Annex I

Developments in Selected Emerging Markets Banking Systems

The Asian crisis illustrated that countries with weak and underregulated banking systems are less able to manage the negative consequences of volatile capital flows and exchange rate pressures.[1] Banking systems in several emerging markets experienced, to different degrees, problems of poor asset quality, outflows of deposits from the banking system or from smaller to larger banks, overexpansion of balance sheets and overexposures to liquidity, market, and credit risks. The policy responses to these difficulties varied across countries and depended, among other things, on the consolidation of the respective banking industry and the extent of regulatory deficiencies.

In this annex, the dynamics of the main Asian banking crises are described, together with an assessment of the performance of the major Latin American and Eastern European banking systems.

Asian Banking Systems

China

In China, the Asian crisis has increased concern among policymakers about the health of the financial system and has given considerable impetus to accelerating the reform process. The People's Bank of China (PBC) is itself being restructured along the lines of the U.S. system of federal reserve banks and the number of provincial branches of the PBC is to be reduced from 31 to 12, with greater centralization of control to prevent political interference at the regional level. Attempts to put the banking system on a sound commercial footing have begun with the introduction of a new system for bank loan classification, recapitalization of the four state commercial banks, and restrictions aimed at getting banks out of stock market speculation.

The authorities have decided to adopt the standard five-category classification of bank loans—pass, special mention, substandard, doubtful, and loss—but will not mandate increases in provisions at this stage. Introduction of the new loan classification system is expected to be completed by end-1998, and guidelines for making the transition are to be issued by the People's Bank. Currently, Chinese banks are only subject to a general provisioning requirement of 1 percent of total loans calculated at the beginning of the year. As yet, there is no specific provisioning requirement and its introduction is to be left to a later stage when the new asset classification is in place. Until end-1996, Chinese banks accrued interest on nonperforming loans for three years. This was shortened to two years in January 1997 and further reduced to one year in 1998.

There are no official assessments of nonperforming loans under the new asset classification system. In March 1998, the Governor of the People's Bank reported that the authorities' estimate of nonperforming loans in the banking system (defined as all loans that were over one day overdue) was 20 percent, with only 6 percent considered as unrecoverable. Some foreign analysts, however, express skepticism in evaluating nonperforming loans of the Chinese banking system and have made estimates higher than the official figure.[2] In addition, many believe that the banks' exposure to the property sector will add to the burden of nonperforming loans as the economy slows down.

To enhance confidence in the banking system, the Ministry of Finance is in the process of issuing Rmb 270 billion of "special" bonds to recapitalize the large state commercial banks, in an attempt to raise their capital adequacy ratios to BIS standards. The recent cut in reserve requirements from 18–20 percent to 8 percent of deposits has freed funds that the banks will use to purchase these special bonds. Although a part of these funds is also to be used by the banks to repay loans from the central bank, full sterilization of the liquidity released is not expected by market partici-

[1] This annex discusses recent developments in the systemically important emerging markets' banking systems to assess the vulnerabilities in these systems and their potential consequences for macroeconomic developments and policies. The analysis draws on publicly available material published by national authorities, banks, and rating agencies. Because of space and resource constraints, this section does not describe developments in banking systems in all emerging markets or even in all countries where there are significant banking problems. Instead, it discusses developments in a few of the more important emerging markets in Asia (China, Indonesia, Korea, Malaysia, the Philippines, and Thailand), Latin America (Argentina, Brazil, Chile, Mexico, and Venezuela), and Europe (the Czech Republic, Hungary, Poland, and Russia).

[2] See, for example, Lardy (1997).

pants in view of the growth slowdown. Concerns remain, however, about whether the increase in bank capital ratios will be sustained. Controls on interest rates and the credit allocation process which still prevent any meaningful "commercialization" of banks and competition among them, are likely to again erode capital adequacy ratios. More fundamentally, the authorities need to confront the legacy of policy lending, first by cleaning up banks' balance sheets and second, by restructuring state-owned enterprises (SOEs) to wean them away from assured funding.

In June 1997, triggered by evidence that banks had been using substantial amounts of their own funds to speculate on the stock markets, the People's Bank banned state banks from trading in stocks and asked them to unwind their positions. In addition, state banks were prohibited from financing the stock market activities of SOEs, securities houses, and trust firms, from making overdrafts for stock purchases, and from engaging in treasury debt repos.

The current reform of the banking system is being pitched within a three-year horizon, but the process is likely to be more prolonged since the reform of financial intermediaries will have to proceed in tandem with the restructuring of SOEs and fundamental changes in the legal and accounting frameworks. Also, while some small commercial banks have been allowed to operate nationwide, their expansion has not been rapid enough to make inroads into the deposit base of the big state commercial banks. Competition from the nine foreign banks authorized to do renminbi business is minimal and still in the "experimental" phase—they are restricted geographically to Shanghai, permitted to do renminbi business only through their main branch, and their interest rates are subject to the same ceilings as those of domestic banks.

Indonesia

Although the external payments crisis in Indonesia has its more immediate roots in the corporate sector, the weaknesses in the overstretched and underregulated banking system contributed to the initial worsening in market sentiment that precipitated the fall in the rupiah and the ensuing rush to hedge corporate foreign exchange exposures. The share of nonperforming loans for the system as a whole was at around 9 percent in early 1997, but this average masked the existence of seven large and balance-sheet-impaired state banks together with a large number of very small undercapitalized banks.[3] Moreover, the group of more dynamic private sector banks began to experience asset quality deteriorations after a rapid expansion of lending fueled by large capital inflows in recent years. Despite an improved regulatory framework, compliance with prudential regulations and credit guidelines was poor, and there were serious doubts on the accuracy and transparency of banks' financial statements—compounded by a tradition of related-party lending, cross holdings of equities and loans, and liberal options for loan restructuring ("evergreening"). Bank Indonesia's reluctance to shut down the insolvent banks also raised doubts about the sustainability of the authorities' strategy for a gradual consolidation of the industry.

Following the widening of the band in July 1997 and the floatation of the rupiah in August, Bank Indonesia tightened liquidity initially but was later on forced to ease its stance as domestic and foreign liquidity conditions sharply deteriorated. The initial tightening intensified the segmentation of the interbank market. Some of the smaller banks were subject to runs as depositors shifted their funds toward state, large private, and foreign banks, or even out of the system. After the closure of 16 small banks in early November, the public accelerated the withdrawal of deposits and Bank Indonesia provided substantial liquidity support, including to some large private banks. Foreign lenders began to selectively reduce and finally cut credit lines, and U.S. dollar deposits fell drastically, leaving some local banks unable to meet their dollar commitments in the international interbank market.

As the rupiah continued to depreciate, fueled by corporates' attempts to hedge foreign exchange debt and the uncertainties about the extent of the overall external obligations, it became clear that many corporate borrowers would default on their U.S. dollar-denominated debts, and the risks of systemic banking problems rose concomitantly. Moreover, although the banks were believed to run matched currency books, there was uncertainty as to whether the debts of the banks' offshore affiliates were actually consolidated in the banks' accounts. Foreign-currency-denominated loans increased by about 200 percent from end-1992 to June 1997, to reach about 20 percent of bank loans, and the exposure to the property sector was even higher—with the big property developers having borrowed heavily in U.S. dollars.

The continuation of liquidity shortages and the escalation of solvency problems in the banking system, which affected also the largest private banks, led the authorities to announce on January 27, 1998, a government guarantee for depositors and creditors (excluding subordinated debt) of the locally incorporated banks, the creation of the Indonesia Bank Restructuring Agency (IBRA), the elimination of restrictions on foreign ownership of domestic banks, and a temporary and voluntary suspension of corporate foreign debt re-

[3]By June 1997 Indonesia had 239 banks, of which 27 were regional banks, 11 were foreign banks, and the remainder were domestic private banks. The seven public banks held over 40 percent of the banking system assets, and the large number of private banks was the result of the deregulation wave that began in 1988 (there were only 64 private commercial banks in 1987).

payments.[4] All outstanding liquidity support from Bank Indonesia to the banks—equivalent to 10 percent of GDP by end-January—was transferred to IBRA and the agency took over the responsibility of managing the weak banks as well as the disposition of bad assets. The restructuring agency plans to convert Bank Indonesia's loans into equity and sell stakes to foreign institutions. By mid-February, IBRA intervened in 54 banks that had used heavily emergency support from Bank Indonesia—after the definition of uniform and transparent criteria for transferring weak banks to IBRA—and 250 examiners were placed in the banks to observe their compliance with prudential regulations. In addition, in an attempt to speed up the consolidation of the banking system, the government announced a sharp increase in minimum capital requirement for banks, redefined nonperforming loans, and issued new guidelines on provisions.[5]

Significant progress in the restructuring process was made in April 1998, but uncertainties remained about the design and commitment to a genuine restructuring of the banking system as well as to the impact of the corporate sector debt problem on the banks' balance sheet.[6] Over the weekend of April 4–5, seven small banks were closed and seven others (including the second, fourth, and eighth largest private banks) were placed under IBRA's control. The seven banks closed had been allowed to borrow from Bank Indonesia in excess of five times their equity and 75 percent of their assets, and their depositors' accounts were automatically transferred to the largest state bank. The seven banks placed under IBRA were supposed to continue to operate normally, but shareholders' rights were suspended and a governance contract would be drawn with a state-owned bank to provide management and control of the bank. There were at least 40 other banks under IBRA management by early May 1998, and analysts expected many others to follow the same fate as their capital adequacy ratios would be under 5 percent—the ratio at which IBRA supervision is required.

The political and economic environment severely deteriorated by mid-May and concerns about Indonesia's financial sector grew considerably. A large part of the Indonesian corporate sector is insolvent, owing to translation losses on their foreign currency borrowings as well as the burden of large off-balance-sheet liabilities related to derivative contracts. Other companies are struggling to cope with high interest rates and the inability to import raw materials, as letters of credit from Indonesian banks are no longer being accepted. Standard and Poor's has stated that banks' nonperforming loans could reach 55 percent of total loans over the next 12–18 months, while Moody's has classified the country's banking system as insolvent, estimating nonperforming loans at 30–75 percent of total loans. At end-May, IBRA announced that it had taken control of Bank Central Asia, the largest private bank in the country. A week later, the steering committee representing foreign creditors and government negotiators reached an agreement on restructuring Indonesia's $59 billion of corporate external debt and on the $8.9 billion owed by Indonesia's banks, allowing the authorities to focus on the domestic side of bank and enterprise restructuring.

