Banking Crises and Bank Resolution: Experiences in Some Transition Economies

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IMF Working Paper
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Prepared by Charles Enoch, Anne-Marie Gulde, and Daniel Hardy¹

March 2002

Abstract

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

Like most transition economies, Bulgaria, Lithuania, and Mongolia suffered severe banking crises, which had to be resolved before growth could resume. The macroeconomic and institutional failings that led to these crises are described, and parallels are drawn with the causes of banking crises in industrial and developing countries. Resolving the crises proved technically and politically difficult, and setbacks occurred. Successful resolution required the implementation of a comprehensive and decisive strategy, involving thorough-going bank restructuring, heavy fiscal costs, and institutional and legal reforms.

JEL Classification Numbers: G21, G28, P26, P34

Keywords: Bulgaria, Lithuania, Mongolia, transition, banking crises, bank resolution

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ABBREVIATIONS

AMC Asset management company
BCC Bank Consolidation Company (Bulgaria)
BFTB Bulgarian Bank of Foreign Trade
BITI Bank of Investment and Technological Innovation (Mongolia)
BNB Bulgarian National Bank
BOL Bank of Lithuania
BR day Bank restructuring day
CAB Central Asian Bank (Mongolia)
CBA Currency board arrangement
EBRD European Bank for Reconstruction and Development
EU European Union
MARA Mongolian Asset Realization Agency
MOU Memoraundum of Understanding
RB Reconstruction Bank (Mongolia)
SB Savings Bank (Mongolia)
SOE State-owned enterprise
SSB State Savings Bank (Bulgaria and Lithuania)
TDB Trade and Development Bank (Mongolia)
UBB United Bulgarian Bank
ZUNK bonds Government-issued bonds for bank recapitalization (Bulgaria)
I. Introduction

It has been estimated that in the past twenty years over half the members of the IMF have experienced banking crises. Among these, much attention was paid to the Nordic banking crises of the early 1990s; more recently, the focus has been on the crises that hit several Asian countries in the late 1990s. Between these two well-recorded episodes was a set of major banking crises that critically affected economic developments in a further group of countries: the transition economies. During the 1990s, most of the countries that were undertaking the difficult transition from a centrally planned to a market economy experienced banking crises of varying severity. These crises reflected in part factors specific to countries emerging from state socialism. Banks in transition economies were characterized by linkages to loss-making public and private enterprises, insider lending, absence of sound prudential practices, and legacy problems from the earlier regimes in their countries, all of which characteristics helped undermine the soundness of banking systems in these countries. To a surprising extent, however, the experiences of the transition economies reflected factors common to banking crises across all types of economies—transition economies were clearly more vulnerable than others to the emergence of banking problems, but overall the factors contributing to systematic banking sector problems in these countries had a great deal in common with those found elsewhere. Similarly, the lessons that can be learned, in particular on how the authorities handled the crises, may also be of wider applicability.

Such considerations motivated this study of three particular episodes of banking crisis in transition economies. Bulgaria in 1996–97 experienced one of the deepest banking crises of any transition economy, in terms of impact on loss of GDP, reflecting the pervasive disruption caused by banking system failure in an economy where financial intermediation had progressed relatively far. Lithuania’s banking crisis in 1994–95 was one of the earlier ones, and illustrates one of the first attempts by the authorities in a transition country to restore banking soundness. Lithuania had to address the banking crisis within the constraints of a currency board arrangement, whereas in Bulgaria the banking sector issues had to be addressed before a currency board could be adopted. Finally, Mongolia’s experience in 1996 shows a crisis in a transition country similar in many ways to a developing country, and where financial deepening had hardly begun. In this case the authorities were able and willing to undertake forceful intervention at short notice to seek to address the crisis within a

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3 See, for instance, Drees and Pazarbasioglu (1998)

4 See Lindgren, Baliño, Enoch, Gulde, Quintyn, and Teo (1999)

5 Hardy and Lahiri (1992) discuss some of the theoretical aspects of bank vulnerability during the transition.
comprehensive framework. In each of these cases the authorities took appropriate action in some regards, but can be seen to have also made some mistakes.

During the 1990s financial sector issues came to be central in the work of the IMF and the World Bank—a centrality that was reinforced in the later Asian banking crises and establishment of the new international financial architecture to seek to safeguard economies from financial crises more generally.

The following sections look at each of the three crisis episodes in turn. The final section presents some conclusions.

II. BULGARIA: THE BANKING CRISIS OF 1996

A. Economic and Institutional Background

Until the 1990s the Bulgarian economy had been fully integrated into the socialist economic block and had specialized in agriculture and certain heavy industries complementary to those in other socialist countries. Bulgaria was correspondingly hit particularly hard by the breakup of the socialist system, in the form of a collapse of demand for its traditional exports and large terms of trade adjustment associated with the move to world market prices. Real output eventually declined by more than a third during the transition process and inflation was persistently high. The enterprise sector had to be profoundly restructured and reoriented to respond to the new pattern of demand and costs. While there was substantial reform momentum in the first year after the break-up of the socialist system, through most of the early 1990s the reform process proceeded less quickly and smoothly than in other countries in central and eastern Europe; continued government subsidies, in particular to the enterprise sector, and lack of fiscal adjustment led to high levels of domestic and international debt. By 1993–94 output had stabilized, but recovery was slow and inflation remained high. Summary macroeconomic data are shown in Table 1.

As part of the transition process, the Bulgarian financial system had to be transformed from one designed solely as an ancillary to the system of central planning, to one playing an active role in the generation of savings and the allocation of investment. Before 1987, the Bulgarian banking system mirrored that in other central and eastern European countries. It comprised only three banks: the Bulgarian Bank of Foreign Trade (BFTB), in charge of international reserve and external debt management as well as other foreign exchange transactions; the State Savings Bank (SSB), in charge of household deposit mobilization and housing loans; and the Bulgarian National Bank (BNB), in charge of currency issuance and commercial and investment banking operations with enterprises. As a result of the introduction of a two-tier banking system in 1987–90, seven specialized commercial banks and 59 new commercial banks were created, and the BNB was turned into a central bank.
Three more commercial banks were licensed in July 1990, leading to a system of 71 relatively small banks, often with capital below the statutory minimum.\(^6\)

