Healthy Banks Are Vital for a Strong Economy

Banking crises have become the "issue *du jour*," said IMF First Deputy Managing Director Stanley Fischer, moderator of a recent IMF-sponsored roundtable on experiences in dealing with banking crises. The number of countries experiencing significant banking problems has increased substantially in recent years—hitting industrial and developing countries alike—and the high costs and macroeconomic disruptions caused by banking crises have become a matter of increasing concern to the international financial community.

Manuel Guitián (left), Stanley Fischer, and Michael Mussa at the IMF-sponsored roundtable on banking crises.

Covering the theoretical and the practical, roundtable participants—including IMF staff and senior officials from member country financial institutions—discussed both general and country-specific experiences. Although these experiences differed according to each country's circumstances, participants generally agreed that a sound banking system was necessary to support effective macroeconomic policy; and that, in most cases, it was costly and counterproductive to keep unhealthy banks alive through artificial resuscitation.

Bank Soundness and Macroeconomic Policy

One of the most important conditions for avoiding serious banking crises is the pursuit of stable macroeconomic policies, according to Michael Mussa, Director of the IMF's Research Department. Nonetheless, principles of sound banking and effective regulation and supervision are vital to limit the adverse impact of macroeconomic disturbances.

The fragility of banking systems also constrains the conduct of macroeconomic policy. Banking problems in the United States and Japan in the 1990s hampered the efforts of these countries to recover from recession. Similarly, during the European exchange rate mechanism crisis of 1992, the United Kingdom was constrained by problems in its banking system. Banking problems imposed costs and constraints on the macroeconomy and the conduct of macroeconomic policy in both industrial and many developing and emerging economies. One of the common themes underlying the cause of banking difficulties in many countries related to the "boom and bust" cycles, according to Mussa. Under boom conditions, banks often extended risky loans that turned sour when the bust occurred. An important aspect of sound regulation was to allow the discipline of the market to operate, to ensure that unsound banks fail and their managements are fired.

Role of Central Bank in a Banking Crisis

As the center of the financial system, the central bank faces both a short-term and a medium-term challenge in a financial crisis, according to Manuel Guitián, Director of the IMF's Monetary and Exchange Affairs Department. In the short term, the central bank may need to act as a lender of last resort; in the medium term, it is a major player in the restructuring of the financial sector. In both of these roles, the central bank faces a dilemma: it must support the financial sector, but it must also fulfill its principal function of maintaining economic stability through a credible, responsible monetary policy.

Lender of Last Resort. Ideally, the short-term response of the central bank to a crisis is to provide relief only to solvent but illiquid banks to prevent them from engaging in "distress sales." A major difficulty with this approach is that it is not always easy to distinguish between insolvency and illiquidity.

The lender-of-last-resort function involves net injections of liquidity into the economy and thus has a monetary impact that conflicts with the chief objective of monetary policy, which is to maintain stability and low inflation.

Because the lender-of-last-resort function can have potentially risky con-

sequences, the central bank should exercise it only in exceptional circumstances, Guitián said. Rather, the central bank should focus on prevention through the appropriate supervision of banks.

Restructuring the Financial Sector. In the medium-term task of restructuring the financial sector, the role of the central bank—as well as those of government and the private sector—must be defined, Guitián said. The central bank is necessarily a focal point, but it faces the dilemma of having to restructure the banking system without endangering its credibility in maintaining price stability. For this reason, Guitián concluded, its role should be strictly advisory, while bank restructuring should be financed by government and private sources.

Case Histories

Mexico. Ariel Buira Seira, Deputy Governor of the Bank of Mexico, said that the banking crisis had its origins in the sudden and drastic reduction in net foreign credits to the country. In dealing with the banking crisis, the Mexican authorities were guided by several principles:

- preventing the development of systemic risk;
- avoiding an undue expansion of net domestic credit by the central bank;
- resisting political pressures to bail out shareholders while protecting the interests of creditors and borrowers;
- minimizing the fiscal cost of policies adopted to overcome the crises; and
- interfering to the least possible extent with the normal functioning of the market.

The Mexican authorities adopted a number of measures to deal with the banking crisis. These included the creation of new programs to help commercial banks and debtors withstand shocks arising from external outflows and devaluation. These actions, said Buira Seira, had successfully mitigated the effects of the crisis.

Estonia. Vahur Kraft, Governor of the Bank of Estonia, noted that his country did not develop a modern banking system until the early 1990s, and the first Estonian currency was introduced in June 1992 under a currency board arrangement. At the end of 1992, more than one fourth of the banking system went bankrupt, mainly because of unfamiliarity with banking practices and, sometimes, incompetence on the part of bank managers.

