EDRC Briefing Notes
Number 19

# Banking Sector Reforms: Recovery Prospects and Policy Issues

Ramesh Adhikari

Soo-Nam Oh

Economics and Development Resource Center

Asian Development Bank

# BANKING SECTOR REFORMS: RECOVERY PROSPECTS AND POLICY ISSUES

Ramesh Adhikari and Soo-Nam Oh

November 1999

This Note is derived from a paper presented at the Fifth International Forum on Asian Perspectives Towards a Sustainable Financial System—Analysis and Prospects, ADB-OECD Conference, 28-29 June 1999.

# Foreword

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JUNGSOO LEE
Chief Economist

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# INTRODUCTION

The importance of banks is premised on the ground that banks are the main channels of savings and the allocators of credit in an economy. The efficiency of banks therefore affects the financial system and the entire economy. Their failures can erode public wealth and confidence in the economy. Bank failures or systemic banking crises occur almost invariably due to distorted management incentives, bad governance, weaknesses in macroeconomic policies, weak supervision, problems in the real sector, or a combination of these.

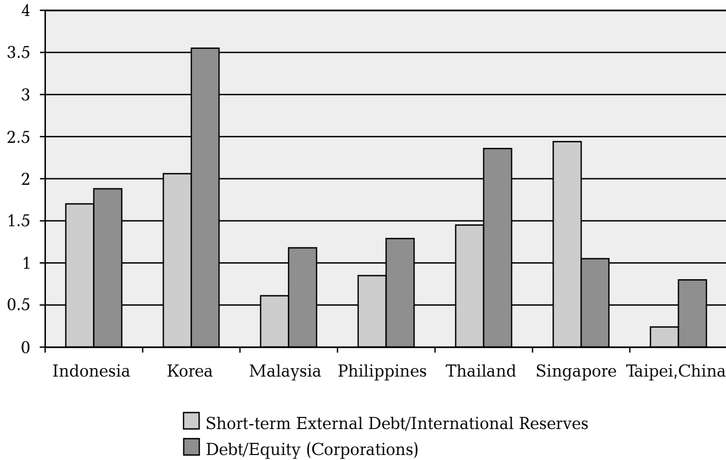
Banking failure cuts both ways. It can be the cause of macroeconomic instability, particularly when it contributes to fiscal deficits and also when it drains foreign exchange reserves. On the other hand, macroeconomic instability can cause banking failure as a result of, for example, currency devaluation, rise in interest rates, and fall in asset prices leading to corporate losses and insolvency. In addition, lack of market discipline or sufficient competition, proper regulation and oversight, and weak legal framework and enforcement are other possible factors contributing to structural weaknesses in the banking system.

While there are many interpretations of the causes of the Asian financial crisis, the majority view is that it is a dual crisis—the combination of a currency crisis due to capital account imbalances, and a banking crisis owing to structural weakness. The Asian financial crisis has unveiled many intricate problems and challenges in macroeconomic management, banking and capital markets management, good governance, institutional capability, and human resource development for both government and private sectors. More importantly, the recent developments underscore the challenges presented by a world of mobile capital—even for economies with strong institutions, human resources, and economic fundamentals. It was also evident from the Asian financial crisis that countries such as Hong Kong, China; Malaysia; Philippines; and Singapore suffered less damage from the crisis than Indonesia, Republic of Korea (henceforth Korea), and Thailand. One principal reason for this was the relative strengths and weaknesses of their banking sector.

## THE ASIAN FINANCIAL CRISIS AND THE BANKING SECTOR

The Asian financial crisis has revealed the difficulties in managing large short-term capital flows subsequent to financial sector and capital account liberalization, given a poorly developed institutional capability and regulatory framework in the banking and capital market sectors. It also highlights the fact that globalization of the financial markets, deregulation in domestic financial and corporate sectors, and capital account liberalization encourage both short-term capital inflows and corporate debt, and increase the vulnerability of the banking sector. In Indonesia, Korea, and Thailand, short-term external debt exceeded international reserves in the precrisis years and corporate debt-equity ratios were also high (Figure 1).

**Figure 1: Debt-Reserve and Debt-Equity Ratios**




Sources: Short-term debt: Bank for International Settlements; Reserves: IMF (1998); Debt-equity: Claessens, Djonkor, and Lang (1998).

