is referred to as the "beta risk" stemming from the covariance with the market return, as in the conventional CAPM, while  $\gamma_{mt}$  is called the "gamma risk," which expresses the risk from the co-skewness with the market return.  $\sigma_m^2$  is the variance of this return in period  $t+1$  adjusted to available information in  $t$  and finally,  $a_m$  is its skewness. If  $a_m < 0$ , then  $0 < \alpha < 1$ , in such a way that the risk premium of an asset can be expressed as a weighted average of beta risk and gamma risk.

By using data on Japanese and US bonds, with the aim of contrasting the characteristics of the former against the latter's, the general moment method enables us to estimate the above pricing equation and the respective results for Japan and the US are summarised in Tables 1 and 2.

Table 1: Risk Premium: Japan

	20 days	60 days	120 days
$\sigma_m$	0.09	0.53	0.34
$a_m$	-0.44	-0.82	-0.30
$\rho$	0.71	0.92	3.49
Weighted percentage of beta risk	99.4	95.6	95.9
Weighted percentage of gamma risk	0.6	4.4	4.1

Data: Nikko Performance Index, 1996-2004  
Note: Estimations significant at 1%

<sup>2</sup> Results are similar to those found by Baba, N. et al. (2005), "Japan's deflation, problems in the financial system, and monetary policy", Monetary and Economic Studies, Bank of Japan, February 2005, pp. 47-111.

Table 2: Risk Premium: United States

	20 days	60 days	120 days
$\sigma_m$	0.14	0.08	0.06
$a_m$	-0.18	-0.15	-0.19
$\rho$	6.76	14.98	14.32
Weighted percentage of beta risk	90.6	88.5	84.2
Weighted percentage of gamma risk	9.4	11.5	15.8

Data: Citibank BIG Bond Index, 1995-2004

Note: estimations significant at 1%

The above estimations show the weighting attributed to gamma risk is clearly higher in the United States than in Japan. This suggests that the price of US assets reflects return distribution skewness to a greater extent than is the case with the price of Japanese assets. As mentioned earlier, one possible explanation for this is the different role that asset markets play in the two economies.

Luis M. Granero  
Valencia, 14 April 2005

## 8.- China

China's enormous capacity for saving of approximately 40% of GDP, which is channelled to investment, makes the role of the banking system crucial in the Asian giant's economy.

Up to 1979, China's banking system was made up of the People's Bank of China (PBC), which acted as Central Bank and was also the only commercial bank. Different types of banks were progressively created, although the country's Central Bank remained the PBC. So, the cornerstone of the current banking system comprises four state-owned commercial banks (see Table 1), which have monopolised the sector for a long time: the Industry and Commerce Bank China, the Bank of China, the China Construction Bank and the Agriculture Bank of China. Each bank is specialised in conceding loans to its sector of reference and together are largely responsible for the current weakness of the banking system, caused mainly by its low performance, lack of capital and high percentage of irretrievable debts.

In addition to this, there is a large number of small local credit cooperatives (in both rural areas and cities), some of which were restructured halfway through the 90s as local commercial banks that are to a great extent controlled by the corresponding local government. These commercial banks have gradually specialised in giving loans to Small and Medium-Sized Enterprises (SMEs). It is also worth mentioning the growing presence of foreign institutions in the Chinese banking system; however, most of them are branches that have a

negligible share of total assets in the local currency.

Table 1: Percentage Share of Total Banking System Assets

Year	Public Banks	Development Banks and misc.	Credit Cooperatives
1995	77	7	16
1996	75	9	16
1997	74	9	16
1998	74	9	16
1999	73	10	16
2000	72	12	15
2001	68	14	17
2002	63	20	11
2003	61	22	11

Source: Economic Report, Bank of Spain. November 2004.

Low capitalisation and the high rate of loan non-payment (which ranges from 20% to 50% of total assets) are the most worrying problems in the banking system. The second problem is due to state-owned banks giving loans to loss-making public corporations, following only official instructions. Therefore, Government support, the existence of exchange controls and the high degree of liquidity in the system are crucial factors when it comes to lessening the risks in this scenario.

The Government founded capital management companies in 1998 and charged them with the responsibility of collecting or renegotiating doubtful loans, simplifying organisation, optimising staff distribution and improving administration in order to raise banks' performance and increase capital. Chinese officials preferred to create an asset management company for each of the four large public banks because, in light of their specialisation, the number and type of customers varied widely between one bank and another. By the end of 2003, these banks managed more than

\$100bn in unpaid loans, the equivalent of 8% of GDP.

Deregulation of the system began halfway through the 90s and was characterised by:

- More responsible concession of loans on behalf of state-owned banks
- A reduction in the cash flow coefficient from 20% to 6% in force in 1999
- Flexibility in determining interest rates

As part of its accession agreement to enter the World Trade Organisation (WTO), China promised to put local and foreign banks on equal terms by the end of 2006. In order to achieve this, China founded the Banking Regulatory Commission at the beginning of 2003, which is devoted to supervising and regulating banks and in particular, to issuing new regulations and guidelines. Competences include the following services within banking activity: accepting deposits and other liability operations from the general public, all types of financial transactions (consumer credit, mortgage loans, factoring...), financial leasing, payments (credit cards, travellers' cheques...), guarantees and deposits and currency exchange. This was a large step forward for foreign banks, which two years later were able to operate with corporate funds and five years on will be able to do the same with citizens' bank deposits. Consequently, more than 100 foreign banks had been authorised to operate in yuans.

The positive intrusion of new banks in China in 2004 saw the government bring forward a plan to reform the four

state-owned commercial banks to raise their competitiveness in order to face up to possible challenges from the foreign banks, which will gain free access to the Chinese market in 2006.

Local experts believe the four state-owned banks have become healthier, more independent, more transparent and more profitable over recent years. In fact, the CBRC calculated that the percentage of bankruptcy loans at the end of 2004 had dropped to 13.2%, down by 4.56% on the beginning of 2004. One move that could have bolstered this drop was the decision made by the BPC to raise banks legal reserve requirement from 7% to 7.5% from April 25 onwards.

Chinese banks hope to modernise their operations and improve their image by going public. To this end, the Bank of China and the China Construction Bank were chosen by the Government to test a pilot reform programme of share participation. The end of 2004 saw the Central Government invest for the first time in history, \$45bn worth of foreign exchange reserves from the two banks in order to help them to increase their capital. Both have announced their intention to make an initial public offering in 2005 by adopting a share system. Meanwhile, the other two banks, the Industry and Commerce Bank China and the Agricultural Bank of China received \$22.5bn each in an aid package.