In the wake of the crisis, many failed banks were allowed to close and some were restructured. The currency board arrangement, with its defined currency issue mechanism and fixed exchange rate serving as a nominal anchor, helped contain the effects of the crisis by giving credibility to the conduct of monetary policy. The stabilization effort pursued by the authorities during the banking crisis, which was supported by credible policies, also helped attract foreign financing. This gave the authorities breathing space to enact radical banking reform. In the last few years, Kraft said, the Estonian banking system had witnessed a gradual but considerable improvement in competence, sophistication, and credibility.

Zambia. The financial crisis that exploded in Zambia in the 1990s was internally generated by poor management and even recklessness in banking practices in some cases, according to Jacob Mwanza, Governor of the Bank of Zambia. During the second half of the 1980s, some banks had been created solely for the purpose of financing the operations of specific public enterprises. Although the Bank of Zambia was in charge of banking supervision, the Ministry of Finance had the authority to grant licenses to establish banks.

The Zambian authorities have acted decisively in the past few years to contain the banking crisis and correct past mistakes, according to Mwanza. In December 1994, Zambia enacted the Banking and Financial Services Act to enable the Bank of Zambia to close commercial banks and impose restrictions on their activities. The law also substantially raised minimum capital requirements necessary to establish banks. Zambia is also creating an effective supervisory department within the Bank of Zambia that will authorize the central bank to undertake on-site inspection of banks without prior warning.

Japan. According to Akira Nagashima, Deputy Governor for International Relations at the Bank of Japan, the banking crisis in Japan was closely related to the emergence and subsequent collapse of the so-called speculative bubble from the late 1980s to the early 1990s. During 1986–88, the yen appreciated sharply, and the monetary authorities followed an expansionary monetary policy to offset the dampening effects of the appreciation of the currency on the economy. Although the money supply and asset prices rose rapidly, there were no signs of rising inflation. Large unrealized capital gains prompted banks to extend credit, but they often lent to companies involved in risk-taking and speculation. In addition, said Nagashima, a widespread sense of euphoria prevailed; the country was "obsessed" with expectations of extremely high rates of return on investments.

When monetary conditions were tightened starting in 1989 and quantitative restrictions on real estate lending were imposed in 1990, the bubble burst and a banking crisis emerged. The authorities acted to mitigate the effects of the crisis by adopting several measures, including the use of central

bank money. However, financing by the central bank was made available under strict conditions so as not to jeopardize the bank's credibility.

The main lesson from the crisis, Nagashima said, was that it was best to act to prevent a bubble economy from emerging. Rules for disclosure and transparency were also important. Another lesson was that "forbearance policy"—banks will recover when the economy does—was not a good way to deal with troubled banks.

Roundtable

In a roundtable discussion, Nasser Saidi, Vice Governor of the Bank of Lebanon, remarked that it would be useful to discuss the role of financial markets in reducing the risk and potential for banking crises.

Jarle Bergo, Deputy Governor, Norges Bank, noted that the Norwegian authorities had dealt decisively with the banking crisis of 1991–93 through the creation of a special independent agency to address banking problems. This strategy had succeeded in avoiding excessive monetary creation.

Antonio Casas González, President of the Central Bank of Venezuela, noted that no single international monetary agency provided a safety net in case of a banking crisis. As the experience of Argentina had demonstrated, a currency board arrangement that provides an anchor for the exchange rate was insufficient to prevent a crisis. When a crisis occurs, the central bank has to intervene because no other agency can act as lender of last resort.

Stefan Ingves, Deputy Governor, Sveriges Riksbank, agreed with Nagashima about the importance of transparency and disclosure in financial crises. Experience has also shown that decisive action has to be taken early, he said, but there was also a need for political consensus.

Esko Ollila, a member of the Board of Governors of the Bank of Finland, shared Mussa's view that overall economic stability was the most important factor in mitigating the effects of a financial crisis. He noted the importance of financial policy reform (in addition to regulatory and supervisory reform) in dealing with banking crises.

Khorshed Alam, Governor of Bangladesh Bank, noted that when governments own banks, the emergence of a crisis would not be apparent, even though banks had nonperforming portfolios.

Bangladesh had experienced banking problems in the past, he said, but the authorities took effective measures to deal with the situation, including restructuring, financial liberalization, current account convertibility, and reform of the legal framework. However, the banking system was still weak and imposed a constraint on the conduct of monetary policy.