Korea

The structural weaknesses of the Korean banks—reflected in an average Bank Financial Strength Rating of D, see Table 2.6 in Chapter II—became increasingly apparent during 1997, as GDP growth slowed and the operating environment deteriorated. These structural weaknesses were the result of years of bad lending practices and a weak supervisory and regulatory framework. Historically, the banking system was the vehicle used to support the government's industrial policies. Although policy loans were scaled back during the 1990s, they left a legacy of poor managerial and credit analysis skills, as well as large exposures to the highly leveraged *chaebols* (conglomerates). Also, in response to the competition from underregulated nonbank financial intermediaries, commercial banks expanded the use of trust accounts—subject to no interest rate or exposure restrictions—that were maintained separate from the rest of the balance sheet but nevertheless heightened the risk profile of the banks.[7] Finally, the system's lack of transparency and regulatory forbearance significantly underestimated asset quality problems. The authorities had traditionally published as bad loans only the two most seriously delinquent categories of loans, amounting to only about 1 percent of total loans at end-1996, while other reported categories including a larger amount of impaired loans were not disclosed.

[4]While the first two measures are already in place, the government is expected to pass a law in July 1998 removing all existing restrictions on foreign ownership of banks.

[5]A new special mention category of loans was created, other categories' definitions were tightened and simplified, and provisions for substandard loans (as well as general provisions) were increased substantially. Since provisions in 1998 will be extraordinarily high, provisions for the existing loan portfolio can be amortized over four years at a minimum of 25 percent of the total amount a year.

[6]These uncertainties, among other factors, led Moody's to lower the Bank Financial Strength Rating of all banks not already rated E to that level on March 20.

[7]The Korean financial system comprises 26 commercial banks (53.4 percent of end-1997 total assets), specialized and developments banks (16.5 percent of total assets), and several nonbank financial institutions (30.1 percent of total assets). The commercial banks are divided into 16 nationwide banks and 10 regional banks, and the sector also includes 52 branches of foreign banks. The trust accounts of the commercial banks accounted for 20 percent of total assets of the financial system at end-1997.

Also, provisioning requirements for nonperforming loans and for losses on the banks' securities portfolios were relaxed over 1995–96.

The banking system exhibited increasing signs of stress during the first half of 1997 as a number of major conglomerates went bankrupt, and the authorities finally announced in August 1997 a set of measures to address their rapidly deteriorating liquidity and solvency condition. In the first quarter of 1997, two rating agencies downgraded the three major creditor banks of two bankrupt conglomerates and subsequently placed them under review for further downgrades during the summer, arguing also that the banks' low profitability and large losses on their securities holdings—among other factors—had left them badly positioned to handle a substantial rise in problem loans. By the first week of September, six highly leveraged chaebols had failed or been placed under bankruptcy protection, raising serious concerns about the banks' asset quality. Concerns were also raised about the condition of the merchant banks, which were heavily exposed to the conglomerates and suffered severe funding problems as domestic and foreign lenders reduced their exposures to them.[8] On August 25, 1997, the authorities announced a set of measures aimed at increasing confidence in domestic and international financial markets. First, official support was provided by the Bank of Korea, in the form of a special loan to Korea First Bank—the fifth largest commercial bank—and the government acquired stock in the bank in exchange for government bonds. In addition, a special funding facility was created to assist merchant banks whose exposure to bankrupt companies exceeded 50 percent of their equity—in the event, 21 out of 30 merchant banks. Second, a special fund was set up within the Korea Asset Management Corporation (KAMC), to which the banks would be allowed to sell their nonperforming loans. Third, guarantees were announced by the government on the foreign liabilities of Korean financial institutions, including both commercial and merchant banks.

These measures were perceived by market participants as insufficient, and as the quality of their balance sheets continued to deteriorate, the Korean banks faced increasing liquidity problems in the international interbank market. Short-term foreign borrowing had soared in the years immediately preceding the crisis, fueled by the ample availability of international liquidity, the perceived stability of the won and the regulatory ceiling on commercial banks' medium- and long-term borrowing in international financial markets. The situation changed dramatically when international investors focused on Korea's financial problems, and many banks saw their credit lines either withdrawn or reduced by their correspondent banks. In December, the Bank of Korea allowed the won to float freely and investors and lenders panicked when they learned that the country's short-term external debt was approximately $104 billion—rather than the $66 billion originally reported—and that usable reserves were lower than expected. As a result, the Korean banks' short-term external liabilities fell from $62 billion in September 1997 to $29 billion at end-December, and despite substantial foreign exchange liquidity support from the Bank of Korea, a default was averted only when the central banks of a group of industrial countries arranged a three-month extension of the maturing bank debts.[9]

A new series of measures to restore confidence and restructure the banking system has been undertaken since December 1997. First, following the results of an evaluation of the merchant banks and their rehabilitation programs, 14 merchant banks were closed between January and April 1998 and the other 16 have to comply with a timetable to achieve capital adequacy ratios of at least 6 percent by end-June 1998 and 8 percent by end-June 1999. A Bridge Merchant Bank was established at end-December 1997, to pay out depositors of suspended merchant banks and to take over, manage, collect, or liquidate their assets. Second, liquidity support in won was provided to help banks cope with the suspension of merchant bank operations. Third, the 12 commercial banks whose capital adequacy ratios at end-1997 (under full provisioning)[10] fell below 8 percent have submitted recapitalization plans to the supervisory authority that will be evaluated by end-June 1998. On January 30, 1998, the government injected W 1.5 trillion in both Korea First Bank and Seoul Bank—following a capital reduction whereby shareholders' equity was substantially reduced—and the two banks are being prepared for privatization. Fourth, the administration of deposit insurance funds for commercial and merchant banks and other institutions was consolidated in the Korean Deposit Insurance Corporation (KDIC), and the coverage was extended to almost all the domestic liabilities of these institutions. Finally, a Financial Supervisory Commission was established and has assumed responsibilities for the supervision

[8]Most merchant banks were first established as finance companies and converted to its new status in the 1990s, to bring funds from the curb market into the formal market.

[9]According to commercial banks' end-December balance sheets, the ratio of short-term foreign currency-denominated assets to liabilities was 58 percent, below the 70 percent ratio required by the regulations.

[10]The recapitalization needs may be underestimated because of the lax Korean loan classification standards. Using that classification and including nonperforming loans of W 7 trillion purchased by the KAMC, the ratio of nonperforming loans to total loans increased from 6.9 percent at the end of the third quarter of 1997 to 8.5 percent by end-1997.

and restructuring of all bank and nonbank financial institutions.

As the problems in the corporate sector continued to escalate in the first quarter of 1998, the Korean authorities unveiled further plans to restructure the financial system. The Korean banking system is closely interlinked with the conglomerates and the merchant banks. Substantial cross-payment guarantees allow the financial difficulties of a single *chaebol* company to threaten the solvency of the entire *chaebol* group, thereby increasing the risks of spillovers from the corporate sector to the banking system. In the first quarter of 1998, more than 10,000 companies went bankrupt—compared with 14,000 for the whole year in 1997 and 11,570 in 1996—with small firms hardest hit as banks continued to lend mostly to the conglomerates. Bankruptcies also continued to grow among the *chaebols,* and the average debt-to-equity ratio of the top 30 biggest ones jumped to 518 percent at end-December 1997 from 386 percent in the previous year—in part owing to the unhedged foreign exchange component. The Financial Supervisory Commission has asked the banks to appoint outside directors to special teams set up to determine the viability of companies in a transparent way by the end of May, and those declared viable should submit restructuring plans to the banks by July 1998. On May 20, 1998, the authorities announced that they will issue W 50 trillion of bonds as part of a plan to buy nonperforming loans and recapitalize the banks. The KAMC will pay W 25 trillion to buy W 50 trillion of bad loans, while the KDIC will invest about W 16 trillion in banks to boost their capital. The banks are expected to raise a further W 20 trillion by selling equity and subordinated debt to private investors, aided by the removal of foreign ownership restrictions in the sector. Finally, W 9 trillion will be available to pay off depositors of failed institutions. The announced support package brings the government resources committed to the financial system—including support to depositors—to W 84 trillion (14 percent of GDP), while impaired loans reached W 118 trillion at the end of March 1998.

Korea's economic recovery depends critically on the speed of corporate and financial restructuring, but despite the reform measures announced many market participants have doubts about whether they can be fully implemented and sustained. The Korea Development Institute has warned that the recession could last three to five years if financial and corporate restructuring proceeds slowly. On the one hand, despite a series of announced corporate bankruptcies, insolvent companies have been allowed to continue operating and undercut their competitors.[11] On the other hand, the top five *chaebols* have submitted restructuring plans to reduce debt-equity ratios to below 200 percent by end-1999, cut business lines to no more than five, and eliminate cross-payment guarantees. Also, the government's requirement that firms be classified according to their chances of survival was announced with no clear guidelines, raising concerns about the banks' ability and willingness to distinguish solvent firms from insolvent ones in a short period of time.

Malaysia

The Malaysian banking system strengthened considerably following the crisis of 1985–88, owing to very rapid economic growth, buoyant share and property prices, and the enactment of strict prudential regulations. Asset quality improved substantially—the ratio of nonperforming loans to total lending fell from a peak of 35 percent in 1987 to 3.6 percent by mid-1997—and capital adequacy was appropriate going into 1997. Moreover, restrictions on foreign borrowing left the corporate and banking sectors with relatively low exposure to foreign exchange risks, ameliorating the impact of the external credit squeeze affecting the region and providing the authorities more latitude to respond with the appropriate macroeconomic and structural policies.