The crisis has also revealed that the key problems in the banking sector were: (i) high exposure to large-scale infrastructure and real estate projects with long gestation periods and controlled by large conglomerates; (ii) large exposure to foreign currency-

denominated loans; (iii) structural rigidities and liquidity crisis facing the export sector; and (iv) deteriorating financial conditions of large conglomerates and manufacturing firms. The crisis purports that bank credits tend to expand during the upswing of the business cycle accompanied by large capital inflows, which were absorbed by nontraded sectors or overinvestment in other sectors such as heavy industries. The tendency is more persistent particularly after financial sector liberalization, as the banks can access offshore borrowing and lend wherever they wish. This may lead to many possible problems, for example, maturity mismatch — short-term funds in long-term investments, and little provision for currency and interest risks. Owing to limited experience and undeveloped risk management, motivation from immediate rewards implicit in the imperfect incentive systems, and inadequate supervision and guidance of central banks and monetary authorities, banks tend to lend too recklessly.

These contribute to increasing nonperforming loans (NPLs). In countries where not only the financial sector, but also the whole process of economic reform are less than complete, the banking sector bears a huge financial burden. The NPL ratios continued to increase in all countries. In Indonesia the ratio is estimated at around 80 percent (Table 1). The cost estimates of banking sector restructuring are high, ranging from 22 percent of gross domestic product (GDP) in Malaysia to 82 percent in Indonesia.

The experience of Thailand shows a policy mismatch coupled with structural weaknesses. It shows that an open capital account with a fixed exchange rate system can be a lethal policy combination, which can damage the economy. In addition, there was no matching institutional capability and oversight mechanism to handle the rapid capital inflows and banking sector activities. When there was heavy pressure on the exchange rate, reliance was placed more on government interventions rather than market forces. This approach did not last long as the international reserve position worsened. Eventually the baht was floated, leading to a massive devaluation. The impact of such devaluation further deteriorated the already precarious health of the banking sector.

The experience of Korea is somewhat different. This very much appears to be the case of selective economic liberalization with

**Table 1: NPLs and Restructuring Cost of the Banking System of the Five Affected Countries**
(percent of total loans)

| | Indonesia | Korea | | Malaysia | | Philippines | Thailand |
|---|---|---|---|---|---|---|---|
| **Estimated NPL Ratio** | | | | | | | |
| Deutsche Bank | 82 | 30 | | 30 | | 20 | 67 |
| J.P. Morgan | 60-80 | 10-15 | | 13 | | … | 47 |
| Bank of America | 82.9 | 19.3 | | 18.2 | | ... | 47.7 |
| **Official NPL Ratio** | | | | | | | |
| Coverage | | Commercial banks | | Commercial and merchant banks, finance companies | | Commercial, thrift, and rural banks | Commercial banks and financial companies |
| Period of overdue payment (months) | | 3 | 6 | 3 | 6 | 3 | 3 |
| Dec 1996 | ... | ... | 3.9 | ... | 3.7 | 3.5 | … |
| Dec 1997 | ... | ... | 5.8 | ... | 5.9 | 5.4 | 19.8 |
| June 1998 | ... | ... | 8.6 | 12.6 | ... | 9.7 | 32.7 |
| Dec 1998 | ... | 7.4 | ... | 18.9 | 12.6 | 11.0 | 45.0 |
| June 1999 | ... | 8.7 | ... | 18.1 | 13.3 | 13.1 | 47.4 |
| **Restructuring Cost** (% of GDP) | 82 | 29 | | 22 | | … | 35 |

Sources: Estimated NPL Ratio: Deutsche Bank (1999), J.P Morgan (1999), and Bank of America (1999). Official NPL Ratio: Central banks. Restructuring Cost: Standard & Poor's (1999).

significant government involvement. Although the impact of such a policy regime has built up over the decades and the economy was under tremendous pressure, the contagion effect from the baht devaluation triggered the Korean crisis. In Korea, while the financial sector had the nominal freedom to become market-based, the interlocking relationships between the government and the financial institutions meant that they were still subject to pervasive government controls, thus constraining market orientation. There was no independent regulatory oversight. Government provided implicit guarantees, sometimes financial assistance, to financial institutions that faced difficulties, particularly those arising from resource misallocation influenced by government decisions. The system worked

well during the high-growth period but could not last long. The policy environment further worsened with the closeness of the government and the enterprise sector, which had grown very fast to become gigantic conglomerates; they in turn started implicitly imposing influence on government decision making. At the same time overvaluation of the national currency was maintained. Export deceleration continued due mainly to the loss of export competitiveness resulting from an overvalued exchange rate and enterprise-level inefficiencies. The system of heavy reliance on a second-best option, whereby government involvement played a more dominant role than market forces in promoting businesses, thus resulted in a banking crisis leading to currency instability with spillover effects on trading partners.

