Karmen Thompson

Asian banking: After the storm

Asia's economic crisis is driving a deep, rapid restructuring of the region's banking industry. Until now, most Asian banks have been protected from aggressive competition. But the crisis has exploded this sheltered world, forcing local banks and regulators to restructure and recapitalize. Changes that would have taken a decade to accomplish will be compressed into the next two to three years, and aggressive players have a historic opportunity to leapfrog established leaders.

Until July 1997, change came slowly. Although local regulators and banks knew that restructuring was needed, they thought it was best achieved gradually. This slowness is understandable: the "tiger" economies were booming, and Asian banks were among the prime beneficiaries, enjoying years of uninterrupted, accelerating growth in credit.

But local banks – private and state-owned alike – cannot afford to tinker at the edges to meet the needs of the new era. Currency and market declines have sent nonperforming loans soaring, and this threatens to wipe out the capital of local banks. In Indonesia, South Korea, and Thailand, bad loans

exceed bank capital by some 300 percent. To make matters worse, as local equity and real-estate markets have crashed, collateral values have plummeted below the level required to cover outstanding loans. Bank stocks too have been severely hit. In this environment, most banks have failed to raise capital locally and have therefore been forced to look to governments and outside investors for a new lifeline.

At the very same moment, the International Monetary Fund and the World Bank are demanding structural changes. Left with little choice, most Asian governments have begun to reshape their banking industries by easing restrictions on foreign ownership, closing insolvent banks, and forcing the survivors to merge, restructure, and raise capital.

Where is the industry headed? Latin America's experience from 1995 to 1997 offers useful clues, since this region endured a currency and banking crisis similar in many respects to the present one. As in Asia, currency depreciation – in the Latin case, a sharp devaluation of the Mexican peso in late 1994 – precipitated a currency and banking crisis throughout the region. Nonperforming loans reached 38 percent of all loans in Mexico and 20 percent in Venezuela and Argentina, levels comparable to those now seen in Asia. Moreover, Latin America entered its crisis with relatively uncompetitive domestic banks and with foreign banks holding only a small share of the market.

In 1990, the four largest banks in Argentina and the four largest banks in Venezuela were owned either by local private interests or by their respective governments. Foreign banks controlled less than 5 percent of assets in each country. In the years following the crisis, local banking sectors in

Latin America consolidated rapidly while foreign market share soared. The turmoil created a window of opportunity, lasting no more than three years, when a few marginal players built themselves into regional powerhouses.

In Argentina and Venezuela, governments realized that a sound banking system was needed for sustained economic growth. The recovery involved efforts to upgrade the skills and the risk management practices of local banking systems by redesigning them and opening them to more intense foreign competition. Foreigners were permitted to invest in local financial institutions, and by 1997 they controlled many of the largest banks both in Argentina and Venezuela, where they held 55 percent and 45 percent of total banking assets, respectively.

If Asia follows the same pattern, any bank with serious regional leadership aspirations must urgently consider whether and how to enter the merger and acquisition market. Yet many challenges stand in the way of successful bank acquisitions in Asia today. We address these issues in "Bank M&A: Historic opportunities, but not for the fainthearted."

Local banks must respond to their immediate financial difficulties and then grapple with a much more demanding customer base and more open markets. What are the major challenges for Asian banks? How should boards and management teams try to build winners in the reformed Asian markets? Read "Rebuilding the banks," the second article in this section.

Bank M&A: Historic opportunities, but not for the fainthearted

Nicolas Leung, Jean-Marc Poullet, and Timothy Shavers

The long-awaited M&A boom is coming, and it will reshape the competitive landscapes of Asian banking ◆ The boldest and best players can emerge as winners, but only if they overcome the unique challenges of M&A in postcrisis Asia

Most observers believed that a crisis-driven boom in Asian bank mergers and acquisitions would start in 1998. They were wrong: in the nine key markets of emerging East Asia – China, Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan, and Thailand – private-sector bank M&A remained roughly flat in 1998, at around $5.6 billion. That is comparable to the levels of 1996, before the crisis.

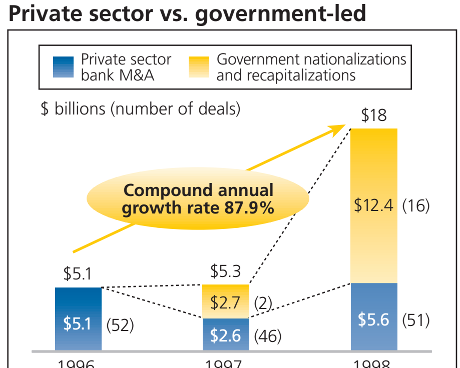
Yet the forces driving this merger boom that never came didn't go away; they intensified. The M&A boom is already starting, and over the next two years it will hit with a vengeance. By the time this wave has passed, a third to a half of Asia's banks will either acquire other banks or be acquired by them. Every player in the region must consider the strategic implications of the changes that are about to occur. The boldest players will seize this brief window of opportunity to reshape Asia's banking industry and become the new leaders of what will probably be the world's fastest-growing financial services market over the next ten years.

