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Concept of Competitiveness in the Financial Sector

Mamiko Yokoi-Arai

and

Naoyuki Yoshino

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Mamiko Yokoi-Arai and Naoyuki Yoshino*

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Abstract

The concept of competitiveness has often been used but ‘competitiveness’ is a loaded and obscure word. When applying it to the financial sector, it is necessary to consider a number of factors that would influence the qualitative aspect of competitiveness. Financial institutions are being required to investigate methods to improve their competitiveness, which has an impact on the overall financial structure of the financial sector. In this paper, we investigate selected factors that comprise the competitiveness of financial institutions. In this context, the financing of small and medium-sized enterprises (SMEs) is becoming increasingly important given their large stake in the economy and new financial techniques that would enable the risk involved in SME financing to be diversified are the subject of increasing attention. The relationship between regulation and competitiveness is also considered.

概要

競争力は多用されながらもその真に意味することが広範囲であり明確でない言葉である。競争力を金融業に適用する場合それは量的そして質的な意味合いを歴史的な背景により持っている。金融機関はその競争力を向上させることが至上課題として考えている場合が多く、またそれを考慮せずして国際的に躍進をすることは考え難い。競争力とは何であるか、またそれをつけることが何であるかを考察する必要性がある。このペーパーでは金融機関の競争力とはなんであるかについて特定分野について検討する。この中で金融機関が競争力を促進するために中小企業金融といったこれまでリスクまたコスト的な配慮により銀行等が融資してこなかった部門への進出も考える必要がある。このためには金融機関がより機動的に他分野で取得した商品開発技術を駆使し、リスク配分を見直さなければならない。また金融監督が競争力にどのように影響を及ぼすかも合わせて考察する。

* Dr Mamiko Yokoi-Arai is Research Fellow of the Financial Research and Training Center of the Financial Services Agency on leave from Queen Mary, University of London. Professor Naoyuki Yoshino is Director of the Financial Research and Training Center, the Financial Services Agency (FSA), and Professor of Economics, Keio University. This paper is still in progress and the authors welcome views and comments. The views expressed in this paper are those of the authors and do not necessarily represent those of the FSA. All errors and omissions are solely the authors’.

Contents

Introduction

The competitiveness of a country's economy and enterprises has become an important theme for governments and business managers alike. The liberalisation of economies that has been seen since the establishment of institutions such as the IMF, OECD, and GATT, the last replaced by the WTO, has gradually increased competition among nations and enterprises alike.

Competitiveness has two dimensions: at the national level and enterprise level. While it is important to distinguish between the two, it is also essential to recognise that they are inseparable. The fate of competitiveness of both nation and enterprises is entwined, a feature all the more strengthened by communication and globalisation.[1]

In this paper, competitiveness as related to finance is discussed. Strengthening the competitiveness of the financial sector becomes increasingly central as an economy moves towards being service oriented. Though competitiveness tends to imply a win/lose situation for some, it more accurately defines a comparative advantage in a particular area allowing a firm to outperform others. Thus, finding an area of specialisation plays an important role in competitiveness.[2]

This paper seeks to examine some aspects of competitiveness as it relates to finance. The way in which the financial sector gains competitiveness has been transformed over the decades from a focus on achieving quantitative superiority to qualitative superiority. This implies that there is a limit to improving competitiveness by increasing market share. The financial sector is becoming a truly knowledge-based service sector in which innovation and comparative advantage determine the well being and growth of a financial institution. Sales force size becomes only marginally important for a competitive financial institution. Financial institutions need to discover their strengths and weaknesses, and develop expertise in areas which are underdeveloped in the financial system.

The first section considers the definition of competitiveness in the context of financial institutions. Competitiveness can be an elusive concept and hence reference to various indices will provide a starting point for discussion. The second section contemplates the relationship between competition and competitiveness. From the origin of the word, competitiveness exists within the context of competition. Nevertheless, their interdependence is not necessarily clear at first sight. This section will examine the implications competition has for competitiveness. The third section considers the concept of competitiveness for a developing country. Competitiveness of a financial institution is different between a developing and developed economy. As mentioned earlier, developing countries tend to concentrate on quantitative competitiveness while developed markets focus on qualitative competitiveness. For financial institutions in developing economies to gain competitiveness, the experience of other developed economies is instructive. The focus then turns, in the fourth

[1] Stephane Garelli, "Competitiveness of Nations: The Fundamentals" (IMD, *World Competitiveness Yearbook* 2006).
[2] *Id*.

section, to the area of SME financing which tends to be overlooked as financial institutions converge. The importance and issues attaching to SME financing are discussed as well as how competitiveness can be gained in the field through new methods of financing. The fifth section examines how regulation affects the competitiveness of the financial sector. Regulation is not a determining factor for competitiveness, but, depending on the policy of a country, can have a large impact. Regulation needs to be considered carefully taking into account the effect it will have on the operation of financial institutions.

This paper glimpses into the competitiveness of financial institutions and attempts to understand what comprises and develops it. Without gaining a better comprehension of competitiveness and the various concepts involved, it will be difficult to have an informed discussion on the subject. This paper only provides input to the specific areas indicated and does not attempt to comprehensively cover topics related to the competitiveness of financial institutions. It is hoped the paper will provide a foundation for further discussion on competitiveness.

I Competitiveness of a Financial Institution

Competitiveness is a somewhat exhausted and loaded word but when one attempts to contemplate the concept in any specificity, the definition becomes far reaching and complex. The Appendix discusses definitions of international competitiveness generally (the competitiveness of a nation) and also competitiveness of the financial system. This section investigates competitiveness of financial institutions given the considerations in the Appendix.

Competitiveness can be considered from two levels: national and enterprise. While the competitiveness of each is distinct, they are not exclusive of each other. Competitiveness does not generally refer to a win or lose situation, but rather a comparative advantage in a specific area.[3] For competitiveness to develop, specialisation becomes important.

While there are a number of policies which can be implemented to improve the competitiveness of a financial system, at its foundation is the competitiveness of firms. In terms of the four elements influencing international competitiveness,[4] government efficiency and infrastructure are more concerned with the public sector, while business efficiency and the outcome of this – economic performance – are the result of corporate activity.

When focusing on the competitiveness of individual financial institutions, there are a number of things which represent competitiveness.

Efficiency

1. Rate of return on assets (ROA) and rate of return on equity (ROE)
2. Financial management

Size

3. Market share (share of deposits and lending)
4. Size in terms of retail sales (number of branches, size of assets and deposits)

IT

5. R&D
6. Financial technology
7. Accumulation of information and database

Resource management

8. Management of human resources
9. Corporate management

1 and 2 above examine the efficiency of a firm through various financial management indices. These are standard indicators of how well assets are employed in the operation of a firm. Then, 3 and 4 consider the size of the corporation in relation to competitors. Economies of scale could be an important factor, as well as having a well-known presence in the market, to determine the competitiveness of a financial institution. The indicators of size will change as the market moves towards being a service-oriented economy. Innovation and R&D will be

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[3] *Id.*

[4] *Infra* Appendix, section A.

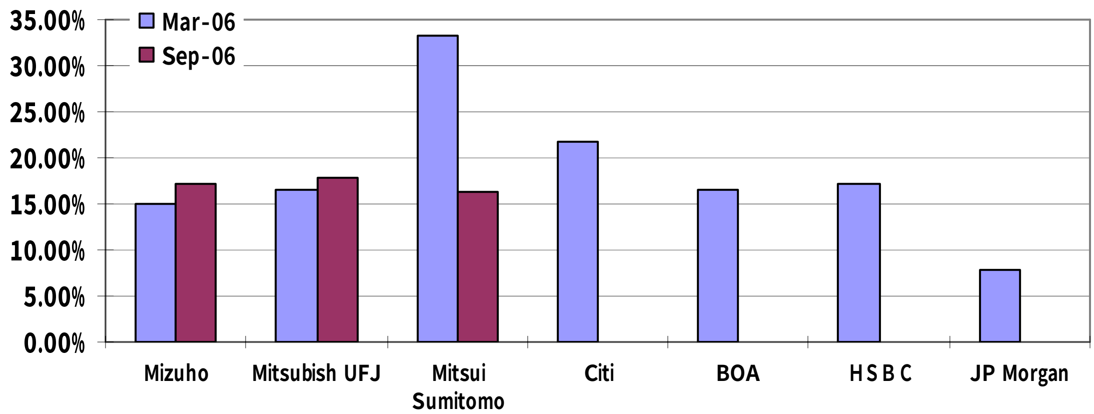
essential for a firm to remain competitive and at the forefront of the market and are covered under items 5 to 7. The ability to process information is imperative for a financial institution which depends on information to be ahead of competitors. Financial services do not require a large amount of investment in land, one of the factors of production, but do require so for labour. Labour is the one factor of production which financial services invest heavily in and will do so even with the development of technology and is covered in points 8 and 9. Having experienced experts that are well trained and informed is a crucial element of competitiveness for financial institutions. Personnel management in the sense of being able to retain good staff and elevate them to appropriate positions is essential. Overall management and creating a positive and ethical corporate governance structure is part of strategy to gain competitiveness. All these factors indicate how well a financial institution is operating as a unified entity.

There are also soft factors which are difficult to quantitatively evaluate such as ethical practices, health and safety, image, flexibility and adaptability, and corporate value.[5] Such elements would affect the long-term success of an international corporation operating internationally.

There is also a general consensus that large corporations are more efficient than small and medium-sized enterprises (SMEs).[6] This implies that the convergence of financial institutions might render them more efficient. However, the creation of mega banks worldwide has not proven to be more efficient yet and there are diseconomies that appear from repeated mergers in a short space of time.[7]

ROE and ROA of large financial institutions are compared as indicators of profitability of banks. They paint a different picture of each financial institution making it difficult to decide which index is more appropriate.

Figure 1: ROE (Profit/Share capital)

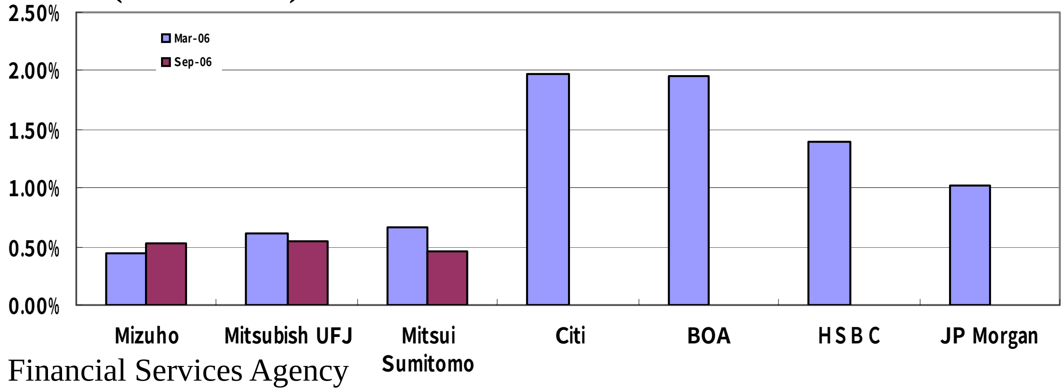


Pre-tax Profits ($m) 2005	8,785	6,106	-1,011	24,182		17,608	6,223
2004	8,449	8,436	3,882	26,333		12,816	10,037

Source: Financial Services Agency

5 From business efficiency criteria in *World Competitiveness Yearbook*.
6 In *id*, there are criteria for large corporations, based on the notion that large corporations are generally more efficient than smaller ones.
7 Robert Cottrell, "Thinking Big", *Economist* (18 May 2006).

