Experiences of Resolution of Banking Crises

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Prepared for joint PBOC/BIS Seminar on:
Strengthening The Banking System in China
February 28-March 2, 1990, Beijing

Executive Summary

Experiences of other countries, including in Eastern Europe, Latin America, and Scandinavia, suggest several important principles for successful systemic bank crisis resolution and bank restructuring. Systemic bank restructuring, a lengthy process, requires sufficient public resources, and deep changes in institutions, rules of the games and attitudes. An early and systematic evaluation of the size of the problem, an overall strategy, and prompt action can help limit economic costs. The approach needs to be comprehensive and credible and repair the immediate flow and stock problems of weak and insolvent banks and corporations. Segregation of non-performing loans from bank balance sheets to loan recovery agencies can be useful in easing the stock problem of banks. But it has risks. The government might have to provide capital to viable banks, but this should be done in such a way as not to undermine incentives for private-sector equity injections and end up rewarding poor management of banks. Also necessary can be extraordinary measures to accelerate the operational restructuring of corporations to return banks (and corporations) to profitability and sustained solvency. This in turns means effective loan workouts and properly structured loss absorption mechanisms that take into account the links between financial- and corporate-sector restructuring.

As part of the changes in legal and regulatory frameworks, exit policies and procedures (for corporations, banks, and other financial institutions) typically need to be revamped and strictly administered. Capital adequacy targets should also be enforced—forbearance can be a risky and costly policy—but have to be meaningful. More broadly, regulatory changes need to balance the need for fundamental reforms with realism and political support. Experience also suggests that systemic restructuring is difficult to design and often leads to moral hazard problems. The appropriate design will depend on country circumstances, including the macro-economic environment, the fiscal and external financing situation and quality of the institutional framework. Existing institutional weaknesses in many developing countries often rule out some options. In particular, in many countries a bank-led approach (where banks are recapitalized and take the lead in corporate restructuring) has not been enough to either resolve corporate-sector problems or lead to the desired medium-term changes in corporate financing and governance. It is also obvious that more centralized, government-led approaches have many risks.

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Introduction

After briefly reviewing the origins and dimensions of many banking crises, this paper points to lessons and principles from cross-country experience with systemic bank restructuring (while the paper does analyze some of the principles which may be used in individual bank restructuring, it main focus is on systemic bank restructuring, i.e., the restructuring of banking system which is in crisis). It then discusses how these lessons may be applied to developing countries. The paper makes clear that, while there are general principles, circumstances typically differ greatly—both in the size of the problems, the institutional framework for systemic bank restructuring, and in the degree of freedom government has in raising financing to defer some costs of restructuring. In the last section, some issues specific to China in systemic bank restructuring are discussed.

Origins of financial crises

This section briefly reviews the latest understanding on the proximate causes of banking crises, before turning to some of the fundamental causes. Understanding the proximate causes may help with predicting crises, but an understanding of the fundamental factors is necessary to help with their prevention.

Financial crises have multiple causes. Causes for financial crises can be divided along two lines: more proximate causes, and more distant, or fundamental factors. The proximate causes of banking crises have included:

- Poor macro-economic policies and macro shocks, including large government deficits, slowdown in GDP growth, declines in terms of trade, increases in real interest rate and inflation, and unexpected depreciations of the exchange rate;
- financial distress including rapid capital outflows, declining foreign exchange reserves, and loss of confidence in the financial system, triggered by large vulnerabilities, such as high short-term debt to foreign exchange reserves, high credit growth, and high bank cash/bank assets; and
- institutional weaknesses, including the presence (or absence) of explicit deposit insurance, absence of resolution mechanisms, weak enforcement of contracts, poor regulation and supervision, and perverse links between corporations and banks.

These indicators predict banking crises relatively well. Slower output growth, increases in real interest rates, declining liquidity, faster credit growth, explicit deposit insurance, poor legal systems, and a generally less-developed institutional framework are found to be associated with a greater likelihood of banking crises. A number of specific institutional factors are often found to be associated with banking crises. Implicit guarantees that governments would stand behind financial intermediaries have often led to investment based not on expected returns but on those likely in the best of all possible worlds. Close links between the government and owner/managers of intermediaries often feature in banking crises. Overborrowing, that is when the non-bank private sector becomes euphoric about the success of reform because of the overly optimistic implicit signals about macroeconomic developments contained in loose credit decisions, is often followed by a banking crisis.

Many of these causes featured in East Asia's financial crisis. In recent years, East Asian corporations were more highly leveraged than those in other countries. These high levels of debt went hand-in-hand with low profitability, suggesting that banks and other outside investors did a poor job of monitoring corporate management. Typically, banks did not apply modern credit-risk analysis and management techniques, and credit tended to flow to borrowers on the basis of close relationships with bank owners and to favored sectors, rather than on fundamentals, such as projected cash flows, or recoverable collateral values. Links between banks, corporations and government were widespread in East Asia and other countries which experienced a banking crisis. In Korea and other countries, the state historically played a big part in setting interest rates and determining the allocation of resources. In Indonesia and Thailand, many of the same families or groups that controlled banks also owned major corporations, introducing distortions into allocation of resources and dangerously concentrating risks.