While Indonesia was liberal in its capital account and exchange rate regime, its banking sector had serious structural problems. In particular, the fragmentation of the banking system complicated bank supervision. The contagion effect, coupled with the impact of natural disasters and political uncertainties, led to a loss of investor confidence and macroeconomic instabilities. This resulted in massive devaluation of the rupiah and further worsening of the already fragile banking sector. The crisis also revealed weaknesses in corporate governance. The case of Malaysia and the Philippines was different, although they were also hit by the contagion effect of the Thai, Indonesian, and Korean currency crises. This was largely because of their relatively robust banking sector.

The external environment also contributed to a certain extent to the outbreak of the Asian financial crisis. For example, the Far East and Southeast Asian countries have been experiencing export deceleration particularly since 1996. Because of the prolonged sluggish growth in demand and considerable increase in competition in the US and European markets and traditional trade links, the export dependence of these countries on regional markets had grown more than before. The second largest market in the world and the largest in the region, Japan, was also going through a period of recession and financial sector problems.

Despite the increasing fragility of the banking sector, sluggishness of the real sector, and the relatively less developed institutional capability and supervisory framework in the financial sector, no

measures were taken to prevent the crisis. The crisis has revealed many problems in the banking sector, including problems in asset and liability management, ownership, governance, competition, and institutions.

## REVIEW OF BANKING SECTOR REFORM MEASURES

A quick review of the reform measures undertaken by the crisis-hit Asian economies indicates that the key reform measures were grounded on the following strategic considerations: (i) stop panic; (ii) achieve short-term macroeconomic stability; (iii) remove structural and institutional weaknesses in the banking and corporate sector and strengthen long-term fundamentals; and (iv) achieve a robust and sustainable banking system. Following these, the guiding principles for banking sector reform were: (i) resolve unviable banks (closure, merger, nationalization); (ii) recapitalize viable banks (capital injection); (iii) resolve NPLs (restructuring, rescheduling, sale and swap); (iv) revamp the regulatory framework (regulation, supervision, reorganization); (v) strengthen bank management and credit culture (governance, foreign participation, no political interference); and (vi) strengthen borrower repayment culture (exit laws, repayment of directed credits, reform of corporate sector).

A full recovery from the crisis will require regaining investor confidence by properly addressing these structural problems. However, short-term macroeconomic stabilization measures are needed to stabilize the economy and assuage investor panic. These measures in the crisis-hit Asian economies have included a tightening of monetary policy (raising of interest rates) and the maintenance of sound fiscal policy. Restoring fiscal discipline and monetary stability in the economy has been important in restoring investor confidence and reversing capital flows. Short-term stabilization measures have been introduced together with a massive international financial rescue package to improve the current account balance and replenish international reserves.

To strengthen this supply response, ensure long-term macroeconomic stability, and achieve a robust banking system, a supplementary set of structural reforms measures have been

required. They were essentially aimed at achieving relative price alignments and institutional reforms in various sectors. The reforms were intended to make the economy more efficient and flexible and thereby engineer sustainable long-term growth by improving allocative efficiency so that resources go only to the most productive uses. In the crisis-hit economies, it was therefore necessary to restructure the banking sector by removing inherent structural and institutional weaknesses. In addition, concomitant measures have been considered to address the social impact of the financial crisis. Banking sector reform is therefore a comprehensive adjustment process entailing a package of macroeconomic adjustments, structural reforms, and institutional and regulatory measures to restore a problem-ridden banking sector to solvency and sound financial health, and to mitigate possible social costs.

The chief responsibility for dealing with the Asian crisis at an international level was assumed by the International Monetary Fund (IMF), the institution in charge of safeguarding the stability of the international financial system. The IMF's goal was to quickly restore confidence in the three hardest-hit Asian economies—Indonesia, Korea, and Thailand—through a combination of tough economic conditionalities and substantial financial support. In 1997, the IMF approved $35 billion in loans for these countries, and in addition, mobilized commitments worth $77 billion from the ADB, the World Bank, and bilateral sources. In 1998 the IMF arranged further loans worth $6.3 billion for Indonesia.

Following broadly the IMF-led framework, the ADB's response has been focused mainly on four key areas: (i) banking sector reform and capital market development; (ii) promotion of good governance and corporate management; (iii) mitigation of social costs of structural reforms; and (iv) provision for stimulating growth in the real sector. Further, the Bank has actively participated in the New Miyazawa Initiative led by Japan, and the Asian Growth and Recovery Initiative led by the United States and Japan. The Miyazawa Initiative is cofinancing many of ADB's sector policy reform packages. To complement this, ADB will administer the Asian Currency Crisis Support Facility, a yen facility equivalent to $3 billion. It will leverage, through guarantees, more funding from international financial markets for restructuring.