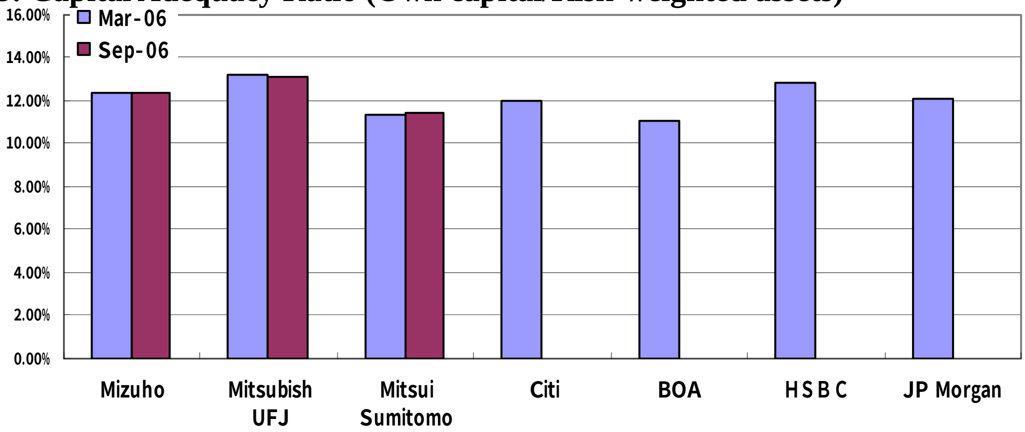
Figure 2: ROA (Profit/assets)



Source: Financial Services Agency

Capital adequacy ration and non-performing loan ratio are indicators of financial management of financial institutions.

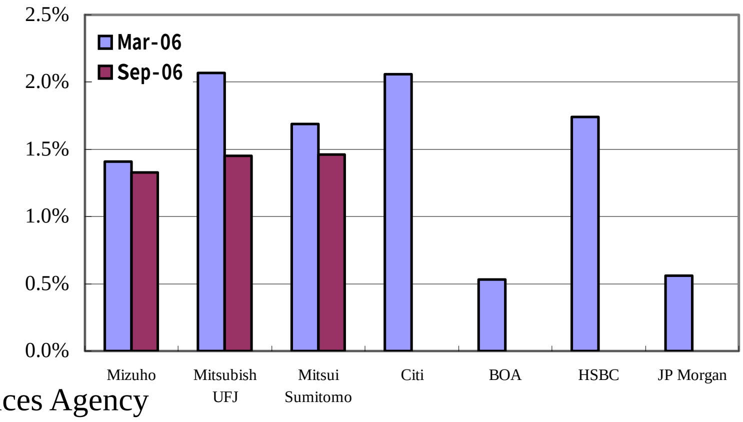
Figure 3: Capital Adequacy Ratio (Own capital/Risk-weighted assets)



Tier 1 Capital ($m) 2005	38,864	39,932	30,389	74415		67,259	68,621
2004	37,786	37,002	34,243	66,871		54,863	43,167

Source: Financial Services Agency

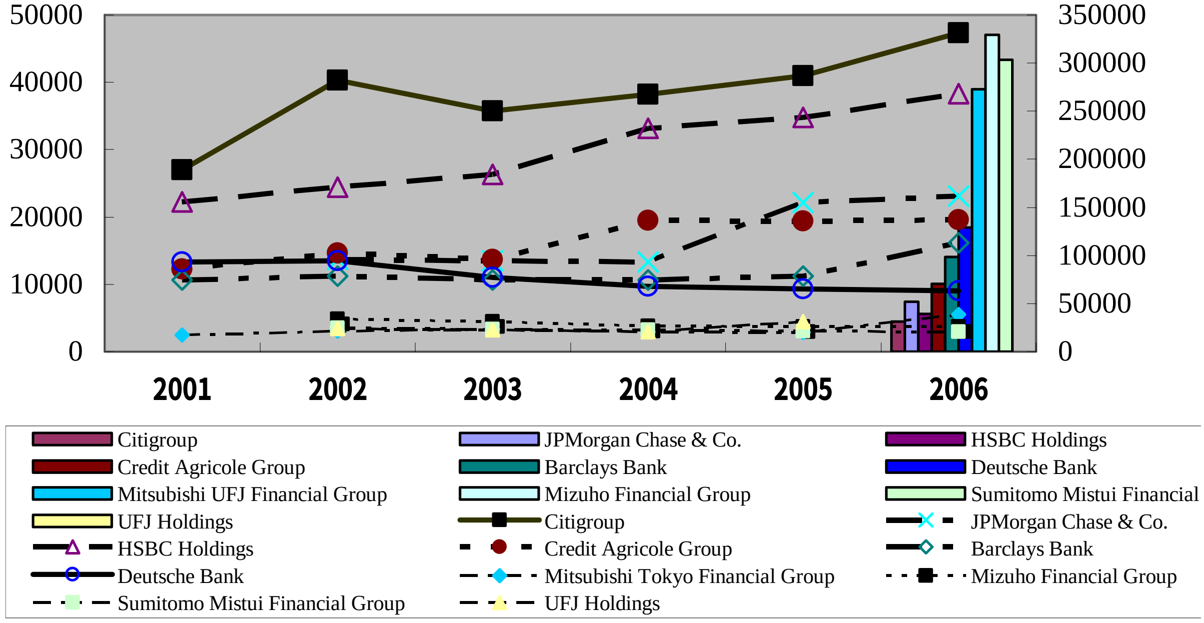
Figure 4: Non-performing loan ratio



Source: Financial Services Agency

Pre-tax profits, tier 1 capital and the number of employees indicate the size of banks.

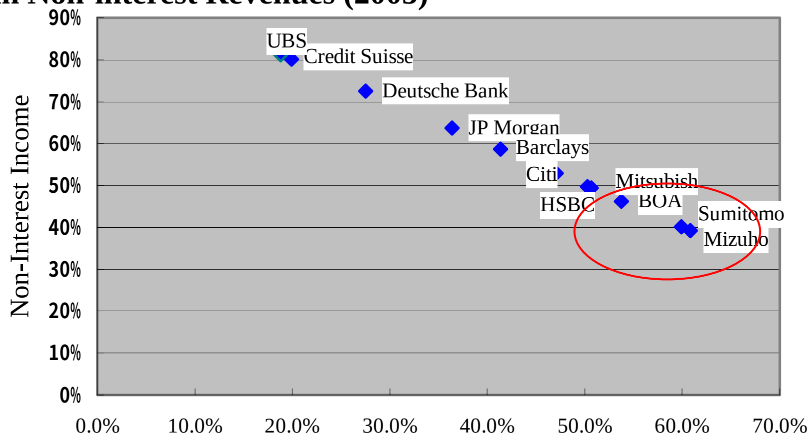
Figure 5: Number of Employees and Asset/Employee Ratio



Source: Banker

Non-interest revenues indicate the diversification of a bank's operations from their main revenue source of interest revenues. Most banks try to diversify so as to limit their dependence on loans and gain greater fee revenues.

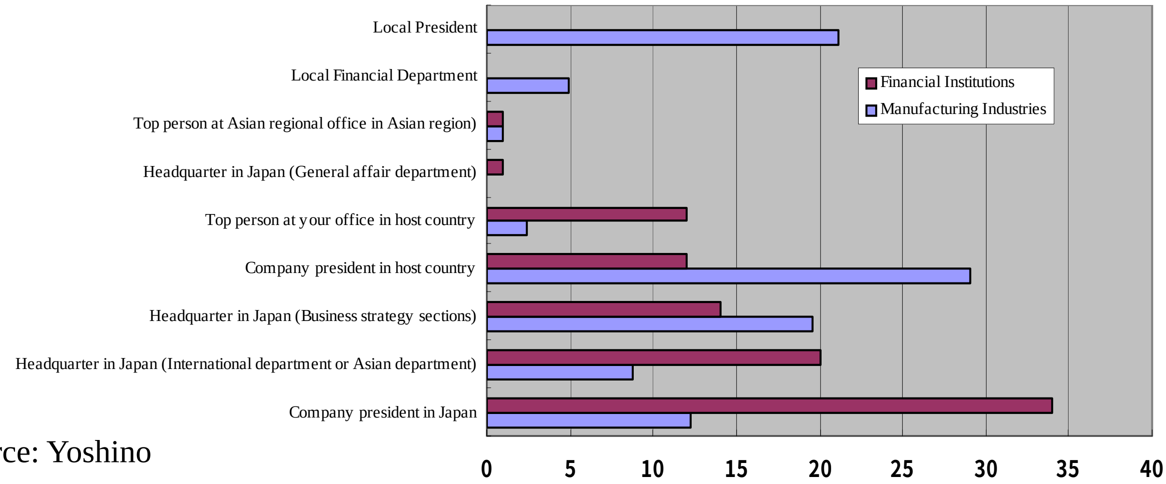
Figure 6: Trend in Non-interest Revenues (2005)



Source: Financial Services Agency, Annual Reports.

Figure 6 plots the ratio of non-interest revenue of Japanese financial institutions and their comparative inability to earn it.

Figure 7: Decision Making: Financial Institutions and Manufacturing Overseas

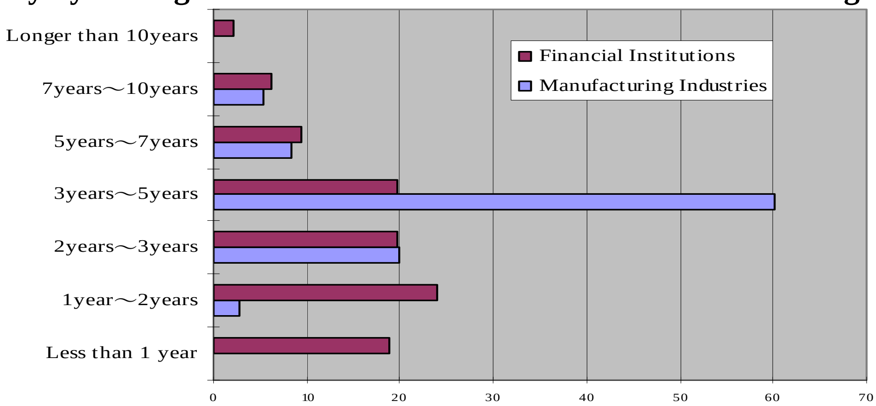


Source: Yoshino

Decision-making at a foreign location is a vital aspect for pushing the company strategy forward. Figure 7 shows where the decisions for the Japanese financial institutions overseas are being taken. The strong influence from headquarters in Japan is highly visible with 34 percent of decisions being taken by the company president. The other functions taking decisions in Japan are also strongly represented.

The level of expertise and how long a financial institution can retain staff is an important aspect of competitiveness. Figure 8 is from a survey conducted of Japanese financial institutions' management overseas. Most staff move on after 2 years which is a relatively short period of time to develop and affect the management structure of an institution. This is considered not conducive to cultivating the local market.

Figure 8: Length of Stay by Management: Financial Institutions and Manufacturing



Source: Yoshino

II Relationship between Competition and Competitiveness

Competitiveness can only exist where there is effective competition. There needs to be competition that enables the efforts of financial institutions to be translated into improved competitiveness and thus also profits and dividends. Unless there is practical and effective competition, the market will not be able to reflect the competitive forces and market signals will be distorted.