Krzysztof Kalicki, First Deputy Minister of the Polish Ministry of Finance, said that the Ministry of Finance had been the main player in overcoming the banking crisis in Poland. A number of conditions had been set for the restructuring of banks, including establishing different paths for individual banks and setting up transparent rules and regulations for restructuring operations. However, financial restructuring alone was not always enough to solve a banking crisis; managerial competence still played an important role in implementing sound banking practices.

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Bank Credit Procedures Are Key

The past decade has witnessed a string of banking crises, some of them associated with sharp swings in asset prices, severe bouts of exchange market volatility, shifts in the macroeconomic environment, and problems in key emerging markets. To prevent such crises in the future, much effort has gone into improving financial system regulation and supervision. Yet, according to Gerald Corrigan, former Chairman of the U.S. Federal Reserve Bank of New York and of the Basle Committee on Banking Supervision, strengthening regulatory and supervisory capability is only part of the solution. The essential requirement is the development of a *culture of credit,* including improvements in banks' credit procedures and the institutional environment in which credit transactions take place.

A group of IMF staff recently had the opportunity to exchange views on banking system soundness and supervision informally with Corrigan at a seminar chaired by IMF First Deputy Managing Director Stanley Fischer. The IMF holds such seminars from time to time to provide staff with an opportunity to go "one-on-one" with leading experts on the key policy issues that arise in the IMF's work with member countries.

Although banking crises might be triggered by a variety of circumstances, their common denominator, according to Corrigan, is poor quality assets, which are often difficult for even the best supervisory systems to detect. The problem often begins right at the loan applica- *(Continued on next page)*

(Continued from page 3) tion stage, when banks compile information about prospective borrowers. In industrial countries, much of the information declared by the borrower can be verified by credit bureaus, tax returns, and securities market prospectuses, and the borrower's obligation to be truthful is backed by legal sanctions. This may not be the case in developing countries, where the mechanisms to verify information about borrowers are generally lacking. Moreover, the fact that some companies belong to industrial groups that are principal shareholders of the banks that lend to them makes the information problem in some developing countries even more acute.

The next stage—loan approval—is also important. The policies and procedures surrounding the credit review process must be flexible and adapt over time to changing circumstances. In the banking systems of many emerging economies, such flexible and adaptable policies and procedures are still in the early stages of development. Incomplete information about the borrower combined with weak approval procedures can greatly increase the potential for problem loans down the road.

Loans need to be monitored, and Corrigan emphasized that monitoring procedures should go beyond simply verifying whether a loan is being serviced. He noted that monitoring systems in developing countries had improved a lot in recent years, but they often failed to catch potential problems because of incorrect or distorted information, or even too much (often irrelevant) information, about borrowers. Monitoring systems need to be forward looking—is the borrower or the industry likely to experience problems in the future? According to Corrigan, this key part of the credit cycle has often been ignored.

Finally, in cases of default, banks in many developing countries were handicapped by an uncertain legal framework for enforcing judgments against borrowers. The legal costs and time involved in collection added greatly to the cost of problem loans. Banks' balance sheets could be further weakened by such dubious practices as capitalizing overdue interest and recording it as income.

In the face of these pitfalls in the credit process—often hidden to bank supervisors—what should governments do to make their banking systems more resistant to crises? Corrigan had a number of suggestions, including:

• *Better information systems.* Governments in developing and transition countries should encourage the establishment of independent, private credit bureaus to gather reliable information on borrowers. In his experience, Corrigan had found that credit bureaus can make a difference in a relatively short time. For example, simply setting up a consistent set of information standards for granting a mortgage could have a measurable positive impact on that segment of the financial sector.

• *Reform the legal framework.* Banks need to operate within a supportive legal environment for debt workouts to succeed. Corrigan advocated legal reforms to sweep away the institutional barriers to the orderly resolution of bad debts. This was an area where technical assistance and prodding from international financial institutions such as the IMF could be very helpful.

• *Last, but not least, strengthen bank regulation and supervision.* In Corrigan's view, accelerating the hiring and training of quality bank supervisors should be the highest priority for central banks in developing and transition countries. Loan examination is a "fine art" that requires education, training, and practical experience. Even with the most outstanding recruits, it takes time (at least two to three years) to recruit and train capable bank inspectors—something those jumping on the "stronger bank supervision bandwagon" tended to forget. (Nevertheless, the process can be accelerated through the "buddy system," whereby trainees from developing and transition countries work side-by-side with seasoned bank examiners in industrial countries.) Corrigan also noted that countries often needed to introduce new, stronger regulatory frameworks to reinforce supervisory efforts.

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