GLOBAL BANKING TRENDS IMPROVING

Banks throughout the world are seeing increased profitability, strengthened asset quality, and built-up capital bases. Better profits no doubt reflect an improving economic climate, but also can be attributed to keener management as expenses are kept in check and the quality of loans booked enhanced.

The overall financial strength of banks, as measured by asset quality and capital ratios, also has improved, with the exception of Japan, where many banks are still laboring under a mountain of poor debt.

In the U.S., the banking system is undergoing consolidation and restructuring due in part to regulatory changes. American banks have made a strong recovery from the late 1980s and early 1990s thanks to a favorable interest-rate environment, recovering economy, and their ability to exploit profitable new financial products such as derivatives. They also have made productivity gains by cutting staff and investing in new technology.

In Europe, the outlook is also brighter, even in Scandinavia, where banks were rescued at a huge cost to the public. The much-awaited consolidation of the Italian banking system is finally taking place. And the process of bank privatization continues, with Italy and France leading the way.

CHALLENGES IN DEVELOPED COUNTRIES

In the longer run, however, banks worldwide, but particularly in developed countries, face several challenges that could make their life more difficult. One problem, disintermediation, is at a more advanced stage in the U.S., but is beginning to affect banks in Europe and Asia too. Banks, which traditionally take deposits from savers and make loans to users of capital, have both come under increasing attack from other providers of financial services. In some countries, such as the U.S., mutual funds have taken a good chunk of savers' money, and corporations depend less on bank loans, instead going directly to the financial markets for their capital needs.

Consequently, banks have come to rely on other sources of revenue, such as trading and private banking, some of which, including trading, are highly cyclical and susceptible to interest-rate changes.

Finally, banks face an uncertain regulatory climate. A number of their new products, including derivatives, have come under increased scrutiny by national and international regulators. And international regulators are working on new capital rules to be applied to currency and securities trading.

U.S. RECOVERY DRIVES RATINGS

Recovery of the U.S. banking industry has driven rating activity over the last couple of years, according to Tanya Azarchs, a director in S&P's Financial Institutions Dept. As asset-quality problems have diminished and capital levels replenished, ratings of some low investment-grade and noninvestment-grade banks have been raised, and several larger bank holding companies have moved into the 'A' category. "While selected upgrades are possible over the next year, enough concerns are mounting that downgrades are also beginning to be a possibility," Ms. Azarchs said.

"American banks' improved performance over the last couple of years can be sustained only if they are able to capture new business," Ms. Azarchs emphasized. Much of the strength in earnings reported by U.S. banks reflected a favorable interest-rate environment. This has changed, as the Federal Reserve raised rates in 1994.

Large money-center and regional banks have come to rely on off-balance-sheet activities such as interest rate and currency swaps and trading to prop up their revenues and earnings.

Ms. Azarchs noted that trading is a highly cyclical business, as the sharp drop in revenue in 1994 bore out. "While cost-saving initiatives continue to be announced, this can't go on forever because at some point cuts could result in under-investment in the business. There will have to be some recovery of the intermediation business to support profitability in the longer term," Ms. Azarchs said. She was not optimistic that banks would be able to do so. Noting, for example, that they have pretty much lost much of the student loan business to the federal government and commercial real estate lending to the capital markets.

In addition, competitive pressures are mounting in the credit card business, on which many banks depend heavily, and in corporate lending.