Why bank M&A activity is about to surge

Local banks need capital, and they must turn to outside investors to find it. Nonperforming loans threaten to wipe out existing bank capital across most of Asia; in Indonesia, South Korea, and Thailand they are expected to peak at 300 to 500 percent of bank equity. At the same time, bank stocks have plummeted. Share prices (reckoned in US dollars) have declined by 80 percent or more in Indonesia, Malaysia, and Thailand and by 40 percent in Singapore and Taiwan. Local banks are now virtually shut out of capital markets: new debt and equity issues reached only $13.7 billion in 1998, less than 25 percent of the 1997 level. Despite repeated attempts, banks in some of the hardest-hit countries, including Indonesia and South Korea, have failed to raise substantial outside capital.

Exhibit

Trend in M&A activity: Private sector vs. government-led



Source: McKinsey Asian bank M&A database

Meanwhile, governments across Asia are forcing the pace of recapitalization and restructuring by adopting wide-ranging and aggressive programs, including measures to nationalize or close troubled banks, to establish management companies for bad assets, and to relax limits on foreign ownership. Nationalizations have soared from nothing in 1996 to $12.4 billion last year (*see* exhibit).

This activity is important in two ways. First, it shows that governments are serious about taking over banks that can't work out their problems quickly enough. Second, nationalized bank assets – which in 1997–98 totaled $15 billion – represent a massive "inventory" that will be sold off to private investors. The sales of Korea First Bank (to Newbridge Capital, a US buyout fund) and

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of SeoulBank (to HSBC) are but a first glimpse of what will become a giant wave of privatization activity over the next several years (Table 1).

Governments are further encouraging the inflow of capital by raising foreign ownership limits more dramatically and rapidly than ever before. Indonesia, South Korea, and Thailand have now joined Hong Kong in allowing 100 percent foreign ownership of local banks. Limits have been raised to 60 percent in the Philippines and to 50 percent in Taiwan; other countries will probably follow suit.

So the table is set for truly industry-transforming transactions. The most respected local banks are negotiating more flexibly than they did in the past. Just three years ago, many deals had to be structured as minority investments, but this approach is now much less common, involving only 11 percent of all agreements in 1998, while mergers of equals and asset purchases have suddenly assumed great importance. Would-be acquirers enjoy new flexibility in structuring deals and have a wider range of attractive partners to pursue (Table 2).

As a result, a number of regional and global banks have become active acquirers. Among Asian players, the Development Bank of Singapore (DBS), Singapore's largest bank, has so far been the most ambitious. In its home market, DBS merged with Singapore's Post Office Savings Bank to consolidate its domestic leadership position and to achieve the scale it requires to become a leading regional player. DBS has also been the most active bank acquirer across the region, taking control of banks in Hong Kong, Indonesia, the Philippines, and Thailand. Thanks to all this, DBS has

Table 1

Top nationalizations and privatization/recapitalization plans

Date	*Bank*	*Percent nationalized*	*Approx. cost to government $ million*	*Privatization/recapitalization plans*
February 1999	Siam Commercial Bank	30	520	To raise $1.5 billion pending central bank approval
October 1998	Bank Danamon (Indonesia)	95	3,315	To be sold back to original owners or privatized
October 1998	Krung Thai Bank (Thailand)	35	1,970	To be merged with two other Thai banks by September 1999 and then privatized
August 1998	Hanvit (Korea)	95	2,500	To be restructured and privatized
August 1998	Laem Thong Bank (Thailand)	100	450	To be merged with Radhanasin Bank and privatized in June 1999
February 1998	First Bangkok City Bank (Thailand)	100	960	To be merged with Krung Thai Bank by September 1999 and then privatized
February 1998	Siam City Bank (Thailand)	97	600	To be privatized in 2Q 1999
January 1998	Bangkok Metropolitan Bank (Thailand)	100	750	To be privatized in 2Q 1999
December 1997	Korea First Bank (Korea)	94	1,370	Sale of 51% to Newbridge for ~$560 million announced in December 1998
December 1997	SeoulBank (Korea)	94	1,370	Sale of 70% to HSBC for ~$900 million announced in February 1999

Source: McKinsey Asian bank M&A database; literature search

Table 2

Top private-sector transactions, July 1997–February 1999

	Date	Acquirer	Target	Percent	Value $ million
Domestic mergers to build scale and skill	February 1999	Bank of Commerce (Malaysia)	Bank Bumiputra	100	990
	July 1998	DBS Bank (Singapore)	Post Office Savings Bank	100	930
	June 1998	Keppel Bank (Singapore)	Tat Lee Bank	100	610
	July 1997	Tirtamas Group (Indonesia)	Bank Niaga	50	290
	September 1998	Hana Bank (Korea)	Boram Bank	100	260
	August 1998	Hanil Bank (Korea)	Commercial Bank of Korea	100	230
Cross-border M&A to obtain growth platforms	February 1999	HSBC (United Kingdom)	SeoulBank (Korea)	70	900
	December 1998	Newbridge (United States)	Korea First Bank (Korea)	51	560
	December 1998	DBS Bank (Singapore)	Kwong On Bank (Hong Kong)	65	450
	May 1998	Commerzbank (Germany)	Korea Exchange Bank	30	250
	November 1997	Chase Manhattan (United States)	Manhattan Card (Hong Kong)	46	250
	March 1998	ABN AMRO (Netherlands)	Bank of Asia (Thailand)	75	180