Banks had poor governance and internal management, inadequate control of risks and many financial institutions were undercapitalized. Faced with little information, and often having links with bank borrowers, bank owners exercised little control over management and in some places, notably Korea, government interference was significant. Banks had inadequate disclosure and transparency and most banks had very limited internal interest rate and exchange rate management systems. In case of non-payment, banks had little means to force corporations to repay and debt restructurings often involved little more than extraordinarily long reschedulings, suggesting that asset quality was already a big problem, even before the crisis.

Non-bank financial institutions in some East Asian countries had many of the same weaknesses. In general, non-banks were feebly supervised and financed many risky investments, particularly in real estate. Moreover, non-banks were often controlled by corporations, such as the large chaebols in Korea, which added to the problem of financing on non-market terms. These weaknesses in the corporate and financial sectors were compound by those in securities markets which lacked depth and breath, with few, good quality institutional investors to be reliable sources of funds. With weak regulatory systems, capital markets neither sufficiently monitored corporate behavior, nor diversified risks that were piling up in the banking system.

Financial liberalization with inadequate supervision often plays into this unholy trinity. In Korea, for instance, offshore borrowing by merchant banks, often controlled by chaebols, was liberalized, while foreign direct investment and portfolio flows were restricted. Chaebols, through the merchant banks they controlled, rapidly built up short-term foreign exchange borrowings, while maintaining a competitive advantage over foreign investment in domestic markets.

In most other crises, multiple factors also featured. Of 86 episodes of bank insolvency over the 1980-94 period, at least 20 of these featured 'cronyism,' meaning excessive political interference, connected lending, or similar labels, and at least 30 featured over-borrowing. Panics by foreign investors played a role in Latin American crises of the 1980s, and premature liberalization could be cited in virtually all cases. And of course,

macro-economic factors are common factors in bank insolvency, especially terms of trade declines or recessions.

But there are more fundamental factors behind most crises. Crises are typically manifestations of deeper characteristics of the financial sector, which make it prone to such events. The financial systems often implicitly protects poorly performing firms by continuing to provide loans. Besides the failure of owners to discipline management of, particularly, state-owned, banks, incentives for prudential banking are typically weak. This includes inadequately designed and weakly enforced lending limits, asset classification systems and loan-loss provisioning rules which fall short of international standards, and no clear exit policy for troubled financial institutions. Countries with systemic bank crises have often huge holes in their regulatory, supervisory, accounting, auditing, and disclosure frameworks and practices. The quality and disclosure of information and financial statements is often unreliable or simply out-of-date. And enforcement of laws and regulations can be pitifully weak. These underlying institutional weaknesses prevailed also in many East Asian countries.

Principles for Banking Crises Resolution

Experiences across many countries point to clear processes and principles for systemic restructuring of financial systems, during the short-term, containment phase while the crisis is unfolding, and during rehabilitation and restructuring phase, including establishing an institutional framework for a sounder financial system. Box 1 describes the main elements of this restructuring process.

Box 1

What is restructuring?

Restructuring, as used in this paper, refers to several, related processes: recognizing financial losses; restructuring financial claims; and operational restructuring of corporations and banks. In cases of systemic bank and corporate restructuring, in tandem with these restructuring processes, the institutional framework for the financial and corporate sector undergoes major changes.

Recognition involves the allocation of existing losses. Losses can be allocated to shareholders—by dilution, to depositors and external creditors by reduction of (the present value of) their claims, and the government, that is, the public at large through increased taxes, expenditures cuts or inflation tax. Restructuring of financial claims can take many forms: reschedulings (extensions of maturities), lower interest rates, debt-for-equity swaps, debt forgiveness, indexing interest payments to earnings, and so on. Operational restructuring, an ongoing process, includes improvements in efficiency and management, reductions in staff and wages, assets sales (for example, reduction in bank branches), enhanced marketing efforts, and so on with the expectation of increased profitability and cash flow.

Restructuring will have to vary by individual bank or corporation. One, conceptually useful classification of corporations can be those that are profitable in the medium-term, those that can not cover their financial costs, and those that cannot cover their financial, labor and material costs. The first probably do not need financial relief, the second are candidates for financial relief, while the third are candidates for liquidation. Of course, projected medium-term profitability will depend on the intensity of operational restructuring and on the overall economic conditions.

First Things First

Contain the crisis with lots of don’ts. Financial-sector crises concentrate minds, but provide little opportunity to reflect. Nevertheless, especially in the early stages of any crisis, there are crucial choices to be made. In the containment phase, international experiences offers a clear guide to the steps to be taken even if they are mainly negative ones: don't provide liquidity an on-going basis to a financial institution until you are satisfied that oversight is more than adequate, don't close a financial institution in the middle of a systemic crisis until there is a credible systemwide policy on resolution; don't announce a blanket deposit guarantee, if depositors are merely running to quality within the system; and don't act aggressively, except in the context of a coherent and workable plan.

