

Market Structure and Business Development Strategy of the Banking Sector

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Abstract

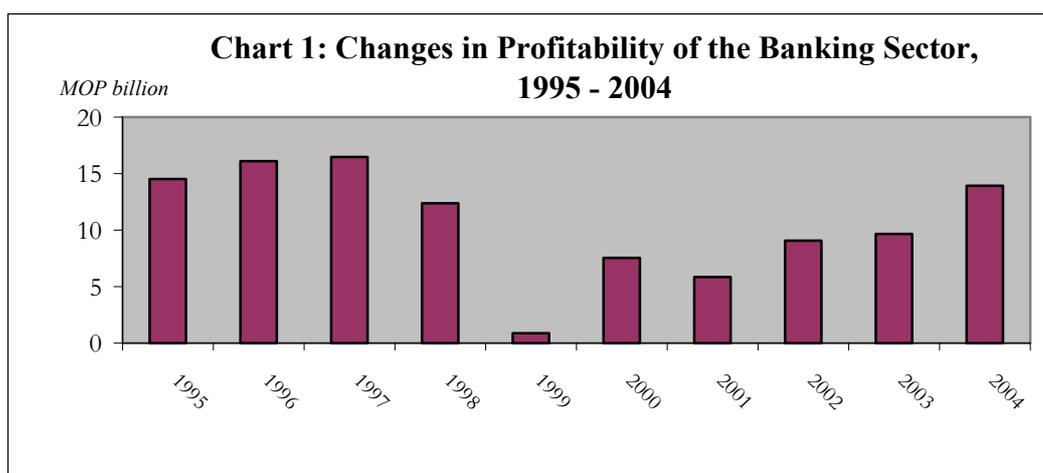
The Macao financial market has a relatively simple structure. The banking sector plays a dominant role whose gloom and boom is largely driven by the interaction of several factors, namely changes in demand for bank finance, regional economic cycle and supervisory environment. Market structure assessment helps to identify information such as the potential and limitation of the financial industry, which helps to map out strategy geared to future market development. This paper attempts to carry out a basic study of the banking sector through the application of theories relating to market structure. It will also recommend several strategies conducive to improving or enhancing performance of the banking sector.

1. An Overview of the Performance of the Banking Sector

A statistical study of the banking performance shows that during the past decade the sector has experienced a process characterised by profitability deterioration to recuperation. The situation is particularly obvious in the early 1990s when the Mainland government implemented a series of austerity measures, resulting in massive early recall of investment in Macao's property sector. Many development projects were put to halt or disrupted due to lack of capital. Consequently, loans extended by the banking sector could not be repaid, leading to a huge accumulation of non-performing loans.

Chart 1 illustrates the change in profitability of the Macao banking sector during the past 10 years. From 1995 to 2004, lending was sluggish and this was generally understood to be the result of non-performing loans arising from reasons mentioned above. Accordingly, the banks became more prudent and in some cases, overly stringent on credit assessment. Coupled with a prolonged period of low credit demand, interest spread income from traditional banking business was severely impaired.

To offset stagnation in traditional banking business, many local banks broadened their revenue base by offering fee-based service. Along with gradual recovery of the economy, banks managed to recover many bad debts. This situation had two outcomes. First, it helped to reduce the outstanding balance of non-performing loans. Second, it alleviated the banks from making further bad debt provision. The combined effect of these favourable factors has allowed the Macao banking sector to regain strength with rising profitability in recent years.



Source: Monetary Authority of Macao.

2. Structure of the Macao Banking Sector

The Macao financial sector is recognised as one of the important economic pillars with properly developed foundation. Operating in a tourism and gaming oriented environment, further development of the banking sector may promote economic diversification. Benefiting from an improvement in loan demand, the sector has huge potential for further growth. Gradually, the sector manages to develop its unique market structure as a result of the development process. Through an analysis of the market structure of the local financial sector, its general situation and features can be elucidated below.

2.1 Formation, cause and feature of over-concentration

The term – over-concentration - will always ring the bell when it comes to describing the situation of the Macao banking sector. Basically, this term pinpoints the deposit/loan business of the banking sector.

For a long time, the behaviour of Macao residents can be described as traditional which extends to banking service. Many people have preference for locally incorporated banks or banks of Mainland capital. It is not surprising that a good chunk of loan and deposit business is handled by Portuguese and Chinese banks. These banks have also established presence in the neighbourhood of their clients with

the intention to secure or expand customer base. Many banks are willing to introduce comprehensive banking service through investment in branch network while retail banking is the mainstream in the sector.