Progress in implementing reform in the banking sector has varied among the crisis-hit Asian economies. Most have introduced legislation to strengthen prudential regulation and improve banking supervision. Throughout the region, disclosure requirements, auditing standards, loan classification, and provisioning rules are being improved. The crisis-hit Asian economies have created financial sector restructuring agencies (e.g., Thai Financial Sector Restructuring Authority; Indonesian Bank Restructuring Authority; and Korea's Financial Supervisory Commission). They have provided substantial public money for bank recapitalization and NPL resolution, and all have closed down or merged some insolvent financial institutions. Of the crisis-hit economies, Korea took the most comprehensive and swift reform measures. Thailand has relied more on market-based bank and debt restructuring approaches than straight bailouts. Nonetheless, they still have to go a long way before their banking sectors are fully restructured.

Good progress has been made in the Philippines and Korea; fair but more needed progress in Thailand and Malaysia; and only limited progress in Indonesia. In almost all crisis-hit Asian economies, good progress has been made in resolving unviable banks. Reasonable progress has been made in recapitalizing viable but problem banks and resolving NPLs in all the countries, except in Indonesia where the progress has been limited but efforts are in place. The progress is similar in other areas such as revamping the bank regulatory framework and strengthening bank management and credit culture. In the Philippines, which had a relatively robust banking sector before the Asian financial crisis as a result of bank restructuring measures implemented since the mid-1980s, several banks have merged and takeovers of some are being considered, and tough regulations of bad loans have been legislated. Appendix 1 provides a summary of major banking sector regulations in crisis-hit Asian economies as of end-March 1999.

On the corporate restructuring front, the progress has been much slower than in the banking sector. There is a strong linkage between the banking sector and the corporate sector in the region. The latter is heavily indebted to both domestic and foreign banks. In particular, the corporate foreign debt is huge and many of them have overdue debt servicing obligations. Insolvency is pervasive.

This situation is slowing down production and investment and obstructing financial restructuring. Furthermore, there are capability limitations. Even though the crisis-hit countries have revamped their bankruptcy laws, they do not have enough trained people to implement them. And the task of handling the restructuring of hundreds of firms is certainly formidable. In Thailand, the government has initiated legal and regulatory reforms and privatization of state-owned enterprises (e.g., Bankruptcy Law, implementation of foreclosures, and Alien Business Law). Government authorities recognize that privatizing state enterprises is necessary for economic recovery as a way to attract new local and foreign investment.

In Korea, the dominance of the *chaebols* is increasing instead of shrinking; in Indonesia, corporates are still not solvent and debtors have just started to negotiate workouts. Further, in Korea, some meaningful progress has been made with smaller chaebols, including the sale of assets and business, a decline in cross-debt guarantees, and ongoing loan workouts. On the restructuring of the larger chaebols, the task is more daunting. The government has issued guidelines requiring the larger chaebols to reduce their debt-equity ratio from 500 percent at the end of 1997 to about 200 percent by the end of 1999. To achieve this, the corporate sector will have to raise a substantial amount of resources through assets sales and new issues of equity. Success will depend on the government developing mechanisms to facilitate this debt-equity conversion. The other problem in corporate restructuring is the possible resistance from labor because restructuring might involve retrenchment.

According to Goldman Sachs, while macroeconomic volatility is stabilizing in the crisis-hit Asian economies, there is still sluggish progress in removing structural weaknesses in the banking and corporate sectors (see Box 1). Foreign exchange liabilities are high and there are still some government-directed credits. On the regulatory front, both regulation and supervision compliance are improving. Overall, it is reported that the Indonesian economy is still relatively more fragile and the Philippine economy is fairly solid. In noncrisis countries in the region, such as Hong Kong, China and Singapore, which confronted a certain degree of macroeconomic volatility during the peak of the Asian financial crisis, the overall recovery is reported to be solid.