Of course, perfect competition may not be optimal for all industries from the social welfare point of view. The demand, technical, and regulatory structure of an industry thus needs to be taken into account in determining whether perfect competition would be appropriate.[8]

Considering the welfare of the financial system and to avoid large rescue costs, competition in the financial system is limited. Banks are somewhat more protected than other industries to ensure that their profitability is secured so that they have an incentive to take risks.[9]

The standard paradigm of competition is not considered appropriate for banking.[10] The asymmetry of information within the banking sector causes market failure. This leads to the primary reason for opposing free competition. In addition, the cost of switching accounts for a depositor is considerable, and affects his/her behaviour. On the other hand, switching costs give the bank a degree of monopoly power even if the bank is not large.[11]

Perfect competition would not be appropriate for the banking sector as the free entry and exit of banks from the market is not possible. Because of prudential regulation such as licensing, capital requirements, and fit and proper rules of senior management, entry to the banking market is not free, thus ruling out perfect competition. The failure of banks has, in the past, been prevented due to systemic concerns. Nor may the exit of banks from the market be freely permitted. In addition, the cost of maintaining safety nets may lead to a reluctance to use safety net resources. However, in leading developing markets, there are usually 'least cost' resolution criteria for bank rescue which means that bank rescues, whether the safety net is activated or not, will depend on cost-benefit analysis.

The financial sector is prone to becoming oligopolistic because it requires large fixed costs. The excess entry theorem argues that when the government is able to control the number of firms and their investments, surplus will be maximised, justifying the government in limiting the number of firms in competition. When the government is able to control only the number of firms, the surplus will only be maximised with the second best number of firms suggesting that government intervention is still required. However, this is based on the hypothesis that the government has perfect information and thus, in reality, the government

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[8] K Suzumura, "Competition, Regulation and Economic Welfare in the Banking Sector" 9 (3) *Monetary Studies* (October 1990) (*Kinyu Kenkyu*, Bank of Japan, in Japanese) pp17-39.

[9] F Allen, H Gersbach, J-P Krahnen & AN Santomero, "Competition Among Banks: Introduction and Conference Overview" 5 *European Finance Review* (2001), at p3.

[10] *Id.*

[11] F Allen & D Gale, *Comparing Financial Systems* (MIT Press, 2000), p235.

may only intensify the competitive environment through its decisions. This is applicable to the financial sector whether the cost structure is different or not.[12]

Further, public financial institutions greatly impact the competitive environment of private financial institutions. The need for, and efficiency of, public institutions should be considered taking into account the effect they have on the business of private institutions.[13]

On the other hand, a monopoly on banking is not optimal for the same reasons that it is prohibited in other industries. Costs would increase and innovation would become stagnant in a monopoly. Banking is not a public utility that allows monopoly to be permitted and many of the traditional utilities that were granted a monopoly have been privatised in recent decades.

The process of allowing a foreign-owned financial institution to enter the financial sector and then to eventually permit the takeover of domestic institutions is usually part of deregulation and/or liberalisation of the financial sector. Allowing the entrance of foreign-owned institutions into the market increases competition within the financial system reflecting entrance criteria having been lowered and a greater number of market players.

While the phenomenon of foreign bank entry brings the positive effects occasioned by competition, there can also be a welfare loss for some sectors. Doing business in a foreign country means that foreign banks are operating at a competitive disadvantage. Foreign banks will have to overcome this through expertise or services.[14] This is why the typical case of foreign bank penetration is when the host country is a developing country and the foreign bank is from a developed country.

Foreign banks are found to reduce the profitability of domestic banks, and there is some evidence that non-interest income and the overall expenses of domestic banks are negatively affected by foreign entry.[15] Foreign bank entry leads to greater efficiency of the domestic banking system. In other studies, foreign bank entry is associated with lower intermediation spreads, reduced non-financial costs, and improved loan quality.[16] This has the effect of improving the competitiveness of domestic institutions. On the other hand, opening the financial market to foreign institutions without appropriate sequencing could lead to the absolute dominance of foreign institutions which could lead to adverse reactions in the host nation as well. It is important to strike a balance between the need to open markets and improve competitiveness with financial market sentiment.

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[12] N.Mori & M. Okamura, "The Excessive Entry Theorem Applied to Different Cost Curves of Financial Institutions" 6 *Annual Report of the Consumer Finance Service Society* (2006) (Shyouhishya Kinyu Sahbisu Gakkai Nenpou, in Japanese) pp73-84.

[13] N. Yoshino & Y Fujita, "Competition and Economic Welfare of Public and Private Financial Institutions" 47 (4) *Economic Research* (October 1996) (*Keizai Kenkyu*, in Japanese) pp313-323.

[14] G Clarke, R Cull, M S M Peria & S M Sanchez, "Foreign Bank Entry: Experiences, Implications for Developing Economies, and Agenda for Further Research" 18 (1) *World Bank Research Observer* (Spring 2003), p41.

[15] S Claessens, A Demirguc-Kunt & H Huizinga, "The Role of Foreign Banks in Domestic Banking Systems" *in* S Claessens and M Jansen eds., *Internationalization of Financial Services: Issues and Lessons for Developing Countries* (Boston, MA Kluwer Academic 2000).

[16] A Barajas, R Steiner & N Salazar, "Foreign Investment in Colombia's Financial Sector" *in* S Claessens and M Jansen eds., *Internationalization of Financial Services: Issues and Lessons for Developing Countries* (Boston, MA Kluwer Academic 2000).

Opening the financial sector to greater international competition may have the effect of opening the economy to fluctuations in entrants' home economies.[17] On the other hand, when a host country's economy is stagnant or in crisis, foreign banks with internationally diversified asset portfolios may be a stabilising influence.[18] Some find that restrictions on foreign entry are associated with lower loan portfolio quality and greater sector fragility.[19]

[17] J Peek & ES Rosengren, "Collateral Damage: Effects of the Japanese Bank Crisis on Real Activity in the United States" 90 (1) *American Economic Review* (2000) pp30-45.

[18] *Supra* note14, p43.

[19] J Barth, G Caprio & R Levine, "Bank Regulation and Supervision: What Works Best?" *World Bank Policy Research Working Paper* 2725 (2001).

III Competitiveness in a Developing Financial System

Financial institutions will develop business strategies according to the markets they operate in. In a relatively underdeveloped market, the financial system may not be deregulated sufficiently to enable financial institutions to enter new product markets or set prices competitively. Financial institutions may thus have to compete by expanding quantitatively.

Information is important in developed financial markets that are liberalised and hence qualitative competitiveness becomes a much more important aspect of competitiveness than quantitative expansion. The ability of financial institutions to develop products that meet the demand of clients or offer timely information determines competitiveness in a well-developed market.

The financial system comprises three main players: financial institutions, the market, and investors (including depositors). Firms create demand for cash and investors supply it. Government is not a direct player but functions to monitor banks, provide infrastructure to the market, and protect investors when financial institutions become insolvent. Financial institutions intermediate the demand and supply of cash in indirect financing. Funds flow through the bold lines in Figure 9.

As a financial market develops, it can provide direct financing to firms. In the simplest situation, funds will flow from investors to firms in a straight line from right to left in Figure 9. However, not all investors may be willing to directly invest in firms due to the higher risk and lack of information. And, not all firms will be able to tap into the capital market due to lack of security, information, or creditability. Then, the financial market will need to develop different avenues for funds to be able to flow from investors to firms and the ability of financial institutions to respond to such needs will become increasingly important and be the source of competitiveness. Financial institutions are often divided into wholesale and retail divisions to deal with the differing needs of the different client base.

For investors who would rather spread risk, vehicles such as collective investment schemes could be developed to allow them to invest in the risk profile they desire (Figure 9, dashed line). Firms that cannot access the capital market directly can use the market if financial institutions securitise their loans and sell them in the financial market, enabling the risk of lending to the firm to be spread among investors while the firm obtains the necessary funds (Figure 9, dashed line). The diversity of the financial system makes available a variety of routes that investors can invest in and firms to access funds from.

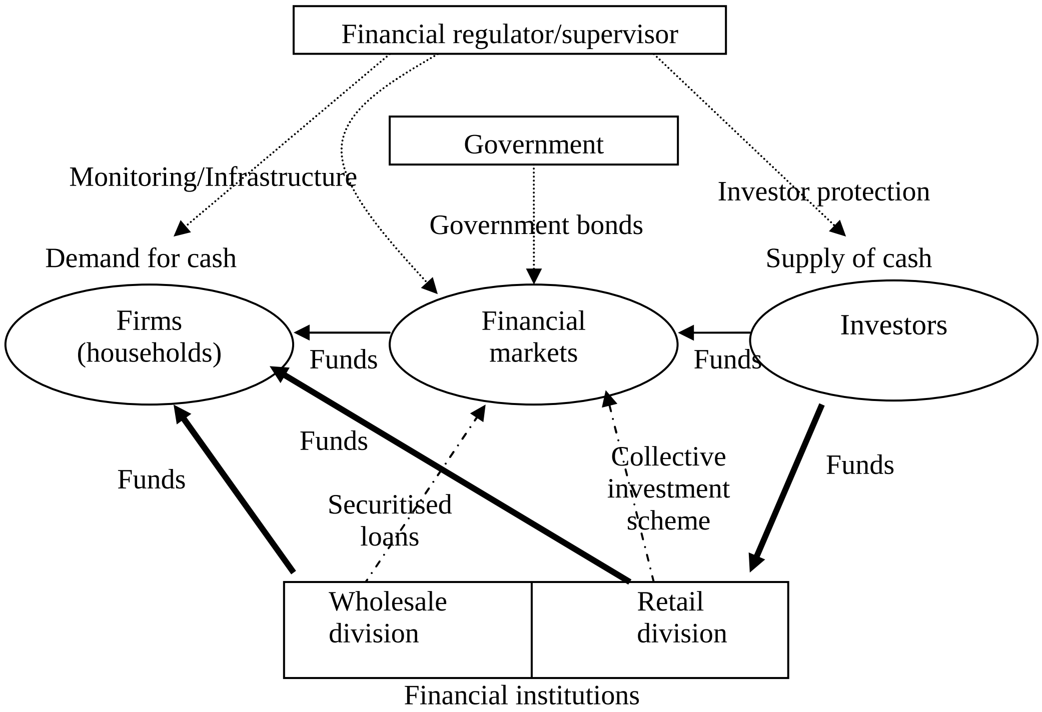


Figure 9: The Main Market Players and Their Role

Depending on the stage of economic development, the channels available for funds to flow through will differ, in turn affecting the way in which financial institutions can accrue competitiveness.

In an emerging market, the supply of funds will be relatively limited in terms of pricing, product line-up, and volume. While there may be abundant potential demand for funds, this may not be realised due to a variety of factors that prevent better access to finance[20]. Adverse selection as a result of information asymmetry also occurs in high risk markets such as SME financing, preventing lenders from willing to lend to potentially high risk borrowers. The market structure is insufficiently developed to support greater demand for, or supply of, financial services. Under such circumstances, there is often regulation of branching and interest rates. Thus, financial institutions resort to increasing their size and market share to gain competitiveness instead of developing new products.

[20] Obstacles to financing are discussed in Section IV.