### Table 1. Bulgaria: Selected Economic Indicators, 1993–98  
(In percent except where indicated)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (in millions of leva)</td>
<td>299</td>
<td>526</td>
<td>880</td>
<td>1749</td>
<td>17,055</td>
<td>21,577</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>-1.5</td>
<td>1.8</td>
<td>2.9</td>
<td>-10.9</td>
<td>-6.9</td>
<td>3.5</td>
</tr>
<tr>
<td>Nominal GDP growth</td>
<td>48.8</td>
<td>75.8</td>
<td>67.5</td>
<td>98.6</td>
<td>875.3</td>
<td>26.5</td>
</tr>
<tr>
<td>CPI inflation (period average)</td>
<td>72.8</td>
<td>96.0</td>
<td>62.1</td>
<td>123.0</td>
<td>1082.2</td>
<td>22.3</td>
</tr>
<tr>
<td>(end of period)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Broad money (in millions of leva)</td>
<td>234</td>
<td>418</td>
<td>584</td>
<td>1,310</td>
<td>6,019</td>
<td>6,597</td>
</tr>
<tr>
<td>Growth in broad money</td>
<td>47.6</td>
<td>78.6</td>
<td>39.6</td>
<td>124.5</td>
<td>359.3</td>
<td>9.6</td>
</tr>
<tr>
<td>Broad money/GDP</td>
<td>78.3</td>
<td>79.5</td>
<td>66.3</td>
<td>74.9</td>
<td>35.3</td>
<td>30.6</td>
</tr>
<tr>
<td>Credit to the private sector (in billions of leva)</td>
<td>11.1</td>
<td>19.8</td>
<td>185.4</td>
<td>622.1</td>
<td>2,151.8</td>
<td>2,733.7</td>
</tr>
<tr>
<td>Credit to the private sector/GDP</td>
<td>3.7</td>
<td>3.8</td>
<td>21.1</td>
<td>35.6</td>
<td>12.6</td>
<td>12.7</td>
</tr>
<tr>
<td>Reserve money (in billions of leva)</td>
<td>55</td>
<td>89</td>
<td>154</td>
<td>352</td>
<td>2,174</td>
<td>2,387</td>
</tr>
<tr>
<td>Money multiplier</td>
<td>4.27</td>
<td>4.71</td>
<td>3.78</td>
<td>3.73</td>
<td>2.77</td>
<td>2.76</td>
</tr>
<tr>
<td>Money market interest rate</td>
<td>48.1</td>
<td>66.4</td>
<td>53.1</td>
<td>119.9</td>
<td>66.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Exchange rate (leva per U.S. dollar)</td>
<td>27.6</td>
<td>54.1</td>
<td>67.2</td>
<td>177.9</td>
<td>1,681.0</td>
<td>1,760.7</td>
</tr>
<tr>
<td>International reserves including gold (in millions of U.S. dollars)</td>
<td>960</td>
<td>1,311</td>
<td>1,546</td>
<td>793</td>
<td>2,539</td>
<td>3,127</td>
</tr>
<tr>
<td>International reserves/reserve money</td>
<td>48.3</td>
<td>80.0</td>
<td>67.3</td>
<td>40.1</td>
<td>196.3</td>
<td>230.6</td>
</tr>
</tbody>
</table>


\(^6\) Most banks had a capital asset ratio below the minimum requirement of 4 percent enacted in April 1990. Their minimum paid-in capital (lev 7–10 million, about $350,000 at the 1992 exchange rate) was very low by international standards.
In response to a view that regarded this fragmented system as inefficient, the incoming Bulgarian government set up a Bank Consolidation Company (BCC) in 1992. Its purpose was to serve as a temporary holding company for the shares of the state-owned banks, with a mandate to merge the existing banks and to strengthen them for privatization. Following these mergers, the numbers of state banks, excluding the SSB, fell to ten by 1996 (Table 2). At the same time, private banks—which were first licensed in 1991—grew in number, so that by 1996 more than 30 were operating. While most remained small compared to the public institutions, some—most notably the First Private Bank—had reached significant size by 1996 in terms of both assets and branch representation. By 1996 five foreign banks and bank branches were also operating in Bulgaria.

In terms of business activities, by early 1996 about one third of lending went to the government, one third to public enterprises, and the remainder to private sector enterprises and households (Table 3). The state banks (excluding the SSB) catered to all sectors of the Bulgarian economy, including the newly emerging private sector, but lending public sector enterprises remained the largest component of their portfolio. Private banks concentrated on lending to the newly emerging private sector, yet they also lent a considerable amount to the government and to nonfinancial public enterprises.

In spite of the structural changes in the banking landscape, certain key problems were evident from the beginning. These included, first, a high degree of concentration: by 1996 the five largest banks (four state owned, one private) held 60 percent of total assets. Second, most banks—especially the state banks—remained to a large extent sectorally and/or regionally oriented, leaving some highly exposed to vulnerable state enterprises (see Appendix I). Third, more or less state-controlled banks were still dominant: in spring of 1996, the ten banks partly- or fully-state owned held two thirds of the assets of the banking sector (Tables 2 and 3). In addition, the shares in these banks that were not directly held by the government belonged, for the largest part, to enterprises that most often were themselves state owned. The BCC acted also as the state oversight body for these banks. However, while adequate prudential regulations had by and large been put in place, they were largely not enforced. The BNB had almost no supervisory powers over the banks that fell under the BCC, and often exerted only limited authority over the private banks.

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7 The first post-socialist government in Bulgaria, which had undertaken the initial reforms, had recently lost the subsequent election to a party descended from the former socialist regime.

8 About 60 percent of the loan portfolio of Economic Bank, one of the weakest banks, was to public enterprises.

9 State ownership in the ten banks ranged from 98 percent of Bulbank, the largest state-owned bank, to 69 percent in Yambol, and 12 percent in Postbank.
### Table 2. Bulgaria: Economic Standing of Banks at the Outset of the Banking Crisis

<table>
<thead>
<tr>
<th>Banks</th>
<th>Number of Banks</th>
<th>Total Assets (Dec. '95)</th>
<th>Net Worth (Dec. '95)</th>
<th>Total Assets (April '96)</th>
<th>Net Worth (April '96)</th>
<th>Asset Concentration Share in total banking sector assets (April '96)</th>
</tr>
</thead>
<tbody>
<tr>
<td>State banks</td>
<td>10</td>
<td>661,584</td>
<td>-39,777</td>
<td>477,864</td>
<td>-93,532</td>
<td>66.3</td>
</tr>
<tr>
<td>Private banks</td>
<td>29</td>
<td>242,453</td>
<td>-13,853</td>
<td>236,118</td>
<td>--</td>
<td>32.8</td>
</tr>
<tr>
<td>Foreign banks</td>
<td>6</td>
<td>6,671</td>
<td>287</td>
<td>6,525</td>
<td>--</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>45</strong></td>
<td><strong>910,708</strong></td>
<td><strong>-53,343</strong></td>
<td><strong>720,507</strong></td>
<td><strong>-93,532</strong></td>
<td></td>
</tr>
</tbody>
</table>

*Including four state owned, one private bank*

### Table 3. Bulgaria: Loan Portfolio of the Banking Sector by Ownership Group (April 1996)

<table>
<thead>
<tr>
<th></th>
<th>State Banks</th>
<th>Private Banks</th>
<th>Foreign Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>in millions of leva</td>
<td>in percent of total</td>
<td>in millions of leva</td>
</tr>
<tr>
<td>Government</td>
<td>106,531</td>
<td>29.0</td>
<td>22,663</td>
</tr>
<tr>
<td>State funds</td>
<td>20,648</td>
<td>5.6</td>
<td>141</td>
</tr>
<tr>
<td>Local government</td>
<td>28,349</td>
<td>7.7</td>
<td>1,398</td>
</tr>
<tr>
<td>Public enterprises</td>
<td>130,199</td>
<td>35.5</td>
<td>49,183</td>
</tr>
<tr>
<td>Private enterprises</td>
<td>80,342</td>
<td>21.9</td>
<td>130,820</td>
</tr>
<tr>
<td>Households</td>
<td>894</td>
<td>0.2</td>
<td>735</td>
</tr>
<tr>
<td>Nonbank financial institutions</td>
<td>102</td>
<td>0.0</td>
<td>4,299</td>
</tr>
<tr>
<td><strong>Total loans outstanding</strong></td>
<td><strong>367,065</strong></td>
<td><strong>100.0</strong></td>
<td><strong>209,239</strong></td>
</tr>
</tbody>
</table>