**Box 1: A Summary of Progress in Bank Restructuring in Selected Countries**

| Key Principles | Korea | Malaysia | Thailand | Indonesia |
|---|---|---|---|---|
| *Fragility Score (Worst=24)*<br>*Pre-crisis*<br>*End-1998* | <br><br>*22 (Highly fragile)*<br>*11* | <br><br>*15 (Some fragility)*<br>*11* | <br><br>*22 (Highly fragile)*<br>*13* | <br><br>*20 (Highly fragile)*<br>*18* |
| 1. Resolve unviable banks | Good progress. 36 NBFIs removed, 4 banks nationalized, exit for 5 of 26 banks. | Fair progress but more needed. 2 of 35 banks absorbed, 16 of 39 financial companies merged into parent banks. | Good progress. 55 of 91 financial companies and 1 bank shut,2 of 25 banks nationalized, 2 banks and 16 financial companies absorbed. | Fair progress: 26 of 237 banks including 2 of Big 5 taken over by IBRA; 4 of 7 state banks to merge. |
| 2. Recapitalize remaining banks | Good progress. Gov't. injected W18 trillion equity into 10+ banks, foreign buyer found for 1, sought for another; more gov't-led recapitalizations expected. | Good progress. Danamodal set up, RM4.55 billion equity placed into 9 Financial Institutions, RM16 billion in additional recaps of more Financial institutions planned by mid-1999. | Fair. Capital support program in place. 2 sold to foreign banks, 2 for sale, 6 raised equity. But many banks still under-capitalized, holding out. | Limited progress. Gov't looking at Rp257 trillion recap of some 55 banks. Preliminary talks with foreign buyers. |
| 3. Resolve NPLs | Fair. Gov't forcing reforms on Big 5. Workouts for small and medium enterprises, | Good pace. Danaharta has agreed to buy RM22billion (5.2% of all loans), may buy up | Fair. Gov't banks committed to NPL restructuring; guidelines and | Limited progress. Foreclosure law needed; banks need recaps before NPLs |

| | | | | |
|---|---|---|---|---|
| | other chaebol. KAMCO actively buying NPLs (7% of all NPLs at present). Closure usually avoided. | to 50% of NPLs, can rapidly foreclose, will restructure loans, even underlying assets. | incentives in place. But no system carve-out of NPLs despite high NPL levels. | can be restructured. No resolution for closed banks' NPLs. |
| 4. Revamp bank regulatory framework | Good progress. Prudential norms now at global standards. Better supervision with set-up of FSC. | Good norms, supervision pre-crisis, helped by Danaharta, Danamodal. Reversion to 6-month NPL definition an issue. | Fair progress. Prudential norms to global standards by 2000; forbearance still an issue. BoT reorganization by 3Q 1998. | Limited progress, still in damage assessment. Weak enforcement, high related-party lending. |
| 5. Strengthen bank management credit culture | Fair progress but more needed since pre-crisis credit culture very weak. Need foreign bank buy-ins. | Rapid NPL sales at >50% discounts exact pain, but await details of bank/ management reforms as part of recapitalization | Good progress. 2 foreign bank buy-ins, more for sale. No gov't-bailout promotes discipline. | Limited progress. Survival, trying to get recapitalized still the singular priority. |
| 6. Strengthen borrower repayment culture | Good progress. Gov't imposing restrictions on chaebol leverage, cross-guarantees; focusing on core competencies, downsizing. | Good pre-crisis. Good bankruptcy framework enhanced by Danaharta Act. But holding company leverage, 'rescues' must be curbed. | Committed but modest progress. Bankruptcy law set up, no bailout of borrowers but need promised foreclosure law and credit bureau. | Some progress. New bankruptcy framework put in place; gov't after repayment of related-party loans, but much more needs to be done. |

Note: BoT means Bank of Thailand.
NBFIs means nonbank financial institutions.
NPL means nonperforming loans.
KAMCO means Korea Asset Management Corporation.
FSC means Financial Supervisory Commission.
IBRA means Indonesian Bank Restructuring Agency.

Source: Goldman Sachs (1999).

## RECOVERY PROSPECTS AND POLICY ISSUES FOR BUILDING A ROBUST BANKING SECTOR

There are signs of recovery from the financial crisis and economies are stabilizing. Exchange rates and stock prices are responding positively. However, this process of recovery needs to be solidified and sustained through completing the effective implementation of the reform agenda in both the banking and corporate sectors. This is because of the fact that the onset of the Asian financial crisis had much to do with structural weaknesses; it was not just a sharp and temporary economic slowdown. Leaving these unresolved or incomplete will impede recovery prospects and may lead to potential repeats of the crisis. Recovery prospects are therefore dependent upon continued government commitments in resolving structural weaknesses in their respective economies. The economic situations in larger economies in the region such as PRC and Japan and elsewhere like Brazil may also influence the pace of recovery.

While there are many policy issues in building a robust and sustainable banking sector in the crisis-hit Asian economies, the most important ones are related to: (i) coordination between macroeconomic and banking sector policies; (ii) reorientation of the development role of the banks toward commercialization; (iii) improvement of corporate governance; (iv) denationalization and privatization; (v) financial restructuring, including resolution of NPLs; (vi) corporate sector restructuring; (vii) improvement of bank regulation and supervision; (viii) strengthening infrastructure; (ix) addressing the liquidity problem and the need for real sector stimulation; and (x) sequencing of reform actions. These warrant full attention of the governments and donors.