Despite the relative strength exhibited by the Malaysian banking system going into the second half of last year, the severe pressures in the stock and foreign exchange markets that followed the depreciation of the Thai baht raised concerns about the vulnerability of the financial system. The main source of vulnerability is the high degree of leverage of the economy—with one of the highest loan to GDP ratios in the world (see Figure 2.13 in Chapter II), together with large exposures to property and stock markets. In order to address these vulnerabilities, Bank Negara Malaysia issued guidelines in March 1997 to limit banks' exposure to property to 20 percent of the loan portfolio and that of stocks and shares to 15 percent of the portfolio, and in October 1997 it required banks to submit individual credit growth plans in an attempt to restrict overall credit growth to 25 percent in 1997 and 15 percent in 1998. In the event, loan growth continued to be high, reaching 30 percent annually during 1996–97.[12] As a result, commercial banks became heavily exposed to the property sector (30 percent of loan portfolios), the stock market (15

[11]The insolvency laws were reformed in the first quarter of 1998, establishing economic criteria for the courts to assess a company's viability, creditor committees, as well as setting time limits on court decisions and rehabilitation processes.

[12]Malaysia's banking system comprises 35 commercial banks (69 percent of total banking system assets at end-1997), 39 finance companies (22 percent), 12 merchant banks (6 percent), and 7 discount houses (3 percent). Many finance companies and merchant banks are subsidiaries of commercial banks, and government involvement in the banking sector is relatively high.

percent), and consumer lending (13 percent) as of end-1997.[13]

With the onset of the regional crisis, banks and finance companies experienced a significant decline in profitability and asset quality deteriorated sharply. The level of nonperforming loans increased from 3.6 percent in June 1997 to 5.7 percent at end-1997. Under the new classification system where loans are deemed nonperforming when past due for three months, the level of nonperforming loans was 6.7 percent at end-1997. Moreover, the level of nonperforming loans under the new classification system increased sharply to 9.3 percent in March 1998. The banking system as a whole remained adequately capitalized as indicated by the 10.6 percent risk-weighted capital ratio at end-December 1997—the same level as the previous year—despite heavy losses also in share-related lending. Two banks and three finance companies fell below the 8 percent capital adequacy requirement for end-1997, and more are expected to do so as the level of nonperforming loans continues to increase led by higher defaults in the property sector and further losses at the banks' stockbroking subsidiaries. The looming oversupply of real estate has not yet been fully felt in real estate prices (see Figure 2.15 in Chapter II) and will put further pressure in asset quality toward the end of the year. In order to ameliorate the expected property price deflation, the government announced on May 20, 1998 that foreign investors are now allowed to buy all types of residential and commercial property without restriction if the cost of the property is a minimum $65,000 and financing is obtained overseas.

Until the first quarter of this year, the policy response of the Malaysian authorities had been to inject liquidity into the interbank market in order to keep interest rates low regardless of the negative impact on the currency. Growing concerns about the vulnerability of the financial system led to a shift in deposits from domestic to foreign and large domestic banks, as well as to increased segmentation in the interbank market. This prompted the central bank to extend significant liquidity support to the affected institutions—primarily Tier 2 banks and finance companies—with Bank Negara's deposits with financial institutions rising to RM 35 billion (12.5 percent of GDP) at end-January.[14] Also, in that month, the authorities announced that all depositors in Malaysian financial institutions would be guaranteed, and the liquidity pressures somewhat eased by the end of the first quarter.

Facing the prospects of a large number of finance companies becoming undercapitalized during 1998, the authorities have taken steps to consolidate the sector. The merger program, directed at consolidating 39 existing finance companies into 6 or 7 anchor companies, is being supported by a one-year guarantee extended by the government to the acquiring institution in the event of any further reduction in the value of the acquired assets. The final approval of the mergers would be contingent upon completion of due diligence, with final payments to shareholders based upon the valuations established through this process. Many domestic and foreign-owned finance companies are expected to be absorbed by commercial banks within the group. The institutions that chose to stay out of the merger program will have to demonstrate that they are able to comply with the capital adequacy requirements, that will rise gradually from 8 percent to 9 percent by end-1998 and to 10 percent by end-1999, and those that are unable to do so will be subject to alternative resolution strategies—including conservatorship or liquidation.

Despite Bank Negara's encouragement, only two bank mergers were completed in 1997 and two others were announced in March 1998. As the economy slows down in 1998 some Tier 2 banks are expected to experience difficulties and this will accelerate the pace of consolidation. The separation of banks into two tiers in 1994 encouraged banks to raise capital to reach Tier 1 status—rather than the intended effect of leading to mergers and acquisitions. As a result, Tier 2 banks had an average equity to assets ratio of 8.7 percent in December 1977, higher than the 7.5 percent average of the Tier 1 banks. This is likely to change in the near future, as Tier 2 banks have increased their portfolios much faster than Tier 1 banks and face the prospects of increased provisions. In order to accelerate the process of consolidation, the authorities announced on May 21, 1998, the creation of an Asset Management Company, designed to manage and liquidate bad assets of the financial system. The pace of consolidation will be slower, however, if the relaxation of foreign ownership rules—currently restricted to 30 percent of equity—does not occur in 1998.

The supervisory and regulatory framework is regarded by market participants to be good by regional standards, and it has recently been improved with a series of measures designed to bring it to international best practices. Between December 1997 and March 1998, the authorities approved a shortening of the period for classifying loans as nonperforming from six to three months, an increase in general and specific provisions, the requirement to publish and comply with capital adequacy standards on a quarterly basis,

[13]A few of the major banks also have exposures to other countries in the region, through their subsidiaries in the Labuan Offshore Financial Center. However, these exposures are relatively small and are expected to add 2–4 percentage points to the banks' nonperforming loans ratios. Off-balance-sheet commitments and contingencies amount to 15 percent of assets on a credit-equivalent basis and although they are taken into account in capital adequacy ratios banks are not required to make provisions against them. Except for a few banks, these exposures are estimated to be relatively small.

[14]In February, the central bank cut its statutory reserve requirements by 3.5 percent to 10 percent, but offset this by cutting back on its interbank lending. Progressive hikes in the reserve requirements, from 8.5 percent in end-1993 to 13.5 percent by mid-1996, had been the main instrument used to manage the surge in capital inflows during the early 1990s.

and to subject all banks to monthly stress tests and ensure that they take corrective action before they actually need additional capital—among others.

Philippines

The Philippines has not been insulated from the financial turmoil in the region, but the country's banking system shows a more favorable risk profile than many other countries in the region. The fact that rapid loan growth is a fairly recent phenomenon—with the resulting low leverage (see Figure 2.13 in Chapter II)—combined with a fairly adequate regulatory framework and a decisive response from the authorities, has contributed to a relatively lower financial vulnerability. The currency depreciation and higher interest rates that accompanied the reversal in capital flows during the second half of 1997 led to a deterioration in asset quality, and prompted the central bank to induce lower domestic interest rates by (1) reducing banks' intermediation costs (via lower statutory reserve requirements and a higher portion of banks' reserve balances with the central bank earning interest); (2) increasing liquidity (through opening of credit windows and outright purchase of government securities); and (3) reducing central bank policy interest rates.

Although the exposure to the property market and foreign currency lending have grown rapidly in recent years, and the risks to the banks of such exposures were heightened by the depreciation of the peso, these risks appear to be of a smaller magnitude than in other countries in the region.[15] First, although U.S. dollar lending is estimated to account for some 30 percent of total loans, the extent to which U.S. dollar loans have been made to unhedged borrowers appears to be relatively small.[16] Moreover, during the currency crisis, the central bank introduced a currency risk protection program—also known as the nondeliverable forward (NDF) facility—which was offered by the central bank through commercial banks to help eligible borrowers hedge existing foreign exchange liabilities. Second, most real estate developers tend to have a low degree of leverage and the initial concerns of a property glut appear to have been exaggerated, as initial supply forecasts were later on scaled back and residential and office prices have shown more resilience than in other cities (see Figure 2.16 in Chapter II). Nevertheless, prospects for the real estate sector remain weak as uncertainties about the region are likely to affect the property market.

The deterioration in asset quality since mid-1997 has led to difficulties in some small banks, but most of the large commercial banks held capital to risk-weighted asset ratios of 15–20 percent by end-1997 and are likely to withstand the increase in bankruptcies and debt restructurings. Only one small commercial bank and three thrift banks (accounting for 0.33 percent of banking system assets) have experienced difficulties as of May 1998.[17] Rural and thrift banks are regarded by market analysts as the weakest segments of the banking system and more failures are expected but with unlikely systemic consequences. The ratio of nonperforming loans to total loans of the commercial banks has increased from 3.4 percent in June 1997 to 4.7 percent in December of 1997 and 6.7 percent in February 1998. Nonperforming loans are expected to increase some 3 percentage points following the reclassification of loans as nonperforming after three months—compared with six months currently—and analysts expect them to reach 10–15 percent by year-end. More important, loan loss provisions covered only 40 percent of nonperforming loans, but provisioning expenses are increasing and the large banks are still reporting healthy profit levels. Overall, the commercial banks were regarded as adequately capitalized as of December 1997, with an average capital adequacy ratio of 16 percent. Even with a 50 percent write-off of the projected nonperforming loans, most of the large banks would remain within the regulatory requirements.

A series of measures have been implemented to strengthen the banking system. Before July 1997, the central bank imposed a limit on real estate loans of 20 percent of the total loan portfolio—with full compliance by May 1998—and reduced the maximum loan-to-value ratio to 60 percent from 70 percent. Also, a 30 percent liquid cover on all foreign exchange liabilities in FCDUs was approved in June 1997. In October, loan classification was tightened (with full compliance by April 1998), and a 2 percent general loan loss provision was imposed (with compliance of 1 percent by October 1998, another half percent by April 1999, and the balance by October 1999). In early 1998, the banks' minimum capital requirements were raised,[18] and increased disclosure of nonperforming loans, provisions, and capital was required for December 1998.

[15]Off-balance-sheet exposures of Phillippine banks, mostly trust accounts and derivatives, are not included in capital adequacy ratios but they are estimated to be small relative to the credit risk exposures in banks' loan books.

[16]Philippine banks' Foreign Currency Deposit Unit (FCDU) loans expanded substantially during 1995–96, but prudential regulations require banks to keep balanced FCDU books.