Furthermore, as the total opening up of the banking sector in 2006 draws nearer, the struggle to win customers of high standing and quality centres the competitive interest of banks with Chinese capital. For example halfway through December 2004, the Beijing

Branch of the Industry and Commerce Bank was the first to open a set of four offices for “rich” customers”, that is, with the aim of offering a service directly to those clients holding more than 500 billion yuan assets. Moreover, the deregulation has forced the government to “clean up” the sector, closing 155 banks that carried out transfers and negotiated currencies illegally in several provinces.

A new regulation was enacted halfway through February 2005 that allows Chinese commercial banks to establish their own capital management businesses and, therefore, invest on the stock market. The regulation also specifies measures designed to regulate the control of risk, related business and the day-to-day operations of new capital firms. These institutions were only able to sell capital or offer trusteeship services in the past. Several commercial banks have already filed official applications to this respect, which must be reviewed by CBRC, the PBC and the China Securities Regulatory Commission.

Despite the moves being made to confront the competition from foreign banks, China’s banks are aware of the fact that they are in crisis and, therefore, the structural reform of the banking system will not cease. However, it remains to be seen if Chinese banks, lacking not only practical experience, but also a large number of qualified professionals<sup>1</sup>, will withstand and win this battle for the rich.

Foreign banks have a comparative advantage over national banks in terms of internal management, capital, services offered to individual customers, mixed management (between stocks and insurance) and their understanding of services and competence.

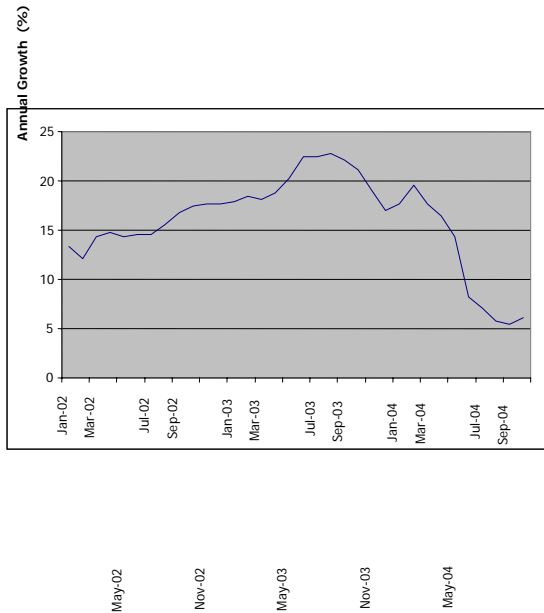
Banking is playing a vital role in the macroeconomic policy undertaken to curb galloping growth in certain sectors of the economy that have overheated. Credit restrictions are not only helping to keep investment in check, but also reducing financial risk in the banking sector. However, loan demand must still be satisfied in order to bolster “healthy” growth in the country. The PBC is amplifying commercial banks’ capacity to assess the risk implicit in conceding a loan and is encouraging them to reject those destined to sectors such as energy, communications and agriculture.

These control measures may have been behind the 18.1% annual growth in China’s foreign debt in 2004. As Chinese banks are limiting the number of loans for new projects, businesses are forced to seek external funding. However, despite short term debt accounting for 45.6% of the overall figure, the PBC does not believe this situation threatens the financial security of a country that has some \$610bn in reserves.

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<sup>1</sup> The Bank of China has appointed a US expert General Inspector of Credit Risk (People’s Daily Online, 03/03/05).

Figure 1: Annual Growth in Bank Loans



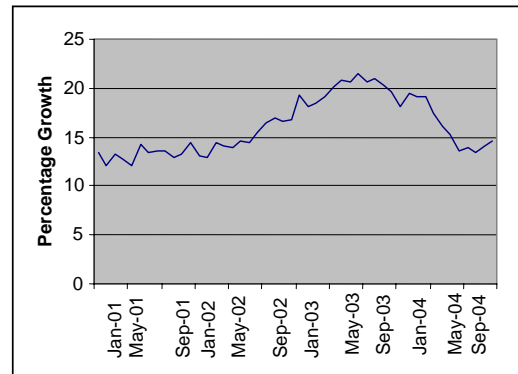
Source: International Monetary Fund, Financial Statistics

In the same line, last November saw the PBC raise interest rates for official loans from 5.31% to 5.58% and from 1.98% to 2.25% for annual deposits with the aim of helping to slow down the economy. China cancelled the favourable interest rate for private housing loans in March 2005. According to the new law, the rate will be raised to 5.51%, 0.2 percentage points higher than before. This measure therefore aims on the one hand to bring the rate in line with the rest of loans and on the other hand to give commercial banks more power to reduce their financial risk.

It is also worth mentioning the Central Bank's recent comments on the increase in the M2, a broader measure of monetary supply that includes money in circulation and all deposits. By the end of 2004, this variable had climbed to 25.3 trillion yuan (US \$3.1tn) on the back of a 14.6%

increase with respect to 2003. Nevertheless, the Central Bank describes the increase in monetary as rational, in regard to the economic boom in the country.

Figure 2: Annual Growth in the M2



Source: Central Bank of China

### Foreign Exchange

The State Administration of Foreign Exchange (SAFE) announced in February that time limits on foreign currency income in current accounts would be readjusted in order to satisfy companies' needs in this area. From now onwards, institutions that are located on Chinese soil will be able to hold their foreign currency income for 90 days (instead of the 10-day limit in force previously). Import, export and production companies will be able to retain 100% of their foreign exchange earnings in their current accounts.

This measure makes the limitations on foreign exchange accounts even more flexible, it reduces the cost to companies of liquidating foreign currency, enhances foreign exchange administration and stimulates Chinese commerce and investment.

### **Bank Cards**

China will promote the use of bank cards in forthcoming years with the aim of improving economic efficiency, fostering transaction transparency and stimulating consumption.

Some 760 million bank cards had been issued in China by the end of 2004 (663 million debit cards and 98 million credit cards). Cards are therefore playing an important role in the domestic economy. In fact, operations carried out by card accounted for 5% of total consumption last year, while in 2001 the figure was on 2%, according to sources from the PBC.

M<sup>a</sup> Luisa Martí  
Rosa Puertas

Valencia, 6 April 2005

## 9.- Argentina

The organisation and running of Argentina's credit activity is regulated by the Ley de Entidades Financieras (Law of Financial Institutions) of 1977. The law, which has been modified on several occasions, covers the sphere of activity in which financial institutions may operate. The regulatory framework is completed by a series of norms, called "communications", announced by the Central Bank of the Argentine Republic (CBAR).

All institutions operating in the Argentine credit system are subject to be regulated and supervised by the CBAR through the Office of Superintendent of Financial and Foreign Exchange Institutions. Apart from regulating and monitoring the credit system, the CBAR is also in charge of conserving the value of the currency; implementing the country's monetary policy, regulating the amount of money and observing the evolution of credit in the economy. It acts as the Government's financial broker before monetary institutions, banks and international finance companies; it manages the gold and currency reserves and promotes development and reinforcement of capital markets.

