Chapter 2

Bank restructuring: international experience

2.1 During the last twenty years, over 130 countries, developed and developing, have experienced banking crises in one form or the other.[1] Countries faced with such crises have tried to tackle them in their own ways. While some succeeded, others did not with the result that in successful cases the crisis could be controlled quickly and the cost to the country was fairly manageable. In cases where, for different reasons, the crisis handling was not effective, the adverse impact of the crisis was prolonged and the cost both in financial terms as well as in terms of human suffering turned out to be enormous.

2.2 The Working Group has made an effort to study the handling of banking crises in some of these countries and has also endeavoured to understand, the strategies adopted by them in the handling of the crises. The objective has been to learn, as far as possible, about the modalities of restructuring in these cases, the steps taken, the sequencing of such steps, the cost to the system in terms of finances and time, and the results achieved. Not surprisingly, from the study, a fairly consistent picture of causes as well as ingredients of successful handling of such crises emerges. Specific steps taken in these cases may have been different, and the institutions, existing or specially created as part of a restructuring strategy, may have been structured, funded and controlled differently, but the underlying objectives and the conditions which were sought to be created for overcoming the crises were by and large similar in most successful cases.

2.3 In the following paragraphs, a brief account of the crisis handling efforts of a few countries where the conditions were somewhat similar to ours is given. At the end of these accounts, an effort has been made to draw common conclusions and to see what lessons these contain for us.

Sweden[2]

2.4 Sweden is an oft-quoted example of successful management of banking crisis by adopting a comprehensive strategy. Its banking problems came to light in late 1990 mainly due to over exposure to the real estate sector. The government opted for a comprehensive approach the main features of which were as follows:

a. A separate restructuring authority, known as the Bank Support Authority, was set up.

b. The government took steps to raise confidence in the country's financial system. It guaranteed that the banks and all other credit institutions would meet their commitments as and when they arose. Along with this, transparency and disclosure of information ensured increased confidence at home and abroad.

c. The respective roles of all concerned agencies, the Ministry of Finance, the Riksbank, the Financial Supervisory Authority, and the Bank Support Authority were clearly defined. There was free exchange of information between these agencies.

d. On the basis of a clear yardstick based on capital adequacy and financial ratios, banks were divided into those which were viable and those which were not. The former category was eligible for financial assistance while the banks in the latter were to be closed or merged with other institutions.

e. The support agreements contained conditions relating to change in management and improvement of internal control and risk management systems. Owners' equity was not guaranteed. This ensured establishment of proper incentives.

f. Structural reforms included strengthening of accounting, legal and regulatory frameworks and prudential supervision.

g. Separate Asset Management Companies, Securum and Retriva, were set up respectively for Nordbanken and Gota Bank, the two institutions which received most of the budgetary support. These were solely funded and capitalised by the government.

2.5 Government support was in the form of capital infusion (86 per cent) and loan guarantees apart from share subscription or share purchases (10 per cent) and interest subsidies (2 per cent). The net fiscal cost to the budget was 4.2 per cent of GDP. This is being recovered by proceeds from sale of assets and by sale, at a substantial premium, of shares in the rehabilitated state-owned Nordbanken (with which the Gota Bank was subsequently merged).

Poland[3]

2.6 Bank restructuring in Poland was also successful mainly because of its comprehensive approach. The strategy of the government's Enterprise and Bank Restructuring Programme (EBRP) was to make a proper assessment of the extent to which a bank was in trouble and then to emphasise organisational restructuring. For this purpose, the programme laid heavy stress on proper and transparent accounting and also provided for detailed audit by international auditing firms.

2.7 Privatisation was one of the main objectives of the restructuring programme. The banks to be restructured were, therefore, first transformed into joint stock companies with the government being the sole shareholder. To manage these banks in their new form, long term technical assistance contracts with reputable foreign banks (twinning arrangements) were entered into.

2.8 The government did not opt for centralised handling of bad debts by another agency since it felt that the bad debts must be recovered by the banks themselves. The banks were therefore recapitalised and the bad debts were left on their own books to be collected by them.

2.9 Since the loans were left on the books of the banks, there was the risk of further lendings to the defaulting borrowers. This risk was fore seen and duly covered by requiring the banks to make provisions for the loan and to set up debt workout units within a specified timeframe. The

debt workout units were also given a time limit within which they were to either sell or restructure the substandard loans. The whole programme was thus run with a firm time schedule.