Source: McKinsey Asian bank M&A database; literature search

emerged as Southeast Asia's biggest bank, with about $70 billion in assets and the stated goal of building a pre-eminent regional franchise.

Table 3

Top cross-border acquirers to date

	Target	Country	Value $ million
DBS Bank	Kwong On Bank	Hong Kong	450
	Thai Danu Bank	Thailand	130
	Bank of Southeast Asia	Philippines	50
	Mitsubishi Buana Bank	Indonesia	50
ABN AMRO	HG Asia	Hong Kong	220
	Bank of Asia	Thailand	180
	Asia Securities Trading	Thailand	3
HSBC	SeoulBank	Korea	900

Source: McKinsey Asian bank M&A database; literature search

Meanwhile, several US and European banks are seizing the opportunity to acquire growth platforms across the region (Table 3). ABN AMRO, a leading example, has acquired Bank of Asia, Thailand's tenth-largest bank by assets before the acquisition (*see* text panel, on the next page), and intends to build on this platform to penetrate the top tier of Thai banks. Early results are encouraging. In the six months after the deal's announcement, Bank of Asia's market share doubled from an already substantial base, and its share price rose by 70 percent during a period of market decline.

These regional and global players are sparking an explosion in cross-border M&A. In 1996, the only such transactions of any significance involved Chinese and Malaysian conglomerates diversifying into banking and multinationals restructuring their Asian portfolios. But since the crisis hit, there have been 36 cross-border transactions in Asia; overall, this kind of activity has more than quadrupled, from $529 million in 1996 to $2.3 billion in 1998. Purchases by US and European banks have increased more than tenfold, from just $80 million in 1996 to more than $1.1 billion in 1998, and the level of activity in 1999 is already far ahead of last year's pace. And all this is merely the tip of the iceberg.

PUTTING IT ALL TOGETHER: ABN AMRO'S M&A PROGRAM

ABN AMRO is a leading example of a top multinational bank that has grown through acquisitions in Europe and the United States and now seeks to replicate this success in Asia. The bank's mergers and acquisitions program there exemplifies a number of successful strategies.

First, ABN AMRO took a programmatic approach. Its Asian acquisition program was launched and managed from its regional headquarters. Roles and responsibilities were well defined: the regional chief executive officer, for example, received authority to carry the ball up to the initial contact and expression-of-interest stage; thereafter, global headquarters participated in the key bidding and negotiating decisions. Clear commitments for capital, as well as targets for the number of acquisitions in each of the region's countries, were proposed and approved at the start of the program.

From the beginning, too, ABN AMRO examined a variety of targets in several markets, an approach that proved essential to the success of its program. The breadth of the effort demonstrated the extent of the bank's commitment to M&A in Asia and thus helped build internal support and excitement for what might otherwise have been regarded as a small-time initiative for an institution of ABN AMRO's size. Although the bank chose three priority markets, it was willing to consider the idea of strengthening its position in others as regional opportunities emerged.

Sound preparation was critical, as well. The preparatory phase of the project – including the development of seven criteria for acquisitions and a prescreening process – lasted four months and involved outside-in analysis of some 30 targets. Eventually 15 leading

Lessons from Latin America

Asia today has all the ingredients required for a great expansion of bank M&A. What will be its magnitude and impact? Latin America's experience after the financial turmoil of the mid-1990s offers clues about what will happen in Asia. In the wake of the 1994–95 Latin American banking crisis, it took more than two years for major foreign players to regain sufficient confidence in these local economies to start making deals to buy Latin banks and for mergers and acquisitions of banks by other banks to take off. July 1999 will mark the start of Asia's third year of crisis. Recent market activity and press coverage suggest that confidence in Asia is returning, setting the stage for an M&A boom.

Latin America offers three other powerful lessons for Asia. First, ambitious players can use M&A to leapfrog the old leaders. In Latin America, three multinational banks – Banco Santander, Banco Bilbao Vizcaya, and HSBC – used aggressive M&A programs to transform themselves into the region's leading bank franchises, with top positions in most key markets. They also adopted M&A models that fit their own distinctive strategies and gave them the ability to add value to their acquisitions (Table 4). These three banks ones were approached, and negotiations took place with 5.