Stop the flow of bad financing and stop looting. For starters, it is important to stop the flow of new financing to bank borrowers in default and limit new lending to insolvent institutions. Managerial and shareholder incentives suddenly shift for a financial institution when it becomes insolvent: managers have no incentive to run the institution on a viable basis and their actions often speedily drain away resources—including liquidity support from the central bank. This was disastrously demonstrated in Venezuela in 1994 and in Thailand in 1997, where large-scale liquidity support—10% of GDP—was extended to finance companies that turned out to be black holes of insolvency. Similarly, the central bank of Indonesia extended vast amounts of credits to weak banks, in some cases exceeding bank equity several times over. In the process, the monetary base was expanded and losses on these credits had to be shouldered by the government (that is, the taxpayer). And, in Korea, banks continued to extend emergency (or so-called bankruptcy avoidance) loans to financially crippled corporations as late as early 1998. All of which shows there is no reason to extend liquidity support to bankrupt banks, non-banks and corporations. When a crisis hits, it may seem that a few more months of forbearance can do little harm. Wrong. Experience shows that costs increase, as happened in East Asia, when authorities were unable (or unwilling) to stop transfer of resources out of financial institutions that had long ago turned insolvent. Intense regulatory oversight is needed to stop what amounts to looting by managers and owners of banks and corporations.

Do not necessarily suspend, but do impose limits. It is often not feasible nor economically sensible to close or suspend a large segment of the financial sector. Abruptly closing banks in a climate of widespread uncertainty can prompt depositors to flee further and faster from banks. It also disrupts relationships between banks and borrowers, shutting off new lending or inducing borrowers to stop servicing old loans. Nor should authorities resort to the quick fix of giving guarantees to depositors and creditors, to stem the loss of confidence. This limits their maneuverability in the future. And guarantees might not be credible anyway if the problems are big enough and the government lacks the resources and capacity to back them up, as happened in Indonesia where a depositor run turned into a currency panic. So, if wide-scale suspension is not the right answer, what is? Preferably, a legal and institutional infrastructure—for prompt corrective action and for intervention in insolvent institutions—is in place before a crisis to provide clarity on any intervention, including the priority of claims and procedures for

transferring performing loans. Short of that, failed financial institutions cannot be allowed to return to "business as usual" without adequate capital, nor should shareholders be indemnified against losses. Countries should rather appoint a conservator or hammer out contractual arrangements, whereby the government holds some of the capital for a transitional period.

Systemic restructuring with public support is necessary

Without systemic and accelerated restructuring, often involving government financial support, problems in the financial and corporate sectors are unlikely to be resolved, and foreign investors enticed back in. In a systemic bank crisis, the problems are too large and run too deep. Insolvent banks will face incentives to gamble or will sharply reduce lending in an attempt to build up capital. Undercapitalized, the financial system will remain dysfunctional. Prompt action and large up-front investments by the public sector—through bank recapitalization—may lead ultimately to lower costs as the moral hazard of repeated bailouts may be avoided and, more generally, as there are large benefits in getting credit flows and economies moving again. These interventions need to be preceded by some fundamental reforms, however, and be guided by principles.

Act promptly, be comprehensive and credible. Fast action is an essential ingredient for success. In many cases, piecemeal solutions were adopted. Japan, for example, has tried for almost a decade (and failed) to resolve its financial-sector difficulties through a policy of low interest rates, and hiding the real losses in its financial system. Prompt action on financial-sector restructuring is also necessary to maintain credit discipline for borrowers. In some countries, borrowers have adopted the attitude that their creditors are less likely than they are to be around in the future, thus reducing their incentive to repay, even when they can.

Fixes, such as increasing lending margins or an inflation tax to restore profitability and recapitalize banks, don't work. Often in systemic bank crises banks tried to raise spreads but only reduced the demand for financing and the number of sound firms able (or willing) to pay the higher costs. Such cases most often led to severe costs to the economy and to financial development. In Korea, for example, limits on deposit rates in the past helped spawn a "curb" market, later formalized in non-bank financial institutions and trust-accounts of commercial banks, which have added to financial instability.

Forbearance on capital adequacy targets is most often a mistake. Most countries saw their problems multiply when banks and other financial institutions were allowed to ignore or violate prudential rules (see Box 2). Capital adequacy ratios are not something that should be up for discussion or compromise. Rather than lower ratios or allow violations, banks could be given instead tax and other relief on loan-loss provisioning to increase retained earnings and boost capital and, possibly, public support. Allowing entry by foreign banks and foreign investors can also be a quick way to raise bank capital. In any events, capital adequacy targets should be designed consistent with the projected profitability in the banking system and supply of new, outside capital. This in

turn requires an analysis of the expected profitability and cash-flow of the corporate sector.

Box 2

Forbearance: Never? If Ever, When? And How?

Forbearance can be structured—that is, adopted as a policy measure and applied to the whole financial sector. It can include regulatory forbearance (where existing supervisory regulations and standards are waived for an institution), accounting forbearance (where an institution is exempted from following standard accounting practice), and tax forbearances that exempt a class of institutions from paying their full taxes. It may result in lower capital adequacy requirements, more lenient tax treatments, tax breaks, loan loss reserves and provisioning requirements that are lower than expected losses, and lenient accounting standards and practices. Forbearance can also be implicit—that is, authorities turn a blind eye to violations of laws, standards and regulation by either individual banks or the entire banking system.

Forbearance may be appropriate when an otherwise healthy financial system is subjected to an exogenous shock that causes a rapid and unexpected deterioration in the financial condition of it borrowers. A natural disaster, for instance, may result in major dislocations that adversely affect the financial system. In such a case, forbearance is very appropriate while the institutions (and their borrowers) get back on their feet. But forbearance may be highly risky when it is applied to institutions that are poorly managed, lack a credit culture, and are engaged in high risk lending practices.