### Coordination between Macroeconomic and Banking Sector Policies

Government must maintain appropriate coordination between macroeconomic and structural policies. Reduction of macroeconomic instability or uncertainty is the most urgent concern for both domestic economic agents and foreign investors. However, achieving this is not easy. The best practice is to start with stabilizing

macroeconomic variables, such as exchange rate, inflation rate, interest rate, and prices of assets including stock and property. However, care should be taken in sequencing macroeconomic policy reforms. For example, a market-based exchange rate system is considered to be superior to a government-administered exchange rate system; benefits of capital account liberalization outweigh its cost, but exchange rate liberalization should precede capital account liberalization.

### Reorienting the Development Role of Banks toward Commercialization

In many of the Asian countries, banks were historically assigned a developmental role, and they were used to channel directed credit to priority sectors at interest rates fixed by the government. The system allowed very close linkages among the government, banks, and the corporate sector, and the risk of moral hazard increased. It is therefore essential to strike a balance between the developmental role of banks and their commercial orientation.

### Improving Corporate Governance

Poor governance leads to resource misallocation, inefficiencies, or losses, all contributing to banking failures rather than helping in avoiding them. There are many reasons for poor governance in the banking sector, however, the most important ones relate to independence of central banks, and the ownership structure of banks. Governance problems are prevalent in both state-owned banks as well as banks owned by family-based conglomerates. There are several possible options to improve bank governance: making central banks strong and independent, selling state-owned banks to the general public or commercializing them, enhancing competition in the banking sector, strengthening the legal and regulatory system, and training board members. To achieve competitiveness in the banking sector, bank privatization should be implemented; entry barriers must be eliminated or reduced; and foreign participation should be encouraged. The role of foreign participation is especially important, because it would not only encourage compe-

tition in the banking sector; it also would enhance overall efficiency by introducing good governance and advanced financial technology. Donors should encourage and support governments in improving bank governance by building in governance reform measures in their country assistance programs.

### Denationalization and Privatization

The problems relating to nationalization and state ownership of banks are a potential source of systemic vulnerability in the banking sector. The Asian financial crisis has led to nationalization of banks in several cases as the crisis-hit countries relied more on the government intervention approach (e.g., bailing out, nationalization). But one worrying factor is that there does not seem to be any explicit time-bound program for their denationalization.

It is commonly argued that bank privatization (i) reduces expectations that the banks will be bailed out in the future; (ii) limits the scope for intervention by government in credit allocation; (iii) creates incentives for restructuring; and (iv) fosters competition and improves productivity. Private sector investment fund vehicles and distressed asset funds can play a key role in assisting the privatization. In many Asian countries, state ownership of banks is considerable. Where privatization has been introduced, it has not quite led to full commercialization and higher efficiency largely because of improper governance and weaknesses in macroeconomic policy and the regulatory system.

### Financial Restructuring, Including Resolution of NPLs

The first task in financial restructuring is the estimation of NPLs and the identification of best possible ways for their resolution. While NPLs are a useful indicator of bank performance, their true meaning depends on the method of their estimation. In a crisis, NPLs are found in large scale, which makes restructuring require large financial assistance. Further, the accumulation of NPLs deteriorates profitability of financial institutions and makes them more cautious in liquidity provision due to a lowered capital adequacy ratio.

There are mainly two approaches to financial restructuring. One is government intervention (e.g., nationalization, liquidation with deposit insurance, etc.) using public money. The other one is through market-based mechanisms (e.g., shareholder capital injection, sale or merger, privatization, liquidation without deposit insurance) using private sector and foreign participation. In the crisis-hit countries, both approaches have been tried. However, the use of public money is the most frequently used approach, despite the fact that it could be costlier to the national economy and may not be sustainable.

The speed and success of NPL resolution depend on several factors. For example, for unviable banks, a legal framework for their easy foreclosure is required. Asset management companies supported by government budget can purchase some NPLs. In addition, creation of secondary markets can help dispose NPLs to institutional investors as well as the general public through auction or issuance of mortgage-backed securities.

When there is a high possibility of bank runs and systemic collapse of the financial system, closing or nationalizing unviable banks is one possible option for the government. In some cases, government can request individual institutions to provide a rehabilitation plan, based on which further measures can be taken such as closure, merger, and acquisition, or financial support for a viable institution. However, the restructuring process must be transparent and implemented consistently. In particular, the financial support should be conditional on fair cost sharing among stakeholders, i.e., shareholders, management, creditors, and depositors. This will also help in mitigating potential moral hazard problems in financial intermediation where asymmetric information is generic. However, some reliance on foreign participation is desirable, since in most cases there is the lack of liquidity in the domestic financial markets, and there is a large demand for financial support for social protection and economic revival.