Of the two transactions that eventually closed in Thailand, the more protracted involved upward of six months of negotiation. Many versions of the original deal structure were developed. Due diligence, involving 30 managers from local and regional headquarters, took a month and a half. Closing the deal required the repeated involvement of Thailand's central bank. Devising the elements of a "win-win" deal for the two parties forced them to secure regulatory waivers to eight statutes.

In ABN AMRO's purchase of Bank of Asia, a flexible deal structure provided for a third-year price adjustment that guaranteed ABN AMRO a positive return above its required return on investment under a wide range of market outcomes. The structure, which allowed the sellers to retain the possibility of an upside gain if their expectations of a market recovery proved correct, was the deciding factor in the choice of a buyer among several competing bids.

Finally, even before due diligence was completed, ABN AMRO started planning to capture synergies. It considered the idea of integrating some activities of its local branch into Bank of Asia, developed plans to cross-sell retail and corporate products, launched an aggressive deposit-gathering and interbank-funding campaign, identified opportunities for transferring skills, and chose executives to join Bank of Asia's management team.

It remains too early to say conclusively whether this deal will create value, but the course of the initial postacquisition integration effort suggests that the high estimates for synergies were justified. In this case, ABN AMRO has managed to establish itself as a future leader in a target market while Bank of Asia has gained the partner it needed to emerge from the current crisis as a market leader.

ABN AMRO's M&A program, and the deals closed to date, illustrate the market opportunities that it is possible for banks to capture in Asia today.

became crucial drivers of the Latin American bank M&A boom, as well as its most obvious beneficiaries.

Second, Latin America's local banking sectors consolidated rapidly. From 1994 to 1997, the number of financial institutions shrank by 32 percent, 14 percent, and 16 percent, respectively, in Argentina, Brazil, and Venezuela. The same pattern, apparent across Latin America, is beginning to emerge in Asia. Indonesia, for example, recently announced the nationalization of 7 banks and the closing of 38 others; the government's stated long-term goal is to reduce the number of banks from 237 to 30 or fewer. Similarly, in South Korea, 5 insolvent banks have been forced to merge with healthier ones, and the largest banks are rapidly consolidating to form a small top tier.

Third, foreign players greatly increased their share of Latin American markets. In Argentina, the proportion of local assets controlled by foreign banks increased from 15 percent in 1994 to 55 percent in 1997; over the same period, it rose from 8 percent to 40 percent in Venezuela and from 6 percent to 22 percent in Mexico. In Asia, this trend is most advanced in Thailand, where ABN AMRO, GE Capital, and DBS have acquired significant local

Table 4

M&A models that have worked in Asia and Latin America

Model	*Key examples*	*Key elements*
Extend global service delivery model into new markets	Banco Santander Citibank HSBC	Acquire 100% or option to acquire later Standardize service delivery model and rebrand Import own management
Build a portfolio of attractive banks	ABN AMRO Banco Bilbao Vizcaya DBS Bank	Acquire minority or controlling stakes, or option to take control over time Maintain existing brand and service delivery model Capitalize on local management Add value selectively
Build a diversified financial services portfolio	AIG GE Capital	Acquire wide range of assets and businesses opportunistically Create bulk of value through shrewd deal making

Source: McKinsey analysis

positions, and in South Korea, whose two leading banks have been sold to foreigners.

Overcoming the challenges

Banks hoping to succeed through aggressive M&A strategies must overcome a number of challenges. First among them is valuation: with asset prices extremely volatile and macroeconomic forecasting all but impossible, few buyers and sellers will agree easily on price. Most sellers, believing that current asset prices are unsustainably low, are going to seek prices that match what they paid or will allow them to cover their borrowings, which are often in US dollars. Many buyers, by contrast, believe that the current uncertain economic outlook justifies relatively low valuations, particularly in view of the paucity of good information and the inherent uncertainty about nonperforming loans and collateral recovery levels. Varying assumptions about these and other key factors within a range of realistic scenarios can produce 300 percent swings in a target bank's valuation.

Often, sellers ask for a price that is two to three times higher than the buyer is willing to pay. In one recent case in Indonesia, the seller refused to consider any price less than 20 times the institution's market value! Adding to the challenge is the fact that many potential sellers are third- or fourth-generation family owners, for whom businesses have more value than cash flows alone would suggest. Because of this "value perception gap" between buyer and seller, straightforward deal structures are not likely to succeed. More flexible and creative proposals are needed, perhaps including deferred-payment and price adjustment mechanisms, as well as evolutionary governance arrangements, in which the acquirer gains management control of the target gradually, giving the previous owners a highly visible continuing role in the business.

Would-be acquirers must also recognize that key government officials are central to any deal. In many Asian markets, banking regulations remain unclear or are evolving rapidly; legislation must often be amended to permit transactions. When these regulations have a material impact on a bank's value, as they often do, this additional uncertainty must be factored in to the equation. Moreover, government support – typically in the form of loss-sharing agreements or the assumption of bad loans – will usually play a critical role in making the economics of deals work. Successful acquirers will therefore treat central bankers and regulators as "sponsors" of the transaction, involving them at every stage.