### Banking system structure

Statistics made available by the CBAR classify financial institutions in two groups: banks and non-bank institutions. There are a total of 91 financial institutions (14 public banks, 59 private banks and 18 non-bank institutions). The following section looks more closely at some of the most significant features of the banking system.

### Strong presence of state banking

One of the characteristics of the Argentine banking system is the strong presence of State banking, which controls 40.2% of assets, 29.42% of loans and 47.76% of deposits. The state-owned Banco de la Nación Argentina (Argentine National Bank) is the largest public institution and is also ranked number one among banks for deposits, assets and loans. The other public institution on a national scale is the Banco de Inversión y Comercio Exterior (Bank of Foreign Investment and Trade). Its mission is to finance regional development and the various sectors of the economy. The remaining 12 public institutions belong to various provinces or towns and are mainly involved in fostering productive sectors within their region.

However, one of the trends that have marked the evolution of state banking in Argentina in recent years is privatisation. Between 1994 and 2005, 14 public institutions have passed to private hands.

Table 1: Credit System Structure

	Assets	Loans	Deposits	Nº of subsidiaries
State Banks	40,20	29,42	47,76	40,25
Private Banks	59,0	69,27	52,06	59,75
Non-bank entities	0,80	1,30	0,18	
Total	100,0	100,0	100,0	

Source: CBAR and own elaboration

### Strong presence of banks with foreign capital

Another feature of the Argentine credit system is the strong presence of private banks with foreign capital. The relative importance of these banks has increased remarkably in recent years, bolstered by the two Spanish banks BBVA and Santander Central Hispano. Five of the top-10 ranked banks by the CBAR belong to foreign financial groups. However, the opposite effect, that is, the presence of financial institutions abroad is scarce.

### Residual effect of non-bank entities

These entities have a residual effect with the credit system; they manage only 0.8% of assets in the system, 1.3% of loans, and 0.18% of deposits. The marked presence of foreign financial companies also stands out (11 out of 16).

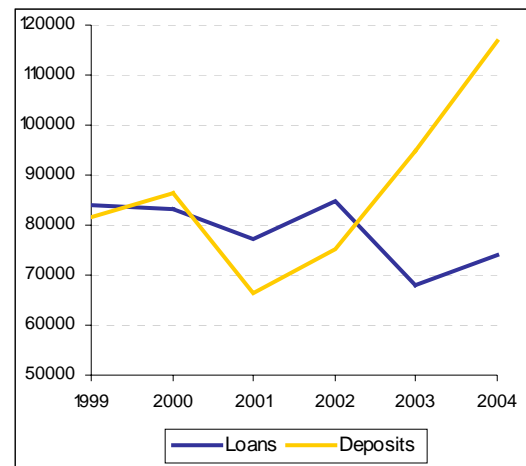
### Financial crash in the crisis between 1999 and 2002

In order to get an overall picture of the current situation in the banking system, we must go back to the last economic crisis and study its impact on the sector.

Figure 1 displays the pattern of loans and deposits in the private sector at current pesos. We can see the devastating effect of the last crisis between 1999 and 2001 on the intermediation function of Argentinian banks. In order to explain the slump in activity, we must review a series of events that took place between December 2001 and the beginning of 2002, which resulted in the Argentine

government losing financial trustworthiness. These events included a succession of governments, property rights being violated by means of freezing bank deposits ("corralito" and "corralón"), declaring the non-compliance of international commitments (defaulting sovereign debt), ending the peso/dollar parity and converting deposits and loans in dollars to pesos at disadvantageous rates.

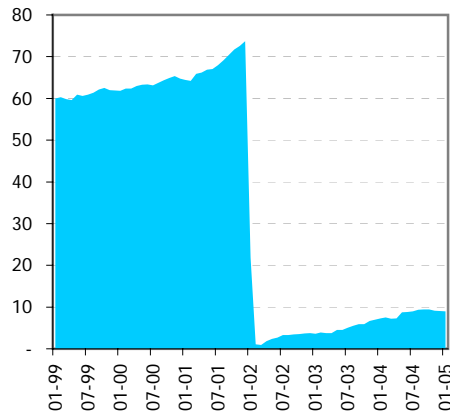
Figure 1: Loans and Deposits. Millions of Pesos



Source: CBAR

As far as the deposit crash in 2001 is concerned, it is worth highlighting that this mainly happened to deposits in pesos, as the percentage of deposits in dollars increased progressively throughout the year until convertibility was brought to an end. This reflects the fear and lack of trust that economic agents placed in the future value of their currency.

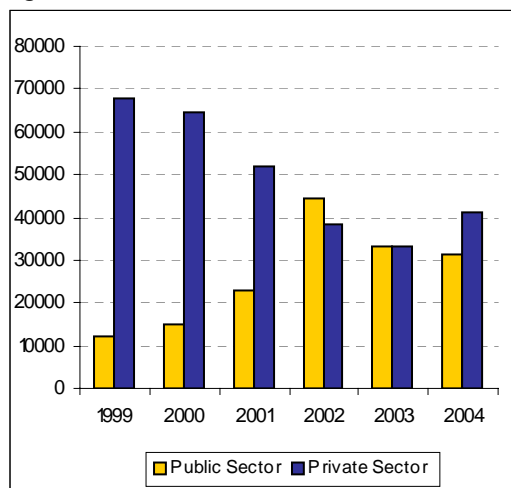
Figure 2: Percentage of Deposits in Dollars. Monthly Values.



Source: CBAR

As far as loans are concerned, it is worth distinguishing between those given to the public sector and those to the private sector. Figure 3 shows how loans to the private sector dropped from 1998 onwards, while public-sector funding increased steadily up to 2003.

Figure 3: Loans in Millions of Pesos



Source: INDEC

The decrease in loans awarded to the private sector could have been due to high interest rates, the high slow payment rate in the sector (12.2%) and the fact that financial institutions had to

keep a proportion of the deposits they captured available in an environment of fleeing deposits.

In regard to the public sector, the marked increase in loans is a reflection of the government's difficulties to access the international capital market, resulting in a dependence on the banking sector. The jump that can be appreciated between 2001 and 2002 captures the debt swap carried out by the government in November 2001. In this operation government bonds were swapped for loans using tax collection as collateral.