Forbearance is not just an issue for developing countries. It has been applied in developed countries also. For example, in the debt crisis of the 1980s, some international banks were allowed to build up gradually their loan loss provisions against impaired sovereign claims to avoid a severe write-down of their capital. During the 1930s depression in the United States, banks were allowed to operate even though many were technically insolvent.

Throughout most of the 1980s. the federal regulators of the savings and loan industry adopted several forbearance techniques. These included lowering required capital levels, allowing extended amortization of loan losses, allowing intangible assets (e.g., supervisory goodwill) to count as capital, and making deposits in failing S&Ls in return for net-worth certificates, which could then be treated by the S&L as regulatory capital. These policies allowed a number of insolvent and undercapitalized S&Ls to continue to operate and make new loans. The ultimate cost of this forbearance to the taxpayer, however, was enormous due to these institutions (which were known as zombie thrifts) generating huge losses.

Have a vision. A coherent realistic and sector-wide medium-term approach to the problem, steadfastly applied, is crucial. In a systemic crisis addressing only the problems of a handful of the most severely affected institutions will not do. Unless credible action encompass all (or most) financial institutions that are ailing or failing, market uncertainty may be heightened, rather than reduced. Asset prices will continue to languish or fall further. Systemic bank restructuring needs to be driven by an well-articulated, medium-term vision for the financial (and corporate) sector. This needs to be developed by the government, preferably in collaboration with the private sector. Private-sector involvement, both domestic and foreign, is essential, not only for design but to help restore confidence. This vision should cover, among others things, the role of various financial institutions in providing financial services, so as to allow greater and fairer competition and so create a more stable financial sector. It also needs to consider the concentration of the sector, for example, how many financial institutions and of what size are expected to (or should) emerge from restructuring. Too many financial institutions can reduce franchise value, and so undermine stability. Also, what part are foreign investors to play both in ownership of financial firms and financial assets? And, where is restructuring in the real sector expected to lead—in ownership and governance of firms,

and the links between the financial and corporate sector? All of this will take several years to complete but markets will demand early on the development of a coherent, credible and articulated strategy.

Have a dedicated focus for the restructuring process. Developing a medium-term approach begins with diagnosing (the size of) the problem, which means rigorously monitoring and scrutinizing all financial institutions, including detailed portfolio reviews by reputable outside (preferably international) auditors. Systemic bank restructuring must also be given immediate focus, and high-level attention. This means forming a dedicated, top-notch crisis team to coordinate the government's response to the crisis. The team should develop specific basic operating assumptions and principles to tackle the crisis and develop an immediate agenda and the general scope and direction of the next steps. Most pressing is empowerment of a single restructuring agency—whether in the central bank, ministry of finance or elsewhere—to avoid gaps and conflicts in approaches and actions.

Rehabilitation and restructuring plans of individual financial institutions can be given credibility and integrity with, for example, the participation of independent parties, including internationally recognized experts. More generally, there will often be a need for third-party inputs and technical assistance at various stages of restructuring. These include diagnostic audits of financial institutions, loan work-out skills to create viable restructured assets, and investment banking skills to sell restructured assets. In many countries, adequate safeguards were not built in during the evaluation and decision making, and transparency was limited. This hardly restores the confidence of investors and depositors. For instance, when (stronger) Korean banks acquired five weaker banks in July 1998, the market reacted adversely as details on the government support for the acquiring banks were initially limited.

Use public resources as necessary, but don't bail out banks, and do change management. Government instinctive reaction to a crisis is to allocate too few public resources. Unsure of the amount of help available, financial institutions tend to hide the true extent of their problems. Existing and potential shareholders will not put up new capital as they are uncertain about the capacity of the government to provide loss protection. More generally, it undermines confidence of depositors and investors. In short, countries need (or must be perceived) to have large enough public war chests to deal with the large costs. This will often require more-developed domestic government bond markets.

Public-sector capital injections can not (or should not be) a bail-out of existing shareholders. Rather the aim is to allocate losses transparently and minimize costs to the taxpayers, while preserving incentives for infusion of new private capital. Corporate and bankruptcy laws establish seniority of claims and the order in which they can be written off, with equity top of the list. Thus, where a bank (or corporation) is still solvent but in dire need of debt relief from creditors or public support, existing shareholders' equity (and so their voting power), should be diluted, but not completely eliminated. Correspondingly, where the bank (or corporation) is insolvent, claims of shareholders and

subordinated debt-holders should be written down completely before public money is forthcoming (unless the government is responsible for the bank's or corporation's losses). In some of the most comprehensive bank restructurings (in 1995 in Argentina, for instance) shareholders, non-depositor creditors, and sometimes depositors sustained losses, without much affecting overall confidence in the restructured system.

In the past, many countries, including some in East Asia (Thailand in 1983-87 and Indonesia 1994), chose not to—for which they eventually paid. They resolved their financial crises, in part, through partial or full public bail-outs, which reinforced the perception of an implicit government guarantee on deposits and other bank liabilities, to the detriment of market discipline. In some cases, bank management, at least partly responsible for the problems, was not even changed as part of the restructuring, which further undermined incentives for prudent behavior. The lingering effects of such policies contributed to the following banking crises, including the present crisis in East Asia.