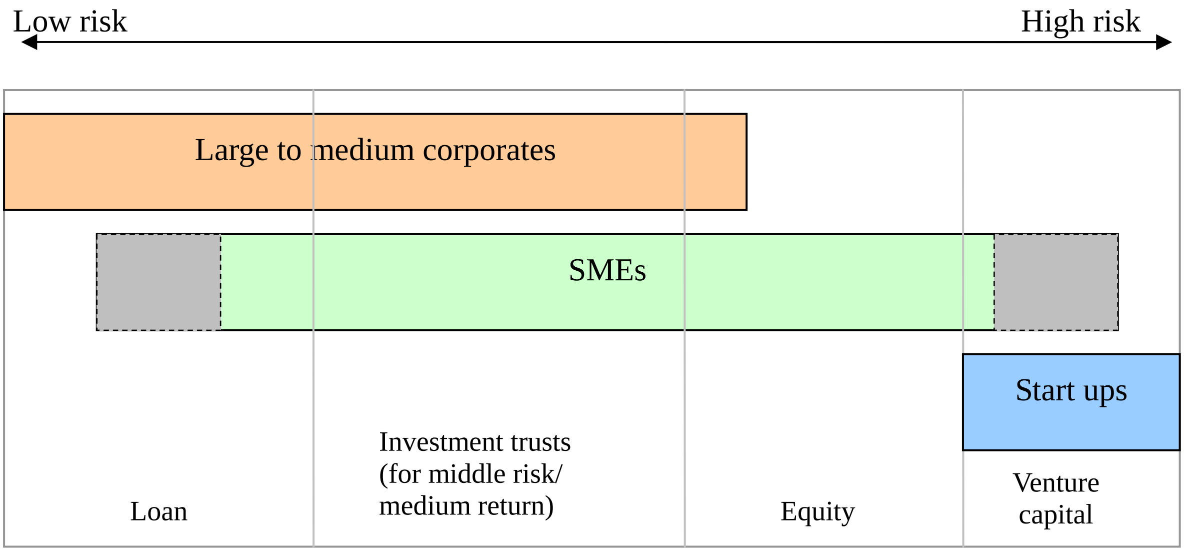


Figure 10: Risk Profile Spectrum and Available Products for Each Level

Figure 10 illustrates the risk profile of borrowers of funds in the financial system. Larger corporates have the lowest risk and are able to access bank loans. Larger small and medium-sized enterprises (SMEs) are also able to borrow from banks. Start-ups have the highest risk and use venture capital if available. The extent to which both large corporates and SMEs can borrow from banks will, however, be affected by the accumulation of non-performing loans at financial institutions. If the volume of non-performing loans is large, then financial institutions will not have the financial capacity to lend to higher risk entities.

Large corporates and SMEs that are mid-market offer medium risk/medium return and can take advantage of financing vehicles such as investment funds and collective investment funds for financing. Of these, the risk that is higher could be financed by equity. Nevertheless, there is clearly a lack of funding sources for the grey area as indicated in Figure 10 and which requires greater financing opportunities to debut.

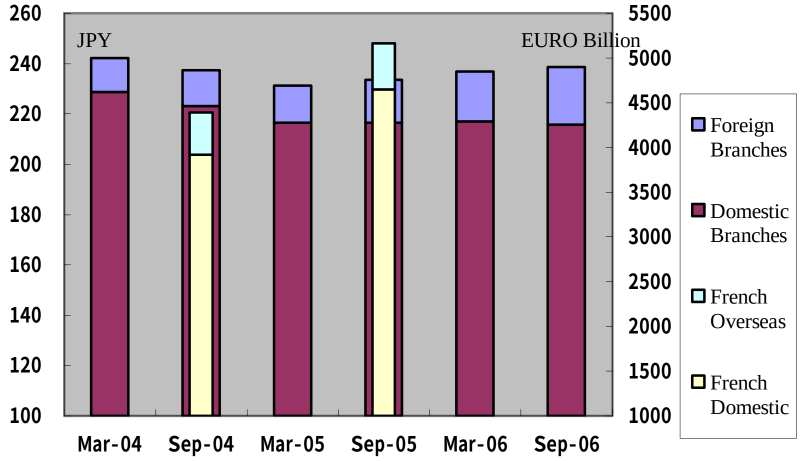
In the post-World War II period, during Japan's rapid economic development, there were a variety of regulations that restricted the supply of financial services. Interest rates were controlled and branching was limited at the discretion of the regulators. Thus, financial institutions gained quantitative competitiveness by expanding in terms of size and assets, and increasing lending. This led to excessive lending which was not based on sound credit assessment. Large banks were more or less similar in size until the mid-1990s.

Japan had an unwritten policy of not letting banks fail reflecting the important role they played during the economic expansion of the post-World War II period. However, this resulted in banks being managed in an uncompetitive manner. As a result, non-performing loans mounted when deregulation progressed, culminating in the inevitable large-scale failure of banks.

As a result of the banking crisis, the number of large city banks was dramatically reduced to mainly three mega-banks, bringing an oligopolistic or monopolistic structure to the market. The mega-banks are competing to acquire fee revenue and increase lending. However, their international competitiveness has reversed in the past decade.

Figure 11 compares the outstanding loans of Japanese and French banks from their domestic and foreign branches.

Figure 11: Loan Turnover in Domestic and Foreign Branches of Banks in Japan and France



Source: Financial Services Agency, Banque de France Annual Report

There are a number of reasons behind this lack of competitiveness. Competitive strategy ought to have changed as the market developed and was opened. However, financial institutions failed to alter their course and regulators did not consider the need to alert financial institutions of their fragility. This led to asset price inflation and a banking crisis.

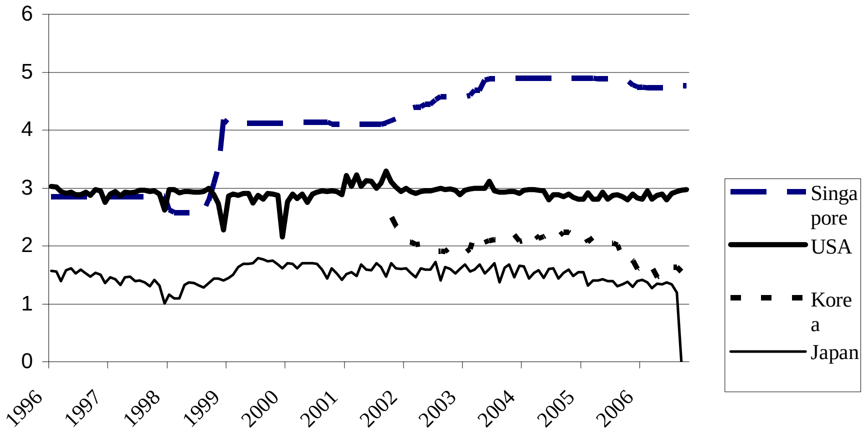
Historically, Japan's financial system has experienced major booms and downswings, but financial institutions have not acquired international competitiveness despite surviving the changes in the economic environment. Japanese banks lack global vision, being entrenched in a national mindset. When financial institutions did venture abroad in the 1980s, this was not the result of a strategic decision, but followed the manufacturers that had gone abroad. Since manufacturers now use the capital market for financing, financial institutions have lost their raison d'être to go abroad. Crucially, they lack the pioneering spirit to cultivate new markets after their recovery from non-performing loans. US banks are one of the strongest lobbying groups in Washington, DC, and have political power within the establishment. They use their power to influence FTA negotiations to enable their expansion to take place in certain overseas markets. While Japanese banks may not necessarily be passive, their willingness to enter new markets is not noticeably strong compared to US and UK banks.

Another reason is the concentration of financing on loans and the fact that commercial banks provide both short and long-term financing. This is called 'over-banking' in Japan and depicts the phenomenon of banks being the dominant avenue of funds, not being able to take higher risks, and having the bulk of their assets tied up in loans. Financial institutions need to specialise in their respective areas while being able to use the financial holding company structure to respond to group-wide functions.

The narrow interest rate margins of banks are the result of public banks and over-banking. Publicly-financed banks offer low lending rates as they are non-profit making, having been financed by post office savings until 2001 and now by the government's Fiscal and Investment Loan Programme bonds (FILP bonds). Banks are forced to compete with the public banks at an obvious disadvantage, forcing them to offer similarly low lending rates.

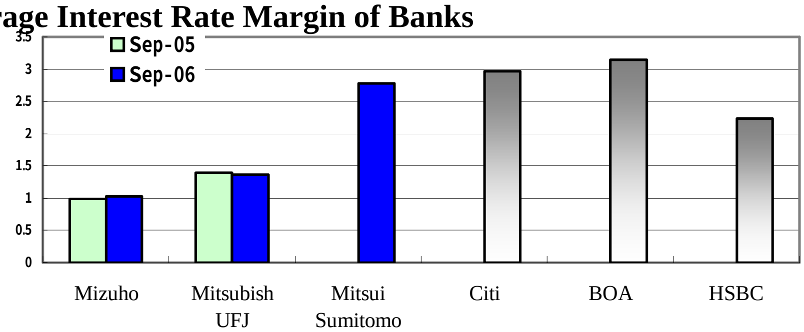
During the past 10 years, the average interest rate margin of Japanese banks has remained around 1.5%. Compared to other countries, Japan's low interest rate margin stands out. The interest rate margin of US banks is approximately 3%, whereas the interest rate margin of Singaporean banks has been over 4% in the past 10 years. Korean banks have had a 2% margin during the past five years (Figure 12).[21]

Figure 12: The Average Interest Rate Margins of Banks



When the interest rate margin of individual banks are compared the difference between Japanese banks and other international banks is marked.

Figure 13: Average Interest Rate Margin of Banks



Source: Financial Services Agency

The banks have also failed to take advantage of the rich expertise of financial engineers who were hired during the 1990s. Financial engineers have not had the benefit of an environment that is open to ideas and challenges. This is reflected in the robustness of product

[21] 1) Japan = (Average investment rats on certificate of deposits) – (Average interest rates on certificate of deposit)

2) USA =(Bank Prime Loan Rate) – (1-Month Certificate of Deposit: Secondary Market Rate)

3) Korea: = (Weighted Average of Interest Rate on Loans & Discounts) – (Time & Savings Deposits)

4) Singapore=(Prime Lending Rate) –(Bank Fixed Deposits (3 Months))

development and analysis of markets. For example, research is rather one dimensional when looking at the Asian markets, not developing into a more complex series of data that would provide insight into the long-term market outlook.

This is a lesson for other developing markets, namely that the strategy of financial institutions needs to change in line with the external environment.

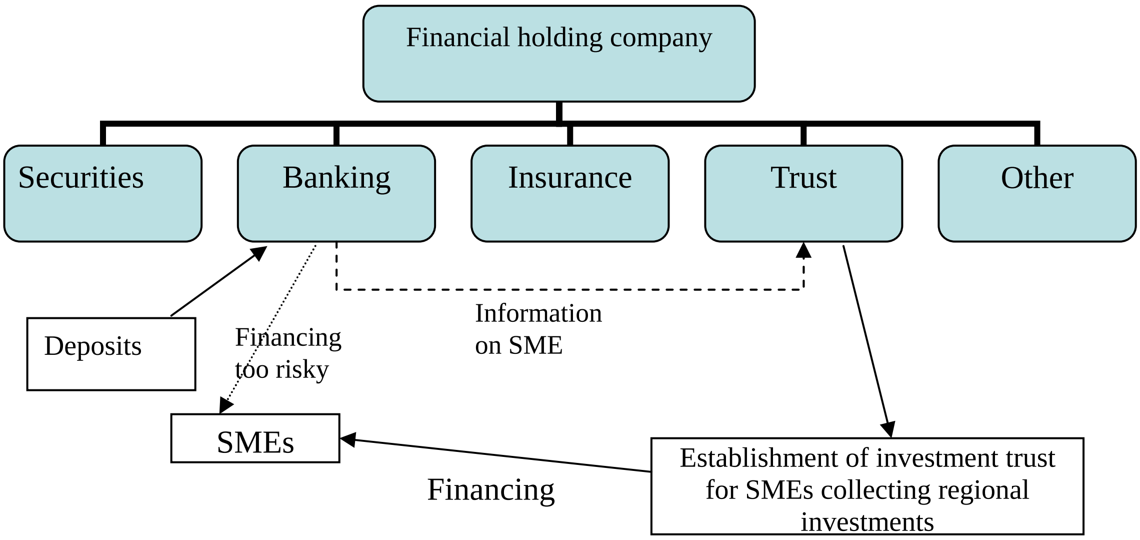


Figure 14: Alternative Funding Possibilities of Consolidated Financial

Since 1991, 180 banks have failed, in sharp contrast to the previous policy of not allowing banks to fail.[22] Some 164 of the failures were between June 1996 and March 2002.[23] Of the failed institutions, more than 90% (166) failed due to non-performing loans.[24] A quarter of the failed institutions experienced large losses from investments in the stock market and 5% failed due to investigations into unfair trading or financial scandals.[25] Nearly 70% of the failed institutions (117 banks) were considered to have management issues. This mass bank failure resulted in the consolidation of financial institutions and the creation of mega-banks that are hoping to become a 'one-stop shop' for financial services.