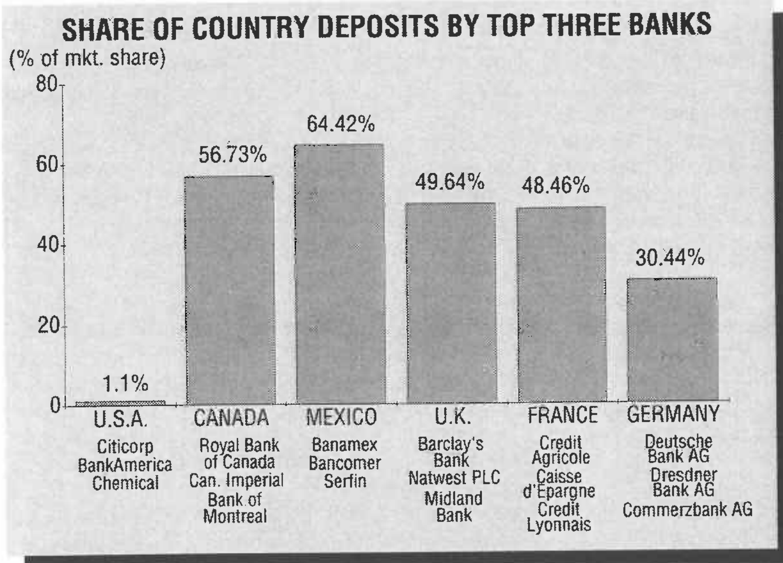
"On the positive side," Ms. Azarchs said, "the barriers between commercial and investment banking continue to fall, so that the handful of commercial banks with investment-banking ambitions will be freer to develop that line of business." In addition, in its 1994 session, the U.S. Congress removed federal legislative impediments to interstate banking. "The much needed consolidation of the U.S. banking sector should get a boost as a result," Ms. Azarchs concluded.

Merger and acquisition activity should continue apace, Ms. Azarchs indicated, as banks faced with limited ability to grow internally look to acquire competitors. "On balance, given the banking industry's challenges, consolidation makes sense," she said "particularly when an acquisition bolsters a bank's competitive position by enlarging its share of its home market; or strengthens its position in a particular business; or gives it a sound position in a new market or business."

EUROPE SLOWS PACE OF DISINTERMEDIATION

With a long tradition of universal banking, continental European banks, have not suffered

from the effects of financial disintermediation to the same extent as have their American and British colleagues. Total credit held in the banking systems of Germany, Italy, Spain, and Scandinavia has remained high. Moreover, in addition to owning large stakes in industrial companies, most of them are allowed to engage in investment banking and can sell other financial services, such as insurance. Consequently, the size and power of the large universal banks has slowed the pace of disintermediation, as few nonbank competitors have been willing or able to challenge them.



On the other hand, the absence of strong competition in these countries has impeded the development of capital markets and helps explain why continental European bankers have been hesitant to adopt new products such as securitization.

Additionally, banks have failed to take advantage of the new single European market. Since 1993, all banks registered in the European Union have been free to set up branches throughout Europe. Few have chosen to do so, mainly due to the substantial costs involved. Stephen Long, a director in S&P's International Finance Dept., suggested that the growing integration of European economies eventually will require successful banks to either be very strong in their home region or have a European network. "To date most have emphasized the former," Mr. Long noted, "with consolidation of banking sectors in Spain, Italy, Portugal, the Netherlands, and Scandinavia the result."

On a more positive note, the short-term outlook for European banks has improved as economic growth picked up throughout Europe in 1994 and banks began to make a serious dent in cleaning up their balance sheets. As a result, European bank ratings stabilized in 1994.

"Over the longer run, however, European banks face structural challenges that could impede their growth and cause ratings to drift downward," Mr. Long cautioned. "These include the fact that Europe is over-banked, costs are very high and not easy to bring down given protective labor laws, and financial margins tend to be thin compared with the U.S. and U.K."

GERMAN BANKS REGAIN FOOTING

In Germany, banks traditionally have played an extremely important role in the economy, in part through being large shareholders in industrial enterprises. And despite recent setbacks with property developer Juergen Schneider and the large conglomerate Metallgesellschaft, German banks are regaining their self-confidence and do not appear to have been badly damaged by their recent problems. "All of the large German banks, including the Big Five universals, had strong profit gains in 1993 and fared decently in 1994 despite financial market turmoil," Michael Zlotnik, an associate director in S&P's International Finance Dept. said.

Although disintermediation has been slow to take hold in Germany, it has been happening. Money market funds, for example, were free to set up shop in Germany as of August 1994. While this will certainly have negative implications for the funding costs of German banks over the medium term, it also offers opportunities. The banks also are expanding their investment banking and other noninterest income-related activities.