### Financial intermediation recovers slowly

As illustrated by the graphs, the financial system has been gradually recovering since 2003 from the damage caused by the crisis in 2001 and 2002. Deposits and loans are also seen to have followed quite different patterns. Over the past few years we have witnessed a gradual recovery in deposits (which have accumulated a rise of 50% since 2002). However, despite the increase in liquidity this brings, private sector loans are still to fully recover. The question that arises is "What has happened to the past buoyancy in loans? The problem appears to be on both the supply and demand side. From a supply perspective, loan sluggishness means banks still see a certain amount of risk in their normal intermediation work and are still cautious as a result of the continuous changes in rules that have damaged their finances. On the demand side, this situation shows how uncertain the market is with respect to interest rates and also the outlook for borrowers' future income. Moves need

to be made in order to clear up uncertainty and solve these problems for the recovery of intermediation to gain momentum. This is vital for future gains to be made and for banks to be viable in the medium to long term.

**Solvency and profitability: the worst is over, but the best is yet to arrive**

Banks faced serious problems of solvency and profitability during the crisis, which are steadily reverting. The financial system closed 2004 with a loss of \$530mn (-0.3% of assets), which despite being negative, is a significant improvement on the previous year (in 2003, losses reached 5.3bn, -2.9% of assets).

Financial margin led the recovery of banks' annual profitability, with higher profits through interest rates (coupled with the fact that fewer funds were required to cover irretrievable loans).

Table 2: Financial System Profitability Indicators

	2002	2003	2004
Financial Margin	6.5	1.1	3.2
Interest	-1.7	-0.5	0.9
Bad Loan Charges	-4.7	-1.1	-0.7
Return on Assets	-8.9	-2.9	-0.3
Return on Equity	-59.2	-22.7	-2.5

Source: CBAR

The smooth recovery witnessed in the financial system can also be appreciated when institutions are analysed on an individual basis: The number of profitable banks rose from 43 or 45 in 2004.

Finally, as far as the solvency of Argentinian banks is concerned, it is worth highlighting their degree of

exposure to the public sector: 40% of total assets are loans the public sector.

Julia Torrecabota  
Valencia, 5 April 2005

## 10.- Brazil

Brazil's financial system is based on the banking system. The ratio of assets and domestic loans with respect to GDP stand around 0.79 and 0.77, in comparison to stock capitalisation as a proportion of GDP, which stood at 0.43. Moreover, if the pattern of the M3 over the past few years is observed, an upward trend can be seen, providing the system with more liquid capital. In fact, over the past 12 months, the M3 rose from 4.3% to 17.6% due to transactions between the financial and non-financial sector.

### Evolution of the banking system: the "Plan Real"

The history of Brazil's banking system is marked by the period of inflation the country suffered a decade ago. A large portion of banking profits was made thanks to inflation. In other words, money was made on demand deposits and transitory resources (without costs). One of the characteristics of the structure of the banking system before the "Plan Real" was implemented in 1994, was its inefficiency. In order to capture more funds, the network of branches was enlarged and as operating costs were offset by inflation, there was no great problem. In addition to this, banks lost the ability to correctly assess risk and analyse investment profitability. State banks were more vulnerable than privately-owned banks as they relied to a greater extent on inflation gains. The situation worsened when states were given more public spending responsibility, but without increasing their funding, which resulted in an upturn in borrowing that left banks seriously short of liquid capital.

When inflation slowed down, many banks began to increase the number of loans they gave, some by up to 60% in 1994, instead of carrying out structural reform, despite the Central Bank raising the cash flow coefficient from 40% to 100% for demand deposits and from 15% to 30% for term deposits.

The Brazilian economy began to slump in 1995 and the financial system was affected by a drastic decrease in liquidity due to the measures taken to face up to the Mexican crisis. As a result, arrears rose from 7% to 12.5% in barely eight months. The two largest banks in Brazil, the Banco Económico and the Banco Nacional went into crisis, creating a climate of uncertainty which threatened the entire banking system. In view of this situation, the Program of Incentives to the Restructuring and Strengthening of the National Financial System (PROER) was put into practice with the aim of balancing and reinforcing the banking system. An obligatory minimum guarantee for deposits was also created. This project was financed by obligatory deposits without compromising the Government budget.

*Public banking* was characterised by poor management, low quality assets, increasing losses and risk being too concentrated in state in question. As a result of this situation, the PROES plan was implemented so as to adapt federal financial aid to privatisation or the selling-off of state-owned banks or converting them into non-banking promotion agencies. The programme intended to reduce states' presence in the banking system. In fact, asset restructuring on behalf of state-owned banks was sped up by swapping loans to states that were in arrears for federal government bonds, thereby

converting state governments into federal government debtors, with the loans in arrears being added to the existing debt to be later renegotiated. The PROES programme gave states three options:

1. Ownership is transferred to the federal government, which will privatise the bank or sell it off.
2. Bank is reorganised and by the owner state but the federal government finances 100%. The bank would have to be privatised, sold or converted into a promotion agency.
3. Reorganisation carried out by the state with the aim of keeping the bank shareholder-run and controlled. In this case, the federal government only financed 50% of the cost and the state in question made a commitment to manage the bank using commercial criteria.

The third stage of restructuring the banking system was the reform of the Federal Bank, which was dedicated to improving the solvency of the four banks it owned: Banco do Brasil, la Caixa Econômica Federal, Banco do Nordeste and Banco da Amazônia. The reform also involved preparing the above banks to compete with commercial banks without ceasing to foster economic and social development in the country. Broadly speaking, the intention was to improve the image of Brazil's banking sector as a whole. Authorities proceeded to investigate several banks and long term loans with low yields or that would be difficult to retrieve were found, which would therefore raise

the level of provision and meet capital demands, due to the high risk. Three types of measures were taken during the third stage of the reform:

1. Transferral of some of the loans to the National Treasury or to a company that creates new assets.
2. Swap not very liquid assets with low yields in the balance sheet of these banks for other more liquid assets with yields at market rates.
3. Three of the four banks would receive an injection of new capital worth 12.5 billion reais at the end of 2001.

*Foreign Banks* have played a leading role in the development of the banking system, becoming a national issue for Brazil due to the fact that they would increase the durability of the banking system and therefore adverse economic shocks would affect the country to a lesser extent. Moreover, it would allow domestic banking to be restructured by letting foreign banks participate in the recapitalisation of private national banks and in the privatisation of government-owned banks. Furthermore, foreign banks provided more sophisticated products, new management techniques and, therefore, greater competitiveness in the sector.

By progressively reducing the demands on foreign banks that initially existed, the government fostered foreign banks' interest in Brazil. However, foreign banks could only take the form of commercial banks and, therefore, seek out other methods of finding their niche in the market, such as using

subsidiaries, which have quadrupled their share of the market. Another significant aspect is the increase in networks of offices owned by foreign banks, which represented 22.7% of the total in 2001, 10 times more than in the old system (before the "Plan Real" was applied). This was how domestic banks in general began specialising in retail banking and foreign banks in wholesale and corporate banking.