2.10 A special legal framework was provided by the government for implementing the restructuring plan. Under the relevant law, i.e., the Restructuring Law of 1993, banks were debarred from extending fresh credit to bad debtors unless in conjunction with a restructuring agreement. The law required that one of the following events take place: (a) the loan is entirely recovered, (b) a restructuring agreement is entered into, (c) the debtor is legally declared bankrupt, (d) liquidation of the debtor is initiated or (e) the debtor has regained creditworthiness by servicing its debt for three months. If these requirements were not met, the bank was obliged to sell the loan in the open market.

2.11 The recapitalisation programme provided a one time substantial capital infusion to ensure that the bank could operate effectively and be suitable for privatisation. This recapitalisation was effected by issuing 15-year bonds, non-negotiable for three years, with biannual redemption starting 18 months from the date of issue. The non-negotiability and the delayed amortisation ensured that public funds were not misused.

The Philippines[4]

2.12 The problems faced by banks in the Philippines in the early 1980s exemplify the special problems in dealing with government-owned banks. Due to non-transparent accounting practices, inadequate provisioning in loan losses and lax supervision, the banking sector in the Philippines was inherently weak. The Monetary Board, the supervisory agency, preferred to give the banks more time to tide over their crises rather than enforce regulation in respect of provisioning, etc. This supervisory forbearance resulted in making the banks' position weaker. The weaknesses were exposed in 1983 when due to political turmoil and deteriorating balance of payments position, the government declared a moratorium on external debt repayment. This led to a crisis resulting in run on banks and capital outflows. The problem was compounded by the government's direction to banks to continue their lending to weak enterprises.

2.13 By end-1985, the Philippines National Bank (PNB) and the Development Bank of the Philippines (DBP) were declared insolvent. These banks accounted for nearly half of the banking system's assets. Their non- performing loans formed about 70 per cent of their combined portfolios and about 21 per cent of the banking system's assets.

2.14 The rehabilitation programmes adopted for these banks were comprehensive and included downsizing, transfer of non-performing assets to the Asset Privatisation Trust, recapitalisation, writing off of government deposits, introduction of new management, closing of branches and cost reduction programmes including significant staff cuts to the extent of nearly 25 per cent in PNB and 40 per cent in the case of DBP. As a result, the banks became much smaller; the total assets of PNB were reduced by 54 per cent and those of the DBP by about 87 per cent. By 1987, both banks returned to profitability and improved their capital asset ratios. In 1989, PNB was privatised up to 30 per cent and further to 57 per cent by 1996.

2.15 The success of the restructuring programme in the Philippines was that it addressed the

basic causes of weakness and that it encompassed financial and operational aspects. Such a comprehensive rehabilitation facilitated phased privatisation.

Thailand[5]

2.16 Thailand's financial sector had been facing problems since the early 1980s due to weak managerial practices and inadequate supervision. The remedial measures then taken included strengthening of the legal, regulatory and supervisory arrangements, government takeover, changes in management, mergers and closures and financial support at market-related rates. The basic weaknesses, however, persisted and, in 1997, deeper structural weaknesses in the economy brought these weaknesses to the fore again.

2.17 Immediate regulatory action involved suspension of operation of 58 finance companies, which were required to submit rehabilitation plans. The Financial Sector Restructuring Authority (FSRA) and the Asset Management Corporation (AMC) were created to aid the restructuring process. The FSRA was established as an independent body under a separate Act in October 1997 to review the rehabilitation of the suspended companies and, where rehabilitation was not feasible, to oversee their liquidation.

2.18 Legal reforms were also undertaken which included amendments to bankruptcy and foreclosure procedures to ensure orderly resolution of corporate debts. Regulation also was further tightened to bring accounting and classification of loans in line with international norms.

2.19 The FSRA assumed the responsibility of either rehabilitating or liquidating the troubled units. The most important point to note about the Thai financial restructuring programme has been that an entirely new institutional framework was created and the legal and regulatory framework was simultaneously amended to meet the requirements of the situation. It was thus a fairly comprehensive programme.

Korea[6]

2.20 The Korean financial crisis that broke out in December 1997 had its origins in the corporate and financial sectors and a poorly implemented capital account liberalisation. The more immediate causes were a deteriorating terms of trade, bankruptcy of important *chaebols* (or conglomerates), and a change in international market sentiment.