*Source: BNB, BCC, and staff estimates.*
B. Early Signs of Banking Sector Weaknesses and Initial Response

Difficult macroeconomic conditions, combined with inadequate internal risk control procedures, and the absence of any loan repayment culture led to a rapid increase in nonperforming loans, soon exceeding 60 percent in a number of banks’ loan portfolios. This derived in large part from the fact that banks allocated much of their lending under government-mandated credit plans, rather than commercial credit analysis, and the major borrowing enterprises were often hard hit by the economic transition. Even after the abolition of directed credit, strong interrelationships persisted between banks and major enterprises, leading to lax credit analysis. The lack of bankruptcies in the enterprise sector throughout the transition period reinforced the pressures on the banks to finance losses. Banking supervision, which was in its infancy, seems to have been ineffectual in preventing this deterioration, in part reportedly because of lack of effective authority of the supervising institutions (the BCC and BNB for the state and private banks respectively) in enforcing their mandates. Insider lending was widespread and there was a perception (evidenced in some high-profile examples) that organized groups were utilizing their influence over the banks and enterprises to profit at the expense of the state. In spite of the BCC’s mandate in that regard, by 1996 none of the state banks had been privatized.

Of the state-owned banks, on the basis of information using Bulgarian accounting standards, only one—Bulbank, the former foreign trade bank—showed positive net worth in early 1996 (Tables 2 and 4). While this bank was the largest in terms of assets, its particular business structure limited potential positive spillovers to other banks and the economy at large: the bank’s activities were concentrated in the trade financing area, with no branch network and few retail banking activities, and it thus had only limited direct interaction with the mainstream of the Bulgarian economy.

The remaining nine state banks—all of which were predominantly engaged in domestic business—showed significant negative net worth at the end of 1995. On one estimate, in three of the state banks nonperforming loans exceeded 90 percent of their total loans. Excluding Bulbank, the average size of state banks' nonperforming loans relative to total loans was 70 percent at end-December 1995.

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10 These were in general likely to show a less negative position than international accounting standards. All Bulgarian banks had by law to present amounts according to Bulgarian standards. A few banks, including Bulbank, prepared two sets of accounts so that they could show their position in a form understandable by the international markets.

11 A notable exception was Bulbank’s holding of a large part of the household foreign exchange accounts.

12 In most industrial countries, banks with arrears in excess of 10 percent of portfolio are considered to be in serious financial difficulty.
Table 4. Economic Standing of the State Banks

<table>
<thead>
<tr>
<th></th>
<th>Assets (Dec. 95)</th>
<th>Net Worth (Dec. 95)</th>
<th>Assets (Apr. 96)</th>
<th>Net Worth (Apr. 96)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulbank</td>
<td>265,238</td>
<td>31,773</td>
<td>263,243</td>
<td>15,648</td>
</tr>
<tr>
<td>Biochim</td>
<td>70,344</td>
<td>-8,219</td>
<td>40,402</td>
<td>12,073</td>
</tr>
<tr>
<td>UBB</td>
<td>63,805</td>
<td>-14,903</td>
<td>35,616</td>
<td>-17,476</td>
</tr>
<tr>
<td>Balkanbank</td>
<td>61,896</td>
<td>-14,400</td>
<td>29,161</td>
<td>-28,594</td>
</tr>
<tr>
<td>Mineral</td>
<td>48,123</td>
<td>-7,740</td>
<td>30,612</td>
<td>-9,133</td>
</tr>
<tr>
<td>Economic</td>
<td>41,895</td>
<td>-15,374</td>
<td>16,738</td>
<td>-20,028</td>
</tr>
<tr>
<td>Hebroesbank</td>
<td>38,876</td>
<td>-5,158</td>
<td>19,462</td>
<td>-9,482</td>
</tr>
<tr>
<td>Expressbank</td>
<td>30,580</td>
<td>-1,429</td>
<td>22,961</td>
<td>-3,133</td>
</tr>
<tr>
<td>Bulgarian Post Bank</td>
<td>22,955</td>
<td>-749</td>
<td>18,820</td>
<td>-5,096</td>
</tr>
<tr>
<td>Yambol</td>
<td>17,872</td>
<td>-3,578</td>
<td>843</td>
<td>-4,164</td>
</tr>
<tr>
<td><strong>Total State Banks</strong></td>
<td><strong>661,584</strong></td>
<td><strong>-39,777</strong></td>
<td><strong>477,864</strong></td>
<td><strong>-93,532</strong></td>
</tr>
<tr>
<td>Private Banks</td>
<td>242,453</td>
<td>-13,853</td>
<td>236,118</td>
<td>---</td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>6,671</td>
<td>287</td>
<td>6,525</td>
<td>---</td>
</tr>
</tbody>
</table>

Source: BCC and staff estimates

According to BNB data, the economic standing of private banks in April 1996 was more mixed. A group of smaller private banks appears to have been relatively more successful in managing their business affairs: in December 1995, among the 20 banks with assets of leva 10 billion (about $65 million) or less, only five reported negative capital. In contrast, more than half of the institutions above that threshold were insolvent. 13 Notwithstanding such differentiation, all private banks shared in the rapid loss of deposits between December 1995 and April 1996, an indication that the public was unable to distinguish between the relatively more healthy smaller private banks and the remainder of the system.

As a result of the above factors, liquidity and solvency problems emerged in the banking sector. In an earlier effort to address banking sector difficulties, the government had issued bank rehabilitation bonds, so called ZUNK bonds, in exchange for state banks'...
nonperforming assets in 1994.14 Due to flaws in the design of the instrument—in particular their low yields—they only restored solvency in a technical sense, but did little to improve the actual economic sustainability to the banks that had received such bonds.15 Instead, the BNB and the SSB increasingly acted as lenders of last resort by refinancing all illiquid institutions. The extent of such refinancing—whether through the BNB’s lending facilities, placements by the SSB, or arrears in the payments system—had reached a point where the authorities’ ability to conduct monetary policy was put in question.16

By the end of 1995 the Bulgarian authorities could no longer ignore the problems in the banking sector. In late 1995 a high-level interdepartmental committee had been established, reporting directly to the Prime Minister. It recognized the seriousness of the incipient crisis, although it could not establish consensus on the necessary remedial measures quickly enough. Nevertheless, a number of steps were taken. From January 1, 1996 substantial provisioning requirements were imposed upon the banks. With greater transparency in the banks’ accounts, the situation of the banks was seen to be far worse than had earlier been estimated. Table 4 shows the economic standing of the state banks according to figures supplied by the BCC at end-December 1995 and end-April 1996. The deterioration in the position of the banks between the two dates reflects both weak performance in the first months of 1996 as well as, probably more importantly, the recognition of losses incurred earlier. The authorities had thus obtained evidence that a large number of institutions were technically bankrupt. The BNB apparently felt, however, that under the banking law it did not have a mandate to close failed banks, because the law at that time did not provide a legal basis for the BNB to place conservators in banks. At a more general level, the authorities faced a dilemma because all existing institutions were either infected, or too small, or too specialized to offer a viable continuation of banking services if a comprehensive approach to

14 The authorities seem generally at this time to have regarded emerging banking sector difficulties as part of the legacy of the former system, rather than that the solvency of the system was deteriorating rapidly under the new system. This attitude served to lessen the feeling of urgency with which the situation needed to be addressed.