DIFFICULT CONDITIONS IN FRANCE

The situation is not as sanguine for French banks, Stephen Long indicated. Their ratings continue to be subjected to downward pressure even though four of them were downgraded in 1994. "Lingering problems in the commercial real estate sector contributed to the downgrades. And in the case of the three large public sector banks, the expectation that they would probably be, or already have been, privatized, thereby losing a good part of their government support, also was a factor." Mr. Long said. "As for the medium term," Mr. Long continued, "the outlook for French banks remains negative, even though the economy is emerging from recession. This reflects the likelihood of continued poor profitability due in large part to narrow interest margins and revenue pressures resulting from weak credit demand and difficult conditions in the financial markets."

SPAIN'S TRANSFORMATION

Since the mid-1980s, Spain's banking system has changed dramatically. The number of large international banks is down to four from seven, as two big private-sector mergers have taken place and several state-run banks have been brought together to form the partially privatized Argentaria. In addition, financial markets have been reformed, exchange controls lifted, regulatory restrictions eased, barriers to foreign

banks eliminated, and fixed-interest rates forsaken.

Spanish banks also are beginning to feel competitive pressure from nonbank financial institutions. On the deposit side, there has been a growth in bond mutual funds in the last couple of years as retail customers, who have in the past left their money with banks, seek alternative investment opportunities. This development has been encouraged by tax breaks as federal and state governments look for ways to finance the public-sector deficit. On the lending side, companies are beginning to rely more on capital markets.

The near collapse, subsequent rescue, and sale of Spain's fifth-largest bank, Banesto, to its fourth, Banco Santander, was the low point in a series of Spanish banking crises. The situation at Banesto, however, was handled swiftly—the Bank of Spain's intervention took place in late December 1993, and the sale of the restructured Banesto was finalized in April 1994 and had little impact on the confidence of the Spanish banking system. Also, asset quality at most Spanish banks came under significant pressure during this period, but the worst appears to be over.

BRITISH COMPETITIVE OUTLOOK GOOD

"British banks have benefited from a recovering economy and falling bad debt to post strong earnings the last couple of years after a difficult patch," Barry Hancock, a director in S&P's International Finance Dept., indicated. "Earnings growth over the last year or so is due also to a steady increase in noninterest income," Mr. Hancock added. Much of that is derived from fees and commissions related to traditional banking services. However, a growing portion came from trading profits. Like U.S. banks, this may not remain a dependable source of income as market conditions change.

"In the longer run, the large British banks' strong capitalization and ability to compete globally with the full-service financial institutions of Europe, Japan, and the U.S. bodes well for them," Mr. Hancock concluded.

SCANDINAVIA EMERGING FROM CRISIS

Scandinavia's battered banks appear to be emerging from the region's worst banking crisis since the war, according to John Gibling, an associate director in S&P's International Finance Dept. The crisis, which affected the banks of Norway, Sweden, and Finland most severely, is estimated to have cost the taxpayers upwards of $20 billion.

In Norway, where the crisis first hit, the three largest banks were rescued from insolvency by the government. Two are currently state owned, while the third is partially state owned. Two of the four largest banks in Sweden had to be bailed out and taken over by the government, while in Finland every bank received some state support and two were nationalized.

"There is," Mr. Gibling said, "clear evidence emerging of a turnaround. During the past year, asset quality improved as the level of nonperforming loans decreased. In addition, profitability has returned, and some of the banks have been able to tap the markets to build up their capital bases." On the other hand, Mr. Gibling noted, many of the banks will be burdened by credit losses for several years, and they remain vulnerable to an unexpected downturn in the region's economy.

DOWNGRADES LESS LIKELY IN JAPAN

Although the operating environment for financial institutions showed some signs of improvement in 1994, Japanese banks continued to be plagued by a weak economy and poor asset quality, which lead to several downgrades, according to Ernest Napier, a director in S&P's Financial Institutions Dept. All of the large banks reported a sharp fall in pretax profits from the previous year as a result of heavy provisioning for bad debts. He noted, however, that future downgrades are less likely now that the extent of the problem is known—S&P has estimated that the total amount of nonperforming assets for the 23 banks it rates, excluding the Norinchukin Bank, is between $285 billion-$335 billion.