2.21 Poor quality of regulatory control that did not provide for internationally accepted accounting and provisioning norms and had lax capital standards and generous exposure limits resulted in the banks building up large liquidity mismatches especially in their foreign exchange portfolio. This situation made the banking system extremely vulnerable to shocks. In 1996, when the terms of trade became adverse, the profit margins of Korean firms were affected. The failure of some bigger *chaebols* in 1997 and the East Asian crisis brought the situation to a head towards the end of 1997.

2.22 In November 1997, the government announced a blanket guarantee for deposits maintained with banks and other financial institutions. This helped retain the confidence of the depositors.

This was followed in December 1997 by a comprehensive reform package that included exit of unviable financial institutions, restructuring of others, and the strengthening of banking regulation and supervision.

2.23 The process of bank restructuring in Korea took the shape of voluntary mergers and foreign investments. Sizeable public funds were provided by the government to purchase NPAs and to recapitalise the banks. The funds were provided through the issuance of bonds by the two government bodies, the Korea Asset Management Corporation (KAMCO) and the Korean Deposit Insurance Corporation (KDIC) which was a new agency formed by merger of all deposit insurance protection agencies and also by purchase of shares, ordinary and preferred, purchase of subordinated debt, purchases of non-performing loans and repayment of depositors.

2.24 The bad loans were purchased by KAMCO at a discount that roughly corresponded to the mandated provisioning levels; the discount was then adjusted after KAMCO had a chance to have the collateral on the loans appraised. As this arrangement was not working satisfactorily, KAMCO later purchased the non-performing assets at a fixed price, 36 per cent of book value for secured loans and one per cent for unsecured loans based on historical estimates of loan recovery.

2.25 Supervision was placed with a new agency endowed with significant operational independence. This agency was also in charge of restructuring financial institutions. Regulations were tightened in the areas of risk concentration, connected lending, maturity and currency mismatches, cross guarantees, and in making financial statements more transparent.

2.26 The Korean crisis underlines the risks involved in supervisory forbearance and the importance of transparent financial statements so as to prevent the confidence of investors being undermined. It also highlights the importance of tighter regulation of on- and off-balance sheet risks and exposure limits. Supervisory forbearance allows problems to become larger and costlier to solve. The Korean experience also shows that where prudential norms are lax and transparency is lacking, the initial estimates of loan losses are likely to be unduly low leading to an underestimation of the resources that may be needed for bank restructuring.

China[7]

2.27 Extensive bank restructuring is being carried out in China since 1997. Four of the largest state-owned banks, viz., Industrial and Commercial Bank of China, Construction Bank of China, Agricultural Bank of China and Bank of China, are undergoing restructuring programmes aimed at improving their efficiency and increasing profits which have stagnated due to huge non-performing assets estimated to be at about 20 per cent of total outstanding loans.

2.28 The poor performance is attributed to decades of government- directed lending and poor management. Each of these banks reportedly has between 800 and 1000 branches and together employ more than 1.5 million employees. The operations are fully guaranteed by the central government, which owns them.

2.29 The series of measures taken by the government to improve management, capital and asset

quality include increasing banks' independence from local governments, setting up asset management companies, conversion of debt into equity, mergers, closures and liquidation, and direct capital injections from the central government. Between 10 and 30 per cent of branches of these banks will be either closed or merged. A new board of supervisors for the banks will oversee the work of the top management of the four banks. This board will include representatives from the People's Bank of China, Ministry of Finance and the State Audit Office.

2.30 Reports indicate that the four banks will introduce wage reforms aimed at identifying qualified banking personnel and giving them better terms which may include higher pay, better housing and improved medical and retirement benefits. The surplus bank employees estimated to be between 10 and 20 per cent of total number of employees would be laid off.

United States of America[8]

2.31 Bank failures in USA were comparatively few in relation to the total number of banks for almost the first 50 years since the setting up of the Federal Deposit Insurance Corporation (FDIC) in 1933. The 1980s and the early 1990s witnessed the most severe banking crisis since the Great Depression years. In this crisis, involving mainly the Savings and Loans institutions (S&Ls), or thrifts, over 9,000 institutions were either closed or merged.