[17]The Philippines has 54 commercial banks (89.6 percent of total system assets), 112 thrift banks (8.4 percent of total system assets), and 900 rural banks (2 percent of system assets). The level of foreign involvement in the banking system has increased recently and the 54 commercial banks include 14 branches and 3 subsidiaries of foreign banks.

[18]Additional loan provisions for "loans especially mentioned" (5 percent, regardless of collateral) and for secured loans classified as substandard (25 percent) with full compliance by April 1999 were imposed.

Thailand

The increasing weaknesses in Thailand's financial system were already apparent in the first half of 1997, as demonstrated by the solvency problems of several finance companies.[19] Although some of the major Thai commercial banks exhibited sound balance sheets, the smaller commercial banks and most finance companies were suffering a serious deterioration in asset quality even before the depreciation of the baht on July 2, 1998, as a result of the economic slowdown and their overexposure to a distressed property sector. Following the suspension of 16 finance companies just before the baht was allowed to float, another 42 were suspended on August 5.

The sharp depreciation of the baht raised further concerns about the quality of the banks' portfolios, as many corporate borrowers had large unhedged U.S. dollar-denominated liabilities, and this led to growing liquidity—both domestic and external—problems. Notwithstanding the measures announced by the Bank of Thailand on August 5, 1997, including a guarantee to depositors and ordinary creditors (subordinated creditors were explicitly excluded) of the 15 banks and the 33 finance companies still in operation, there were runs by depositors on some of the smaller banks.[20] The Bank of Thailand provided liquidity support through the Financial Institutions Development Fund (FIDF), that arranged a "recycling facility" to channel some of the deposits back to the smaller banks. The FIDF liquidity support to finance companies and commercial banks reached about 15 percent of GDP during 1997. Meanwhile, the banks were suffering increasing difficulties rolling over their large short-term offshore liabilities—a large share of which was owed to Japanese banks through the Bangkok International Banking Facilities (BIBFs).[21]

The continuing financial instability led the authorities to announce a financial sector restructuring package by mid-October 1997, but the markets remained unsettled until after the new government adopted a series of specific measures to begin to address the financial system's problems. The October package included the creation of a Financial Sector Restructuring Authority (FRA)—to assess the rehabilitation plans of the finance companies and dispose of their assets, an Asset Management Corporation (AMC)—to manage and sell the bad assets, as well as tighter loan classification and provisioning rules and a relaxation of the limit on foreign ownership of financial institutions—from 25 percent to 100 percent, for up to 10 years. However, the October package failed to reassure investors as it continued to delay the final fate of the finance companies and did not address the severe bad loan problem of the other financial institutions. The new government that took over in November subsequently closed down 56 of the 58 suspended finance companies and, in the first quarter of 1998, the Bank of Thailand intervened four commercial banks, and had their management replaced and the capital of existing shareholders written down through debt-equity swaps by the FIDF.[22]

The strategy to restructure the financial sector became increasingly focused on strengthening the core banking system during the first half of 1998. The authorities took concrete steps to initiate the sale of assets of finance companies and to restructure and recapitalize the banks, but substantial hurdles remain in both tasks. The FRA auctions of noncore assets began in February 1998. The first assets being sold were automobiles, which make up around 6 percent of the total assets to be sold, while actual hire purchase loans (core assets) were auctioned much later in June 1998. The bulk of the assets are commercial real estate loans and these auctions are likely to be more difficult unless stronger property and contractual rights can be enforced. Current laws in Thailand make it difficult to foreclose and liquidate an insolvent debtor, and in order to facilitate this process the authorities have amended the bankruptcy law and are in the process of proposing amendments to the Code of Civil Procedure.[23] In addition to the AMC, which will be a bidder of last resort in the sale of finance companies' assets, the authorities created a Radhanasin ("Good") bank (RAB), to bid for a limited portfolio of superior assets.

The sheer size of the banks' recapitalization needs, heightened by the expected deterioration of the loan portfolio, makes further government support quite likely. Officials at the Bank of Thailand estimate the

[19]By mid-1997, Thailand had 15 domestic commercial banks, 91 finance companies, and other smaller nonbank financial intermediaries. The finance companies account for around 25 percent of financial sector assets and many of them are controlled by the commercial banks. The three largest commercial banks account for 50 percent of total banking system assets and the largest six banks account for 75 percent of total bank assets. There are also 19 foreign banks that held only about 9 percent of assets, but this underestimates the importance of foreign banks that execute much of their business offshore.

[20]At the same time, the authorities sought to minimize moral hazard by imposing a deposit cap of 3 percentage points over the average rate offered by the five largest banks.

[21]Of the total external debt of $92 billion at end-1997, about $39 billion was in the banking system. Foreign banks account for a large share of the debt maturing in 1998, but most of the funds borrowed from their own headquarters are being rolled over. The lower rollover rates have been experienced by the domestic Thai banks and finance companies.

[22]The four banks are First Bangkok City Bank PCL, Siam City Bank PCL, Bangkok Metropolitan Bank PCL, and The Bangkok Bank of Commerce PCL, respectively, the seventh, eighth, ninth, and eleventh largest in terms of total assets by January 1998.

[23]Although important amendments to the 1940 Bankruptcy Act were passed in March 1998, the limits to the special protection normally granted to new creditors of distressed firms was only modified—rather than repealed, and further procedural clarifications are slated to be approved by parliament toward the end of October.

level of bad loans to have at least doubled by the end of December 1997 from around 9 percent earlier in the year. Nonperforming loans on a 90-day-past-due basis were estimated at above 25 percent of total loans at end-1997, and only one-fifth of them were provisioned against. Moreover, as asset prices and GDP continue to fall, nonperforming loans are expected to reach at least 30 percent during 1998, leading to recapitalization needs that could approach 30 percent of GDP (see Table 2.7 in Chapter II). The strategy of recapitalization centers on financial institutions' raising new capital on their own—except for the four intervened commercial banks—including from potential foreign partners. The banks have to sign memorandums of understanding with the Bank of Thailand by August 15 on their proposed recapitalization plans, but market participants expect that a sizable portion of the recapitalization requirements will be met by the government, especially for small banks. As of early May 1998, about B 230 billion (4 percent of GDP) of new equity had been raised, with B 107 billion contributed by the FIDF.[24] Another indication of the likely official support emerged in late May, as the government took over seven other finance companies and Bank of Thailand officials suggested that only 5 to 10 of the remaining 28 finance companies would eventually succeed raising capital on their own. Also, the authorities announced that no more bank closures would be forthcoming.

The Thai authorities have been gradually improving the banks' regulatory framework as well as accounting and disclosure rules, but the framework remains less stringent than other emerging markets. Recent improvements include the introduction of capital adequacy standards and the tightening of nonperforming loans recognition and provisioning requirements. Thai commercial banks and foreign branches are currently required to maintain a minimum capital ratio of 8.5 percent and 7.5 percent, respectively, while foreign BIBFs are exempt from capital requirements. At present, loans become substandard only after 6 months in arrears. After 12 months the uncollateralized part becomes doubtful, while the collateralized portion remains substandard. This has been tightened and, beginning July 1, 1998, loans with payments overdue more than 3 months will be classified as nonperforming or substandard. The provisioning rate for substandard loans was raised to 20 percent of the value of the loan from 15 percent in 1997, but banks are allowed to subtract 90 percent of the collateral value to calculate the provision.[25] This implies that the full impact of the new provisioning requirements cannot be determined until the authorities release the new valuation standards. As the extent to which property values have fallen in Thailand is highly theoretical owing to the illiquidity of the real estate market, rating agencies estimate that the new requirements are only slightly more onerous than those currently in place. Moreover, the provisioning requirements will be phased in gradually, with 20 percent of the new provisions to be made by the second half of 1998, 60 percent by the second half of 1999, and 100 percent by the second half of 2000.

Latin American Banking Systems

Argentina

The recovery and strengthening of the Argentine banking system was tested by the contagion effects of the Asian crisis and showed a remarkable resilience. Deposits continued to grow during the last quarter of 1997, in sharp contrast with the Tequila shock—when deposits fell by more than 15 percent in four months, and despite the fact that they are partially covered by a limited deposit insurance scheme. The stock of deposits grew by 29 percent in 1997, outpacing the increase in loans of 18 percent over the same period. The most important effect of the sharp increase in interest rates in the fourth quarter of 1997 was the losses in the banks' fixed income portfolio that contributed to the generalized decline in profitability for the year as a whole.[26] Some banks were able to minimize the effects of the higher interest rates on their profit and loss accounts by shifting securities from their trading book to the investment account (where securities are valued at cost but have to be held for one year) or to the available-for-sale account (where securities are marked-to-market but unrealized capital gains/losses are accounted in shareholder's equity).

Asset quality improved steadily throughout 1997, with the ratio of past-due loans to total loans falling to 10.2 percent in December 1997 from 12.9 percent in December 1996. Although the stock of problem loans as percentage of total loans remained substantially higher among public banks than among private banks, both groups experienced a similar improvement in

[24]See Chambers and Karacadag (1998). Two of the three largest banks in the country led the recapitalization move with good international response, but unfavorable market conditions forced several finance companies to postpone equity issues in April–May 1998.

[25]Doubtful loans will be those that have not been serviced for 6 months, compared with 12 months before, while those not serviced for over one year will be classified as bad loans. Provisioning levels will be 50 percent and 100 percent, respectively. There will be a 1 percent general loan provisioning requirement and a 2 percent requirement for special-mention loans.

[26]Overnight interest rates shot up to over 12 percent in late October 1997, but returned to precrisis levels of around 6 percent by end-November. The return on average equity of the 18 largest Argentinean banks fell to 5.5 percent in December 1997 from 6.8 percent in December 1996, and the net interest margin also fell to 3.3 percent, from 5 percent by end-1996 (see Salomon, Smith Barney, 1998a).

asset quality. Loan loss reserves remained relatively low for the system as a whole—at 60 percent of past-due loans in December 1997, but they show a positive trend and, more important, net past-due loans were just 22 percent of total equity. This reflects the relatively high level of capitalization of the Argentine banks that ended the year with a ratio of equity to assets of 12.4 percent. The risk-weighted capital adequacy ratio for the system as a whole fell from 19.6 percent in December 1996 to 18.2 percent in December 1997; for private banks the fall was from 15.5 percent to 14.6 percent, but the capitalization levels still remain well above the 11.5 percent requirement of Argentine regulations.