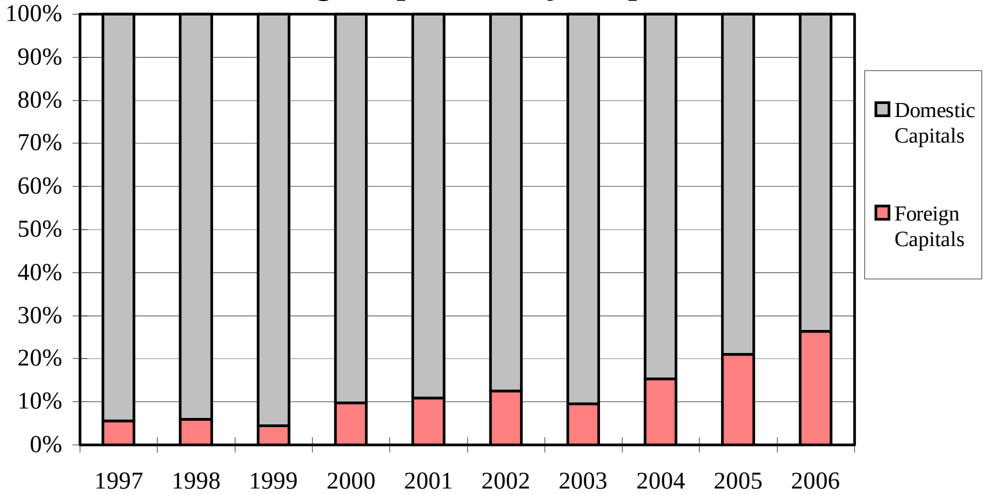
Figure 14 illustrates alternative funding possibilities that a financial institution with a full spectrum of financial services might offer. A mega institution can offer a wide range of products to consumers according to their risk appetite. So long as it does not create a conflict of interest, information can be shared in the group to provide the appropriate output to clients.

Japanese banks have not actively been encouraged to improve efficiency as strong shareholder monitoring was not the norm because of cross-shareholding. Horiuchi[26] argues

[22] Deposit Insurance Corporation of Japan, "Statistics of Failed Banks" 4 *Deposit Insurance Studies* (September 2005) pp168-186 (in Japanese).
[23] Deposit Insurance Corporation of Japan, "Introduction" 4 *Deposit Insurance Studies* (September 2005) (in Japanese).
[24] Deposit Insurance Corporation of Japan, "Analysis of Causes of Bank Failure" 4 *Deposit Insurance Studies* (September 2005) pp1-3 (in Japanese).
[25] *Id*., p4 (in Japanese).
[26] A Horiuchi, "Is Japan's Financial System Efficient?" 16(2) *Oxford Review of Economic Policy* (2000)

that the market discipline mechanism did not work in Japanese banks as the government protected the industry until the late 1990s. According to Aoki and Dinc[27], cross-shareholding among major corporations is still a strong feature of Japanese corporates. While this has improved somewhat in recent years as a result of increased shareholding by foreign capital, compared to other international banks, the concentration of shares held by related firms remains strong.

Figure 15: The Share of Foreign Capital in Major Japanese Banks



Source: *Shikihou* (Quarterly Corporate Financial Information),1997-2006

The boom and bust of the Japanese financial system provides lessons as to what is necessary to create a sustainable financial system. Emerging economies need to take heed of the changes required of financial institutions for them to remain competitive as the market structure changes.

As the market develops and deregulation takes place, size becomes a somewhat limited benchmark for competitiveness. Investors will gain a better knowledge of financial products enabling them to be better equipped in making an informed choice. Further, as the financial market expands and capital markets grow, investors will have a wider choice of financial products. Thus, demand for loans will be met by a diversity of other products limiting the scope of gaining competitiveness through size. The concept of competitiveness then needs to be expanded to allow for the complexity of the market place.

Competitiveness is a dynamic concept that requires adapting to the changing landscape of finance. Financial institutions need to recognise that the foundation of competitiveness will change as the market structure alters. Competitiveness will become a multilayered and complex formula to define, and stage of economic development and market deregulation will play a crucial role in determining how it is achieved.

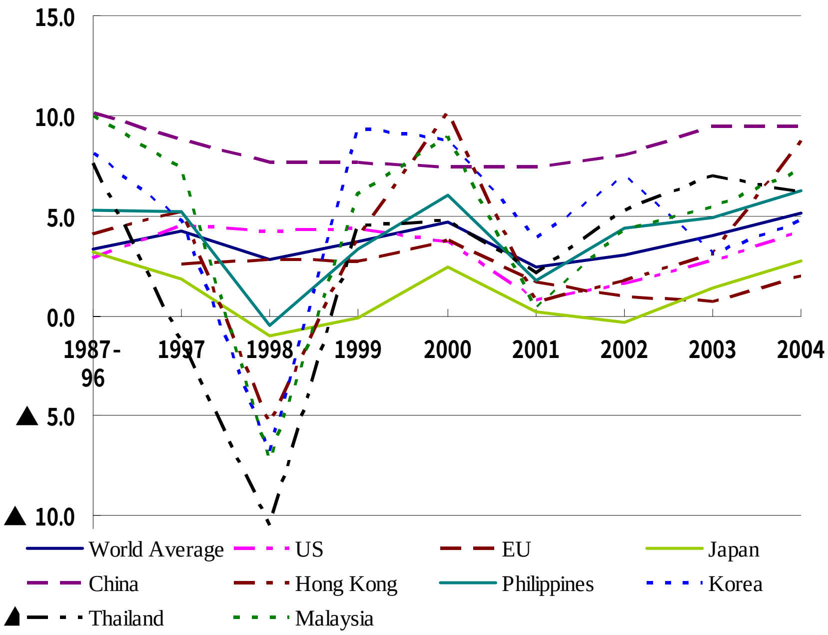
27 M Aoki & S Dinc "2 Relational Financing as an Institution and Its Viability under Competition" in M Aoki & G R Saxonhouse, *Finance, Governance, and Competitiveness in Japan* (Oxford University Press, 2000) pp 36

IV Competitiveness in SME Financing

The notion of small and medium-sized enterprises (SMEs) is different in each country,[28] and thus for the convenience of this analysis, we define an SME as a firm having fewer than 100 employees. Among APEC countries, SMEs account for about 98% of all enterprises and 60% of private sector jobs.[29] SMEs generally do not have the creditability to borrow from capital markets and often require bank loans for financing.

Asia has achieved an astonishing rate of economic growth over the past decade (see Figure 16). Because of the large proportion that SMEs contribute, the competitiveness of SMEs is essential for Asian economies to grow further.

Figure 16: Real GDP Growth Rate of Major Economies



Source: IMF, *World Economic Outlook* (September 2005).

The interdependence of economies is strong in Asia as well, and trade and investment are a strong driving force of the link between the economies. Table 1 indicates that despite the lack of any organised regional arrangement, the capital inflow from Asia to Asia is strong.

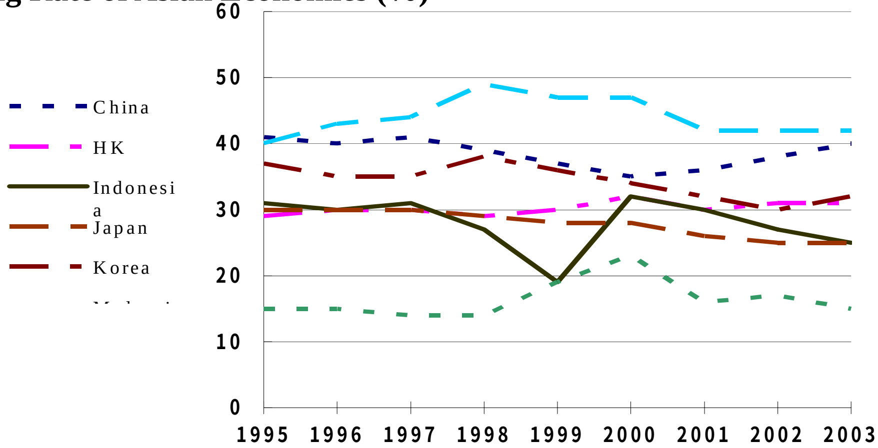
Table 1: Capital in and outflows as percentage of total flows

	Portfolio outflows to: Asia	Portfolio inflows to: Asia	Portfolio inflows to: Europe
USA	42.8	37.1	15.7
Europe	37.2	30.7	65.6
Asia	8.2	18.9	7.7
Others	11.8	13.3	11.1

Source: Yoshino et al. (2006)

[28] See the variety of definitions for SMEs in APEC, “Profile of SMEs and SME Issues in APEC 1999-2000” (APEC Small and Medium Enterprises Working Group, 2002), section 1.3, pp7-9.
[29] *Id.*, p32.

Figure 17: Saving Rate of Asian Economies (%)



Sources: ADB, Asian Regional Integration Centre; UNCTAD.

Asian countries have astonishingly high savings rates and thus being able to channel the funds to those in need of cash within the region is a theme that policy makers have been working on for the past decade (see Figure 17). In this context, not being able to intermediate these funds to SMEs that are in need of financing seems highly inefficient.

In addition, SMEs need to be able to tap into the technology and expertise available in the domestic and regional market. Asia has made leaps in terms of research and development which has had a crucial impact on competitiveness.

Table 2: R&D Investment in Japan and East Asia

Country	Region		Local	Foreign	Total
China	Eastern	North East	1	0	1
		Beijing area	21	2	23
		Yangtze River delta	13	2	15
		Pearl River delta	4	0	4
		Total	39	4	43
	Central		5	0	5
	Western		2	0	2
	Total		46	4	50
Hong Kong			96	108	204
Indonesia			1	0	1
Japan	Hokkaido		4	0	4
	North East		8	0	8
	Tokyo suburbs		164	30	194
	Central		24	0	24
	Osaka suburbs		52	0	52
	Chugoku		4	0	4
	Shikoku		2	0	2
	Kyushu		6	0	6
	Total		264	30	294
Malaysia			8	1	9
Philippines			1	1	2
Singapore			6	5	11
Korea			5	0	5
Taiwan			2	4	6

Source: UNCTAD, *World Investment Report*.

SMEs provide the majority of employment in many countries. Thus, to increase the number of available jobs, it seems logical to address the issue of SME development.[30] Further, and crucially, the financing of SMEs tends not to be a priority for large financial institutions due to the cost of assessing and monitoring them and the higher risks involved. The private debt market is the main channel for SMEs to obtain financing and access to public equity and debt markets is usually limited.

It is necessary to consider why access to credit is biased against small enterprises and what might be done to rectify this. Larger financial institutions tend to lend to larger, older, and more financially secure SMEs.[31] This puts at a disadvantage the smaller and upstart firms that are most in need of funds. This is because the larger firms are more transparent and relatively safe to lend to. This leads to larger financial institutions lending money at lower interest rates and earning lower yields on SME loans.[32] This means that larger firms will tend to receive more and better offers for loan products.