"Further comfort can be taken from the fact that the rate of increase for new problem loans has declined sharply and that banks are writing off loans at a much faster pace," Mr. Napier added. "Regulators have helped the process along by giving banks more flexibility to write-off and reserve against their problem loans. On the other hand, with no significant rebound in profitability expected in the near term, and the equity market likely to remain closed, it will take the Japanese banks several years to clean up their balance sheets. As a result, the outlook for most Japanese banks remains negative."

The amount of time needed to resolve asset-quality problems will vary by institution and type of institution, Mr. Napier said. This is in part due to the fact that the earnings generation capability of the trust banks and long-term credit banks is not as great as that of their city bank counterparts. In addition, the trust banks and the long-term credit banks have more problem loans as a percentage of total assets. This reflects, in part, their traditional role as major lenders to the real estate, construction, and nonbank financial industries.

"In the longer term, a growing weakness in the banks' underlying performance is also a cause for concern," Mr. Napier added. "Several years of weak loan demand and a drop in profits from foreign exchange and bond trading this year have caused banks to focus on shoring up their core businesses, in addition to thinking about new business opportunities."

"On a more positive note," Mr. Napier said, "several Japanese banks have established broking subsidiaries, and others are expected to fol- ▶

low." Though banks are prohibited from trading equities, they have begun to grab some of the Big Four brokerage firms' underwriting activity."

On the regulatory front, interest rates on bank deposit accounts were liberalized, completing a process of interest-rate deregulation started 15 years ago. Banks now are allowed to compete for deposits, which may result in a significant increase in funding costs. Also, late in 1994, five city banks were given investment management licenses.

Japanese bank ratings
As of Dec. 1994

Issuer	Long-term/short-term ratings	Outlooks
City banks		
Asahi Bank Ltd.	A-/A-2	Negative
Dai-Ichi Kangyo Bank Ltd.	A+/A-1	Negative
Daiwa Bank Ltd.	A-/A-2	Negative
Fuji Bank Ltd.	A+/A-1	Negative
Hokkaido Takushoku Bank Ltd.	N.R./A-3	N.M.
Mitsubishi Bank Ltd.	AA-/A-1+	CW-Negative
Sakura Bank Ltd.	A/A-1	Negative
Sanwa Bank Ltd.	AA-/A-1+	Negative
Sumitomo Bank Ltd.	A+/A-1	Stable
Tokai Bank Ltd.	A-/A-2	Negative
Bank of Tokyo Ltd.	A+/A-1	Stable
Norinchukin Bank	AA+/A-1+	Negative
Trust banks		
Mitsubishi Trust & Banking Corp.	A-/A-2	Negative
Mitsui Trust & Banking Co. Ltd.	BBB+/A-2	Negative
Sumitomo Trust & Banking Co. Ltd.	A-/A-2	Negative
Yasuda Trust & Banking Co. Ltd.	BBB/A-3	Negative
Long-term banks		
Industrial Bank of Japan Ltd.	A+/A-1	Stable
Long-Term Credit Bank Ltd.	A-/A-2	Stable
Regional banks		
Ashikaga Bank Ltd.	BBB+/A-2	Negative
Chiba Bank Ltd.	A-/A-2	Negative
Gunma Bank Ltd.	A+/A-1	Negative
Hokuriku Bank Ltd.	N.R./A-2	N.M.
Joyo Bank Ltd.	A+/A-1	Negative
Shizuoka Bank Ltd.	AA-/A-1+	Negative

N.R.—Not rated. N.M.—Not meaningful.

ASIA'S PROMISE AMONG EMERGING MARKETS

The adoption of free-market economic policies, including deregulation and privatization, by many of the emerging countries of Asia, Latin America, and Central Europe has created tremendous opportunities, as well as risks, for banks in those regions.

In Asia, banking systems that have long been dominated by governments are being deregulated, according to Graeme Lee, a director in S&P's International Finance Dept. Governments have intervened in the past either by owning banks directly, such as in India and Indonesia, or by steering private-sector banks' lending decisions, such as in South Korea and Thailand.

Deregulation has taken several forms. In India and Taiwan, new banking licenses are being granted. And in Malaysia, Indonesia, Thailand, and South Korea, interest rates have been liberalized. Also, some countries that have hitherto prevented foreign competition are opening their borders. "Governments in the more developed countries of the region recognize that future economic growth will be enhanced by a more efficient allocation of credit, which freer markets will facilitate," Mr. Lee said.