2.32 The US banking system was highly segmented geographically and functionally, thereby increasing the risk profile of the banks. For instance, in 1987, 90 per cent of bank failures took place in states that still had restrictions on inter-state banking. Further, technological innovation and competitive pressures from credit card companies, money market mutual funds, insurance, securities houses and pension funds led to an erosion of the banks' and thrifts' traditional hold over the payments system, low-interest deposits, and commercial loans. Enhanced deposit insurance along with financial deregulation and growth in real estate construction fuelled by tax incentives, encouraged new entrants into the industry and led to higher risk- taking. Combined with poor management, imprudent lending practices and fraud, this led to an unprecedented crisis in the US banking system. The moral hazard effect of deposit insurance was strengthened when a number of large institutions, such as the Continental Illinois Bank were saved on the basis of the "too big to fail" principle.

2.33 Overlap between the jurisdiction of different regulatory institutions and regulatory forbearance further complicated the problem. The regulators, on account of budget cutbacks, reduced the strength of examiners and with it the quality and frequency of examinations. These factors delayed the diagnosis of the crisis and its resolution, the final cost of which increased several fold. One of the estimates of the final cost to the government for cleaning up the thrift industry alone places it at around US$ 150 billion.

2.34 In dealing with troubled banks, the FDIC mostly opted for the strategy of "open bank assistance" which involved preventive intervention before closure. This usually included assistance from the Federal Reserve in the form of emergency credits for temporary liquidity purposes. In the case of merger with healthier banks, FDIC entered into "income maintenance agreements", where it stood guarantee for a minimum return on the earning assets that were acquired.

2.35 The FDIC strategy in respect of failing institutions was mostly by way of arranging for "Purchase and Assumption" (P&A) under which the acquirer purchased some or all assets and assumed some or all liabilities of the failed bank. In the case of "clean bank" P&As, only the good assets were taken over. When this proved to be a drain on its resources, FDIC opted for "whole bank" P&As where the entire assets and liabilities were taken over. When this became difficult to arrange for, "small bank" P&As were introduced where a smaller package of assets including some non- performing loans were taken over by the acquirer. By 1990, FDIC subjected all assistance to three criteria: competitive bidding, "due diligence" review by potential acquirers and quantitative limits on guarantee by it.

2.36 The crisis also resulted in a number of changes in the regulatory framework. The Competitive Equality Banking Act, 1987, provided for the establishment of "bridge banks" to take over the operations of a failing bank and maintain banking services for its customers. It helped "bridge" the gap between the failure of a bank and the time when the FDIC can implement a satisfactory resolution of the failing bank. This arrangement ensured that the banking needs of the normal customers and better borrowers are not affected.

2.37 The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 allowed for placing temporary stewardship of problem banks with the federal authorities and in some cases allow for a temporary public equity stake when institutions are sold to the private sector. The FSLIC was liquidated and the FDIC took over insurance of thrifts. A new Office of Thrift Supervision was established to regulate thrifts. The Resolution Trust Corporation (RTC) was set up and given six years to clean up the assets of the thrift industry.

2.38 The RTC's two main roles were that of a conservator and receiver of the insolvent thrifts. As a conservator, the operations and employees of the thrifts under its charge came under its control until the best method of resolution was determined and implemented. The RTC could raise US$ 20 billion through general Treasury bond financing and contributions from federal home loan banks. It could also issue US$ 30 billion of special Resolution Finance Corporation bonds, using zero coupon treasury bonds as collateral.

2.39 The FDIC Improvement Act, 1991, among other things, provided for rules requiring regulators to act quickly (Prompt Corrective Action) when a bank's core capital falls below 2 per cent of risk assets and to replace management and limit the asset growth of "critically undercapitalised" banks. It also provided for restrictions on the Federal Reserve's ability to provide credit to ailing banks and introduction of differential deposit insurance premiums.

Conclusion

2.40 In view of the pivotal role of the banking sector, banking problems need to be dealt with delicately. There is, however, no unanimity in the approach to resolution of banking crises. The responses to banking crises in various countries range from "benign neglect" or a policy of free exit to that of treating the sector or, at least a part thereof, as "too big to fail". The latter approach is based on the perception that the failure of a big bank may disrupt the payments system and have a domino effect on other banks apart from causing distress to depositors and borrowers

alike. However, guaranteed protection to banks, whether explicit or implicit, is likely to generate or perpetrate behaviour that might lead to the very same kind of banking problems that such guarantees seek to prevent. Government ownership of these banks makes the situation more complex.

2.41 Restructuring of a banking system has to operate at two levels. The first needs to address macro systemic issues pertaining to factors responsible for ensuring banking soundness. These may include availability of a proper operating environment including legal and other institutional support, well-conceived internal systems and procedures, effective internal and external controls as well as regulation and supervision.