In general, SMEs are disadvantaged with respect to financing due to 1) information asymmetry, 2) lack of transparency, 3) vulnerability to external shocks, and 4) weak governance structure. Information asymmetry is caused by the lack of financial information regarding SMEs. Larger corporations are more resilient to external shocks because they have a variety of operations that they can depend on when one of their sections is affected. SMEs will often not have the option to diversify. Larger corporations do not depend on a single manager for their management capacity which can be downstreamed or replaced. However, the management of SMEs is often dependent on the management expertise of a single person, meaning a weak governance structure.

This is an anomaly given that SMEs are the powerhouse of economic growth. For the sake of national competitiveness and also that of financial institutions, it would be sensible if SMEs were better financed and there were mechanisms to enable this. Financial institutions would be able to enter a more niche market through the development of new lending techniques.

New technologies have been developed enabling the credit scoring of SMEs. Where large corporations are using the capital market directly for funding, financial institutions are seeking new areas to finance. Also, financial institutions need to diversify their loans to adhere to regulatory requirements. This may lead to financial institutions looking into financing SMEs as a business opportunity and finding ways to resolve the opaqueness of SME finances.

In this context, two directions can be identified:

- government support to overcome the lack of profitability of SME financing
- using market mechanisms to ensure that credit decisions with respect to SME

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30 *Id.*
31 Allen Berger & Gregory Udell, "A More Complete Conceptual Framework for SMEs" (Prepared for presentation at the World Bank Conference on Small and Medium-Sized Enterprises: Overcoming Growth Constraints, 14-15 October 2004), p7.
32 *Id.*, p7

financing are based on sound credit assessment

In a developing country context, regulatory and state intervention may be necessary to kick start SME financing, which is often not financially sustainable by a private institution. On the other hand, it is generally accepted that state-owned institutions operating with government subsidies and mandated to supply additional credit to SMEs may not benefit the industry in the long run although beneficiaries may benefit in the short run. Financing from state-owned institutions may be based on credit assessment and some funds may be channelled for political purposes that may be detrimental to the economic viability of SME financing.[33]

The financial system does not necessarily cater for the needs of all customers. Banking systems and capital markets are often skewed towards those already better off, which are large enterprises and wealthy individuals.[34] The size of the firm is one of the main determinants affecting access to finance.[35] Size may reflect not only profitability, financial and legal collateral, but also political collateral.[36] However, size can be overcome by developing automated credit scoring systems.

Another reason why SMEs are not catered for is the high transaction cost for their loans thus making them unprofitable. Loans to SMEs lack security, they are often obtained and repaid in small amounts, and there is difficulty in designing the contract and enforcement.

The entrance of foreign financial institutions into the banking market can affect the way in which SME financing is provided. Foreign-owned institutions may have a comparative advantage in transaction lending[37] and domestic institutions may have the same in relationship banking.[38] Foreign institutions may have difficulty in processing soft information while domestic ones will have understanding of the language, culture, and regulatory environment easing the processing of soft information.[39]

In addition, foreign-owned financial institutions having a large presence could inhibit the financing of SMEs. Most banks with an international presence are large. For large banks, organisational diseconomies may make it difficult to provide relationship lending services to small businesses at the same time that they are providing transaction lending.[40]

Nevertheless, in some Latin American countries, the growth of lending to SMEs was higher for larger foreign institutions than domestic financial institutions.[41] This may reflect technological advances allowing credit scoring and greater data availability. This could assist

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33 *Id.*, p12
34 Stijn Claessens, "Access to Financial Services: A Review of the Issues and Public Policy Objectives" World Bank Policy Research Working Paper WPS3589 (May 2005), p2.
35 T Beck, A Demirguc-Kunt & V Maksimovic, "Financial and Legal Constraints to Growth: Does Firm Size Matter?" 60 *Journal of Finance* (February 2005).
36 *Supra* Claessens, note 34, p11.
37 See *supra* p16 for definition of transaction lending.
38 See *supra* p16 for definition of relationship banking.
39 *Supra* note 31, p10.
40 AN Berger, LR Klapper & G Udell, "The Ability of Banks to Lend to Informationally Opaque Small Businesses" 25 (12) *Journal of Banking and Finance* (2001) 2127-67.
41 G Clarke, R Cull, MSM Peria & SM Sanchez, "Banking Lending to Small Businesses in Latin America: Does Bank Origin Matter?" *World Bank Policy Research Working Paper* 2760 (2002).

large foreign financial institutions in overcoming the difficulties they face when lending to SMEs.

The tax and regulatory regime will have an impact on the cost of financing to SMEs. Stamp duty and value-added tax could make factoring inefficient. Restrictions on the structure of financial institutions could reflect negatively on whether financial institutions are able to use lending techniques in which they have a comparative advantage.

Lending to SMEs[42]

There are mainly six lending methods of which five are transaction based (financial statement lending, small business credit scoring, asset-based lending, factoring, and trade credit) and the sixth being relationship lending. There are three additional lending methods (securitisation of loans, credit guarantees, and government subsidies) that are also explained below (discussed in order of significance).

Financial statement lending involves underwriting loans based on the strength of a borrower's financial statement. The borrower's financial statement (eg, using GAAP or IFRS) must be informative as well as strong. Financial statement lending is reserved for relatively transparent SMEs.

Relationship lending (discussed before other transaction-based methods because of its significance) is designed to address information problems that are not feasible or cost-effectively solved by other technologies. The primary information used by lenders is based on soft information about the relationship between the lender and the borrower. The lender acquires information about the borrower and the business over time with respect to the provision of loans. Relationship lenders collect information beyond that which is available on the firm's financial statements and information that is readily available to the public. Relationship lending tends to be labour-intensive and costly.

However, relationship banking can, in a number of ways, be developed using financial techniques that can support the financing of SMEs. This can be especially beneficial to start-ups and/or regional enterprises which have higher risk profiles.

Banking groups can combine the information within the group to support SMEs that may prove risky for an individual bank. This would diversify the risk of investing in SMEs to those group banks that have an appetite for higher risks. While a bank might hold information about a potential SME in which to invest, the risk might be too high for it. In such a case, the bank could then pass on the information to a trust company within the group which can establish an investment fund that could invest in the SME.

Another tool for regional start-ups would be the establishment of a regional/community fund. The US has a strong culture of venture capitalists (VCs) who

[42] *Inter alia* Berger & Udell, *supra* note 31, pp20-27.

support business initiatives which are high risk but innovative and offer significant returns. Nevertheless, the development of VCs is nascent in most financial systems with little appetite on the part of banks and other investors to shoulder the high risk as well as the knowledge base necessary to assess start ups.

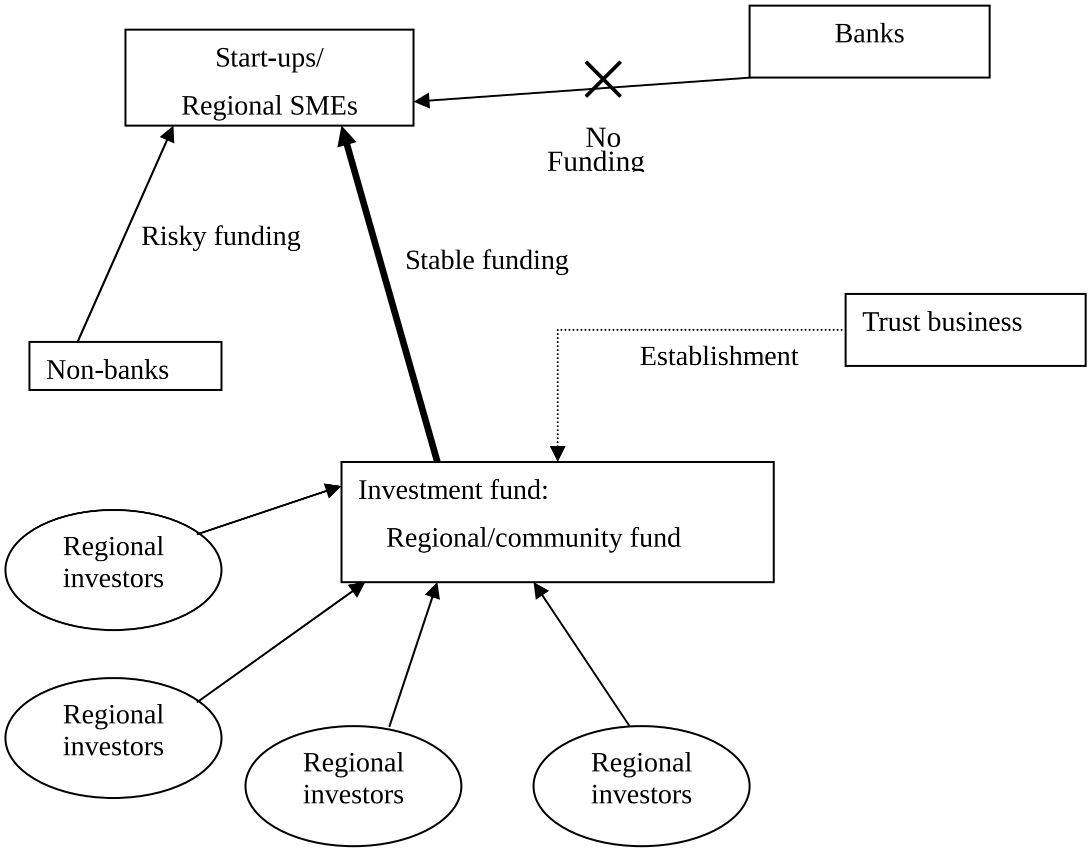


Figure 18: Regional/Community Funds for SMEs

A regional/community fund could be established with the objective of providing funds to SMEs in a certain region/locality to revive the regional/local economy. The investment fund could be rated using the credit scoring information that is discussed in detail below. This would provide stable financing to start-ups that tend to be affected by the macroeconomic outlook. Again, a trust company could become involved to establish an investment fund for regional investors to invest in.

Small business credit scoring is based on hard information about an SME and its owner. Information on the owner is primarily personal consumer data (eg, personal income, debts, financial assets, home ownership) obtained from consumer credit bureaus. This is combined with data collected about the SME by the financial institution. The data is entered into a loan performance prediction model which yields a score or summary statistic for the loan.

In Japan, the Credit Risk Information Database (CRD) was developed by the Small and Medium Enterprise Agency with the cooperation of the Credit Guarantee Association and private financial institutions. CRD collects financial statement data and non-financial default data from member credit guarantee associations and financial institutions. Individual firm names cannot be identified as all specific information is encrypted. Approximately 3 million firms provide data and there is an accumulation of 400,000 default data.

Asset-based lending is where the underlying assets of the firm (which are taken as collateral) are viewed as the primary source of repayment. For working capital financing, banks use short-term assets such as accounts receivable and inventory. For long-term financing, they use equipment.

Factoring involves the purchase of accounts receivable by a 'lender' known as a 'factor'. Like asset-based lending, factoring focuses on the underlying value of the asset rather than the risk of the firm but there are three important distinctions: 1) factoring only involves the financing of accounts receivable; 2) under factoring, the underlying assets, accounts receivable, are sold to the 'lender' (ie, factor); and 3) under factoring, the borrower outsources credit and collection services of the accounts receivable in addition to receiving financing.

Trade credit is when one provides goods or services to the borrower with an agreement to bill them later. Trade credit utilises most of the techniques of transaction lending. Trade credit represented a third of all debts extended to for-profit US firms (excluding farms, financials, and real estate) as of 1998.

Securitisation of loans is where a loan to an SME is securitised allowing the risk of the original loan to be divided, attracting investors with a variety of risk appetite. With the development of a secondary market for securitised loans, liquidity of the product is likely to improve as well giving greater scope to SME loans.