15 The earlier rescue operations replaced nonperforming assets with government bonds, which in some cases did not pay market interest rates or did not fully cover the nonperforming portfolio. The experience of these recapitalizations shows that, while replacing bad debts with government paper may make a bank technically solvent again, the lack of proper valuation of the government paper and the absence of concomitant measures to change the way in which the bank operates, means that the bank is likely soon to fall into difficulties again.

16 Similarly, the extent of government indebtedness, and hence the extreme difficulty that the government had in borrowing by this time, rendered impractical all measures that would have had a substantial fiscal impact, such as a government-financed recapitalization of the banking sector.
addressing banking sector weakness were to be adopted; any solution would have to go beyond closings to ensure the continued provision of banking services.

Around this time too the public became fully aware of the banking crisis: banks developed serious liquidity shortages, especially in foreign exchange, and lines outside banks became commonplace. Not surprisingly, there were widespread rumors about the failing health of the banking system, by itself a factor aggravating the problems. Deposit runs occurred against at least two banks of significant size. In addition, the sudden emergence of a large volume of items in arrears in the payment system caused system-wide liquidity shortages and accelerating loss of public confidence in the system. To keep the system afloat the BNB injected leva 25 billion (or 16 percent of end-1995 reserve money) into the system in the first four months of 1996, and the SSB increased interbank lending by leva 12 billion (8 percent of reserve money). At the same time, the BNB’s attempts to establish control over the situation were stymied: in the absence of an efficient bank bankruptcy law it was unsuccessful in trying to close two smaller banks, leading to a further erosion of confidence, and visible financial disintermediation.

Initial policy response

In May 1996, with widespread deposit runs on the banks, the authorities acknowledged the existence of the crisis and determined to take action.\textsuperscript{17} Measures included amending the banking legislation and working out, in secret, the technical details of bank closures. A modified law, which allowed the BNB to suspend bank management and replace it by BNB-appointed conservators, was passed by the Bulgarian parliament. Following the establishment of the legal basis, the authorities took the decision to close the two most vulnerable large banks—First Private and Mineralbank—along with three smaller banks during the following weekend. A weekend was chosen to allow sufficient time for the complex logistical tasks involved, including the planning of the physical seizure of all bank branches, and notification of foreign central banks to close the respective branches abroad. The closures went relatively smoothly, although it appeared that the owners and managers of at least one bank—where the cash reserves were found to have been seriously depleted—had received advance warning. Depositors demonstrated at some locations, but in general remained relatively calm following an announcement that their domestic currency deposits would be available after two weeks at the SSB. Foreign currency deposits, the BNB announced, would be transferred to Postbank and paid in four installments over a two-year period.\textsuperscript{18}

\textsuperscript{17} There was awareness of the banking sector difficulties at the BCC and BNB since late-1995. As noted above, the authorities had established a high-level inter-agency committee to address the situation at that time, but although this committee developed extensive plans for action little had actually been put into place by the time the crisis emerged into the open.

\textsuperscript{18} Immediate payment was possible but only in leva.
Restrictions were placed on the operations of the remaining weaker banks. These restrictions were laid down in memoranda of understanding (MOUs) between the BNB and each individual bank. A key element of the MOUs was to forbid any new lending prior to achievement of a viable capital asset ratio. In order to retain some control over macroeconomic liquidity targets, under the economic program being agreed between the Bulgarian authorities and the IMF, limitations were placed on the volume of the total unsecured refinancing that the BNB could provide, and commitments were made to enhance supervisory standards.

**Evaluation of the initial response**

The measures introduced in May 1996 had some initial effect, most notably reflected in a brief period in July when deposits in the banking sector stabilized. Thus, the closure in May 1996 of the most affected banks initially achieved a significant reduction in pressure on the BNB and the SSB. However, with a number of banks known to be insolvent still remaining in system, the measures essentially only bought time to address the underlying situation. In addition, problems emerged with the closure process itself and with the deposit insurance system. Specific issues of concern included:

- The BNB applied to the court system to request insolvency of the institutions in question, but failed to withdraw their licenses. All the banks opposed the BNB’s applications, and—given the untested legal basis for the BNB’s actions as well as inadequate preparation of the legal system for the challenges of bankruptcy procedures for banks—lengthy court procedures emerged, involving courts at all levels. The courts all failed to accept the BNB’s assessment of the financial health of the institutions in question, and instead required a further “independent” assessment of the banks’ balance sheets. Decisions on all banks involved were repeatedly postponed.\(^{19}\)

- Failure of the system to act decisively on the question of insolvency, combined with the generous deposit insurance arrangements, allowed banks—most notably the previously largest private bank—to continue some operations. Given that their liabilities had all been taken over by the deposit insurance system, some institutions managed to create a public perception of having regained profitability. Using their newfound strength, they led intense court battles against the BNB to fight the closure decision.\(^{20}\)

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\(^{19}\) Even by 2001 only around half of the banks in question have been declared legally bankrupt.

\(^{20}\) In the process, in some cases, the BNB also lost its influence over the conservators working in the banks, who instead actively worked toward seeing them reopened.
The implementation of deposit insurance arrangements was unsatisfactory. Thus the SSB, which was charged with paying out domestic currency deposits, received a relatively illiquid government bond to cover the new and, as it turned out, very liquid liabilities. In the event, deposit withdrawals were substantial—more than 70 percent of deposits being withdrawn in the first week after the deblocking of the accounts—, which were overwhelmingly financed out of the liquid assets of the SSB. On foreign currency accounts, depositors were given a choice between withdrawal in leva cash or payments over two years in four six-monthly installments. However, as the choice was not made binding, depositors had a choice at any point to opt for leva currency payments, on relatively favorable terms, which complicated liquidity management.

The extent of government indebtedness limited its ability to handle the banking crisis in a more comprehensive fashion, either through bank recapitalizations or through recognition of prompt payment of deposit insurance liabilities as an explicit fiscal cost. The resultant nontransparencies undermined credibility in the authorities' efforts at resolving the crisis.

The banking crisis and the authorities' inadequate attempts to respond to them had serious macroeconomic costs. The provision of substantial liquidity by the BNB over the period July to September 1996, without any ability to undertake equivalent sterilization of the liquidity effect, exerted continuous pressure on the exchange rate. The leva depreciated from around 70 to the U.S. dollar in September 1995 to around 230 in September 1996. The basic interest rate in early-September 1996 stood at 108 percent (180 percent annualized compounding), almost three times its level of late 1995.