### Brazil's Banking Structure 1995-2003

Table 1: Number of Banks According to Capital Structure

Banks (1)	1995	1998	2000	2001	2002	2003
Public (2)	32	22	17	15	15	14
Private	210	182	175	167	152	150
Domestic	144	105	91	81	76	78
Domestic with foreign capital (3)	28	18	14	14	11	10
Foreign Controlled (4)	21	43	57	61	56	53
Foreign (5)	17	16	13	11	9	9
<b>Total</b>	<b>242</b>	<b>204</b>	<b>192</b>	<b>182</b>	<b>167</b>	<b>164</b>

Source: Cosif

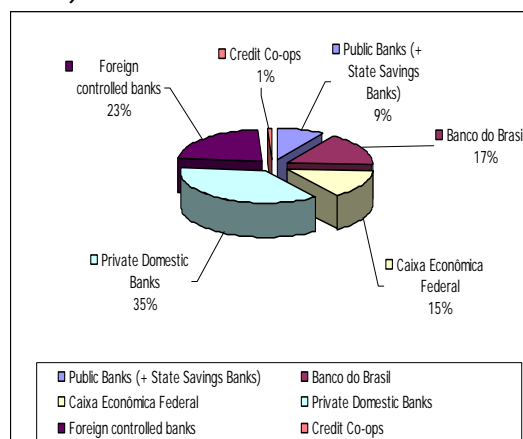
Note:

- 1/ Includes multiple banks, commercial banks and the Caixa Econômica
- 2/ Includes the Caixa Econômica Federal
- 3/ Includes banks with foreign capital
- 4/ Multiple and commercial banks controlled by foreign capital (except subsidiaries)
- 5/ Subsidiaries of foreign banks

As can be appreciated in Table 1, once the "Plan Real" was implanted, private banking has had a greater presence than public banking due to the privatisations that were carried out, even though the number of private banks has been declining over time.

Public banks display the same pattern. Another aspect worthy of mention is the minimal presence of foreign banks, either through subsidiaries or shares in local banks due to the restrictions they face when it comes to operating in Brazil. Nevertheless, despite their testimonial presence in comparison to domestic banks, the importance of foreign banks is growing in multiple and commercial banks and they maintain a certain degree of stability in domestic banks with foreign capital and in foreign bank subsidiaries.

Figure 1: Percentage Share of Assets by banking institution (%; Average 1997-2003)

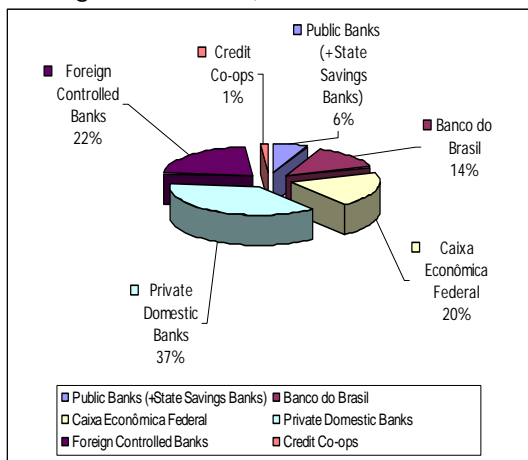


Source: Central Bank of Brazil and own elaboration

Private domestic banks and those controlled by foreign banks have the largest percentage of assets with regard to the sector as a whole. They managed 36.5% and 22.8% on average over the 1997-2003 period respectively and 34.5% and 16.9% of deposits, benefiting from privatisations in the sector, although their presence has grown more important over the last few years. In contrast, public banks along with caixas estaduais (state-owned savings banks) and the Banco

do Brasil manage a smaller percentage of assets with 8.9% and 10.2% respectively and 10.2% and 17.9% of deposits. Moreover, both institutions' importance in the sector has been declining steadily over the long period under consideration in terms of assets, although the Banco do Brasil continues to display a similar percentage of total deposits the banking system. The Caixa Econômica Federal manages 14.5% of total asset and 19.5% of deposits, although since 1997 both assets and deposits have been decreasing more and more.

Figure 2: Percentage Share of Credit Operations in the Banking Sector (% Average 1997-2003)



Source: Central Bank of Brazil and own elaboration

Credit operations display a similar structure, with private domestic banks managing an average of 36.5% and those controlled by foreign banks 22.4%. The Caixa Econômica Federal has seen its percentage of the credit management pie wane. Nevertheless, it remains amongst the banks that have the highest percentage of total credit management in the banking system with 19.7%. In contrast, the Bank of Brazil, one of the most important banks

in the country, increased its share between 1997 and 2003, averaging 13.7% of the total. Public banks, as was the case with assets and deposits, have seen their importance in the system as a whole decline considerably, managing only 6.4% of credit operations.

Table 2: Percentage Share of Total Foreign Investment in the Banking Sector in 2003 by Region 2003 (%)

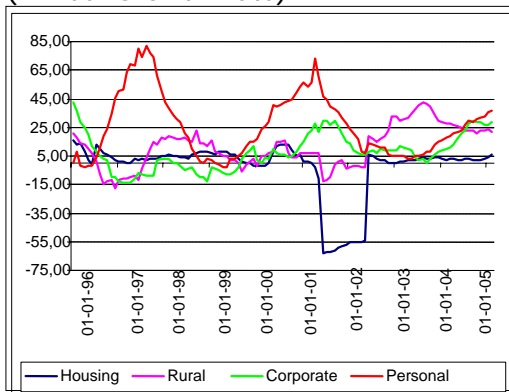
	Share-holders' Equity	Assets	Deposits	Credit Ops
South America	2.59%	1.97%	1.86%	3.47%
Asia	2.97%	2.30%	1.25%	3.41%
Caribbean	0.36%	0.22%	0.20%	0.07%
Europe	75.87%	72.80%	83.87%	71.94%
Euro-zone	69.15%	60.42%	62.28%	55.90%

Source: Central Bank of Brazil

Foreign banks played an important role in the restructuring of the banking system in Brazil following the application of the "Plan Real" and once the laws affecting their operations were made more flexible. The foreign banks that have established themselves in Brazil come mainly from Europe, as can be appreciated in Table 2. Within this region, Spain and the Netherlands figure prominently with 25.18% and 21.9% of total assets respectively. As far as deposits are concerned, the two countries manage 24.53% and 25.30% respectively. The presence of countries such as Japan and South Korea is much less noticeable with 1.26% and 1.04% of assets and 1.56% and 1.85% of credit operations respectively. Brazil's trading partners, such as Argentina, Uruguay and Venezuela maintain their presence in Brazil, albeit to a lesser extent than the countries mentioned above.