The process of consolidation of the highly fragmented Argentinean banking system continued during 1997, albeit at a slower pace than after the liquidity crisis of 1995. The total number of banks fell from 205 in December 1994 to 153 in March 1996—when several loss-making provincial banks were privatized and a number of private banks were merged or taken over by stronger institutions—and it stood at 138 institutions at end-1997.[27] More important, the three largest private banks have continued to increase market share, and they are expected to further accelerate the consolidation process with their recent introduction of new products and the new requirement that all companies pay their salaries electronically through the banking system. This will certainly force medium and small banks to rethink their strategies or sell out to stronger/larger banks.

The monetary authorities have strengthened considerably the regulatory framework after the Tequila crisis, developing a "systemic liquidity policy" and a so-called BASIC system of banking oversight, which contributed to reducing the liquidity and solvency risks of the Argentinean banking system. The systemic liquidity policy takes into account the fact that emerging markets are likely to face sharp and unexpected reversals in capital flows and that this could severely endanger the objectives of macroeconomic and financial system stability. The two main instruments of the liquidity policy are a stand-by repo facility with international banks and legal liquidity requirements for the banks, that together cover some 30 percent of the deposit base. The repo facility is a line of credit arranged with a group of foreign financial institutions, whereby the central bank and the participating local banks have the option to engage in repurchase agreements with Argentine government securities for up to $6.7 billion. The legal liquidity requirements apply to deposits and other liabilities (such as lines of credit from abroad, interbank repo operations, and commercial paper) and have been increased from 15 percent in February 1996 to 20 percent by February 1998.[28]

The BASIC[29] approach to banking oversight combines aspects of the conventional approach to bank regulation and supervision (with on-site inspections and off-site analysis) with the monitoring and discipline imposed by the market (including the use of credit rating agencies). The approach includes the obligation for banks to issue subordinated debt for an amount equivalent to 2 percent of total deposits. In order to ensure an adequate production and dissemination of information about the soundness of the system, the central bank has established a credit bureau and makes available banks' balance sheet information on the internet on a monthly basis. The accuracy of the information is checked through quarterly external audits, and since January 1998 banks have to obtain two ratings from well-established private credit rating agencies. The regulatory framework has also been enhanced with a tightening of capital requirements through the introduction of a more stringent criterion for calculating risk-weighted assets, requirements for market risks, and strict rules for loan classification and provisioning (see Box 2.8 in Chapter II).

Brazil

Among the Latin American emerging markets, Brazil's financial markets were probably the most affected by contagion from Asia. The monetary authorities' rapid and forceful defense of the real, engineered through massive intervention in foreign exchange markets and a doubling of the basic reference interest rate to 43 percent in late October 1997, led to liquidity pressures and a deterioration in asset quality in the banking system that is still to be felt in the banks' balance sheets. The deterioration in asset quality is unlikely to create systemic risk as the large domestic banks are very well capitalized and, together with a large number of foreign entrants, have shown that the trend toward consolidation started after the Real Plan in 1994 continues unabated.

The events of October 1997 had a major impact on the liquidity and funding—both domestic and external—of the Brazilian banking system. Banks with large leveraged positions—the major investment banks and some of the smaller banks—were exposed to margin calls and a number of medium-sized com-

[27]Five other provincial banks are in the process of privatization and the largest state-owned commercial and mortgage banks are slated for future privatization.

[28]Although this may appear to be a relatively high liquidity ratio, it is lower than that required in other countries with currency board arrangements. For instance, liquidity ratios are 25 percent in Hong Kong SAR and 30 percent in Estonia and Lithuania (see Baliño and Enoch, 1997).

[29]The acronym BASIC stands for bonds, auditing, supervision, information, and credit rating (see Banco Central de la República Argentina, 1997).

mercial banks that suffered from a flight-to-quality of their deposits were the most severely affected by the liquidity pressures. There were apparently no cases of banks obtaining emergency liquidity from the central bank, but the monetary authority injected large amounts of liquidity through rediscount lines and through the purchase of government bonds. Brazilian banks were very active issuers in the Eurobond market during 1996 and 1997, and in order to ameliorate the effects of reduced access to that market, the central bank eased restrictions on bond maturities and allowed short-term foreign borrowings to be invested in high-yielding dollar-linked government bonds.

The impact of the increased interest rates on asset quality will be felt mostly in the second and third quarters of 1998, but the rapid decline in rates to almost precrisis levels suggest that the deterioration may be less than originally expected. The ratio of nonperforming loans as reported by the central bank (loans in arrears and liquidation less accrued interest charges) rose from 7.1 percent in December 1996 to 7.8 percent in December 1997 and 8.3 percent in March 1998. Because of accounting lags, nonperforming loans are expected to peak in the second or third quarter of 1998. However, loan loss provisions also grew considerably and in March 1998 they covered 138 percent of nonperforming loans. At the beginning of the crisis, analysts estimated that nonperforming loans would double from their 1997 level, but the relatively more favorable interest rate environment and increased write-offs in the first quarter of 1998 have led to downward revisions in these estimates.

The public sector continues to have a strong presence in the banking system, controlling 44 percent of total banking system assets by mid-1997, and public-sector banks have weaker financial fundamentals than the private sector ones. Banco do Brasil, the largest commercial bank in the country and one of the main providers of funding in the interbank market, suffered record losses of over $7 billion in 1996 and was recapitalized by the government. Under new management, the bank has taken steps to reduce political interference in its lending decisions, cut costs, and invest in automation technology. In 1997, the bank showed positive profits for the first time since 1994 but nonperforming loans remain at 13.3 percent of total loans. Rapid asset growth in 1997, driven by a 37.8 percent expansion in the loan portfolio, contributed to a fall in the equity to assets ratio from 6.8 percent at end-1996 to 5.5 percent at end-1997. In December 1997, the federal government acquired ownership of the largest state bank, Banespa, following a swap of R$53 billion in state debt for long-term government securities and a clean up of its operations. The bank still has a ratio of nonperforming loans of 23.7 percent but its private sector loans have been fully provisioned, its payroll cut from 34,000 to 22,000, and several branches have been shut down.[30]

The top-tier private banks have successfully integrated the provision of credit with fee-based services—such as underwriting, capital markets advisory, asset management, and insurance—while a number of medium-sized and small retail banks—with smaller regional bases and branch networks—are having difficulties adapting to the new low-inflation environment. The largest banks expanded quite rapidly during 1997, with asset and loan growth of 45 percent and 33 percent, respectively.[31] They have continued to enjoy growing noninterest income—mostly fees and commissions, but many of them suffered large losses in their trading books during the last quarter of 1997. For the past three years these banks have cleaned up their portfolios, writing off substantial amounts of bad loans—that stabilized at 3.2 percent of total loans at end-1997. The compression in interest margins has led to a rapid expansion in consumer lending—particularly in the areas of automobile loans and credit cards—where loan losses are relatively higher. The top three banks (Bradesco, Itaú, and Unibanco) are regarded as very well managed and, with large capital adequacy ratios (in the 12–18 percent range at end-1997), they are well positioned to withstand the deterioration in asset quality anticipated by several analysts, as well as to proceed with further acquisitions. In contrast, the medium-sized and small domestic banks had lower asset growth than the larger ones (at 7.7 percent during 1997), lower noninterest income, and a higher level of nonperforming loans (4.4 percent of total loans by end-1997). While these institutions are still well capitalized, with an equity to assets ratio of 11.4 percent, they have had declining earnings and face increasing competition from the larger and more diversified banks.

The consolidation process initiated since the introduction of the Real Plan in mid-1994 has accelerated in 1997 and analysts foresee that the number of banks will shrink over time from 233 institutions at present—including commercial, investment, multiple, and savings banks—to about 100.[32] The successful

[30]The other public banks are more specialized in their operations. Caixa Econômica Federal is the main institution providing housing finance and BNDES is the primary development bank.

[31]This discussion is based on 74 private banks for which the financial statements for end-1997 were available from Fitch IBCA Ltd. The large banks are those with assets above $4 billion and the group of medium-sized and small banks comprises 52 institutions with assets below that level.

[32]At the outset of the Real Plan, there were 271 banks operating in Brazil. During the first three years of the plan, 40 banks were intervened by the central bank, of which 29 were liquidated, 4 failed, 6 were placed under temporary administration, and 1 continued to operate. A further 32 banks went through restructurings that resulted in the transfer of control, some of them with government support through the restructuring program PROER (see International Monetary Fund, 1997). The cost of restructuring the commercial banks,

process of guided consolidation executed by the central bank has led to an increasing participation of foreign investors (currently estimated at around 18 percent of the banking system's equity) and to a series of mergers and acquisitions among domestic banks. Recent foreign investment in Brazil's financial system began in March 1997 with Hongkong and Shanghai Banking Corporation's purchase of Banco Bamerindus, once the country's third largest private sector bank. In April 1997, Spain's Banco Santander acquired a small bank that was later on used as a vehicle to purchase a medium-sized bank, and in April 1998 Spain's BBV agreed to buy a controlling stake in Banco Excel Econômico—the ninth largest private bank. In September 1997, Banco InterAtlantico took over another mid-sized bank and a Portuguese bank announced its intention to buy another one. In addition, several Brazilian investment banks have been acquired by foreign institutions, while others are diversifying into the retail business.

In response to the increased foreign competition, the three largest private banks have acquired medium-sized banks, and they are preparing to bid in the sale of the remaining state banks. In June 1997 Banco Itaú acquired Banerj, in December 1997 Banco Bradesco acquired BCN, and in March 1998 Unibanco acquired a controlling stake in Banco Dibens, in an attempt to consolidate their leadership in the industry and expand their client bases. Two large state banks have already been privatized, two have been liquidated, and the authorities hope to complete the privatization of seven state-owned banks in 1998. Several options are being considered for the remaining ones under PROES (Program for the Reduction of the State Public Sector in Banking), including converting them into development agencies (which would not take deposits from the public), restructuring them, or liquidation.