C. Comprehensive Approach to Resolution

Relapse into crisis

As the initial round of bank closures fell short of what was needed to stabilize the system, the negative effects of maintaining undercapitalized banks in the system persisted and again became apparent. Among the problems were negative cash flow, mounting uncollected interest, and further declines in the quality of banks' loan portfolios. Associated with this

21 After the negative reaction to plans in December 1995 to introduce explicit limited deposit insurance, the authorities during the crisis declared their intention to protect depositors in full. Shortages of foreign currency resources, in particular, as well as broader fiscal pressures, induced the authorities, however, to seek not to delay payment or to transform the obligations with less liquid forms.

22 The situation was greatly aggravated by the fact that reform efforts in the enterprise sector were stalled and many of the banks' major borrowers became illiquid during the period.
was widespread disintermediation from the banking sector, with significant declines in both leva and foreign currency deposits. Deposit outflows occurred from almost all Bulgarian banks, including Bulbank. Reflecting the inadequate liquidity of the banks, sizeable delays in payments of deposits occurred, lines outside banks again became a common sight throughout the country, and most banks had to resort to formal or informal queuing mechanisms to restrain the speed of outflows.

The banking crisis now spilled over into the public debt markets and the payments system. Participation of banks in the public debt market declined sharply as even those banks with adequate liquidity feared further pressure for deposit withdrawals and preferred to hold (domestic and foreign currency) cash. These preferences threatened to paralyze the government debt markets and required extraordinary liquidity injections by the BNB. In addition, and further derailing the BNB’s ability to control liquidity, there were increasing delays in the payments system. By early September, payments queues as large as leva 10 billion had developed, despite several costly BNB attempts to clear them. In addition to the monetary consequences, these delays in the payments system threatened to lead to serious contagion effects, spreading the crisis even to the relatively stronger banks, which, through delayed receipt of payments due, themselves were experiencing liquidity problems. By early September the public was clearly expecting a further wave of bank closures.

Resolution strategy

The authorities began to plan to reestablish confidence through a comprehensive and wide-ranging restructuring of the banking sector. As a precondition, they developed criteria for a redesign of the sector, ensuring that the exercise would only leave open institutions that were clearly viable and could, if necessary, be supported by the authorities. The exercise was based on a bank-by-bank analysis of liquidity, earnings, net worth, and foreign currency positions. Based on these indicators, a simulation exercise using different assumptions regarding the progress of the crisis was undertaken, which suggested that 15 more banks (B-list banks) should be closed immediately, while the BNB should publicly declare its support for the remainder (A-list banks) of the system.23 At the same time, it was recognized that the banking framework, in particular the supervisory system, needed to be strengthened substantially to allow the public to regain confidence in the financial sector.

While some banks had improved their loan collection efforts, the situation of the enterprise sector severely limited the degree to which banks could improve their loan portfolios.

23 The focus at this time was largely on liquidity rather than solvency criteria, since liquidity figures were considered more reliable, and illiquidity was having the most immediate effect in undermining monetary control.
Implementation

The authorities put nine further banks under conservatorship on September 23, 1996, which—together with the institutions closed earlier—meant that roughly one third of the Bulgarian banking sector had been closed. At the same time, in an attempt to reestablish tighter monetary control, the BNB increased the basic interest rate to 25 percent per month. Finally, reacting to the shortcomings of the previous deposit insurance system, the BNB decided that, for the second round of bank closings, deposit insurance payments would be deferred until the banks in question had been declared bankrupt by the courts.

Reflecting the fragility of the situation, at least two of the A-list banks became subject to intense pressure during the first three weeks of October. Runs on these banks were initiated through rumors that the Customs Service was shifting its accounts due to the poor financial health of the institution in which its accounts were held. Following these rumors, intense demand for the withdrawal of foreign currency deposits developed, and banks lost about $23 million (equivalent to about 1 percent of reserve money).

The BNB’s policy was geared toward restoring confidence through firm signals of support for the remaining banks. To that end the BNB accommodated the banks’ leva liquidity demand through its Lombard window and, later, conducted outright purchases of ZUNK bonds. Among the state banks, Biochim (the most heavily affected) was granted refinancing of leva 3 billion. Total outstanding claims on deposit money banks during this period increased by another leva 15 billion (about 10 percent). Although the BNB refrained from direct refinancing in foreign exchange, its public announcements that the second wave of closures had been final would have to imply full support for the remainder of the system, thus posing significant risks to monetary stability. Although the BNB’s instruments were thereby severely challenged, it is not clear that its policy was necessarily misguided; in almost all cases of systemic banking crisis, there has been similar testing of the surviving

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24 The authorities cited technical reasons for the failure to close all ‘B-list’ banks. In particular, the BNB felt that it had no legal mandate to close banks that had marginally positive capital and that had agreed after the May crisis with the BNB on an MOU until end-1996.

25 It was hoped that this would lead to popular pressure for an acceleration of the court processes. At the point when this decision was taken none of the banks closed in May 1996 had actually been declared bankrupt by the courts.

26 Given that the runs were predominantly on foreign currency deposits, the banks in question appear to have temporarily resorted to informal rescheduling. However, withdrawals could be accommodated through purchases of foreign exchange in the interbank market, where the BNB was a seller for almost all of the month of October.
banks after initial bank closures, even if the effect of the closures was ultimately to help achieve the successful resolution of the crisis.  

By November 1996 the banking sector had stabilized to the extent that no insolvent banks remained in the system. Nevertheless, at least one of the state banks that had been subject to the runs in late fall remained extremely vulnerable. The BCC continued its attempts to increase confidence in the sector by privatizing at least one of the large remaining state banks. In the event, progress on the privatization of the bank in question was slow. During this period too, further active policy measures were hampered by inflationary pressures, an emerging political crisis and an intense debate about the possibility of switching the monetary regime to a currency board arrangement (CBA). Thus, by late 1996 official intervention in the banking sector came to a halt, leaving the institutions to attempt their own stabilization efforts. Some of these were successful: a few smaller private banks managed to raise their capital. In addition, the solvency of the remaining institutions was helped by the rapid devaluation of the leva, given that banks mostly had long foreign exchange positions. However, the remainder of the state bank system increased its profitability during the period as a result of returns from high domestic interest rates, exchange rate revaluation gains, as well as increased business due to a "flight to quality."

D. Banking Sector Restructuring and the Introduction of a Currency Board

Banking sector considerations in designing the currency board

Starting in November 1996, the Bulgarian authorities began planning in earnest the introduction of a currency board, a monetary arrangement in which the central bank's ability to lend to the government and commercial banks is abolished or, at least, severely curtailed. Such arrangements have in other countries contributed to the reestablishment of public confidence in the domestic money and domestic economic institutions and proven instrumental in arresting high and hyper-inflationary situations. However, none of the other

27 It is arguable that the rapidly reemerging problems in the banking sector derived at least in part from failures in policies elsewhere, in particular the lack of progress in the enterprise restructuring to which the authorities had also committed themselves.

28 Discussions over the possibility of introducing a CBA developed at the same time as the banking crisis, in large part reflecting disillusion with the BNB's operation of the existing systems of supervision and monetary control. By end-1996 all political parties had endorsed the objective of adopting a CBA.