## Corporate Sector Restructuring

The goals of corporate restructuring should include: enhancing transparency and eliminating insider trading; improving

financial structure; establishing core competencies; and strengthening accountability of major shareholders and management. The government should play the role of a facilitator by providing the guidelines and legal/institutional framework, and financial institutions have to be allowed to lead corporate sector restructuring as creditors.

However, it is often argued that banking sector reforms made ahead of corporate sector reforms could lead to subsequent reversals as recapitalized banks continue to give credit to loss-making enterprises. Since the banking sector and the corporate sector are mutually dependent, to achieve a successful banking sector reform, corporate sector restructuring should be implemented simultaneously.

### Improving Bank Regulation and Supervision

To maintain a sound and stable banking system, prudential regulation should be enhanced and bank supervision strengthened. Core Principles for Effective Banking Supervision prepared by the Basle Committee provide minimum requirements. Measures to strengthen prudential regulations in the banking sector include making the definition of NPLs more strict, raising loan-loss provisions, raising capital adequacy ratios, limiting bank exposure to the property sector, and strengthening lending guidelines.

Further, a balance needs to be struck between traditional supervisory-based regulation and market-based regulation. Market-based processes can instill the discipline required for prudent behavior rather than processes being imposed by the supervisory authorities. Transparency in the financial system is important for market-based processes to work. Poor and inadequate bank supervision was a major reason for the lack of incentives for bank owners and managers to behave in a prudent manner. The attempts to strengthen bank supervision prior to the crisis were inadequate, delayed, and for some countries not effectively implemented. The focus of supervision in the globalized environment should be toward greater emphasis on bank risk management. A strong and independent bank supervision function is necessary to achieve a sound banking system.

Supervisory authority should develop a CAMEL (Capital, Asset Quality, Management, Earnings, and Liquidity) system not only to evaluate the safety and soundness of a bank but also to categorize banks with deficiencies into particular component areas. The CAMEL rating needs to be extended by adding risk factors such as sensitivity to market risk and governance. In addition to the on-site and off-site examinations, prompt corrective action is an important vehicle for effective supervision.

**Strengthening Infrastructure**

A well-designed and operated financial infrastructure can lead to higher efficiency in financial intermediation. It essentially enables financial institutions to provide better services at a lower cost, and customers to enjoy high return at a lower risk. The key components of financial sector infrastructure are: legal system for supervision, bankruptcy, foreclosure, central bank monetary policy, and bank secrecy; accounting and disclosure standards; data collection and dissemination; payments system; deposit insurance (to a certain extent); asset management companies; and human resources development. In particular, the set-up of bankruptcy and foreclosure laws is also required to encourage financial and corporate sector restructuring. The crisis also demonstrated the necessity of explicit deposit insurance to prevent bank runs and an asset management company to enable financial institutions to concentrate on banking activities. Improvement of human capital, in particular for better investment decisions, risk management of banking institutions, and bank supervision has become an urgent task.

**Liquidity Problem and the Need for Real Sector Stimulation**

Following the aftermath of the financial crisis, financial institutions have become extremely conservative in their lending policies. The fact is that the Asian economies are either growing sluggishly or are at or near recession. Under such circumstances, the perceived risk of loan default is high. Further, financial restructuring itself subjects banks to increased stress, as insolvent banks

are closed down and stricter loan loss provisioning and bad debt classification standards are imposed.

One of the most daunting challenges facing the countries affected by the crisis is the prevention of the vicious circle of credit crunches and the slowdown of the real economy affected by capital outflows while financial sector restructuring is ongoing. The credit crunch raises interest rates and induces a further contraction in the real economy. As the real economy slows down, NPLs rise and the credit crunch is exacerbated by the increased conservatism of banks in their lending. This feeds back to the real economy and induces greater slackness. Efforts to distribute limited liquidity to viable but marginal corporations, in particular small and medium-sized ones, are most urgent.

## Sequencing of Banking Sector Reforms

The sequencing problem must be dealt with. Different weights may be placed on each of the above based on the urgency for implementation. For example, the mitigation of liquidity problems may come first, as it is the most urgent issue, followed by other policy issues including the resolution of NPLs and consolidation of the banking industry. Afterwards, the role of banking institutions and strengthening of the industry infrastructure may follow as medium and long-term issues. Furthermore, a gradual approach may be undertaken to reflect country-specific situations in the design and implementation of specific policy measures. For example, two separate sets of policy recommendations might be necessary—e.g., one for the crisis-affected economies, and the other for vulnerable economies.