More generally, most bank recapitalizations in developing countries using public resources failed, with one recapitalization following another. Efforts mainly fixed balance sheets, with little attempt to correct the underlying problems. Repeated recapitalization led to moral hazard; with an implicit government guarantee there was little incentive for prudential banking. Hungary, for example, had to recapitalize its banks several times before it got it right. Venezuela repeatedly restructured its banks. Even industrial countries have not been immune to recurrent recapitalizations—for example, France's Credit Lyonnais in the 1990s. Mergers can help but only where they make commercial sense to the acquirer. Merging two weak financial institutions will compound the problem making the bigger bank a bigger problem down the line. Reprivatizing banks hastily is a no-no as is clear from the experience of Mexico in the early 1990s and Chile in the late 1970s.

Restructuring can strengthen financial discipline by allocating losses not only to existing shareholders, but (at least some) losses also to creditors and depositors who should have been monitoring the bank. Allocating losses to creditors or depositors will not necessarily lead to a run on the banks or end in contraction of aggregate money and credit, and output. In past crises, most notably the United States (1933), Japan (1946), Argentina (1980-82), and Estonia (1992), governments imposed some losses on depositors and there were little (or no) adverse macro-economic consequences nor flight to currency (Box 3). Economic recovery was rapid and financial intermediation, including household deposits, was restored within a short time (Figure 1). Financial discipline was further strengthened when management, deemed to be part of the problem, was changed as well, and banks were operationally restructured. Similarly, rapid withdrawals of deposits at a few small banks in Argentina in early 1998 reinforced financial discipline and provided authorities with useful information.

Box 3

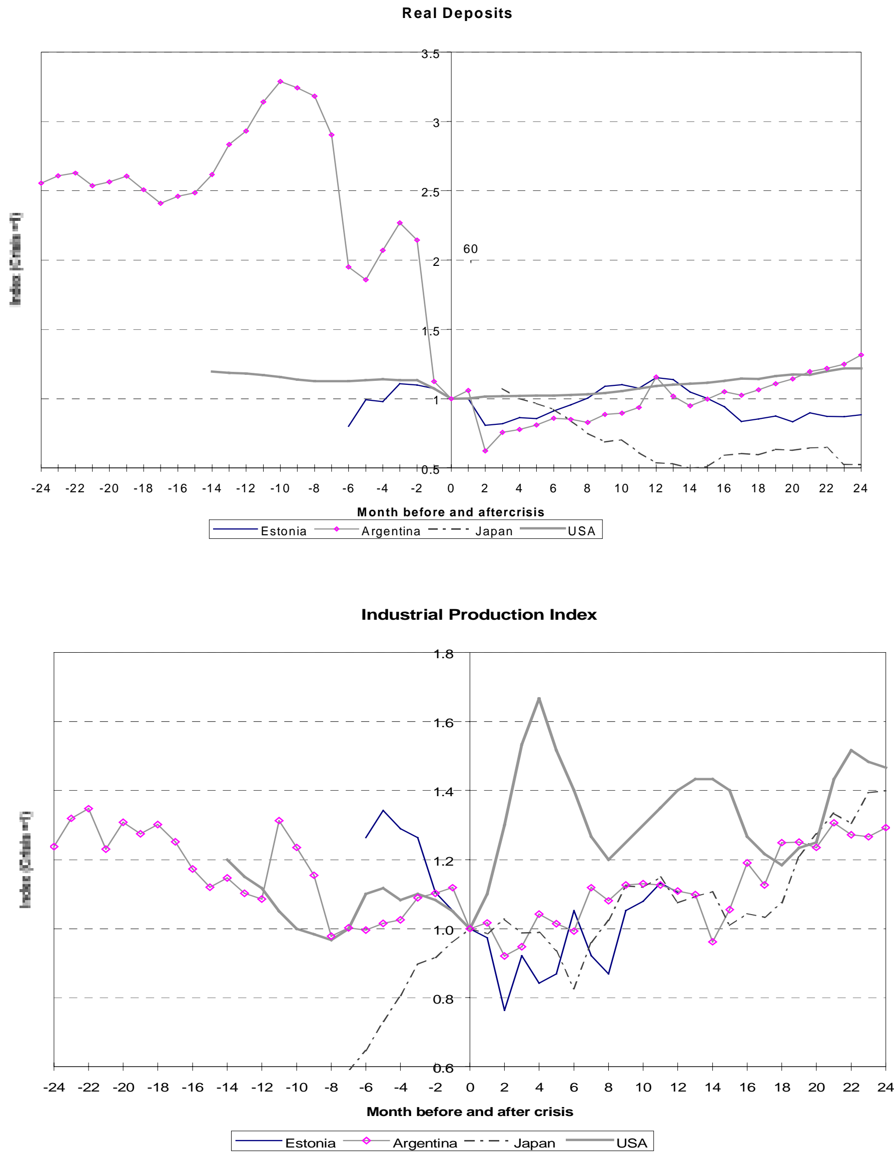
Lessons from systemic restructuring and burden-sharing

In some past crises—notably in Estonia (1992), Argentina (1980-82), Japan (1946), and United States (1933)—governments adopted a more or less common approach. First, policymakers undertook a comprehensive program of financial restructuring. Next, regulators restored public and investor confidence by demonstrating that institutions still in business were solvent and well capitalized; measures to signal this included injections of (private) capital into marginally solvent banks and relicensing procedures in cases where bank solvency crises affected much of the financial systems' assets and deposits (in the United States, for example). Old, partly distressed, assets were separated from new assets, and existing depositors absorbed losses. In some cases, new deposits were ranked senior to pre-crises obligations. This allowed viable financial institutions to maintain existing deposits to fund existing assets, while attracting new deposits to fund profitable new investments, thus facilitating restructuring. To limit the public's desire to shift from deposits to currency, the relative return on deposits was correctly priced. Finally, the time during which deposits of insolvent banks were frozen was kept to a minimum; a complete deposit freeze or a lengthy workout would have increased flight of depositors to currency, or other substitute assets.