29 The long positions (usually in excess of permissible prudential limits) originated largely from foreign exchange denominated ZUNK bonds.

30 Examples of countries where such arrangements had been put in place include Argentina, Estonia, Hong Kong, and Lithuania.
countries that introduced a currency board arrangement (CBA) in the recent past had done so while facing banking sector challenges comparable to those in Bulgaria.

Notwithstanding the urgency of macroeconomic stabilization, there was concern that the reconstitution of the Bulgarian banking sector might be especially difficult within a currency board framework. The major considerations regarding the banking sector in the preparation for the CBA included:

- In view of the constraints on the provision of lender-of-last-resort support under a CBA regime, the soundness of all banks that would be in the system when the CBA was established was to be reevaluated using the latest data available. It was agreed that no unsound bank, that is a bank with negative capital, should be permitted to exist at the time of the change in the monetary arrangement.

- Given the need to maintain confidence in the banking sector, it was felt that even after the introduction of the CBA some limited lender-of-last-resort facilities should be available.

- Under a CBA, bank liquidity management, as well as system-wide liquidity distribution via interbank markets, was seen to take on an added importance. Availability of sufficient liquid assets, along with the institutional arrangements in place for effective interbank markets, became another focus of attention.

- Adequate capitalization of banks also acquired added importance. It was felt that given the strictures of a CBA the path toward achieving adequate capitalization (estimated to be at least 12 percent of assets in Bulgaria) should be accelerated.

- The banking law had previously hindered decisive and fast action by the central bank to cope with problem banks. Therefore, the “Law on Banks and Credit Activity” had to be amended to accord greater and more precise supervisory powers to the BNB, and to allow faster procedures for bank closure by limiting banks’ recourse to judicial protection to a degree more consistent with international practice.

The currency board arrangement and bank soundness

At the time when a CBA was first considered, there was concern that Bulgarian’s foreign currency reserves were far from sufficient to cover domestic monetary liabilities, as is required under a CBA, except at an extremely depreciated exchange rate, and that confidence in the banking sector was so weak that there would likely be runs on the banks that would quickly test the constraints of the CBA. At an early stage it was envisaged that the introduction of a CBA might well have to be accompanied by the imposition of exchange controls and/or controls on the withdrawal of deposits. These indeed might have served to undermine the credibility of the CBA at its outset and reduced the likelihood that it would be able to function effectively.
In the event, discussions over the introduction of the CBA were protracted; as the
government seemed unable to handle the enfolding crisis in the winter of 1996, confidence
collapsed, and the exchange rate fell dramatically as hyper-inflation ensued. This hyper-
inflation, while disastrous for the well-being of many Bulgarians, served to severely erode
the liabilities of the banking system, making their coverage by the country’s foreign reserves
much more feasible. At the same time, the resignation of the government and its replacement
after elections, generated confidence in the country and its institutions, served to substantially
recapitalize the banking sector (by restoring positive market value to the state bonds that
dominated their balance sheets), and rendered remote the likelihood of serious runs on the
banking system.

With the new government in place, the authorities changed the central bank law to
form the legal basis for a CBA. The currency board, linking the leva at 1,000 to the deutsche
mark was officially introduced on July 1, 1997.

The final currency board design has two features in particular specifically focused on
the handling of the banking sector.

- The currency board consists of two distinct departments within the BNB, the issue
  and the banking department. While the issue department represents the currency
  board proper, the banking department’s assets—which also are covered through
  foreign exchange—are available for emergency lender-of-last-resort support. It is
  expected that the existence of this facility should of itself help avoid a system-wide
  panic in case of difficulties of individual banks. The use of the facility and the
  operationalization of the criteria used in the law to justify such support were to be
  regulated by BNB ordinance.31

- To ensure a smooth transfer to the currency board environment it was decided to
  retain banking supervision within the BNB. The new supervision department became
  the “third pillar” of the currency board organization, headed, as are the issue and the
  banking departments, by a BNB deputy governor.

At the time of designing the CBA, the authorities again reviewed the state of the
banking sector and undertook several supporting measures to ensure that the banking sector
was sound and seen to be sound at the outset of the CBA. Most notably, they engaged into a
limited recapitalization of one state bank that was marginally undercapitalized prior to the
shift in the monetary regime.32 In addition, efforts toward privatization of the state bank

31 In the event the preparation of this ordinance postdated the establishment of the CBA by
several months.

32 The scheme included government purchases of ZUNK bonds from Bulbank and the
transfer of these bonds to the bank in question. A second round of the exercise, initially also
(continued)
sector were accelerated, leading to the sale of one large state bank to a group of three investors (the European Bank for Reconstruction and Development (EBRD), Bulbank and Bank Oppenheimer). Privatization and/or management contracts for other state banks were also actively pursued, with clear prospects for the sale of at least one bank emerging at the time.\textsuperscript{33} In addition, a reorganization of the banking supervision department of the BNB; a redesign of prudential regulations governing licensing, capital, liquidity, open foreign exchange positions; and an ambitious plan to increase on- and off-site inspections were implemented.\textsuperscript{34}

E. Epilogue

The currency board to date has largely achieved its main macroeconomic targets—reducing inflation, limiting the budget deficit and restoring confidence in the Bulgarian economy—while avoiding any major testing due to renewed banking sector pressures. This outcome can be ascribed to a variety of factors, not least of which are the confidence enhancing measures undertaken prior to, and at the time of, the introduction of the arrangement. In addition, the hyperinflation of the spring of 1997, during the political hiatus at the time of the preparation of the CBA, served to greatly deflate the real value of banks’ liabilities, substantially improving the solvency of the banking system. Finally, the abolition of the minimum price on ZUNK bonds, together with increased demand for these bonds as confidence returned in response to the establishment of the CBA,\textsuperscript{35} increased the value and the liquidity of the state banks’ assets.\textsuperscript{36}

planned prior to the move to the CBA, was postponed, once it was seen that the bank had ample liquidity and no crisis seemed imminent.

\textsuperscript{33} In the event, the introduction of private sector involvement into the state banks at the outset of the CBA fell short of what had initially been intended. Most notably, a management contract for the weakest state bank with a major international bank fell through shortly before completion. The authorities considered that the situation of the bank in question was sufficiently serious as to justify a delay in the implementation of the CBA.

\textsuperscript{34} Bulgaria already had a relatively advanced prudential framework, even before the most recent redesign of the regulations. As noted above, earlier problems derived in large part from the fact that compliance with these regulations was low because the BNB was not in a position to exert pressure on delinquent banks.

\textsuperscript{35} The election of a new government, which took office in April 1997, also served to increase market confidence.

\textsuperscript{36} The minimum price by law had earlier been set at 90 cents to the dollar. At a time when Bulgarian Brady Bonds (the closest comparator instrument) were trading around 50 cents to the dollar, this restriction meant that there was no trading in ZUNK bonds, which were therefore totally illiquid and deemed by observers to have minimal value.
Notwithstanding the initial positive developments in the banking sector under the currency board, challenges remain. The most important include:

- The subsequent privatization process was initially slow and subject to a number of setbacks. While these, in part, resulted from the changing business plans of potential investors, in part they seemed to derive also from bureaucratic red tape and somewhat unrealistic expectations on the side of the authorities. More recently, however, the process has been brought near to completion.