Successful acquirers must also meet the challenge of undertaking adequate due diligence in an environment where detailed and reliable data often cannot be had. Information on borrowers, for example, is sometimes mostly qualitative and may not include financial statements or credit agency reports. Although local players understand and accept this practice, it greatly complicates the difficulty facing cross-border acquirers new to the market. They will have to form teams of managers and advisers with deep local market knowledge to supplement the efforts of their head offices.

The required resources can be enormous: Citibank sent some 50 to 100 people, including many bankers from abroad, to Bangkok City Bank, where their due-diligence effort uncovered problems that ultimately killed the transaction. In a recent smaller deal, the acquirer had to deploy a due-diligence team of more than 20 people for two months. Given the nonperforming-loan problems of most targets, ensuring confidence in a due-diligence analysis will require the involvement of senior credit and risk executives from the acquirer's head office.

A particular note of caution is warranted about deal pricing and the challenge of capturing synergies. Price-to-book ratios have fallen,* but prices – on a discounted cash flow basis – have not sunk to "bargain basement" levels, especially in competitive bidding situations. Most of the acquisitions soon to take place in Asia will therefore fail to create value unless the acquirers can achieve significant cost and revenue synergies.

Given the current uncompetitiveness and lack of sophistication of most Asian banks, significant synergies should be available. Yet they will prove difficult to capture. In such markets as South Korea, militant unions stand in the way of cost cutting, while government officials are reluctant to see large numbers of people added to already swollen unemployment rolls. In every market, it will be expensive and time-consuming to deploy best practices in such areas as credit management, information technology, and cross-selling. Often, the only easy profit opportunity will be the cost of funding, since the acquirer's superior credit rating cuts the interbank funding costs of the target and helps it increase its deposit base.

Successful acquirers will therefore enter every negotiation with a clear understanding of the sources and scope of opportunities to create value. Both traditional bank buyers (such as ABN AMRO and DBS) and nonbank buyers

* From an average of 2.4 in 1996 to 0.8 in 1998 for private-sector deals in Indonesia, Malaysia, South Korea, and Thailand.

(like Newbridge) will begin early on – even before they complete due diligence – to prepare for the immediate integration of the target and to pursue opportunities for improving its profits.

Every bank active in Asia must consider the strategic implications of the unprecedented M&A wave now gathering strength. Banks that move aggressively have a historic opportunity to reshape Asia's banking industry and to secure a leading position in it. The Latin American case is instructive: there, as in Asia today, a financial crisis rapidly restructured the banking industry, producing both winners and losers. Before the crisis hit Latin America, Banco Santander, Banco Bilbao Vizcaya, and HSBC were relatively minor players in the region. Just four years later, they are its leading bank franchises.

Likewise, when the current Asian crisis has passed, a handful of banks will have emerged in each market as the leaders – and they may not be today's top names. Two or three may succeed in building preeminent regional bank franchises with leadership positions in all or most of Asia's major markets. Early frontrunners include ABN AMRO, DBS, and HSBC, but most industry-shaping transactions in Asia are still to come.

Which companies have the vision, commitment, and appetite for risk needed to show the way? In less than 24 months, we will know the answer.

Rebuilding the banks

Dominic Casserley and Gregory Gibb

The region's banks are mostly small and inefficient ◆ Now that has to change

Asia's local financial institutions can no longer afford merely to tinker at the edges; more open markets, more demanding customers and foreign institutional investors, and more intense competition from abroad are all putting extraordinary pressure on private and state-owned banks to raise their game to unprecedented levels. To survive, such banks will have to improve their performance hugely over the next few years. In fact, they will have to remake themselves from the ground up.

The transformation of Asian financial institutions will unfold in three stages. In the first, they will have to secure their lifelines by recapitalizing and restoring public confidence in their basic solvency. In 1998, foreign banks like Citibank, HSBC, and Standard Chartered were flooded with deposits from Hong Kong, Malaysia, and Singapore as frightened depositors moved money from local institutions to these seemingly more secure multinational ones. To win back such deposits and reassure long-term corporate borrowers, local banks will certainly have to show that they are financially sound by writing off bad loans, receiving new capital, and implementing more transparent policies.

Refocusing, stage two, will have to proceed nearly in parallel with the first or follow it immediately. During this second stage, which is likely to last two or three years, institutions will have to refocus on areas where they can build the greatest competitive advantage. Accustomed until now to being all things to all people, they will have to redirect their efforts to customers and products that attract the least intense foreign competition. Of course, the banks must also recruit staffs capable of developing and implementing these more focused strategies, and they will have to learn how to analyze their opportunities in a more sophisticated way. That in turn will mean relying on ideas from staff members who are close to customers, not on commands from senior management. In short, refocusing presents local financial institutions with a twofold challenge: they must alter not only their strategies but also their basic management culture.