Like their American and European colleagues, Asian banks also are beginning to feel the competitive pressures of disintermediation, according to Mr. Lee. More companies in Asia are borrowing directly from the capital markets through bond issuance. And the region's stock markets, by attracting investors from throughout the world, also are becoming a cost-effective way for companies to raise capital.

"Yet the prospects for Asia's banks remain quite good," Mr. Lee emphasized. Because Asian economies are expected to continue to grow rapidly, the demand for capital will expand as new borrowers surface. And as the living standards of the region's people increase, so will their savings and need for more sophisticated financial products. In addition, the development of domestic stock and bond markets will provide business opportunities for banks in countries such as Malaysia and Singapore that allow commercial banks to engage in investment banking activities.

MORE STABILITY IN LATIN AMERICA

Greater economic and political stability, privatization programs, and the return of expatriate funds have ushered in a period of growth as well as new opportunities for Latin American banks. Economic reforms have brought rampant inflation under control, and political stability has made the region a magnet for foreign investment—both big pluses for Latin banks. However, financial institutions throughout the region will need to cut costs, increase their client bases, and diversify their activities to continue to do well.

Although it continues to be burdened by problems left over from the 1980s banking crisis, the Chilean banking system still is considered the strongest of those in major Latin American nations, according to Mr. Chambers. This is due to the system's rigorous supervision, good overall asset quality, increasing sophistication, and history of systemic support.

In Colombia, reforms that allow banks to engage in commercial banking, the privatization of four, and robust economic growth has strengthened the banking system. "Compared with other Latin American countries, Colombia's banking sector is stronger than that of Argentina and Venezuela, however, it is weaker than Chile's and Mexico's," Mr. Chambers said.

Brazil's banking sector is suffering from the poor performance of government-owned banks—six large national banks and 24 banks controlled by state governments. Nonperforming assets are thought to be quite high. Several state banks were rescued by the central government in the fall of 1994, and a few others are believed to be in trouble. In addition to asset-quality problems, Brazil's public sector banks

also are weighed down by bloated payrolls and an overextended branch network.

Alternatively, Brazil's private-sector banks are the most efficient in Latin America, according to Mr. Chambers. They have pared back staff and improved productivity the last couple of years. "Although the economic situation in Brazil is still a bit shaky, because they are well managed, generally profitable, and have a smaller amount of nonperforming assets, the country's private banks are well positioned to take advantage of recovery when it comes."

"Argentina's private-sector banks, which account for 25% of the loans in the banking system, have survived, and some are beginning to thrive, despite a decade-plus of turmoil," Mr. Chambers said. Argentina's economic and political rebirth has helped. Mr. Chambers expects that consolidation will take place among private-sector banks over the next few years, even as they enjoy excellent growth prospects.

CENTRAL EUROPE'S EMERGENCE A STRUGGLE

In Central Europe, banks are still struggling to adapt to freer markets. Hungary, Poland, and the Czech Republic, which have been at the forefront of the drive to replace central planning with market economies, have had mixed results in their attempt to create efficient banking systems. In 1990, the government of the Czech Republic purchased a substantial part commercial banks' bad debt and subsequently sold them off as part of the country's privatization program. Czech banks are in relatively good shape, although their level of bad debts remains high compared with other banking systems.

The Polish government took a somewhat different approach to dealing with the country's nine state-owned and 80 private banks. The private banks, which accounted for 10% of Polish bank assets, had more problems than their state-owned counterparts—about 25% were thought to be insolvent. Some were recapitalized, while others were forced to merge with a state-owned bank.

Meanwhile, the two healthiest state-owned banks were privatized without the government taking bad loans off their balance sheets. The remaining seven were recapitalized, but were required to come up with programs to deal with their problem loans.

In Hungary, the government has spent over $3 billion bailing out banks, yet has made little progress in reforming the country's banking system. Almost all the biggest banks are still state owned, only the Foreign Trade Bank has been partially privatized, and there are no plans to sell off the others except for Budapest Bank.

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