- The SSB for long operated as a quasi-fiscal organization, intermediating resources between household depositors and government borrowing. The process of changing the SSB from a “narrow bank,” to which the authorities accord full deposit guarantees in exchange for a very limited and safe investment strategy, into a full-fledged commercial bank, now called DSK Bank, with its deposit insurance subject to the same limitations as those of the other banks in the system, is ongoing, with plans for divestiture of the state’s ownership in the bank.

- Despite some economic recovery, banks in Bulgaria have so far not substantially resumed lending.

- Banking supervision long suffered from deficiencies. Since the crisis a new regulatory framework for supervision has been put in place. The focus more recently has moved to compliance and enforcement.

In conclusion, a full recovery of the financial sector in Bulgaria remains closely linked with the prospects for stabilization and growth in the country. Once growth becomes more robust, the banking system will have greater potential to recover its strength. The prospect of EU accession provides a good medium-term framework both for macroeconomic policy and structural measures to further bring about the necessary strengthening and safeguarding of the banking system.

III. LITHUANIA: TRANSITION INTO BANKING CRISIS

A. Economic and Institutional Background

Lithuania is the southernmost and largest Baltic country, with a population of 3.7 million. From the period after the Second World War up to independence in the early 1990s,[37] Lithuania had been part of the former Soviet Union and shared its centrally planned economic and financial system. Output declined by 40 percent during the transition, and inflation peaked at an annual rate of about 1,000 percent.

[37] Lithuania declared independence in 1990 and gained international recognition in 1991, after the failed coup attempt in Moscow.
The macroeconomic situation was transformed by the introduction of a CBA on April 1, 1994, under which the national currency was tightly pegged to the U.S. dollar and full convertibility was enshrined in law. Inflation was reduced rapidly and began to converge to the level of the countries' main trading partners. Macroeconomic conditions have been relatively stable throughout the remainder of the period under consideration (Table 5).

In the banking sector, the former Soviet financial institutions continued to dominate for a period after independence, at first with unclear ownership relations between Moscow and Lithuania. The Bank of Lithuania (BOL) was founded in 1990 to become the central bank of the new republic. However, its role initially differed from the classic model of a western central bank in at least two important regards: first, until October 1992 Lithuania was still part of the ruble zone, which left the central bank no room for independent monetary policy. Second, in October 1990 the BOL took over the branches of two former Soviet State banks and was thus initially engaged in both central and commercial banking; in 1991 it provided as much as 40 percent of total outstanding credit to the economy. In these circumstances, and in the absence of a relevant legal framework, the development of banking supervision was slow.

In the aftermath of independence, Lithuania, like most other transition economies, witnessed a sharp increase in the number of financial institutions. This development mainly reflected the fact that minimum capital requirements were not changed from their 1991 levels, in spite of high inflation and depreciation of the currency (Table 5). By the beginning of 1994, 28 banks operated in Lithuania, some of which acted as lending agencies for one or two enterprises only. In addition, an undetermined number of enterprises were engaged in banking business without having obtained the necessary license.

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38 In February 2002 Lithuania will repeg its currency from the U.S. dollar to the euro to facilitate EU accession.

39 The Russian crisis of 1998 provoked an economic recession, but the downturn has since been overcome.

40 The bank had initially been founded in 1922, but later became a part of Gosbank.

41 The talons replaced the ruble in October 1992. In a second currency reform in June 1993 the litas (plural litai, LTL.) replaced the talons. Prior to the currency reform, the BOL had no role in currency issuance, but was limited to collection of bills and physical distribution of currency among branches.

42 The banks taken over were the Social and Development Bank and the Industry and Construction Bank.
Table 5. Lithuania: Selected Economic Indicators, 1993-98
(In percent except where indicated)

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<td>Nominal GDP (in billions of litai)</td>
<td>11.6</td>
<td>16.9</td>
<td>24.1</td>
<td>31.6</td>
<td>38.3</td>
<td>42.9</td>
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<td>Real GDP growth</td>
<td>-16.2</td>
<td>-9.8</td>
<td>3.3</td>
<td>4.7</td>
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<td>5.1</td>
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<tr>
<td>Nominal GDP growth</td>
<td>240.3</td>
<td>45.8</td>
<td>42.6</td>
<td>31.0</td>
<td>21.4</td>
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<td>CPI inflation (period average)</td>
<td>410.4</td>
<td>72.1</td>
<td>39.5</td>
<td>24.7</td>
<td>8.8</td>
<td>5.1</td>
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<tr>
<td>Broad money (in billions of litai)</td>
<td>2.7</td>
<td>4.4</td>
<td>5.6</td>
<td>5.4</td>
<td>7.3</td>
<td>9.6</td>
</tr>
<tr>
<td>Growth in broad money</td>
<td>100.4</td>
<td>63.0</td>
<td>29.0</td>
<td>-3.5</td>
<td>34.1</td>
<td>32.4</td>
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<td>Velocity</td>
<td>23.1</td>
<td>25.8</td>
<td>23.3</td>
<td>17.2</td>
<td>19.0</td>
<td>22.4</td>
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<td>Credit to the private sector (in billions of litai)</td>
<td>1.4</td>
<td>5.9</td>
<td>12.1</td>
<td>9.9</td>
<td>7.6</td>
<td>6.9</td>
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<td>Credit to the private sector/GDP</td>
<td>12.1</td>
<td>34.9</td>
<td>50.2</td>
<td>31.4</td>
<td>19.8</td>
<td>16.1</td>
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<td>Reserve money (in billions of litai)</td>
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<td>1.8</td>
<td>2.4</td>
<td>2.5</td>
<td>3.3</td>
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<td>Money multiplier</td>
<td>2.13</td>
<td>2.40</td>
<td>2.30</td>
<td>2.17</td>
<td>2.20</td>
<td>2.26</td>
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<td>Money market interest rate</td>
<td>n.a.</td>
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<td>26.7</td>
<td>20.3</td>
<td>9.6</td>
<td>6.1</td>
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<td>Exchange rate (litai per U.S. dollar)</td>
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<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>International reserves including gold (in millions of U.S. dollars)</td>
<td>412.2</td>
<td>587.3</td>
<td>819.0</td>
<td>834.3</td>
<td>1062.7</td>
<td>1460.0</td>
</tr>
<tr>
<td>International reserves/reserve money</td>
<td>140.0</td>
<td>128.8</td>
<td>133.9</td>
<td>133.5</td>
<td>128.5</td>
<td>137.1</td>
</tr>
</tbody>
</table>

Nonetheless, concentration remained high: in 1992 two of the old institutions, Agrobank and the Savings Bank, together with the commercial banking arm of BOL (which later became the State Commercial Bank) accounted for more than half of the banking systems’ deposits and loans. In late 1995 the five largest banks accounted for 77 percent of deposits and 71 percent of assets. Yet, given the relatively low level of financial intermediation (Table 5), the transmission of financial sector developments to the rest of the economy remained limited.