Local financial institutions will have to change their strategies and their management cultures

Finally, in the third stage they will have to raise their skills to world-class levels in management leadership, human resources, marketing, distribution, processing, and risk management,* steadily narrowing the gap between themselves and foreign organizations like ABN AMRO and Citibank, which are expanding in Asian markets. To meet this challenge, surviving local banks will almost certainly be forced to import managers and techniques from abroad.

Asia's strongest local financial institutions could complete all three stages of the transformation by 2005. Banks that do so will benefit from, and perhaps drive, the coming boom in mergers and acquisitions. Those that do not will be swallowed up. But since the challenges facing private and state-owned banks differ so markedly, it is best to consider the problems of each separately.

* *See* Partha Bose and Alan Morgan, "Banking on shareholder value," *The McKinsey Quarterly*, 1998 Number 2, pp. 96–105.

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STATE BANK OF INDIA: A GIANT AWAKENS TO ITS CONSUMERS

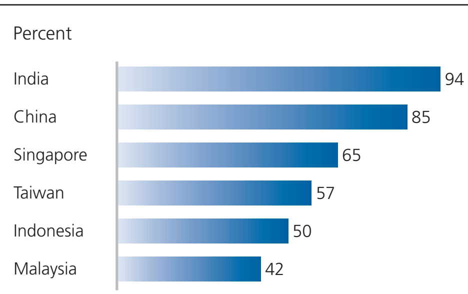
In India's historically restricted market, the State Bank of India (SBI) stood apart from the other 26 public and 34 private banks in 1998 by virtue of its size. With $40 billion in assets, $30 billion in deposits, and more than 20 million accounts, SBI accounted for about a quarter of India's entire banking system. Its dominance extended to corporate lending, consumer deposits, and, to a much lesser extent, consumer lending.

The bank's business mix directly reflected government economic policy. Like all Indian banks, SBI had to direct 40 percent of its lending to priority corporate sectors, including agriculture and small business. It directed 50 percent of its other loans to India's top corporations and less than 10 percent to consumers, and many of its consumer loans were really loans to employees. Through much of the 1990s, SBI adhered to an implicit government policy encouraging individual saving rather than borrowing and did little to build a consumer-lending business.

By contrast, SBI had unparalleled strength in gathering consumer deposits. Its massive network of nearly 9,000 branches reached into virtually every village in the country, making the bank a trusted household name. Despite this remarkable franchise, or perhaps because of it, SBI essentially took depositors for granted during most of the 1990s. It offered a very limited range of products: a plain-vanilla savings account with high-interest checking, and a fixed-term deposit account.

Exhibit 1

State-controlled banks' share of deposits, 1997



Source: Asiaweek Financial 500; Monetary Authority of Singapore; analyst reports; McKinsey analysis

State-owned banks

During much of the 1990s, the major state-owned banks dominated many Asian banking markets; as late as 1997, they held significant shares of the action in China, India, Indonesia, Malaysia, Singapore, and Taiwan (Exhibit 1). In some cases, governments saw their participation in banking as a critical element of a centrally controlled supply-driven economic strategy of funneling money to specifically targeted priority industrial sectors. Indeed, governments hoped to manage the flow of funds to key corporate sectors not only by exercising firm control over state banks but also by guiding all banks through ministries of finance and central banks. Moreover, state ownership of banks sometimes benefited powerful government officials financially.

State banks were not managed to maximize their economic performance. Although this history of serving political rather than economic ends did not prepare them well for the future, some of their assets will prove very valuable.

By the late 1990s, increasing foreign competition forced SBI to abandon its former passivity in retail banking. The government had long allowed foreign banks to participate in the Indian market but restricted them to just a few branches. In 1995, it decided to promote the expansion of automatic-teller machine networks. Such institutions as Citibank and HSBC developed them quickly and were rewarded with rapid growth.

SBI realized that its coveted market share was very much at risk, and by 1998 it had strengthened its consumer operations. The bank announced plans to create almost 100 specialized personal-banking centers throughout the country – centers that would at long last avoid the mistake of favoring corporations over consumers. Starting out with no automatic-teller machines in 1996, it had installed no fewer than 50 by 1998. To improve its overall service and efficiency, it began to computerize more than 1,500 branches, an effort that will cover more than 80 percent of its business when complete. In addition, SBI entered into a joint venture with GE Capital to launch a Visa credit card for its customers.

As the 21st century approached, SBI was drafting aggressive plans for new financing, payment, and insurance products to take further advantage of its extensive branch network. But substantial challenges remain to be met – particularly training the bank's hundreds of thousands of employees for the new tasks, products, and services that lie ahead.

Like many government-owned banks in Asia, SBI will lose market share in the coming decade. But if it continues to act quickly, it should be in a good position to remain a mass-market leader for the daily banking needs of low- and middle-income Indian consumers.

In many cases, state banks have extensive branch networks and relationships with all kinds of customers: large corporations, middle-market companies, and consumers. They are also well known in their local markets. Properly harnessed, these franchises could be very valuable. (*See* boxed insert, "State Bank of India: A giant awakens to its consumers.")