### Financial System Credit Structure<sup>1</sup>: Recent Data 2004 - 2005

Figure 3: Financial System Credit  
(Annual Growth Rate)



Source: Central Bank of Brazil and own elaboration

Credit in the financial system has been marked by the implementation of the "Plan Real". As analysed by the OCEI last November, mortgages and loans to rural areas were mainly obtained from the public financial system (around 60% of all loans), while the rest were supplied by the private sector. In contrast, corporate and personal loans are mainly given by the private financial system, with close to 76%, while the rest are given by the public system. It must be underlined that the public system's share has diminished and the private sector's share has grown following the application of the "Plan Real" and the privatisations carried out since 1994.

Personal loans from both the public and private financial systems have registered the largest annual changes with respect to other types of loans. In

the public financial system personal loans rose by 26.04% on average throughout 2004, while the private system registered a 24.51% increase. This growth has continued into 2005 with the public system chalking up a 28.08% rise in personal loans in February and the private system recording a 38.68% increase.

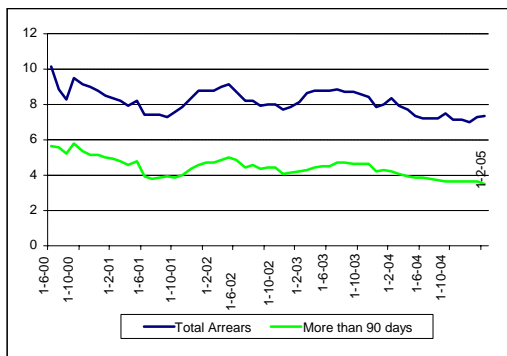
Corporate loans, like those mentioned above, mainly come from the private financial system and are also amongst those to register the largest variations in 2004, with average rises of 24.34% and 20.7% for the public and private systems respectively. In 2005, corporate loans have increased at a slightly higher rate of 26.75% (February) in the case of the public financial system and 29.65% in the case of the private financial system.

Rural credit and mortgages are mainly given by the public financial system and continue to register significant growth rates. Rural credit from the public system rose on average by 23.08% while loans from private system increased by 27.14%. As far as mortgages are concerned, the public financial system witnessed a 5.56% increase while the private sector suffered 2.5% decrease, although in February this year the a change in tendency from negative to positive is observed.

<sup>1</sup> For further detail, please consult the OCEI's November 2004 report on Latin America

### Slow payment in Brazil's banking system

Figure 4: Total Arrears and Arrears of more than 90 days (percentage of loan portfolio)



Source: Central Bank of Brazil and own elaboration

Figure 4 illustrates arrears as a percentage of total loans (15 to 90 days and more than 90 days), which have followed a downward pattern from halfway through 2000 up to 2005. The only exceptions were in 2001 and 2003 when the Brazilian economy slumped, causing delays in payment to rise slightly. Since the "Plan Real" was implemented in 1994, loans have been given more efficiently, to a certain extent guaranteeing payment and this has decreased arrears to the point where the figure is quite low in comparison to other Latin American countries.

María Jesús Herrerías  
Valencia, 4 April 2005

## 11.- México

In order to analyse Mexico's banking system, it is a good idea to observe its performance over history, together with that of the financial system to which it belongs. To this end, the first part of this section includes a detailed summary of the performance of both systems before moving on to the structure of Mexico's financial system and thereby more accurately place the banking system. After this, we present an analysis of the main Mexican banking indicators for multiple banking, commercial banks and development banks.

### A bit of history

In 1821, when Mexico became independent, the first signs of financial activity to exist were the creation of the Mint in 1536 and the Nacional Monte de Piedad (a non-profitmaking financial institution) in 1775.

Founded in 1830, the Banco de Avío (the first bank in Mexico) aimed to boost the textile industry.

Mexico's National Stock Exchange began operations in 1895 and was the first attempt to organise the country's incipient stock market. In 1910, it changed its name to Bolsa de Valores de México (Mexican Stock Exchange).

Following the Mexican revolution in 1910, organising the country's financial system was crucial. Diverse action was taken between 1914 and 1916 with this in mind, including the creation of the Comisión Reguladora e Inspectoría de Instituciones de Crédito (Regulatory and Inspection Commission of Credit Institutions).

The Constitution in 1917 laid down the foundations of Mexico's new financial system.

In 1925, the Credit Institution and Banking Establishment Law was enacted and the Bank of Mexico was created in the same year. In 1931, the organic law of the Bank of Mexico S.A. is announced, thereby enabling it to operate as a Central Bank.

Legal framework since then remained practically unchanged until 1976. However, it is worth mentioning that in the interim the General Law of Securities and Credit Operations in 1932, the creation of Mexico's first development bank, the Nacional Financiera, in 1934, the Banco de Nacional de Crédito Ejidal in 1935 and the Banco Nacional de Comercio Exterior (national bank of foreign trade) in 1937.

In 1946 the decree creating the National Stock Market Commission was announced. In 1975 the Stock Market Law emerged; one year later, operating norms for multiple banking were provided. Multiple banking was defined as operating as a deposit, finance or mortgage bank.

Petrobonos were issued in 1977 and in 1978 Cetes (Federal Treasury Notes – Spanish initials) were issued as a means of financing the federal government and as a way of controlling money in circulation. Cetes became the leading rate worldwide on the money market.

On September 1, 1982 private banking is nationalised, exchange control is

established and in 1990 a reprivatisation process begins.

The Federal Government sent proposals to Congress that aimed to modify Mexico's financial system. These included the General Law of Credit Organisations and Auxiliary Activity, The Standard Law of Public Service in Banking and Credit, the Law of Investment Societies and the Organic Law of the Bank of Mexico, as well as amendments to the Stock Market Law.

Mexico underwent strong financial liberalisation at the end of the 80s and beginning of the 90s. The process was characterised by the rapid development of the stock market, banks' authorisation to participate in that market; dealing desks are developed and investment banking is fostered.

The recent features of the new financial system in Mexico include bank reprivatisation, deregulation of the banking system, the creation of new financial groups and opening up to foreign capital.

Two further proposals were sent to congress in June 1990; the Law of Credit Institutions and the Law to Regulate Financial Associations (universal banking), which can be deemed the legal base of Mexico's current banking system as the private sector is once again allowed to participate and partly opens up banks to foreign investment.

Savings banks were legalised in 1991, favouring small savers. In 1992 bond options were passed and in 1993 financial societies of limited object were working. That same year, the Bank of Mexico became independent, which

was of the utmost importance, no longer playing the traditional role of the Federal Government's financial instrument.

Within the framework of what later would become the North American Free Trade Agreement, in 1993-1994 Mexico allowed the subsidiaries of foreign banks to enter the country. Globalisation of Mexican banking begins in the context of this treaty.