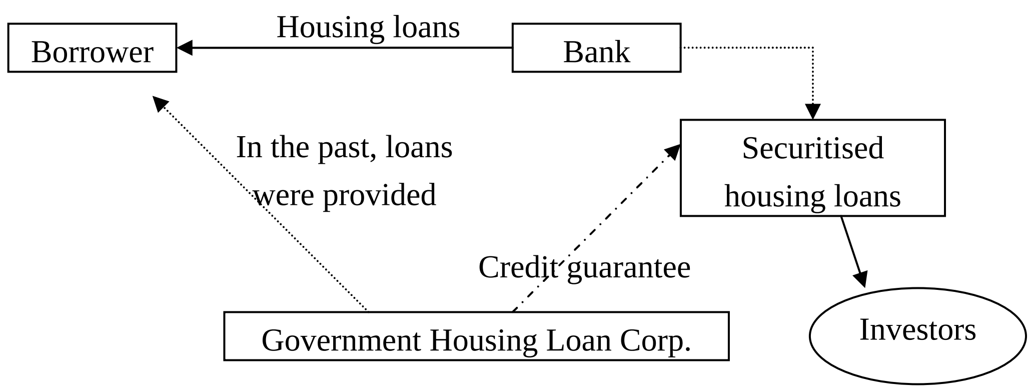
When looking at the development of securitised loans, there are generally three stages. Initially, banks were the traditional lender for all borrowers and funds would be transferred seamlessly from the depositor via the bank to the borrower.

During the 1970s in the US, depository institutions lacked sufficient funds to extend housing mortgage loans. This led to the development of securitised housing mortgage loans both in the US and Germany which were the precursor of the securitisation market. Housing loans in Japan were traditionally provided by the government's Housing Loan Corporation which had a virtual monopoly of housing loans. In the 1980s, due to a decrease in lending to corporates which were able to tap into the capital market, banks started to provide housing loans in Japan. This development made the Housing Loan Corporation redundant and it was required to refocus its operations on supporting the housing loan market instead of directly financing loans. The Housing Loan Corporation now provides credit guarantees to the securitised housing loans of the banks. This stabilises the risk profile, enabling banks to lend more safely for housing.

This leads to the possibility of securitising loans to SMEs. Banks tend to avoid lending to SMEs for a number of reasons. Financing SMEs is more risky than to larger corporations as there is a higher possibility of default by an SME not to mention lack of financial information regarding both existing and defaulting SMEs.

Japan has overcome this problem by providing credit guarantees in exchange for financial information from SMEs. The Credit Guarantee Association extends credit guarantees to SMEs borrowing from banks. SMEs that receive such credit guarantees must submit their financial information to the Credit Guarantee Association. Based on the submissions, the Association compiles the CRD (mentioned above) which in turn can be used by banks providing loans to SMEs.

(A) Securitisation of housing mortgage loans in Japan



(B) Securitisation of SME loans

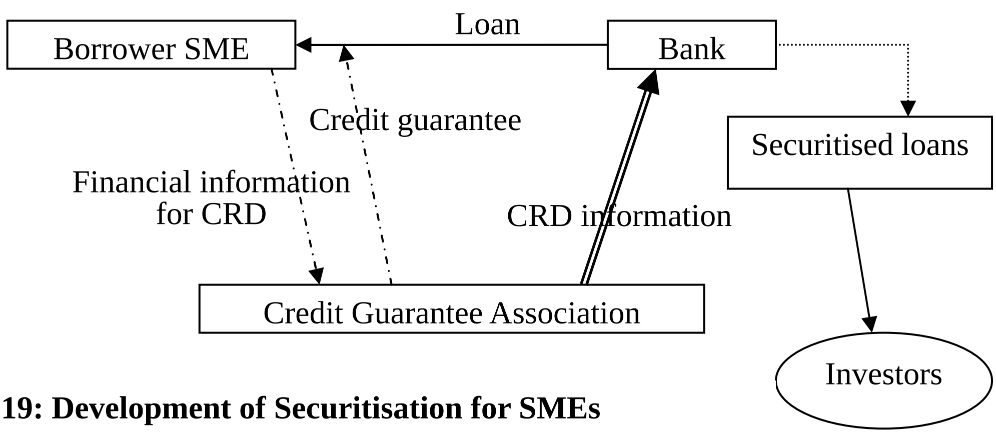
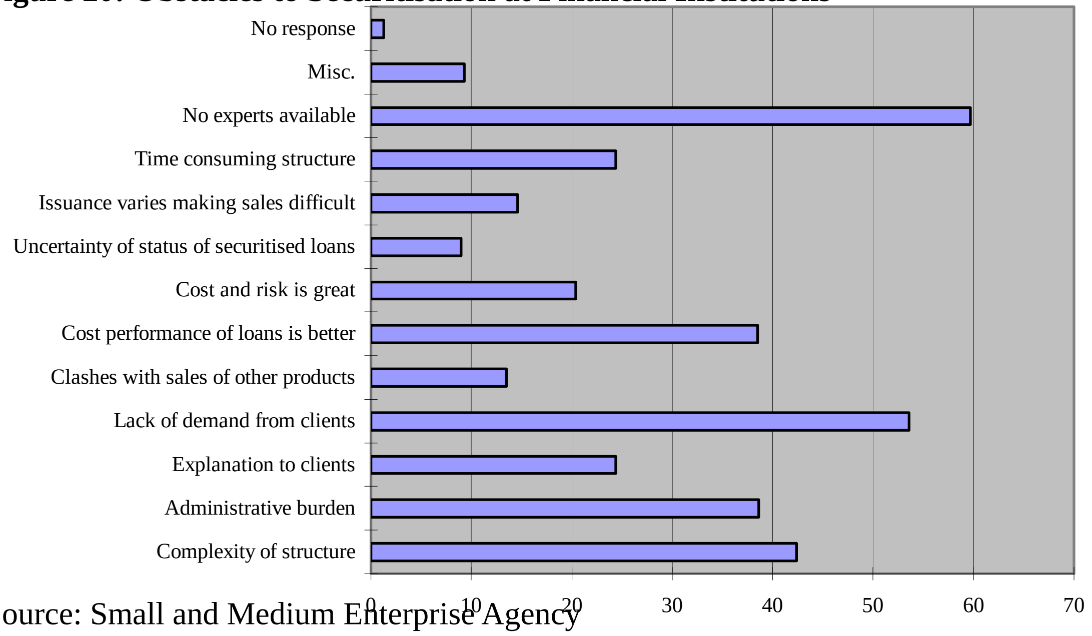


Figure 19: Development of Securitisation for SMEs

In Japan, 83% of financial institutions have never offered securitised loan products and only 16% have experience in securitised loans.[43] There is a definite lack of expertise and understanding towards securitisation which would accomplish better financing for SMEs.

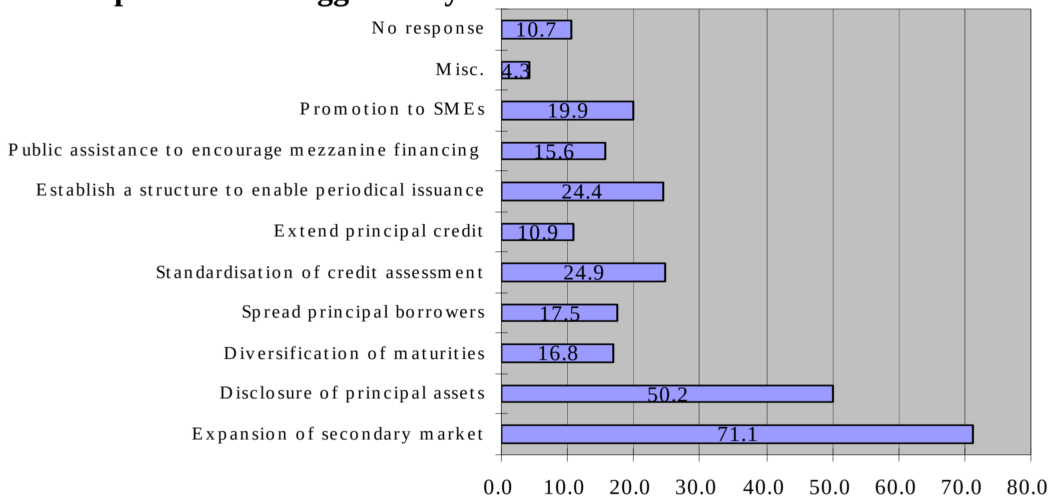
Figure 20: Obstacles to Securitisation at Financial Institutions



Source: Small and Medium Enterprise Agency

The reason why financial institutions have not offered securitised loans stems from infrastructural and personnel reasons. Results of a survey of institutional investors and financial institutions indicate obstacles to securitisation (Figure 20).[44]

Figure 21: Improvements Suggested by Investors for Better Securitisation of Loans



Source: Small and Medium Enterprise Agency

When financial institutions were asked what would assist the development of a securitised market for SMEs, the suggestions in Figure 21 were offered.[45]

[43] Small and Medium Enterprise Agency, "The Report of the Study Group of New Financing Methods of SMEs" (25 July, 2006), p38 (in Japanese).
[44] *Id,* p39 (in Japanese).
[45] *Supra* note 43, at p. 39 (in Japanese).

There remain issues, both on the part of SMEs and also financial institutions that are hampering the use of securitisation. On the other hand, the causes can be resolved. Thus, securitisation is likely to become an increasingly important method of financing SMEs.

Credit guarantees are where the government guarantees loans so as to encourage SME financing by private financial institutions. The level of guarantee should reflect the credit and default risk of the SME concerned. This could be based on credit scoring information.

In the US, the Surety Bond Guarantee (SBG) program of the Small Business Administration (SBA) guarantees up to 90% of a surety's loss. Participants must obtain SBA's approval for each bond guarantee issued. Under the Preferred Surety Bond (PSB) program, sureties receive a 70% guarantee and are empowered to issue, service, and monitor bonds without SBA's prior approval. There is a move in Japan to develop more partial guarantees like the US so as to share the risk of SME financing and prevent the moral hazard stemming from a 100% guarantee.

V The Relation between Regulation and Competitiveness

When considering the nexus of regulation and competitiveness, there needs to be a cushion of ‘competition’ between to make a beneficial analysis. In other words, regulation that affects competitiveness – competition – will need to be analysed first.

Regulations that affect competitiveness are those that affect the conditions of perfect competition, such as exit and entry into the market, homogeneous goods or services, perfect and complete information, and equal access to technology. Financial services are well known for their information asymmetry and licensing that restricts competition. When regulations obstruct competition too much, then the competitiveness of a financial institution might be compromised.

The regulatory structure affects the competitiveness of financial institutions when market signals are distorted. Government activity will generally affect competitiveness through the institutional framework, infrastructure development, legislation, and compliance with international standards. The institutional framework addresses both the procedural aspect and policy direction of the regulatory system.

Surveys such as the *World Competitiveness Yearbook* and the World Bank’s *Doing Business* in 2006[46] provide a useful guideline as to what government activities affect business activities. Both reports include a number of factors that need to be addressed by the government. The *World Competitiveness Yearbook* requests:[47]

- Institutional framework (central bank and state efficiency)
- Business legislation (openness, competition and regulations, and labour regulations)

The World Bank report also includes many government procedures which would affect businesses and thus competitiveness:[48]

- Starting a business (time and cost of approval, and paid-in capital)
- Dealing with licenses (procedures for approval of new products)
- Hiring and firing workers (rigidity of employment, hiring and firing costs)
- Getting credit (legal rights, depth of credit information index)
- Protecting investors (disclosure, director liability, ease of instigating shareholder suit, strength of investor protection)
- Enforcing contracts (procedures, time, and cost)
- Closing a business (time, cost, and recovery rate)

While these indicators are developed for general corporations, they are applicable to

[46] World Bank, *Doing Business in 2006* (2006).
[47] IMD, *World Competitiveness Yearbook 2006*, Criteria and Factors of Government Efficiency.
[48] World Bank, *supra* note 46, pp77-89.

financial institutions as well. The better accommodating they are to business, the more likely the competitive gains are to businesses. Competitiveness does not directly necessitate measures be available for financial difficulty or investor protection, but such availability is strongly implied, especially for internationally active corporations.