While dealing with banking sector reforms, too much focus on the short-term issues can be costly because banking policymakers may miss the broad picture of financial sector reforms. The trade-off between the efficiency of financial intermediation and financial stability should be considered in policy design. The resolution of NPLs should be speeded up. A flexible rather than rigid application of prudential regulation and supervision may be considered during the crisis.

# Appendix: Comparison of Major Regulations

## 1. Loan Classification and Provisions

| Country | Regulations |
|---|---|
| Indonesia | Current (0.5%), special mentioned (1.25% gross of collateral), substandard (3.75% net of collateral), doubtful (50% net of collateral), and bad debt (100% net of collateral) |
| Korea | Normal (0.5%), precautionary (2%), substandard (20%), doubtful (75%), estimated loss (100%) |
| Malaysia | Substandard (20%), doubtful (50%), bad (100%) |
| Philippines | Unclassified (0%), loans specially mentioned (5%), substandard (25%), doubtful (50%), loss (100%) |
| Thailand | Pass (1%), special mention (2%), substandard (20%), doubtful (50%), doubtful of loss and loss (100%) |

## 2. Single Customer Limit

| Country | Regulations |
|---|---|
| Indonesia | 20% of equity capital (10% for related party) |
| Korea | loans: 15% of the equity capital; guarantees: 30% |
| Malaysia | 25% of a bank's shareholders' funds |
| Philippines | 25% of unimpaired capital |
| Thailand | 25% of Tier 1 capital |

## 3. Group Limit

| Country | Regulations |
|---|---|
| Indonesia | 50% of equity capital |
| Korea | Current: 45% of bank's equity capital; end of 1999: 25% |
| Malaysia | 50% of total credit facilities |
| Philippines | 30% of unimpaired capital |
| Thailand | Incorporated with the single customer limit |

## 4. Lending to the Property Sector

| Country | Regulations |
|---|---|
| Indonesia | No new loans for land purchase or property development, except in the case of low-cost housing |
| Korea | None |
| Malaysia | Exposure to the broad property sector limited to 20% of outstanding loans; no bridging finance for the development of properties exceeding RM250,000 |
| Philippines | 20% of total loan portfolio |
| Thailand | Lending growth is monitored by the central bank (Low-cost housing is classified as a priority sector; land accumulation, condominiums, and golf courses are classified as a nonpriority sector) |

## Appendix. *(cont'd.)*

### 5. Lending to Stock and Share Purchases

| Country | Regulations |
|---|---|
| Indonesia | Prohibited from underwriting commercial papers |
| Korea | No lending for speculation purpose<br>No lending based on collateral of its own stocks or in excess of 20% of the issued stocks of any other corporation |
| Malaysia | Out of total outstanding loans: commercial banks and finance companies—20%, merchant banks—30% |
| Philippines | |
| Thailand | For finance and securities companies, margin loan is classified as a nonpriority sector |

### 6. Capital Adequacy Ratio Target

| Country | Regulations |
|---|---|
| Indonesia | 4%; end of 2001—8% |
| Korea | March 1999—6%; March 2000—8%; end of 2000—10%<br>(For the banks not doing international businesses, apply lower ratios by 2%.) |
| Malaysia | 8% |
| Philippines | 8% (BIS standard), 10% of total risk assets |
| Thailand | Commercial banks: 8.5% (4.25% for Tier 1 capital)<br>Finance companies: 8% (4% for Tier 1 capital) |

### 7. Opening the Financial Market to Foreign Participants

| Country | General Ownership | Bank Ownership | Remarks |
|---|---|---|---|
| Indonesia | • Restrictions sharply reduced, except a few | • 99% | • World's 200 biggest banks above the rating A are allowed to open branches in Jakarta |
| Korea | • No general restriction (30% for 39 public interest corporations) | • 10% by reporting (domestic investors are allowed only up to 4%)<br>• Over 10%, 25-33%, and over are allowed with permission | |

**Appendix.** *(cont'd.)*

| | | | |
|---|---|---|---|
| Malaysia | • 30% (49% for telecoms) | • 30% | • No new license issued since 1983 (both domestic and foreign banks)<br>• Foreign banks are allowed to extend financing to nonresident-controlled companies up to a maximum of 40 percent of total financing requirement<br>• Restriction on opening of new branches, including off-branch ATMs, for foreign banks |
| Philippines | • Various (40% for mining and telecoms) | • 30% (40% on approval) | • Foreign banks may acquire, purchase, or own up to 60% of the voting stock.<br>• Foreign banks may set up branches with full banking authority |
| Thailand | • 100% for 10 years | • 100% for 10 years | |

Source: ADB (1999).

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