The central bank has made important progress in strengthening regulation and improving supervision of the banking system, though much remains to be accomplished. An 8 percent risk-weighted capital adequacy requirement was introduced in August 1994, and it was increased to 10 percent in May 1997 (effective December 1997) and to 11 percent in November 1997 (effective January 1999). In addition, in May 1997 Brazil introduced capital requirements for the coverage of counterparty credit risks arising from derivatives positions, but there are no requirements to cover for market risks. Following the events in October 1997, the authorities moved quickly to establish "fire walls" in the banks' asset management operations, that is to separate the treasury and proprietary operations of the banks from those of the funds they manage for third parties. From a regulatory point of view, rating agencies have expressed concerns with respect to the quality and frequency of disclosure, the exclusion of renegotiated loans from measures of nonperforming loans, the booking of operations through offshore subsidiaries, complicated ownership structures designed to avoid taxes and regulations, and the significant holdings of some banks in nonfinancial enterprises. Supervision has shifted from emphasizing compliance with financial ratios to the appointment of a team of supervisors to each bank in order to understand and assess the bank's risk exposures and controls, with a view to achieve an effective consolidated supervision. Finally, the central bank is establishing a centralized credit risk database which will collect and disseminate information on individual borrowers with outstanding debts of R$50,000 or more.

including the recapitalization of Banco do Brasil, is estimated at around 4 percent of GDP, but this does not include the costs associated with the clean up of the state banks.

Chile

The Chilean banking system continues to be the strongest in the region, and this strength has allowed the system to withstand the fallout from the recent Asian crisis. As a result of more than a decade of economic growth and stability, combined with one of the best regulatory environments in emerging markets, Chile has the highest loan leverage in the region, with system loans measuring 57 percent of GDP as of 1996 and cumulative loan growth exceeding GDP growth by 33 percent since 1990. Loan growth reached 19.7 percent in 1997—13.7 percent in real terms, almost double GDP growth—and asset quality remained at levels comparable to those of industrial countries. Past-due loans were just 1.06 percent of total loans at end-December 1997, roughly the same level as in 1996, with loan loss reserves covering 167 percent of such loans.[33] With roughly one-third of total exports destined for Asian markets, Chile is one of the most vulnerable countries in the region to a recession in Asia. Moreover, the central bank's response to pressures in the foreign exchange market with a 200 basis points increase in interest rates early this year, is also going to contribute to a slow down in economic activity and a deterioration in asset quality. However, the prudent lending practices of Chilean bankers, strict limitations to currency and maturity mismatches, and the regular upgrading of provisioning requirements by the supervisory institutions have kept the system's vulnerability to such deterioration in asset quality or to currency depreciation relatively low.

Chilean banks' earnings have come under pressure in recent years, as the industry has experienced a series of mergers that have intensified competition and reduced interest margins. Profitability continued to be depressed as the net interest margin deteriorated from

[33]This discussion of Chilean banking developments is based on data of the Superintendencia de Bancos e Instituciones Financieras collected and published by Salomon, Smith Barney (1998b).

3.05 percent in 1996 to 2.64 percent in 1997. Net income for the system grew only 4.4 percent in 1997, while return on average equity declined from 15.7 percent in 1996 to 13.8 percent in 1997. Noninterest income grew at a faster rate of 14.7 percent, bringing this source of revenues to almost 20 percent of total revenues—still a low percent compared with other countries in the region. The contribution of net revenues from affiliates also grew strongly in 1997 and is expected to become a more important source of revenue as the banks take advantage of the opportunities created by the new banking law. The weak profitability was also influenced by large merger-related costs incurred by the system's two largest banks.

After four years of legislative discussion, a new General Banking Law was approved in October 1997. The new law will allow banks to extend their scope both domestically and internationally, and restore the industry's profitability levels. Banks will now be allowed to open affiliates and subsidiaries abroad, buy minority or majority stakes in foreign financial institutions, and lend directly to foreign corporations and domestic firms operating abroad. However, banks' participation in foreign credit operations will be limited to 70 percent of their capital and reserves, and to countries with which Chile has established reciprocal supervisory arrangements. Previous fire walls will be dismantled to permit banks to directly own and operate brokerage, securities underwriting, fund management, and insurance subsidiaries. Banks will also be permitted to offer a second group of domestic businesses such as factoring, credit collection, custodial services, and financial consulting. Also, new, objective criteria for the granting of banking licenses have been published.

Despite their excellent asset quality, Chilean banks show less impressive capitalization levels, and the new law attempts to remedy this with the imposition of stricter rules for capital adequacy. The ratio of equity to total assets fell from 5.3 percent at end-1996 to 5.0 percent at end-1997. The new banking law has eliminated the previous maximum leverage limit and has established a modified version of the Basle Committee risk-weighted capital adequacy requirements beginning in 1998. The financial system's capital adequacy ratio was 11.5 percent by end-1997, with the domestic banks showing a lower 10.5 percent ratio. Chilean banks and finance companies that were not in compliance with the new requirements as of November 1997 had to present a recapitalization plan to the Superintendency of Banks and Financial Intermediaries and will have two years to comply with the 8 percent ratio. In anticipation of the new law, many banks proceeded to increase their capital ratio during 1996–97, and as of end-January 1998, all financial institutions met the new capital adequacy requirement. Under the new law, bank regulators will also establish a new system of bank ratings according to levels of solvency, and management quality. Banks with higher capital adequacy, solvency, and management ratings will receive fast-track authorization for their new domestic and foreign business expansions.

A consolidation trend is resulting in fewer but stronger financial institutions that will expand into nontraditional financial service areas. In just two years and a half, the 10 largest banks have gained 8 percentage points of market share and account for 85 percent of the system's total loans.[34] Two mega-mergers in 1996–97 gave birth to the two largest banks in Chile, Banco Santiago and Banco Santander Chile, that jointly account for 30 percent of the system loans and are refocusing their businesses to provide universal banking services as other institutions in the region. Competition will remain intense and some of the banks that currently have single-digit market shares are likely to merge.

Mexico

The Mexican banking system remains entangled in severe asset quality problems, but the deterioration in asset quality appeared to have stabilized toward the end of 1997 after two years of robust GDP growth and significant government assistance. With the change to accounting practices patterned on U.S. GAAP at the beginning of 1997, past-due loans roughly doubled to 13 percent of total loans, but fell to 11.2 percent at the end of the year. However, the measure of past-due loans excludes the downside risk of loans sold to FOBAPROA and allows for some degree of transitory regulatory forbearance, especially with respect to mortgage loans. Including the 25 percent downside risk on loans sold to FOBAPROA, the share of problem loans rises to 18 percent on average for the largest banks assuming no recovery value on these loans. Moreover, the level of loan loss provisions remains at 61.2 percent, a relatively low level given the large amount of past due loans that will have to be charged-off in the near future. Banks have recently been required to start provisioning for the expected losses in the FOBAPROA loans.

Although the Mexican banks appear to be well-capitalized, with the capital adequacy ratio for the system at 13.7 percent at end-1997,[35] the proportion of equity in their capital bases is relatively low. Moreover, the high capital adequacy ratio also reflects the low risk-weight assigned to government securities (including FOBAPROA loans) and the large revaluation gains of shares in subsidiaries and affiliates. As part of their

[34]By end-1997, the Chilean financial system comprised 32 institutions: 29 commercial banks (of which 17 are foreign-owned and one is government-owned) and 3 finance companies.

[35]This ratio incorporates the impact of market risks; if only credit risks are considered, the capital adequacy ratio increases to 16.9 percent.

recapitalization programs, some banks issued mandatorily convertible subordinated bonds, which are counted as Tier 1 capital by Mexican regulations but would be considered as Tier 2 by the Basle Committee guidelines.

The largest Mexican banks recorded increasing profitability in 1997, albeit from the very low levels of 1995 and 1996. Many banks showed some real loan growth, especially in the last quarter of 1997, but this was barely sufficient to cover the decline in spreads. The latter reflects the heavy past-due loan portfolio and the mortgage discount programs launched by several banks in 1997, as well as competition from lower cost capital market funding. For most large banks, nonrecurring trading gains account for over one-third of total revenues, and they were quite substantial in the second and third quarters of 1997 but fell substantially in the final quarter. Most banks reported some growth in fees and commissions, in particular from credit card and fund transfer fees. Many of the medium-sized and small banks suffered losses during 1997, as they focused on loan provisioning and recoveries as well as in a rapid increase of their branch networks—to reduce their dependence on money market funding.

The consolidation of the Mexican banking system accelerated in 1996 and 1997, spurred by the entry of foreign participants and the merger of some domestic medium-sized banks. By the time recently announced mergers and acquisitions have been completed, about 75 percent of the banking system's assets will be concentrated in just five banking groups, with foreigners owning minority stakes in three of them. Foreign participation in terms of total assets reached 19.9 percent by end-1997, including foreign banks' affiliates and controlling stakes in domestic banks, and it is expected to grow following the approval of legislation allowing unrestricted foreign ownership in the largest banks. Moreover, many of the financial groups own insurance companies and private pension fund administrators (Afores), in most cases jointly with foreign entities. The distribution of insurance and pension products through banks branches is expected to increase the banks' noninterest income and improve their operating efficiency indicators.

The quality of the regulation at the National Banking Commission (CNBV) has continued to improve, with new measures on disclosure and self-regulation, but rating agencies note some remaining deficiencies. The adoption of U.S. GAAP standards and measures related to the mark-to-market of securities are major improvements in the transparency of information about banks' positions. Also, the CNBV has adopted measures to provide that information to the market and to strengthen the role of agents that validate that information (external auditors, rating agencies, and credit bureaus). The merger of the National Banking and Securities Commissions to create the CNBV in 1995 was a first step in the process of consolidated supervision, but the absence of consolidated accounting still makes it difficult to establish effective limits on group lending. However, accounting criteria for financial groups were issued by end-1997 and the controlling groups are required to publish consolidated financial statements since March 1998. The CNBV is preparing regulations aimed at creating a risk management unit inside the banks and improving corporate governance.