Applying these criteria to financial institutions, they can be translated into the following regulatory structure that supports competitiveness:

- International standards: the regulatory structure should follow international standards in so far as appropriate and especially the specific items mentioned below.
- Licensing: clear requirements and a decision-making timeframe available for obtaining a license.
- Capital requirement: following the Basel Capital Accord and Basel Core Principles in so far as possible.
- Policy: gradually sequencing the effective liberalisation of the financial market.
- Regulations in general: following international standards with clear procedures, disclosure of the decision-making process and 'no action letters'; action is taken when non-compliance is detected and financial institutions are appropriately penalised.
- Developing infrastructure such as payment/settlement systems, credit information databases, execution system for financial and capital markets, and legislation that is appropriate; this may need to be initially developed by the public sector and eventually sold off to the private sector.
- Supervision: ensuring that timely supervision is carried out to check internal procedures, book keeping, and management; off-site monitoring is carried out by means of periodic call reports.
- Safety net: safety nets are available for bona fide investors but with criteria that limits moral hazard.
- Investor protection: investors require avenues to address inappropriate advice or unlawful behaviour on the part of financial institutions.
- Rescue procedure: measures are available for banks that are solvent but facing difficulty in restructuring.

Regulations that are lax may cause regulatory arbitrage, attracting financial institutions to the financial market, but this in turn may create morally hazardous behaviour on the part of financial institutions. It is necessary to balance liberalisation with appropriate safeguards to maintain a certain level of prudence within the financial system. This will in turn lead to greater competitiveness of financial institutions.

It is important to bear in mind that the financial sector is very different from other industries. This stems from the nature of bank deposits that can cause a bank run if a bank's insolvency is suspected. Banks will not have the funds to pay back depositors if many depositors demand their money at once due to the fractional reserve system of banks. Thus not all financial institutions have to be as well regulated as banks. Securities firms and insurance companies do not use funds as banks do and their difficulties would not translate into systemic risk, at least not initially.

Another aspect may be consideration of the regulatory cost to the financial industry. In order to effect regulation whose costs are justified, most advanced financial regulators have a mandate to only pursue regulation that is the least-cost solution. This not only rationalises regulation but also prevents unnecessary regulation. Japan does not have this objective in place vis-à-vis regulation, which means that regulation is not formulated on this principle. If the regulatory cost is too high, the burden could have an effect on the operation of financial institutions which would further impact competitiveness to a certain extent.

Conclusion

Competitiveness is a somewhat opaque concept with many facets. Its importance to the industry is undeniable although the actual content is elastic. Competitiveness is a well used term when discussing the financial services sector, but its definition has never been precisely determined.

To measure the competitiveness of financial institutions, there are a number of benchmarks that can be considered. These are both quantitative and qualitative, encompassing a variety of factors that would determine the long-term well-being of a financial institution. There is no one item that would improve competitiveness, which is essentially the consequence of financial institutions pursuing a myriad of business efforts.

While consolidation of financial institutions may improve their capacity, it does not necessarily strengthen their ability. It is essential that financial institutions carefully take into consideration the various parameters of competitiveness and carve out their own comparative advantage. Unless specialisation can be cultivated it is not possible for financial institutions to gain competitiveness by merely expanding their size.

Another facet of competitiveness is that it requires a minimal level of competition to exist within the financial system. Competitiveness is an empty word if competition is limited and entrepreneurship is not rewarded by growth. Nevertheless, perfect competition is neither suitable nor possible to achieve. Balancing the need for competition and that of the economy will become imperative for financial institutions to attain competitiveness. Entry by foreign banks needs to be contemplated in this context, ascertaining what sequence and content would maximise welfare overall.

Learning from the experiences of other countries will be important in trying to avoid the pitfalls of expanding financial institutions. Grasping the avenues of financing for each level of risk will be an important precursor to understanding where competitiveness can be gained. If a country depends on direct financing for financial intermediation, new products can be sold, but if it depends on banks for funding, there is a need to create products that can satisfy diverse risk appetites.

Many Japanese banks have failed over the past decade. Prior to that, Japan had a ‘no bank failure’ rule, which in the worst scenario allowed banks to be taken over, and regulation that severely limited competition. This resulted in banks’ mounting non-performing loans and limited international competitiveness. Banks did not carry out a strategic rethink of management that would be viable in the long run.

Financial institutions need to develop expertise in areas where they have an advantage and to embrace innovative ideas, all the while giving careful thought to the risk spectrum and developing products according to their risk appetite and strategy.

In this context, SME financing is an area often neglected due to the cost intensive nature of the business. On the other hand, it is an ideal area that can be developed successfully to gain a comparative advantage in. SME financing is also essential in that it provides the bulk of employment in most Asian countries. By developing SMEs, financial institutions could also grow and simultaneously create employment.

The lending techniques involved in SME financing were also contemplated in this study, with several new methods considered. By combining conventional methods of financing, SMEs could be catered for much better, improving economic performance as well.

Regulation will affect competition if it alters the way in which financial institutions react to competitive criteria. Government interference can affect these parameters leading to limited competition. It is thus essential that the government considers to what extent markets will be open and how this will be achieved. Without reference to an overall policy, the government may be intervening unnecessarily to the detriment of the economy.

Competitiveness needs to be contemplated in the framework of the financial system and balanced with the various interests of the economy. Expertise in areas where a financial institution has a comparative advantage should be developed to extend growth further. Competitiveness should be viewed as a dynamic concept that changes according to the stage of economic development and government policy.

Appendix

Discussion on International Competitiveness

A. Competitiveness of a Nation

Competitiveness has been defined by some leading international institutions and academics. To obtain an idea of the breadth, some are cited below:

OECD[1]

"As a starting point, competitiveness for a nation will be defined as the degree to which it can produce goods and services that meet the test of international markets, while simultaneously maintaining and expanding the real income of its citizens."

From Jose Maria Fanelli & Rohinton Medhora[2]

Competitiveness is defined as "an economy's ability to grow and to raise the general living standards of its population in a reasonably open trading environment without being constrained by balance of payment difficulties."[3]

World Bank, *Competitiveness and Development*[4]

"Competitiveness implies elements of productivity, efficiency and profitability. But it is not an end in itself or a target. It is a powerful means to achieve rising living standards and increasing social welfare – a tool for achieving targets."

IMD, *World Competitiveness Yearbook*[5]

Competitiveness analyses how nations and enterprises manage the totality of their competencies to achieve prosperity or profit.

Considering the definitions above, the following points are included in competitiveness:

- an element of growth and rise in living standards
- to achieve growth, productivity, efficiency, profitability, and stretching of competencies.

Growth can be represented by parameters such as real income, trade, investment, and employment. While these are indices of the national economy, the second element applies to

[1] Jan Maarten de Vet, "Striving for International Competitiveness: Lessons from Electronics for Developing Countries" March 1993 (OECD Development Centre Working Paper No 84), p15

[2] Jose Maria Fanelli & Rohinton Medhora, "Finance and Competitiveness: Framework and Synthesis" in *Finance and Competitiveness in Developing Countries* (International Development Research Centre, Canada).

[3] I Haque, "Trade, Technology, and International Competitiveness" World Bank (1995).

[4] Competitiveness Advisory Group to the President of the European Commission, June 1995.

[5] Stephane Garelli, "Competitiveness of Nations: The Fundamentals" (IMD Competitiveness Yearbook 2006).

firm level activity. Factors such as productivity and efficiency are not only realised through efforts that can be quantified, but also qualitative endeavours such as societal framework, management practices, and attitudes and values.[6]

In tandem with the above analysis and according to the research methodology of the *World Competitiveness Yearbook*, factors influencing competitiveness can be divided into four elements:[7]

- economic performance
- government efficiency
- business efficiency
- infrastructure

These elements comprise a number of factors that account for national competitiveness, including policy level input from the government.

For competitiveness to exist there must be a foundation of effective competition. Unless there is scope to innovate and overtake an underperforming firm/industry/system, competitiveness cannot be nurtured. In an over-protective regulatory environment, or monopolistic market, competitiveness is meaningless.

B. Competitiveness of the Financial System

Competitiveness has a national and firm level output. When measures to deal with financial difficulty are considered, they need to be discussed within the context of either systemic issues or individual firm level insolvency.[8] Competitiveness bears the same taxonomy in that it needs to be considered from both the financial system level and financial institution level to comprehend the implications for each.

Competitiveness of the financial system will crucially depend on the aggregation of individual firm activity, which is reviewed below. Besides the operation of individual financial institutions, elements that affect the international competitiveness of the financial system are the regulatory environment and tax regime.

It is thought that protective measures by the government do not assist the development of competitiveness in the long term. Competitiveness is nurtured through competition and it is generally accepted that the more competition there is, the more competitive a system becomes. This is an oversimplification, as there are occasions when competition can be harmful such as in the case of market failure. However, the benefits of competition are being increasingly recognised worldwide.

So long as the basic threshold for prudential supervision is ensured, as laid out in the Basel Core Principles, there is scope for greater competition within the financial system. Thus, some of the regulatory measures which may have an impact on the competitiveness of the

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6 *Id.*
7 *World Competitiveness Yearbook*, Methodology in a Nutshell.
8 Mamiko Yokoi-Arai, *Financial Stability Issues: The Case of East Asia* (Kluwer, 2001), chapter 2.

financial system are as follows:[9]

- Licensing and exit regime: unless appropriate entrance and exit procedures from the financial market are possible, there will be no effective competition
- Regulatory capital: a too burdensome or complex regime
- Regulatory burden: when the burden on financial institutions to comply with financial regulations is too heavy, this may be detrimental to the competitiveness of the financial system and may lead to regulatory arbitrage

Nevertheless, in the case where a financial system is in the process of liberalisation and relatively closed, competitiveness can be measured by maximisation of market share and branches.

The Corporation of London has been carrying out a survey of competitive factors for financial centres. It should be noted that these are factors considered imperative for a 'financial centre' and not a financial system. The survey looks to investigate factors that attract financial institutions and investors to the financial market to invest and establish themselves. A financial centre has a hub-like nature and is the centre of finance regionally or globally. The most important competitive factors for financial centres are listed in descending order below:[10]

Factor of competitiveness	Rank	Average score
Availability of skilled personnel	1	5.37
Regulatory environment	2	5.16
Access to international financial markets	3	5.08
Availability of business infrastructure	4	5.01
Access to customers	5	4.90
A fair and just business environment	6	4.67
Government responsiveness	7	4.61
Corporate tax regime	8	4.47
Operational costs	9	4.38
Access to suppliers of professional services	10	4.33
Quality of life	11	4.30
Cultural & language	12	4.28
Quality/availability of commercial property	13	4.04
Personal tax regime	14	3.89

Some factors may not be appropriate for considering the competitiveness of a financial system, such as quality of life, and availability of commercial property. However, many of the other factors are essential for a financial system to gain competitiveness.

[9] See *supra* section IV for a discussion on this theme.
[10] Z/Yen Ltd for the Corporation of London, *The Competitive Position of London as a Global Financial Centre* (November 2005).

Financial Research and Training Center
Financial Services Agency

3-1-1 Kasumigaseki, Chiyoda-ku, Tokyo 100-8967
Japan

Tel. 03-3506-6000 (ext 3293)
Fax. 03-5251-2849
URL. http://www.fsa.go.jp/frtc/index.html