Seek private contributions. Government can help clean up banks' balance sheets in various ways—rehabilitating assets, loss-sharing, reducing debt, and injecting new capital (Box 4). The way in which it is done will matter and will depend, among others on the existing ownership structure of the distressed financial institutions. In case of state-owned commercial banks there is no choice but for the government to step up with public support, provided management is changed and the banks will undertake the necessary operational restructuring. But in case of privately-owned financial institutions, private capital can be called upon, also to use as much private-sector information to decide on the options. Wherever possible undercapitalized financial institutions should seek private capital at the same time as public support is offered. Those financial institutions that choose not to participate on the terms offered will either be sound or, (more likely), have weak portfolios with private owners not willing to put up new capital and should be closed down. In all cases, assisted financial institutions should be required to draw up an acceptable business plan, verified by third-parties, that covers capital restructuring and operational restructuring to reduce costs and improve profit prospects without taking on additional risks. Adequate safeguards, of course, are needed to ensure that financial institutions do not subsequently become undercapitalized—tight and regular monitoring and supervision, on-site and off-site.

Put in place supportive fundamental reforms. Resuscitating financial systems must be done in tandem with other fundamental reforms—initially strengthening prudential regulation, adopting internationally accepted accounting, auditing and financial reporting standards and practices, and toughening compliance and regulation. And then forging all the institutional and legal tools to resolve failed institutions and dispose of their assets.

Figure 1
When Depositors Absorb Losses
Estonia (1992), Argentina (1980-82), Japan (1946), and USA (1933)



Box 4

Different Kinds of Support to Banks

Asset rehabilitation involves swapping impaired assets for cash or bonds. These will be at market prices (less, possibly substantially less, than book value). Even so, these swaps will improve capital adequacy, liquidity, the ability to make loans and can reduce funding costs. Risk-weighted capital ratios improve because the swap, generally, replaces risky loans with low-risk investments, such as government bonds or cash.

Loss-sharing arrangements can take various shapes. They might be proportional, or the bank could take the first hit up to a certain amount, with the government covering subsequent losses according a sliding scale. Loss sharing could also be for a limited period, say three or five years. Put-back options, interest guarantees and options to buy back assets could be used to structure loss sharing. The loans to be covered and loss-sharing could be based on an (aggregate) assessment of the distribution of expected loan losses under different economic scenarios by sector. For example, commercial real-estate loans may have more favorable loss-sharing arrangements than home loans, with corporate loans somewhere in between.

Liability reductions involve writing down creditors' claims, which improve capital-to-assets-ratios and potential profitability, without raising additional equity. While some East Asian countries have given creditors a blanket guarantee, it may still be possible to write down the some creditors.

Equity purchases by government, subordinated debt, or unrequited injections of cash or bonds (negotiable or non-negotiable) will also immediately increase net worth, improve capital ratios, liquidity, and potential profitability. If asset values and corporate earnings are temporarily low, but will recover as the economy strengthens, support through (temporary) government capital injections may make sense. This would follow the model of the Resolution Finance Corporation in the 1930s in the United States, where a systemic economic collapse threatened banks. Temporary government support through purchases of preferred stock allowed viable banks to survive. Self-selection incentives were built in, with private shareholders needing to come up with their own capital. But the 1930s scheme was successful, largely because falling asset values were outside the control (and responsibility) of banks, and many banks were solvent conditional on the economy improving. Incentives to gamble with depositors and lenders' money were low, partly because deposit insurance was limited. Anyway, opportunities for high-risk, high-reward investment were few and far between.

Where governments give support through purchase of preferred stock, they might forego dividends for some time to boost banks' income. Options to put-back private equity stakes to the government at certain prices and options to buy the government stake could be used to balance burden sharing. Subordinated debt convertible into equity if not repurchased by the bank within a specified time (or in the event of financial problems or managerial ineptitude) can be used to protect the government from banks' inability to service the debt (by allowing government to intervene). Such contingent clauses can also be a powerful incentive for owners and management to rehabilitate the bank as quickly and effectively as they can. Governments can finance equity, subordinated debt and cash injections by selling government paper in the market, or inject bonds, which banks can sell for cash. The main drawback of unrequited cash or bond injections is, of course, that the government does not have any ownership or control rights.

Granting government loans or placing deposits will also improve bank liquidity and provide an opportunity for the bank to buy unimpaired assets. This does not immediately increase capital, however, nor does it improve capital ratios because assets and liabilities increase by the same amount. Moreover, unless the bank has new, fit-and-proper owners and managers or is under air-tight supervision, there is a real danger that the old-style investment mentality will resurface—that is, investing funds in risky assets, as their gamble on recovery.