The Mexican authorities have submitted to Congress a set of measures to further strengthen the banking system and modernize the regulatory framework. The federal government would assume FOBAPROA's liabilities, a move that would increase the transparency of the restructuring process and could eventually, through refinancing, improve the liquidity of the banking system.[36] Under the new legislation, FOBAPROA would be divided into two agencies, one to accelerate the disposition of the bad portfolio taken over from the banks and another one to administer a new limited deposit insurance scheme. FOBAPROA has a loan portfolio of $45 billion and the difficulties of marshaling the approximately 440,000 loans in the absence of a secondary market for bank loans has led the government to explore the possibility of creating coinvestment partnerships with private asset managers who would manage, collect, and sell the loans.[37] The new deposit insurance scheme would cover only small depositors, with a view to induce more market discipline and reduce moral hazard. Finally, the CNBV would get new powers and autonomy under the new legislation.

Venezuela

The recovery of the Venezuelan banking system continued in 1997, underpinned by strong GDP growth and high oil prices. The crisis of 1994–95 had caused a remarkable contraction of banking activities, with the ratio of loans to GDP falling to 8 percent by end-1996, one of the lowest levels among emerging markets (see Figure 2.13 in Chapter II). Higher economic growth and disposable income, combined with negative real interest rates, fueled an increase in the demand for credit that resulted in real loan growth of 61 percent during 1997. The loan to GDP ratio rose to 12.4 percent at the end of 1997, as the economy continued to remonetize with the fall in inflation and the

[36]The fiscal cost of the bank rescue programs is currently estimated at 14.4 percent of GDP, up from an estimate of 11.9 percent of GDP in October 1997, owing to the higher costs of restructuring several regional banks and a lower loan recovery rate than projected earlier.

[37]In July 1997, FOBAPROA started the sale of assets, through its subsidiary Valuación y Venta de Activos. The first pool of loans was valued at 49 cents on the dollar. The subsidiary was absorbed by FOBAPROA in August and the sale of assets has not resumed yet.

loan portfolio reached 50 percent of total banks' assets—from a low of 34 percent in 1996.

The banking system has emerged from the crisis with relatively good asset quality and adequate capitalization.[38] Nonperforming loans, which had reached 23.4 percent of total loans at the peak of the crisis in March 1995, fell to 7.4 percent in December 1996 and to 3.9 percent in December 1997. Moreover, loan loss reserves remain adequate at 91.7 percent of nonperforming loans. The banks are well-capitalized on average, but the ratio of net worth to risk-weighted assets fell from 17.9 percent at end-1996 to 15.6 percent at end-1997. This was largely a result of the change in the structure of the banks' balance sheets that showed an increase in loans (carrying a 100 percent weight) relative to government securities (carrying a zero weight), as demonstrated by the fact that equity to total (unweighted) assets rose from 12.9 percent at end-1996 to 13.1 percent at end-1997.

The drastic fall in oil prices since the end of 1997 and the sharp increase in interest rates required to defend the exchange rate of the bolivar, caused liquidity problems at some institutions at the beginning of 1998 and is likely to lead to a considerable deterioration in asset quality toward the second half of the year. The changes in the monetary policy instruments used by the Central Bank of Venezuela in 1998 demonstrated that the interbank market becomes segmented as liquidity dries up.[39] The rapid expansion in loan portfolios during 1997 was concentrated in the consumer and mortgage sectors, with a large share of loans directed to the purchase of assets like real estate, equities, and durable goods. These sectors are quite sensitive to an asset price deflation and could be a source of deterioration in asset quality. Although the large banks appear to have developed adequate credit scoring systems and to have maintained relatively strict lending policies, most of the small and medium-sized banks have also been expanding their loan portfolios aggressively and lack the risk controls and information systems to support safe loan growth. Analysts estimate that 12 out of the 40 universal and commercial banks have capital adequacy ratios that might be too low to compensate for the increased provisions necessary to maintain an adequate coverage following the expected asset quality deterioration.

The two most important structural factors that have influenced developments since the banking crisis have been the entrance of foreign banks and the adoption of the universal bank paradigm. Starting in December 1996, foreign participation in the Venezuelan banking system changed from being almost marginal to representing 41 percent of the total system assets in December 1997 (see Figure 2.16 in Chapter II). During this period, three of the five leading banks came under the control of foreign institutions, and the trend continues in 1998. The increased foreign presence has strengthened the system and is imposing competitive pressures that will lead to further consolidation in the system. Consolidation will also be aided by the transformation of many institutions into universal banks, and 11 banks have already been approved to operate as such. Universal banks are allowed to perform all the activities of the different specialized institutions that operate in the country (commercial and investment banking, mortgages, leasing, and asset management), subject to certain operational restrictions.

Banking regulation and supervision has improved after the crisis, but market participants note that the institutional capacity and enforcement powers of the Superintendency of Banks and Financial Institutions (SBIF) need to be strengthened further. The SBIF has introduced a new chart of accounts, general and specific loan loss reserves, and minimum standards for the approval and management of consumer credit and has strengthened on-site inspections. More recently, the SBIF has moved to improve the reach of consolidated supervision through the signature of agreements with several of its regional counterparts—but it still needs to implement procedures for the consolidated supervision of financial groups and offshore operations of Venezuelan banks, and for monitoring connected lending and credit concentration.

European Banking Systems

Czech Republic

In the Czech Republic, the four largest banks still account for over 60 percent of banking system assets, although their market share has been falling, mainly owing to competition from the 23 foreign-owned banks and branches that have increased their share to over 20 percent.[40] Until recently, the large banks all remained under state control, even though three of them had been substantially privatized via voucher privatization in 1992–93. However, the government has announced its intention to sell its shareholdings to strategic investors so as to improve the financial strength and operating performance of the banks. The first such sale occurred in March 1998 when the state's 36 percent stake in the third largest bank, In-

[38]The official assistance to the banking sector amounted to $11 billion—18 percent of 1994 GDP—and the authorities expect to recover $2.6 billion through the sale of the assets (as of May 1998, FOGADE had recovered $1.6 billion from asset sales).

[39]Reflecting concerns about the costs of an increasing stock of central bank bills, the central bank shifted to treasury bonds and nonnegotiable CDs as the main instruments of monetary policy. The lower liquidity of the latter instruments led to liquidity problems in many of the medium-sized and small banks.

[40]Further details on the Czech banking system can be found in International Monetary Fund (1998).

vesticni a Postovni Banka (IPB), was sold to Nomura Europe. Preparations for the sale of controlling shareholdings in the other three large banks are under way, and foreign observers have noted that the nationwide presence of these banks would be attractive to foreign banks, but that uncertainty over the quality of their loan books will depress sales prices.

Preliminary data for 1997 for the banking system (excluding the Consolidation Bank and banks under Czech National Bank conservatorship) suggest that banks were relatively successful at increasing gross profits from banking activity faster than assets, and at holding growth in operating costs somewhat below asset growth. However, owing to a large increase in provisions, net profits grew by only 6 percent. For the sector as a whole, net profits fell to only 0.36 percent of assets, with the profitability of foreign-owned banks increasing and that of both the large and small domestic-owned banks weakening. The weak balance sheets have also been reflected in slow asset growth: lending fell in real terms in 1997 by around 2 percent. The risk-weighted capital ratio for the banking system as a whole was around 10½ percent at end-1997. Within this aggregate, capital ratios of the largest banks were only modestly above the National Bank's 8 percent minimum requirement, while the capital ratio for the group of small domestic banks appears to have fallen to below 8 percent.

While the asset quality of many of the banks remains poor, this largely reflects lending decisions taken several years ago, and there are indications that credit risk management has recently improved substantially. The May 1997 currency crisis and increase in interest rates do not appear to have had substantial direct effects on bank profitability, reflecting reasonably good market risk management by Czech banks. While classified loans (all loans for which interest and principal are overdue more than 30 days) represented 27.0 percent of all loans at end-1997, this represented a fall from 29.3 percent of all loans at end-1996 and 33.0 percent at end-1995. A high proportion of these classified loans are long-standing loss loans, which tend not to be written off because of accounting and tax regulations, and because of legal hindrances to bankruptcy proceedings and sales of collateral. After the deduction of the value of collateral or guarantees on classified loans and the weighting of the uncovered component by the National Bank's provisioning requirements (which reflect probabilities of losses), risk-weighted classified exposures were equivalent to 9.5 percent of all loans, and were fully covered by provisions. Some observers have, however, questioned the valuation of collateral by some large banks, especially with regard to real estate, and have suggested that there is substantial underprovisioning by some banks. Indeed, all of the four major banks substantially increased provisions in 1997, with some indicating the intention to also allocate the majority of 1998 operating profit to increasing provisions.

Recent changes to the Czech regulatory and supervisory framework for banks and financial markets have focused on eliminating some of the factors that made possible the various types of fraudulent behavior and insider dealing that flourished in the early years of reform. Some of the important aspects of an amendment to the Banking Act that came into force in February 1998 are (1) the introduction of limits on bank participation in nonfinancial institutions; (2) the introduction of "Chinese walls" between commercial and investment banking activities within banks; and (3) strengthened requirements for securities transactions performed by banks either on their own account or on clients' account. A second amendment to the act is under discussion and would include, inter alia, stronger requirements on bank management with respect to their relationship with shareholders. Finally, an amendment to the Bankruptcy Law approved in January 1998 should strengthen the position of banks as creditors by (1) providing for a wider and more precise definition of insolvency; (2) requiring faster bankruptcy filing; and (3) allowing faster decisions by judges and faster liquidation of companies.