To show the degree of concentration, indices of absolute and relative concentration are employed. The result shows that, statistically, banking business here is highly concentrated. There is a formula for computing absolute concentration. We take the sum of market share of n largest companies. The formula is as follows:

$$CR_n = \frac{\sum_{i=1}^n X_i}{X}$$

where,

n = number of banks;

X_i = total deposit (excluding public sector) or total loan (excluding credit against stocks, bonds and commercial papers) of bank i in the market;

X = total deposit or total loan of all the banks in the market;

CR_n = market share index of n banks which carry the highest weights;

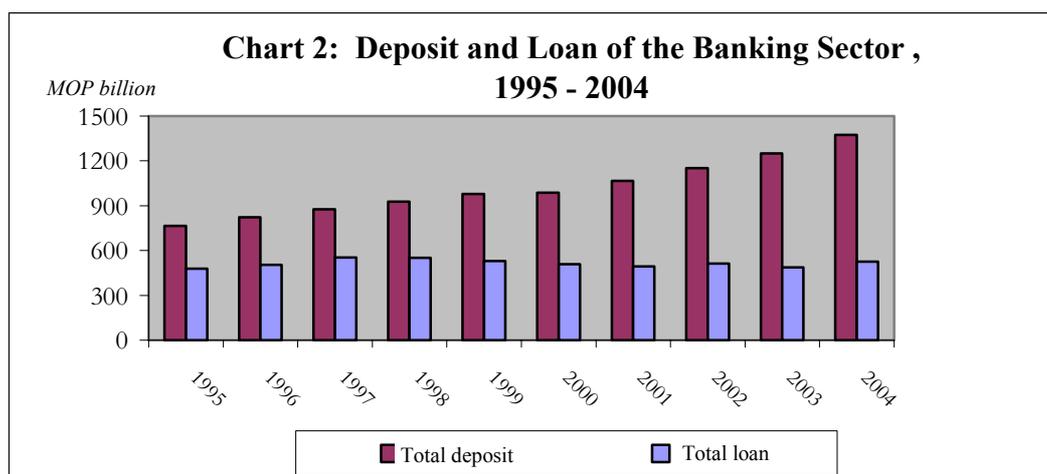
CR_{nd} & CR_{nl} = deposit and loan indices of n banks carrying highest weights.

When the data of deposit and loan of the banking sector for 1995 and 2004 respectively are plugged into the formula, CR_{4d} for four banks with highest market share are 0.71 and 0.66 while CR_{4l} are 0.6 and 0.58, which are close to the monopoly digit of 1. Concentration prevails in the Macao banking sector in the past decade and there has been little change. There were a total of 22 and 23 banks in operation in the year 1995 and 2004 respectively.

Hirschman-Herfindahl Index, HI, can also be used to further validate the degree of concentration. HI is a composite index for market structure used to measure the degree of industry concentration. The formula is as follows:

$$HI = \sum (X_i/X)^2 \quad i=1, 2 \dots n,$$

Similarly, the result of the computation also shows over concentration.



Source: Monetary Authority of Macao.

2.2 Stringent entry and exit barriers imposed by regulatory authorities

In the early 1980s, the Portuguese Macao government restructured the banking supervision department, which was under the Director of Finance Services, into an autonomous issuing institute (IEM), which was the predecessor of the Monetary Authority of Macao. Since then, the banking regulator has enforced a comparatively more stringent market entry and exit mechanism.

According to the provision of the banking law, entities wishing to conduct banking business in Macao must obtain licence by submitting application, with final approval vested in the hand of the Chief Executive. The prescribed capital requirement for applicants is not high. It would be more difficult to satisfy assessment criteria such as applicant's qualifications and potential contribution to the local financial sector than to merely meet the minimum capital requirement.

Since the 1980s, the Monetary Authority of Macao has implemented a series of guidelines, by following closely new standards adopted by international regulatory bodies with modification to accommodate the local financial market. A stringent market entry and exit mechanism has been included. A high standard has been established for the banking sector which is governed by tough entry and exit mechanism in full compliance with international standards.

2.3 Homogenous core business with similar product characteristics

As mentioned earlier, one of the characteristics of the banking sector is that its business is rather traditional and homogeneous. Deposit and loan remain the major source of revenue while the latter is highly concentrated on a number of customers. Thus, banking products tend to be similar with little differentiation. Take bank credit for example, business lending ranks first, followed by mortgage and credit card financing. Product similarity results in high interdependence among counterparts and oligopolistic operation. Besides, competition among several major banks is severe as this is a long-term competition for the same customer base.

2.4 Few market players with large scale operation

As at the end of last year, there were a total of 23 banks authorised to operate in Macao. Based on area and population, Macao has a high density banking network. On average, one branch office serves around 3,500 customers. Nevertheless, most of them are some small offices equipped with 3 counters. In fact, there are not many large scale credit institutions in Macao. Therefore, banks that can marginally classified as big have competitive edge in capital, know-how and reputation.

Given the factors mentioned above, larger credit institutions have already secured substantial market share, which creates barriers to new entrants. It is worthwhile mentioning that many banks in Macao are indeed branches of world renowned banks. Despite the fact that their parents have world class operation network and capital, their

business scope is rather limited as long as they maintain same kind of service station presence in Macao.

2.5 The Macau Association of Banks controls pricings

The Macau Association of Banks is an organisation established at the initiative of the banking sector with management position assumed historically by market leaders on rotation basis. It has no statutory power over industry practices. However, interest rate adjustments developed through collective discussion are closely followed by banks in Macao. In addition, fees levied by banks are made uniform through the platform of the association by express understanding instead of putting it in black and white. Under the coordination of the association, it is undeniable that the banking sector in Macao is applying an uniform pricing policy.