Reforming many state-owned banks is a matter of turning bureaucratic organizations into market-oriented, profit-making businesses. This is hard to do at the best of times – and potentially overwhelming during a financial crisis, when state banks may be crucial sources of liquidity for whole economies.

Yet Singapore's state-controlled bank, the Development Bank of Singapore (DBS), managed to face the challenge. In August 1998, the country's government turned to a Westerner, John Olds, from J. P. Morgan, to run the bank and set it on a new path – among other things, by merging it with another state-controlled institution, the Post Office Savings Bank, to create a strong platform for regional expansion.

DBS basically operates in one city-state and has a staff of just 4,000 people, all fluent English speakers. Few other governments will face such a simple situation, be so bold, or have an equal ability to attract strong reform-oriented managers. How would China's government, for example, attract them to reform its four big state-controlled banks? In 1997, the largest of them employed more than 600,000 people, operated in every province of the country, and functioned only in Mandarin and other Chinese dialects. Similar challenges face anyone trying to reform state banks in Indonesia or Korea.

State banks can, however, move down more than one path to change. In 1998, Taiwan started to reform its government-controlled banks: Chang Hwa Commercial Bank, First Commercial Bank, and Hua Nan Commercial Bank. First Commercial branches quickly put up splashy banners to herald a new name, "First Bank." But real change would be long in coming: the nonautomated, bureaucratically run branches behind the banners remained pretty much the same.

Given the extent of the change that state banks must undergo to become full-fledged commercial players, many of them might be wise not to attempt a full transformation. Instead, they could break themselves up into institutions specializing in particular activities and ally with other entities to extract the value of their customer relationships and networks, without attempting the enormous cultural challenge of a total revamping.

Many state banks are deeply involved in lending for infrastructure, so turning this part of these institutions into independent project-financing enterprises could make a lot of sense. Similarly, large corporate lending businesses could be hived off from state banks and become parts of specialized investment or wholesale banks, though governments may have to scrub these units' loan books clean before any private institution would accept them. Relatively focused entities of this kind might raise money from the capital markets, with all the discipline that entails.

If these large wholesale units were spun off, state banks would be left only with retail and small-business activities, carried on mostly in large branch networks. Such networks are profoundly inefficient, and in some countries branches in outlying provinces or regions are subject to local political influence. Yet the networks, for all their deficiencies, could be valuable to local or foreign entities aspiring to push into the markets they serve. Through alliances, mergers, or even outright sales, governments could energize local economies and release the power of these franchises by putting them under more market-oriented managements.

Private local banks

Like state banks, their private local counterparts face stark choices – and similar ones at that: building the capital, products, organizations, and skills they will need in a more competitive environment. While less hidebound than state banks, they will not find it easy to change. They must also deal with the

THAI FARMERS' BATTLE

The recent experience of Thai Farmers Bank, Thailand's second-largest and one of Southeast Asia's best-managed private banks, illustrates the problems that Asian institutions face in recovering. Thai Farmers was fast off the block in 1998 to ensure its survival, but the extent of the crisis overwhelmed its initial attempts at recapitalization, forcing a rapid second effort to secure its lifeline.

By pursuing a strategy that was well articulated even before the crisis, Thai Farmers raised $834 million in equity in global markets in March 1998 at a cost of 88 baht a share. In doing so, the controlling Lamsam family diluted its holdings in the bank to less than 10 percent, while foreign institutional investors acquired a 49 percent stake. To shore up the short-term cash flow, the bank announced a hiring freeze and began considering other areas for cost cutting. To attack potentially crippling bad loans, it established eight specialist teams with a total staff of 150 to focus on loan collections. The bank was quick to recognize that collecting on bad loans is different from lending money and often requires an independent force, less attached to the customer relationship, to solicit repayment.

In June 1998, the bank announced that it was buying the remaining 51 percent of Phatra Thanakit, a finance company in which it already had a 49 percent stake. Phatra Thanakit was experiencing financing problems as depositors, fearing the worst about the quality of its assets, withdrew their funds. In the wake of the purchase, the shares of Thai Farmers fell to 40 baht. In July 1998, seven Thai banks announced surprisingly poor results because of growing bad-loan provisions, and Thai Farmers' share price fell to 35 baht. In mid-August, Thai Farmers forecast that its nonperforming loans would peak at 38 percent of its total credit in mid-1999 and that 50 percent of these nonperforming loans would have to be written off. Its share price skidded to about 20 baht.

Clearly, the first $834 million that Thai Farmers raised in global markets was not sufficient: growing loan loss reserves had swallowed it up. In December 1998, the bank successfully replenished its capital base by raising 40 billion baht ($1.1 billion) in a highly innovative structure involving a mix of preferred capital securities and debentures.