In 1995 the country suffers a profound economic crisis due, among other things to a high current account deficit, which resulted in strong devaluation-inflation and meant people and businesses that owed banks money had serious problems to pay it back, which prompts a rapid increase in consumer credit arrears and puts Mexican banking in a difficult situation. The consequence was that banks gave no more credit for consumption for at least five years.

This situation prompted the creation of the Fondo Bancario de Protección al Ahorro (Bank Fund for Savings Protection), in order to rescue savers and, above all else, bankers. In 1999 this fund was substituted by the Instituto para la Protección del Ahorro Bancario (Institute for the Protection of Bank Saving). At the end of 2004, this institution's net debt totalled slightly more than 733 million pesos (approximately \$65.5bn), which is 8.9% of GDP.

Before NAFTA, individual foreign banks were not allowed to own more than 5% of a Mexican bank, while total foreign participation could not exceed 30%.

Also in 1995 it is established that the main banks in the country, Banamex,

Bancomer and Serfin, cannot be bought by foreigners, but in 1998 this measure is abandoned. This takes us to the current situation where one of the most striking characteristics of Mexico's banking system is the great presence of foreign banks, particularly financial associations from the US and Spain. Banorte is now practically the only bank that is 100% nationally owned.

The process of opening up to foreign capital recently resulted in the three most important banks in the country being bought. This means that around 80% of commercial bank assets are controlled by foreign financial institutions.

In 2000, the Law on Commercial Tenders and the Miscellany of Guarantees is passed, aiming to protect savers' resources that are deposited in banks. Court orders for the capitalisation of multi-banking institutions also came into force.

The Popular Savings and Credit Law, which was passed in 2001, intended to cover the wide range of social banking institutions, namely popular savings societies. The law has undergone reform in 2005.

The Saving System for Retirement Law and the Law of Transparency and Promotion of Guaranteed Loans were reformed in both 2002 and 2005, aiming to stimulate savings. The Law Regulating Credit Information Societies (reformed in 2004) and the Law of Settlement Systems were passed in 2002 in order to make financial markets more efficient.

It is worth highlighting that a new Stock Market Law has been sent to

Congress this year, which would replace the law that has been in force since 1975. The main aim is to create a legal framework that enables capital markets to run more efficiently with a special emphasis on allowing more medium-sized businesses to gain access.

### **Structure of the Mexican Financial System**

According to Article 3 of the Law of Credit Institutions, Mexico's banking system is made up of the Bank of Mexico, multiple banking institutions, development banks, the National Savings Trust and public trusteeships created by the Federal Government as economic stimulus, as well as those that carry out the duties the law assigns the Bank of Mexico and are created to this end.

Financial intermediaries in Mexico are supervised and mainly regulated by the Treasury Department (SHCP in Spanish) and the Bank of Mexico (Banxico).

Banxico regulates the settlement system and Treasury supervises and regulates through various institutions including the National Banking and Securities Commission (CNBV in Spanish), the National Insurance and Deposits Commission (CNSF), National Retirement Savings Commission (CONSAR) and the National Commission for the Protection and Defence of Users of Financial Services (CONDUSEF).

The structure of the Mexican financial system can be divided up as follows:

#### **Credit Institutions**

- Multiple Banking
- Development Banking

#### Financial Group Control Societies

- With a bank
- Without a bank

#### Stock Market Sector

- Mexican Stock Exchange
- Operating Investment Companies
- Equity Investment Companies
- Security Investment Companies
- Capital Investment Companies
- Investment Companies of Limited Object
- Investment Company Share Distributors
- Stock Market Houses
- Share Rating Agencies
- Foreign offices
- S.D. Indeval (a securities depository)
- Companies providing services to stock brokers

#### Derivatives

- Mexican Derivatives Market
- Service Providers
- Liquidating partners
- Operators
- Market Makers

#### Other brokers

- Insurance Companies
- Deposit institutions
- Auxiliary credit organisations
- Depositories
- Financial leasing companies
- Saving and Loan societies
- Financial societies of limited object
- Credit Unions
- Retirement Fund Management Companies
- Investment companies specialised in retirement funds
- Deposit Companies
- Foreign exchange houses

- Factoring Companies
- Credit bureaus

### Monetary environment

Monetary aggregates in the Mexican economy in 2004 reflected the expansion observed in recent years by registering higher real growth rates than GDP.

The monetary base grew at a nominal rate of 15.2% in 2004, as can be appreciated in Table 4 and at a real rate of 6.6%, 2.2% higher than GDP growth, which stood at 4.4%.

Table 1: Monetary Base, inflation and GDP 2000-2004 (billions of pesos and %)

Year	Base	%Change	Inflation	GDP
2000	209		8.96	6.6
2001	226	8.1	4.40	-0.2
2002	264	16.8	5.70	0.8
2003	304	15.2	3.98	1.4
2004	340	11.8	5.19	4.4

Source: based on information from Banxico and INEGI

Similarly, the broad monetary aggregates (bM1, bM2, bM3 and bM4) which apart from the private savings in the normal M1, M2, M3 and M4, include public sector savings, made up of savings made by the Federal Government, by government bodies and companies, state and local governments, Federal district government and promotion trusts, grew faster than GDP in 2004, as can be observed in Table 2.

Table 2: Broad Monetary Aggregates December 2004 (Billions of pesos and %)

Aggregate	2003	Real % change	2004	Real % change
M1a	902	9.1	998	5.2
M2a	3,682	9.4	4,079	5.3
M3a	3,716	9.6	4,168	6.6
M4a	3,747	9.0	4,207	6.7

Source: elaborated with information from Banxico

It is also worth underlining the fact that growth was lower in 2004 than in 2003.

Average circulation (M1a) in 2004 (5.2%) grew in real terms less than the rest of aggregates and much more if compared to the growth rate in 2003 (9.1%).

The M2a (5.3%), which measures how much residents in Mexico save, grew at a similar pace to the M1a, but lower than that recorded in 2003. This indicator is determined to a great extent by pension savings and the montization of family transfers.

#### A sample of indicators of the Mexican banking system.

There are 27 commercial or multiple-service banks associated to the CNBV and six development banks.

However, in Mexico there are four multiple banking institutions that exercise a strong influence on the secondary money market and the determination interest rates: Banamex, BBVA-Bancomer, Santander-Serfin and Scotia Bank Inverlat, which manage slightly more than 60% of all short and long term securities traded.

#### Total portfolio of commercial banks

According to the latest figures published by the CNBV in December 2004, the total value of commercial banks' portfolio has risen for three consecutive months. In the fourth quarter of 2004, the figure stood at 1,076,757 million pesos, which meant an annual increase of 3.6% and a quarter rise of 0.93%.