Applying the Principles for Banking Crises Resolution

Even when the principles of restructuring are agreed, governments still have face critical decisions. What is the best way to provide public support? How should the cost of restructuring be shared by financial institutions, corporations, and taxpayers? How to decide on the lead agent for restructuring? How to arrange loan workouts? What should be the speed and sequence of restructuring? And when should financial institutions be recapitalized?

What type of mechanisms for public support?

Maximizing private capital contributions—before providing public support—is easier said than done. Potential and existing shareholders, including foreign investors are often—understandably—reluctant to provide new capital. Often there is no choice but to make public money available for bank recapitalization. Any scheme must not be blanket recapitalization, however. It must discriminate based on asset quality and the reasons for non-performing loans. No support should be given to non-viable banks, which should be closed promptly. At the same time, support programs need to be broad enough to address the recapitalization needs of banks on a generally uniform basis. In many countries, no particular party can be tapped for new capital. Banks may have to be directly recapitalized and the government, if it does not already, will have to assume responsibilities of ownership and restructuring, until the bank can be sold to strategic investors with sufficient capital and expertise to manage it.

One aspect in the burden sharing is the structure for dealing with distressed loans. Such loans may be taken over by governments at their face value (less any provisions). To the extent that banks under-provision (which is often), the government will provide support accordingly. Contingent arrangements are also possible. In Chile, government purchases of non-performing loans was conditional on existing shareholders repurchasing those loans from future profits (Box 5). In Mexico, recapitalized banks bore 25 percent and government 75 percent of losses on non-performing loans, preserving some incentive for banks to manage and recover on these loans. In the end, non-performing claims continued to mount up (and the government is now the largest holder of financial assets in Mexico, but provides no intermediation) and corporations have not been restructured sufficiently by banks.

Coordinate various reforms carefully

The proper coordination of major structural reforms is essential. Especially, rehabilitation of financial institutions and non-financial corporations cannot be considered separately. With widespread insolvency in the corporate sector, simply restructuring of financial institutions will not be enough to ensure business as usual for financial firms and corporations. Indeed, this is an especially risky time for re-capitalized banks that now have the resources to resume lending, and are confronted with demands for credit still shaky corporations. They may be reluctant to lend, but how are they to survive without a corporate clientele? And how are they to resist strong political pressures to lend to enterprises that are insolvent?

Box 5

How Chile handled its banking crisis

Chile's banking crisis in 1981-83 permeated the entire financial system, affecting roughly 60 percent of total loan portfolios. The crisis stemmed from macroeconomic problems, compounded by unsound financial practices. After an initially delayed reaction, in 1984 the government took an aggressive and comprehensive approach. Depending on their level of solvency, some banks were liquidated, others rehabilitated. Altogether, the government liquidated eight banks of the 14 it had taken over and 26 comprising the banking system. It also liquidated all eight finance companies it had taken over, leaving nine operating. Along with mergers, this reduced the number of banks by a third and finance companies by two-thirds.

Rehabilitation took two forms. One was aimed at improving borrowers' capacity to repay loans to banks. This mainly consisted of across-the-board debt reschedulings (for corporations and consumers) at below-market interest rates and coverage for exchange rate losses, affecting about 25 percent of the banking system's total loan portfolio. The other was aimed at rebuilding the capital base of the banking system. Distressed loans were transferred to the central bank. Existing shareholders could not receive dividends until the central bank was repaid. Payments due to the central bank depended on the extent of loan recovery, thus shifting the burden of non-performing assets on to old shareholders. This was followed by recapitalization and equity sales of the restructured banks to small investors, using various credit facilities and subsidies to encourage them to buy.

The government strengthened banking supervision by improving loan portfolio analysis, including an early-warning system for potentially problematic loans, and increasing transparency of financial transactions. Banks were also required to be rated by two private credit rating agencies each year and obligated to the timely publication of information on their financial condition, with stiff penalties for non-compliance.

The break-up of highly indebted conglomerates, closure of perennial loss-making firms, and reprivatization all helped corporate restructuring. Corporate ownership was deconcentrated and the equity base expanded by selling shares to the general public and encouraging investments by private pension funds, as well as involving foreign investors through debt-for-equity swaps. And more privatizations followed in 1986-88.

Typically, restructuring of banks and corporates is poorly coordinated. In Mexico in 1995, for example, recapitalized banks were formally in charge of restructuring corporate loans but did very little, partly because Mexican bankruptcy procedures are long-winded and cumbersome. Non-performing assets ballooned from $15 billion in 1995 to $64 billion in 1998, or 15 percent of GDP. Only today are the authorities coming to grips with the problem. That Mexico was still able to recover relatively quickly had more to do with its closeness to (and recent integration through NAFTA with) a major export market, the United States, than with its reform program. Moreover, domestic financial intermediation was low and many exporting firms were able to obtain financing from foreign sources, which partly nullified the effects of the financial-sector crisis.

Evidence from transition economies also shows that when non-financial corporate sectors were put on a sounder basis, financial sectors were able to establish and retain viability. But banks in these economies did not restructure enterprises. It was hard budget constraint, and privatization, that encouraged the necessary restructuring. In other cases, Bulgaria, for instance, delays in restructuring of non-financial corporations has led to repeated recapitalization of the banking system and periods of sky-high inflation. In contrast, Chile in the early 1980s, after some failed attempts, opted for comprehensive, integrated bank and corporate restructuring (see Box 5).