2.42 Tackling micro level, individual bank problems forms the second level. These broadly include resolving the bank's problems at a financial and operational level. International experience has shown that attention needs to be paid to both financial and operational aspects to successfully restore solvency and ensure sustained profitability.

<u>Financial restructuring (micro level, individual bank issues)</u>

2.43 Financial restructuring of a bank is mainly aimed at restoring its solvency. It involves one or more of the following: capital infusion, reduction of other liabilities, management of assets with a view to increase their value and other instruments aimed at increasing profitability. Capital infusion may take the form of additional capital contribution from the present owners or conversion of existing liabilities such as subordinated debt and even deposits into capital. Issue of fresh subordinated debt and government recapitalisation bonds are also other methods of improving the capital base.

<u>Operational restructuring</u>

2.44 Operational restructuring attempts to provide the ideal conditions within a bank to ensure that the profitability increases and is sustained over a period. The key elements here are the quality of internal governance and the structure of a bank's operations. The operational restructuring tools may include changes in ownership and management and a drastic reengineering of its operations to cover, among other things, its business strategy, product mix and pricing, loan recovery procedures, branch network, staff costs and increased resort to automation and other new technology.

<u>Systemic restructuring (macro level issues)</u>

2.45 Systemic restructuring addresses the environmental issues such as the efficiency of the banking structure, ownership, entry and exit policies, distribution of banking assets, permissible activities, etc. The operating environment also includes the political, legal and other institutional infrastructure, the structure, quality and efficiency of which have a direct bearing on whether banking efficiency is promoted or hampered.

2.46 Different countries have opted for different strategies depending on the structure of their banking system. If banking assets are fragmented between different banks, consolidation by

merger will help achieve economies of scale and also economise on scarce managerial expertise. While healthier banks could be merged, consolidation could also be done by liquidating those that are insolvent. In the United States, thousands of banks and thrifts were merged or closed.

2.47 In a more concentrated banking system, large insolvent banks could be split, the viable parts sold and the rest liquidated. Breaking up of monolithic banking systems was adopted in several emerging market economies of Eastern Europe. In Nicaragua, Peru and Tanzania, large problem banks were downsized by placing restrictions on asset growth. In Argentina, Estonia, Latvia and Venezuela, several bigger banks were either closed or merged. Simultaneously, some of the countries permitted entry of new banks including foreign banks.

2.48 Privatisation of state-owned banks was found to have shown positive results. However, the mode of privatisation is important. If transfer is to individuals with inadequate banking experience or if the bank's assets are poorly priced, further banking crises are likely to result. Privatisation will also enable the government to recoup the cost of restructuring, or at least a part thereof, if it has succeeded in restoring the bank to health and in greatly increasing its market value.

2.49 Establishment of what are variously termed as asset management companies or loan workout units and transfer of assets to them at market-related prices were found to be beneficial. Apart from improving cash flow, it enables the management to concentrate on the business of banking rather than waste efforts in chasing hard core non-performing assets.

2.50 While there is no unique solution to banking crises that could be prescribed and applied across the board to all countries, there are some common threads that seem to run through all cases of successful restructuring. Ultimately, each bank needs to be restored to a minimum level of solvency through financial restructuring. Thereafter, only longer term operational and systemic restructuring can help them maintain their competitiveness and enable them to ensure sustained profitability. Only a comprehensive approach to restructuring can have a lasting effect on the cost, earnings and profits of the banks to be restructured.

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[1] Please see annex to Chapter 1 of Lindgren, Garcia and Saal (1996) for a concise survey of banking problems worldwide. See also Caprio and Klingebiel (1996a, 1996b), Hausmann and Rojas-Suárez (1996), Honohan (1997), Sheng (1996) and Sundararajan and Baliño (1991).
[2] Drees and Pazarbasioglu (1998), Dziobek and Pazarbasioglu (1998). ¸ ¸
[3] Dziobek and Pazarbasioglu (1998). ¸
[4] Dziobek and Pazarbasioglu (1998), Nascimento (1991). ¸
[5] Bank of Thailand (1998a, 1998b) and Johnston (1991).
[6] Baliño and Ubide (1999), Bank of Korea (1998).
[7] Leggett (1999), Ping (1999).
[8] The Federal Deposit Insurance Corporation (1997, 1998), Sheng (1996).