The increase in annual terms was mainly due to strong growth in consumer credit (40.8%) and commercial credit (14.8%), both of which were also the most significant in terms of total portfolio share (without taking the Institute for Protection of Bank Savings (IPAB) into account), with 35.6% and 15.8% respectively, as can be appreciated in Table 3.

Table 3: Total Portfolio (TP), by Type of Credit. December 2004

Concept	Q4 Change	Annual Change	% of TP
<b>Total</b>	<b>0.9</b>	<b>3.6</b>	<b>100.0</b>
Commercial	12.8	14.8	35.6
Financial Institutions	12.4	61.9	4.0
Consumption	11.8	40.8	15.8
Housing	0.6	2.2	11.5
Government	-19.4	-24.1	15.4
IPAB	-8.4	-12.6	17.7

Source: CNBV

The portfolios that have diminished were those related to government loans (-24.1%) and IPAB loans IPAB (-12.6%).

The government and the IPAB absorb some 33.1% of the portfolio as a whole.

### Commercial Banking Portfolio Arrears

Arrears fell by 6.8% in the last quarter of 2004 and by 17.4% over the year as a whole.

### Commercial Banking Slow Payment Index

The Slow Payment Index (arrears as a proportion of total portfolio) stood at 2.51% at the end of 2004, due to the decrease in arrears, together with an increase in the current portfolio. The indicator has been improving steadily. In 1999 it stood at 8.9%, in December 2000 it dropped to 5.8% and finally, in 2003 it was 3.15%.

### Commercial Banking Coverage Index

As arrears are less, the Coverage Index (provisions for risk such as the proportion of arrears) displayed a 34.67 point increase in 2004, rising from 167.11% to 201.78%.

Both the Coverage Index and also the Slow Payment Index reached their best ever levels.

### Commercial Bank Resource Capturing

Commercial and multiple banking institutions had captured a total of 1,633,697 million pesos by December 2004.

Capital captured rose by 7.57% in 2004, the largest rise both in the last quarter of the year and in annual terms was observed in bank bonds, up by 42.8% and 41.8% respectively. However, bank bonds do not even

account for 1% of total funds captured, as can be appreciated in Table 4.

Table 4: Total Resources Captured by Source of Funds. 2004

Concept	Q4 Change	Annual Change	% of Total
<b>Total</b>	<b>6.66</b>	<b>7.57</b>	<b>100.0</b>
Callable deposits	7.80	6.07	42.72
Term Deposits	-0.11	8.23	44.04
Bank Bonds	42.87	41.80	0.07
Interbank loans and other orgs.	31.87	18.66	13.18

Source: CNBV

Callable deposits and term deposits represented 86.7% of total resources captured.

### Further commercial banking indicators

Financial margin (interest revenue less interest expenses) stood at 104.853 billion pesos at the end of 2004, up by 23.1% on the previous year.

As far as non-financial income is concerned (commission received less commission paid, plus intermediation profit), commercial banking generated 46.630 billion pesos in 2004, down by 15% on the figure observed in 2003, mainly due to the marked decrease in intermediation profit, which fell 67.6%.

Total net income (financial margin, plus non-financial income) stood at 25.377 billion pesos at the end of 2004, a 17.6% decrease in relation to the end of 2003. The increase in interest rates played a predominant part in this decrease.

## Development banking

According to information from the CNBV, Mexico's development banking sector is currently made up of the following institutions:

Nacional Financiera (Nafin)  
 Banco Nacional de Comercio Exterior (Bancomext)  
 Banco Nacional de Obras Públicas (Banobras)  
 Sociedad Hipotecaria Federal (SHF)  
 Banco Nacional del Ejército, Fuerza Aérea y Armada (Banjército)  
 Banco del Ahorro Nacional y Servicios Financieros (Bansefi)

Development banks' sphere of activity revolves around aiding small and medium-sized businesses, public Works, housing, popular savings and credit and foreign trade.

Development banks had assets worth 582.979 billion pesos at the end of 2004, which was a 13.2% decrease with respect to figures recorded at the end of 2003. This was mainly due to the drastic decrease registered by Nacional Financiera in this aspect.

Each institution's proportion of total assets throughout 2004 can be observed in Table 5.

Nafin and Banobras are seen to account for 66% of the total, which makes them the most important in the country due to the amount of assets they handle, despite Nafin assets diminishing since 2003.

Table 5: Development Banking Assets December 2004

Institución	%
Total	100.0
Nafin	40.5
Bancomext	14.7
Banobras	25.5
SHF	15.5
Banjercito	2.3
Bansefi	1.5

Source: based on information from the NBSC

## Development banking credit portfolio

The total credit portfolio of development banks stood at 444.153 billion pesos at the end of 2004. This figure declined by 17.686 billion pesos (8.6%) throughout the year due to the reduction in Nafin, Banobras and Bancomext's portfolios.

Similarly, the balance of the current credit portfolio was 437.388 billion pesos in the fourth quarter of 2004, down by 8.1% (14.840 billion pesos) on the same period in 2003.

Table 6: Reduction in the Current Development Bank Portfolio in 2004

Credit	%
Total	100.0
Housing	-43.0
Financial Agents	-18.3
Commercial	-17.3
Government Bodies	-11.7
Miscellaneous	-9.7

Source: CNBV

The most striking detail from Table 6 is that housing mortgages fell by nearly 50%.

### **Development bank portfolio in arrears**

The portfolio in arrears stood at 6.764 billion pesos, a 33.1% decrease (2.847 billion pesos) in relation to the figure observed at the end of 2004. Bancomext figured prominently in this total with around 90%.

### **Development bank slow payment index**

The fact that the decrease in arrears was larger than that observed in total assets saw the slow payment index register a favourable 1.5% in the fourth quarter of 2004, in comparison to 2.1% in the previous quarter.

### **Development bank coverage index**

Development banks witnessed credit risk provisions to the tune of 15.486 billion pesos in the fourth quarter of 2004, down in real terms by 1.8% with respect to the same period in 2003

The coverage index for credit risk stood at 228.9% in the fourth quarter of 2004 and has remained above 100% for the past two years.

Total funds captured stood at 553.432 billion pesos in December, which meant a 14.1% decrease over the year as a whole.

Development banks' financial margin stood at 7.662 billion pesos in 2004, a 3.9% increase with regard to the previous year. Development banks made profits to the tune of 408 million

pesos in 2004, 1.5% more than in 2003.

In conclusion, Mexican banks should penetrate the economic system to a greater extent, reduce their costs and lower their high level of financial intermediation.

The arrears problem is beginning to be overcome, but corporate loans are still restricted, which hinders investment and job creation.

Parallel to this, legal framework should continue to be strengthened in order to provide Mexico's financial and banking system with efficient and effective regulation and supervision.

Héctor Ruiz  
Toluca, Mexico. 5 April 2005