How to coordinate reforms? There is no blueprint for sequencing of bank, corporate restructuring and macro-economic policies. One important aspect has been whether to recapitalize banks before, or after, corporate restructuring. Under an ex-ante recapitalization, with appropriate burden sharing, the government recapitalizes banks based on an assessment of probable losses (determined by outside audits and independent portfolio reviews). Some loans may be transferred, at the time of the recapitalization or afterwards, to asset management companies. For remaining loans to individual corporations, the main function of bank and other creditors, is to drive operational restructuring, reduce debt to manageable levels, and, if necessary, provide working capital. (The government does not intervene directly.) This approach has been used in most transition economies (with some success in Poland), and in many developing countries (with limited success) and is used in several East Asian countries.

Ex-ante recapitalization can be fast and signal to the market that problems are being resolved. It also formalizes government' guarantees of bank liabilities. And, provided it is accompanied by substantive improvements in corporate governance and bank operations and is well monitored, it can be an up-front investment that leads to lower ultimate costs. But ex-ante recapitalization has also carried big risks. Governments routinely respond to such systemic bank solvency problems by injecting capital into insolvent banks, without change in governance and bank operations, and recapitalization is wasted. Banks will have better capacity to work out loans and takes losses when recapitalized, but they may still delay restructuring and roll over non-performing loans since they are able to attract new funds anyhow. And, likewise, corporations may have little incentive to undertake necessary operational restructuring, if they have access to new funds anyway. Banks in Japan, for example, have shown no inclination to undertake corporate restructuring, as they can continue to carry non-performing loans at low costs.

The risks are very real for many developing countries as corporate restructuring is often too heavy a burden for many developing countries' banks. Most banks do not have the necessary skills, technical capacity and institutional development—and that cannot be remedied overnight. Also, banks may not always have enough bargaining power in the restructuring negotiations with corporations. Because of the social and political consequences of restructuring and other "too-big-to-fail" reasons, banks have often not been able to hold their own against large corporates, such as large state-owned enterprises, or big family-controlled conglomerates. This has resulted in weak corporate restructuring and, ultimately, bigger fiscal costs.

The other sequencing model involves tighter links between financial- and corporate-sector restructuring. In the extreme, this is ex-post recapitalization, where banks receive public funds as, and when, they provide financial relief to corporations. This model provides more time to undertake the necessary fundamental reforms and maintains pressures on banks and corporations to agree quickly on realistic financial and operational restructuring. The main drawback is uncertainty, as depositors and other creditors can be uncertain about the quality of their claims. One compromise might be to provide some public funds or guarantees immediately with further support conditional on progress in corporate debt restructuring.

Conclusions

Experiences from other countries suggest several important principles for successful systemic restructuring. It requires sufficient public resources, deep changes in institutions, rules of the games, and attitudes, an early and systematic evaluation of the size of the problem, design of an overall strategy, and prompt action. The approach needs to be comprehensive and repair both the flow and stock problems of weak and insolvent financial institutions and corporations. Shifting non-performing loans from bank balance sheets to loan-recovery agencies can be useful in easing the financial institutions' stock problem—but it has risks. The government might have to provide capital to viable financial institutions, but this should not undermine incentives for private-sector equity injections. Extraordinary mechanisms to accelerate operational restructuring of corporations are necessary to return financial institutions and firms to profitability and sustained solvency. This, in turns, requires effective loan workouts and properly structured loss absorption that also take into account the links between financial—and corporate-sector restructuring. Exit policies and procedures—for firms and financial institutions—need to be revamped and strictly enforced. Capital adequacy targets need to be meaningful, but should be enforced as forbearance is risky and costly.

Experience also shows that systemic restructuring is difficult to design and often leads to moral hazard. Appropriate design depends on country circumstances, including the overall macro-economic environment, its fiscal and external financing situation, and quality of the institutional framework. While there is no catch-all solution, there is no alternative to comprehensive and integrated solution. Existing institutional weaknesses in many developing countries also make some options less preferable. In particular, a bank-led approach—where banks are recapitalized and take the lead in corporate restructuring—has rarely been sufficient to resolve corporate sector problems—and thus restore financial institutions' capital positions. It is also clear that more centralized, government-led approaches have many risks for developing countries. Hard-budget constraints and complementary actions will be necessary.

In addition to these difficulties, systemic bank restructuring in China poses some specific challenges. Major constraints to bank restructuring in China include: (i) the lack of banking skills at the level where information is gathered and decisions are made, (ii) a large role of the government in the credit allocation process, (iii) limited accountability of individuals and local decision making units in credit and restructuring decisions, (iv) limited quality of information for internal control and external supervision purposes, and (v) unreliable information of banks' clients' financial situation. Furthermore, the Government has to take into account any adverse social implications of enterprise reform as a result of banking reform.

The Government has already embarked on some major reforms including asset classification according to internationally acceptable principles, and the allocation of some fiscal resources for bank recapitalization. The experience of other countries suggests that bank restructuring is a long process and it will be important to continue to devote substantial financial and human resources over a long period of time.

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