On the whole, Thai Farmers Bank has acted quickly to emerge as a winner after the end of the current period of discontinuity. Its effort demonstrates the need to address many challenges simultaneously, including the management of bad assets, raising capital, restructuring expenses, and enhancing skills. Success will depend on continued flexibility and innovation to stay ahead of the challenges and changes likely to arise as the economy revives and the industry restructures.

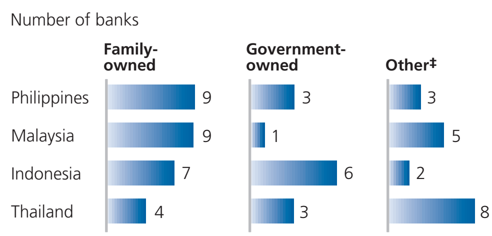
expectations of their customers and with the growing capabilities of their competitors. (*See* boxed insert, "Thai Farmers' battle.")

As local product regulations and demarcations fall by the wayside, private local banks will have to resist the immediate temptation to become true universal banks. Instead of trying to be all things to all people, they must define market niches, invest in their chosen businesses, and build strong risk management capabilities. Which customers can such institutions serve with what range of products to generate attractive risk-adjusted returns? How can they attract quality staff as global banks expand into their markets? Such questions will have to be answered.

Besides these strategic challenges, organizational issues confront private local banks. At the end of the 1990s, for example, families still controlled many of them (Exhibit 2). As they face up to more intense competition, the ability of family members to serve in senior roles will have to be judged objectively, for they will need the best managers they can find. Moreover, as these banks expand, their capital requirements will rise. Families will have to be prepared to meet their share or reduce their ownership stakes. In fact, as in the West, the need for management skills and capital will slowly squeeze many families out of dominant roles in "their" banks. This pressure will raise issues of pride, or "face," for throughout the 1990s in many Asian countries, families had to own banks to be regarded as leaders of the business community.

Exhibit 2

Ownership of top 15 banks*: Examples from Southeast Asia, 1997†



* Based on largest shareholder.
† Before the crisis.
‡ Owned either by public shareholders or by foreigners.

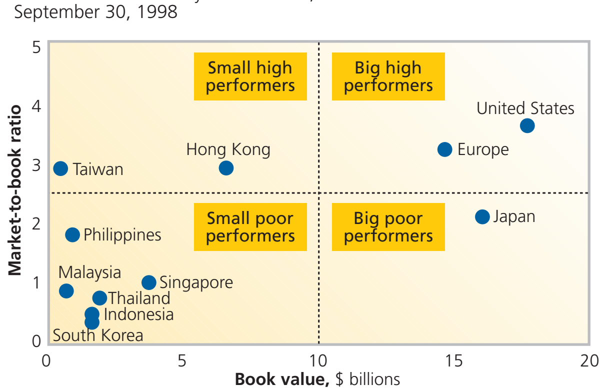
Source: EXTEL; Tara Siam Business International; McKinsey analysis

Nevertheless, markets have changed so much that Asian banks have no choice but to change their corporate strategies fundamentally. Exhibit 3, a strategic-control map for Asia, highlights the average value of the top three private banks in all Asian markets relative to the average value of the leading banks in the United States and Europe as of September 30, 1998. Apart from banks in Japan, Asian institutions were relatively small by international standards, and they were also relatively undiversified within Asia: because of past regulatory constraints, the top three banks in each Asian market hold the vast majority of their assets in their home countries.

Exhibit 3

Strategic-control map of listed private banks

Average of three largest listed private banks in each country or region*
Book value as of fiscal year-end 1997; market value as of September 30, 1998



* China and India are excluded, since fewer than three private banks are listed in those countries.

Source: Datastream; Asiaweek Financial 500

The small size of the leading Asian private banks and their lack of international diversification make them vulnerable, and banks below the top level are even more so. All of these banks will have to struggle to finance improvements in the products, technology, and skills needed to compete with the global giants, and in a world of declining margins they will continue to be subject to geographic concentration of credit risks without any adequate reward. The corporate strategy for such banks must help them resolve these problems.

Financial turmoil in Asia will force many banks to sell out or to ally themselves with foreign institutions to increase their capital base and to acquire the skills they need to compete. In 1998, for instance, Bank of Asia, in Thailand, sold 75 percent of its equity to ABN AMRO, and Kwong On Bank of Hong Kong sold out to Singapore's DBS. Other banks could pursue intraregional mergers to create regional banks with greater geographic diversification. After all, why should the only broadly based regional competitors be HBSC, Standard Chartered, Citibank, and ABN AMRO? For most banks, attempts to act alone will lead only to narrow niche roles or to an eventual sale forced by weakness.

In the 1980s and 1990s, vast wealth was created and then destroyed in Asia, enriching its banks and later impoverishing them. That cycle will probably be repeated during the first decade of the 21st century, but by then the winners in the coming struggle will strive to earn profits differently. In an environment of more transparent information, more sophisticated customers, more open competition, and more demanding international investors, banks will have to manage all elements of every financial business with far more discipline than they showed in the 1990s. And to secure positions of leadership, many will have to expand through acquisitions.