Hungary

While the banking sector in Hungary—where bank lending to the nongovernment sector is about 25 percent of GDP—is substantially smaller than in the Czech Republic, the process of restructuring the banking system is further advanced as the result of greater privatization and previous government policies to clean up the balance sheets of banks and enterprises.[41] This process has not, however, been costless: it is estimated that the cost of restructuring the banking sector over 1992–96 was around 10 percent of GDP, and that less than half this amount was regained in subsequent privatizations. The process of sales of state shareholdings in large banks continued in 1997, and none of the seven largest banks—all of which had their origins in the state sector—now have majority state-ownership. For the most part, privatization has been via strategic investment by foreign financial institutions, and institutions from Belgium, Germany, Ireland, Italy, the Netherlands, and the United States now hold strategic—typically majority—shareholdings in five of the seven largest banks. The two exceptions in this regard are the largest bank, the National Savings Bank (OTP), which was sold via public offerings, and Postabank, the least healthy of the major banks, which has a dispersed ownership but is now looking for a strategic investor. As a result of pri-

[41]For further details on the Hungarian financial sector, see van Elkan (1998).

vatizations, capital injections by the new owners, and growth of new foreign-owned banks, it is estimated that by early 1998, over 70 percent of bank capital was foreign owned, and that foreign controlled banks accounted for well over 60 percent of the assets of the banking system, up from 46 percent at end-1996.

While the Hungarian banking system is clearly among the healthiest in Central and Eastern Europe, profitability has been only moderate and capital adequacy ratios are declining—albeit from relatively high levels. Pretax profits were at around 2 percent of average assets in 1996 and the first half of 1997, lending spreads have fallen sharply, fee income is still relatively low, and overhead costs remain fairly high. Classified credit exposures totaled 10.9 percent of total banking system credit in mid-1997, with a majority of these being in the "watch" category. Specific provisions for the banking system as a whole appear adequate, although analysts have reported that some banks appear underprovisioned. As of mid-1997, banking system capital stood at 16.9 percent of risk-weighted assets, down around 2 percentage points from end-1996 and by more from its peak at end-1995. Looking ahead, the challenge for the large Hungarian banks will be to ensure that efficiency is improved and the rapid expansion in balance sheets that is under way—loans grew around 14 percent in real terms in 1997—does not translate into a worsening in asset quality.

The supervisory and regulatory framework in Hungary is also stronger than in many transition economies. New laws on financial institutions and supervision became effective in January 1997, along with the establishment of a single supervisor for banks and other financial institutions, as part of a shift to universal banking and in preparation for eventual EU membership. Since January 1998, branches—rather than only subsidiaries—of foreign banks have been permitted, and in 1999 banks will be permitted to provide a range of brokerage and investment banking services currently provided through fully-owned subsidiaries. Finally, Hungary also has a relatively effective bankruptcy framework: indeed, the bankruptcy law put in place in 1992 was found to be too strong and was replaced by one slightly less stringent, but still substantially more effective than most other countries in Central and Eastern Europe.

Poland

In Poland, the expected liberalization of foreign bank entry from 1999—as part of Poland's OECD membership and EU association agreement—appears to have contributed to an acceleration of the privatization and restructuring of the banking sector. In the early years of transformation, Poland was characterized by a relatively fragmented banking system, privatization had not proceeded especially far, and foreign participation in banking was low. This has changed recently, however, with the privatization of five of the regional banks over 1993–97, and of one of the four specialized banks—Bank Handlowy, the third largest bank—in 1997, via its sale to institutional and individual investors, employees, and three foreign financial institutions, which together acquired 28 percent of the bank. As a result of privatization, the share of assets of state-controlled banks had fallen to 52.4 percent at end-1997, down from 86.1 percent at end-1993. Sales of state-owned shareholdings have continued in 1998, and it is expected that the privatization of the largest bank—the Pekao group, that accounts for around 20 percent of sector assets—will begin in the second half of 1998. However, two other state-owned specialized banks—including the second largest bank, the State Savings Bank (PKO), which holds about 18 percent of total sector assets—are unlikely to be sold before 2000.

Until recently, competition in the banking sector has not been especially strong, and profitability in 1996 was reasonably good, with healthy interest margins and a return on average assets of 2–2½ percent. Preliminary data for 1997 from the National Bank of Poland suggest, however, that profitability declined in 1997, with after-tax earnings growing by only 3 percent, a substantial fall both in real terms and in relation to the strong growth in assets (28 percent in nominal terms). The major factors behind the pressures on profits appear to have been a decline in interest spreads and increases in reserve requirements, overhead costs, and specific provisions, which are likely to continue with the increased foreign bank entry.

The asset quality of Polish banks is relatively good, owing to the bank and enterprise restructuring of 1993–94 and the effective prudential framework. Based on the National Bank's quite stringent loan classification system—loans that would be classified as "watch" loans in other countries are included in the substandard category—"irregular assets" fell during 1997 from 13.2 percent to 10.4 percent of gross claims of commercial banks, with the proportion of loss loans falling from 7.4 percent to 5.3 percent.[42] While part of this decline may be due to the recent strong growth in new loans, the longer-term improvement from end-1993—when irregular and loss loans were around 31 and 17 percent, respectively—is impressive. For the commercial banks as a group, irregular loans were essentially fully provisioned at end-1997. Capital adequacy for most commercial banks was also healthy, with a median risk-weighted capital ratio of around 17½ percent, and around three-fourths of all banks reporting ratios above 12 percent.

The prudential supervision framework in Poland is relatively strong and was boosted by the implementa-

[42]For further details of the performance of the Polish banking system in 1997, see National Bank of Poland (1998).

tion of a new Banking Law that became effective in January 1998. Prudential regulations are generally consistent with, and sometimes exceed, the EU and Basle Committee standards. The main challenges for the General Inspectorate of Banking Supervision will be to move toward consolidated supervision, to implement capital requirements for market risk, and to increase staff resources to be able to conduct more frequent on-site inspections.

Russia

In Russia, the phenomenon of lax licensing in the early years of transition was more marked than in any other country in the region, with the number of commercial banks growing to around 2,500 at end-1994. Since 1995, however, the Central Bank of Russia (CBR) has worked aggressively to close down many of the weaker banks, and by end-1997 the number of banks had fallen by around one-third. Despite the large number of banks, the banking sector is relatively underdeveloped, with the ratio of M2 to GDP at only around 16 percent, reflecting the high inflation of earlier years and lack of trust in the ruble and the banking system. There has been some consolidation among the larger banks, and the share of the top 200 banks in total assets has grown from 81.9 percent to 88.4 percent at end-1997. The Sberbank (State Savings Bank) is by far the largest bank in Russia and accounts for around one-third of banking system assets and around 78 percent of household deposits. Other important banks include the large banks that form part of the "financial industrial groups" (FIGs) that have large holdings of some of Russia's leading companies, obtained in some cases during the "loans for shares" transactions of 1995. As of end-1997, there were 165 banks with foreign equity, including 16 fully owned subsidiaries: the share of nonresidents in total equity was less than 6 percent, substantially below the current 12 percent ceiling on foreign participation.

Commercial banks in Russia are characterized by the extremely short-term nature of both sides of their balance sheet, widespread use of foreign currency denominated assets and liabilities, and a relatively high proportion of securities in their assets. Loans to the nongovernment sector appear, however, to have begun to grow, with a real increase in 1997 of around 14 percent. This, along with an increase in holdings of government securities, was funded through a substantial real increase in deposits and an increase in foreign borrowing which contributed to a swing of nearly $10 billion in the net foreign asset position of banks.

After strong profitability in 1996 because of high yields on government securities and large interest rate spreads, banking sector profitability fell sharply in 1997. Preliminary data from the CBR indicates a fall of 47 percent in 1997 ruble pretax profits. The return on equity of the largest 100 banks was reported to have fallen from around 80 percent in 1996 to around 20 percent in 1997, with the return on assets falling from around 3 percent to less than 1 percent. Contributing factors include lower interest rate spreads, lower earnings on government securities, and losses on securities holdings in the market turmoil of the fourth quarter of 1997. Some losses from the latter turmoil may, however, have been carried forward into 1998, following a CBR decision to allow banks to carry forward revaluation losses on holdings of government securities. It is likely that the continuing market turmoil in 1998 has put further pressure on the profitability of some banks, and one major bank—Tokobank, about the seventeenth largest bank—was placed under CBR administration after liquidity problems in May 1998. Many of the major banks underwent ratings downgrades in early 1998, with ratings agencies citing the sovereign downgrade, and the likely effect of the market turbulence on already weak financial positions. This weakness has shown up in reduced access by banks to international markets in early 1998 after substantial growth in access in 1997.

The asset quality of Russian banks is mixed, with substantial holdings of assets with little credit risk and smaller holdings of loans with high credit risk. There is little data on aggregate nonperforming loans, but one official estimate suggested that around 22 percent of loans were nonperforming at end-1997, a modest improvement from earlier higher levels. It has long been suggested by observers, however, that loan provisioning may not be adequate. Systemwide capital adequacy data are not available, but many banks reported risk-weighted ratios of over 20 percent at end-1996. The high capital ratios relative to the CBR minimum requirement of 7 percent reflect the relatively small holdings of assets with high risk-weights, and suggest that many banks may be well protected against credit risk. The capital adequacy regulations are not, however, designed to protect against market risk, and it remains to be seen how banks have been affected by the recent large fluctuations in the value of their portfolios of government securities.

The prudential supervision framework in Russia was substantially weaker in the early years of transition than in many of the other countries in the region. However, there was a substantial improvement in January 1996 with the introduction of Instruction No. 1 of the CBR. This instruction sets requirements, which have been gradually improved and tightened, for capital adequacy, bank liquidity, large exposures, connected lending, shareholdings in other companies, and issuance of bank bills. During 1997, the CBR tightened rules on the calculation of bank capital, and on loan classification and provisioning requirements, and issued instructions to improve the internal control procedures of banks. It has also established limits on open foreign currency positions which must be met and reported on a daily basis, and has introduced limits on

overall foreign borrowing. From January 1998, the CBR has required banks to use a new chart of accounts and to follow accounting standards that are closer to international standards. Prudential supervision is still mainly done by off-site supervision, but the CBR is now conducting on-site supervision of the largest banks. It also monitors the health of 14 large banks—which account for about two-thirds of all assets—on an ongoing basis in a special department. A law on bank bankruptcy is under discussion and would allow the CBR to act more swiftly in closing banks and removing management. Market observers have recognized the major steps taken over the last two years in improving the prudential framework, but have highlighted important further priorities which include the full implementation of international accounting standards—including consolidated accounting, the clarification of links with affiliated companies (especially in the case of the financial industrial groups), and the incorporation of derivatives and off-balance sheet activities into the prudential framework.

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