Based on the model of market structure and the above analyses, the structure of the banking sector in Macao can best be described as oligopolistic with the following features:

- (i) High market concentration;
- (ii) High entry and exit barriers;
- (iii) Little product differentiation;
- (iv) Few large scale enterprises (given the small market there are relatively numerous competitors);
- (v) High degree of control on pricings.

Table 1: Market Structure and Characteristics

Market structure	Concentration	Entry barrier	Product differentiation	No. of entities	Pricing control
Perfect competition	Low	Low	No	Massive	No
Monopolistic competition	Relatively low	Relatively low	Yes	Many	Moderate
Oligopolistic competition	Relatively high	Relatively high	Yes or no	Several	Certain extent
Monopoly	High	High	One	One	Large extent

Source: Wong Wing Chit (January, 2004).

The local banking sector has not achieved a market with perfect competition. As such, competition is less strenuous when compared with industry operating under conditions of perfect competition. Perhaps, this situation is well perceived by many banks which choose to pursue a more conservative marketing strategy. Nevertheless, viewing the future from another perspective, it appears that an objective environment conducive to developing benign competition exists in the market.

3. Development Strategy of Oligopolistic Industry

It is painstaking to operate in an oligopolistic industry characterised by high market concentration and confronting challenges from counterparts. As such, supervisory authorities should make the market players understand that there is room for development even in a highly concentrated market and encourage them to develop feasible and appropriate development strategies by exploiting objective and subjective market factors.

3.1 Win customer loyalty by making full use of human resources

In the banking sector, there exists executives equipped with solid financial and management expertise. They are capable of mapping out appropriate strategies even

under extremely competitive market condition. It might be difficult to revolutionise the oligopolistic situation in the offing. However, they can make use of their expertise and enthusiasm in leading their staff to attain new accomplishments. The banking sector has gone through many ups and downs during the past decade. It is indeed a blessing to have a team of socially responsible managers with entrenched management experience to help the banks overcome difficulties and turnaround.

Competition acts as a catalyst in enhancing efficiency of the banking sector. In recent years, many people with college education have joined the banking sector. Along with different training programmes implemented to enhance knowledge of modern banking operation, professional standard of the sector is basically being enhanced. The banking sector in Macao has a team of professionals capable of confronting challenges. With further effort directed to training, strengthening internal risk control mechanism and broadening business potential, the banking sector is expected to experience enhancement in competitiveness and achieve favourable return.

The banking sector is used to be passive in operation. In recent years, many banks have adopted a more proactive role by establishing temporary offices at the site of new building to solicit new clients. Professionalism and warm attitudes of the banking representatives are impressive. Apart from that, the sector also manages to modernise its image and earn favourable return by introducing new services, such as flexible financial planning, customised financing and expedient shares and remittance settlement. Comparing with monotonous print advertisement, courteous attitude of the banking professionals is more effective in winning customer loyalty.

3.2 Broaden business potential and customer base to make a breakthrough

Continuous improvement in profitability has been noted in the banking sector in recent years. Apart from objective factors such as recovery of substantial amount of bad debts, the introduction of fee income service also helps to significantly boost profitability. It is recommendable for banks to develop financial derivatives to increase

income in a highly concentrated market. The attempt exploits new source of revenue and allows a breakthrough in business development.

In an oligopolistic market, banks with the objective to broaden business scope have to cope with many limitations such as collusion among oligopolists. This kind of long term concerted effort has suppressed positive competition and contained market agility. Internally, the banks need to tackle challenges posed by imbalance between loan and deposit brought about by limited market and slack demand for bank finance. Some foreign banks are over cautious in capital commitment and look upon their branches as just service stations. Local banks may have limitation in sourcing new capital. It is imperative for banks to adopt a focusing strategy if they intend to break away from these limitations. Otherwise, it would be difficult for them to elevate their business to a higher level.

To address the issue of market limitation, the MSAR government has incessantly encouraged the sector to establish business relationship in the Mainland loan market, particularly the Pearl Delta River and Guangdong West. Banks should seek new opportunities through syndication and equity investment in Mainland banks. Besides, foreign banks with subsidiaries in Macao need to be reminded the potential of the market and change their mindset by actively participating in local financing and make full use of their international reputation and brand name. As regards local banks, some of them have the options to enhance competitiveness and respond to new market development by introducing strategic partners or selling their own equity.

4. Conclusion

Given the uniqueness of banking operation, it would be inappropriate to superimposing general business operational model on the banking sector although they have the same objective of profit maximisation. Having experienced decades-long transformation, the banking sector has now developed into an oligopolistic industry. To succeed in a highly concentrated market, it requires painstaking effort

to maintain stable business development and achieve more lucrative return. To this end, the concerted effort of the business sector, along with the coordination of the local administrative and supervisory authorities, is needed. Only in this way we can create a market environment conducive to attaining greater achievement in the financial industry.

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