In light of the perceived weaknesses in the financial system and to form the basis for a modern banking sector, the authorities undertook a series of measures. Important steps included the enactment of the Bank of Lithuania and the Commercial Banking Laws in December 1994, which provided the legal basis for all banking activities, created a clear two-tier banking system, and defined the BOL’s supervisory role. Prudential regulations put in place at that time included a higher minimum core capital requirement, a capital adequacy ratio, limitations on both connected lending and lending to a single borrower, as well as open position limits. The new banking laws of 1994 created the necessary legal basis for a prudential framework to support a market economy, but significant restructuring within the BOL, as well as training of supervisors, was required to operationalize the framework.

Owing to the previous absence of prudential regulations, the formerly prevalent practice of directed lending, as well as the weak credit evaluation skills of commercial bankers, improved supervision alone could contribute little to a rapid change in the quality of the banking environment. At first banks profited from high inflation—which averaged more than 400 percent in 1993 (Table 5). In the absence of indexation, inflation eroded the real value of both assets and liabilities. Inflation also masked the cash-flow problems that would normally be associated with a similar level of nonperforming loans, allowing banks to continue imprudent lending practices longer than they could have in a more stable environment. However, once macroeconomic policies were tightened—most notably after

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43 In October 1990 the Savings Bank became legally a state-owned Lithuania institution. However, as the vast majority of its assets were held in Moscow and could not be withdrawn, it remained dependent on the Russian State Savings Bank.

44 The figures for Lithuania are in line with other successor states of the former Soviet Union. However, other formerly centrally planned economies had deeper financial markets. For example, the ratio of quasi-money to GDP in 1993 for Bulgaria was about 61 percent, nearly 50 percent for the Slovak Republic, and about 25 percent for Poland.

45 The regulations also foresaw stepwise adjustments in prudential ratios toward European Union (EU) requirements.
the introduction of the CBA in April 1994—inflation declined and banks started to feel the liquidity and solvency consequences of their weak loan portfolios.  

B. Early Signs of Banking Sector Weakness and Initial Response

A number of banks failed to make progress toward compliance with the prudential norms established in 1994, most notably on capital requirements. The continued violations of the prudential norms remained unsanctioned. In addition, the prudential norms themselves were not fully consistent with those in a market economy, as the law foresaw a stepwise adjustment toward international practice. As these regulations were progressively being phased in, banks already in breach of the old norms slipped even further into noncompliance.

The increasing stress on the banking system was first felt by the smaller institutions. Starting in 1994, a total of 14 smaller banks were forced into bankruptcy procedures. Yet, in spite of the large number of institutions involved, the economic impact initially remained modest, as these banks’ combined assets only accounted for about 5 percent of the total assets of the banking system.

Signals of deeper banking sector problems first arose during the summer of 1995. Aura Bank, a medium-sized institution, faced liquidity problems after deposit withdrawals that were caused by rumors questioning its solvency. To avoid a crisis, Aura Bank received support both from the government and the BOL. Still, banking problems continued to deepen during the fall of 1995, and public confidence in the system continued to erode. Deposit withdrawals were ongoing, bank capital diminished, and bank losses increased substantially. In the fall of 1995, the government had to provide liquidity support to Vakaru Bank, another medium-sized institution.

By late December 1995 the banking sector fragility had developed into a full-scale crisis. An on-site inspection by the BOL revealed the insolvency of Innovation Bank, the largest private bank, and its would-be merger partner, Lithimpex Bank, mainly due to serious portfolio quality problems. The two banks were put under moratoria, which suspended all their commercial banking activities, except for the collection of loans and other assets. Deposits held with both institutions were blocked. Vakaru Bank, which had obtained liquidity support earlier in the fall, again experienced liquidity problems and was now put

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46 Inflation, nevertheless, initially remained far above the rate in the United States despite the pegging of the litas to the U.S. dollar.

47 Most banks had problems in complying with capital adequacy requirements, given initially low capital requirements at the time the banks were founded and erosion of the capital base due to high inflation (the minimum capital requirement was not adjusted from its 1991 level, in spite of high inflation and currency depreciation). In addition, the nonavailability of tax deduction for loan-loss provisions reduced the incentive to make adequate provisions.
under conservatorship by the BOL. With the extension of the crisis to these three institutions, about 30 percent of deposits in the system were affected.

Depositors reacted rapidly and shifted their deposits to the state-controlled banks, where individuals’ deposits were fully guaranteed by the Civil Codes, thus liquidity shortages emerged even in relatively solid private banks. The interbank market came to a standstill, deposit withdrawals continued, and confidence in the banking system was shaken. In the event, from December 1995 to March 1996, about 25 percent of the existing household deposits left the banking system. Around this time the press increasingly started to question also the solvency of the three state-owned banks. Audits of two state banks (State Commercial Bank and State Savings Bank) revealed that both had made losses in 1995 and that they would need to be recapitalized in order to meet the capital adequacy ratio. When these audits were published by local newspapers, a systemic crisis appeared in prospect.

After the BOL’s initial intervention no further action was being taken regarding the two commercial banks under moratoria. The attendant uncertainty caused a further loss in public confidence in the financial system as a whole. In an attempt to calm depositors’ rising fears, parliament passed a law pledging state assets to guarantee in full the deposits and creditors at the two banks. This move, however, was not consistent with the deposit insurance law, passed in December 1995, which provided limited insurance of 4,000 litai ($1,000) per depositor, and only applied to litas deposits, excluding the large amount of foreign exchange deposits held with banks. To restore interbank trading, parliament passed a law providing for the extension of government guarantees of one-year duration for interbank deals for a volume up to a total of 300 million litai ($75 million, or 12 percent of reserve money), albeit with little measurable impact. As a measure of last resort and in order not to weaken banks already in distress, the BOL decided not to enforce penalties on banks that did not meet reserve requirements.

**Evaluation of the initial response**

The early attempts of the government and the BOL to address the banking sector problems largely failed. The CBA, which was put in place in 1994—before the crisis—severely limited the central bank’s ability to pledge financial support. In the event, funds of only 19.3 million litai (about 0.8 percent of reserve money outstanding at end-1995) were lent by the central bank to commercial banks during the first quarter of 1996. While the

48 In December 1995 about 40 percent of total deposits and nearly 70 percent of time deposits were denominated in foreign currency.

49 This episode illustrates why it is generally recommended that banking sector matters should be given urgent attention prior to the introduction of a CBA (Enoch and Gulde, 1997).

50 To appreciate the very limited extent of this intervention, it is worth considering that during the Swedish banking crisis from 1991 to 1992, the Swedish Central Bank increased its...
CBA thus prevented support of solvent but illiquid banks, it also avoided prolonged liquidity support to insolvent banks, a behavior that might otherwise have been extremely damaging to monetary stability. At the same time, the uncertainty associated with the banking crisis led to significant capital outflows. Net foreign assets of the central bank decreased by 506.6 million litai ($126.6), equivalent to 20 percent of reserve money at end-1995, associated with a concomitant decline in reserve money.

Uncertainty about the relative responsibility of the government and the central bank, coupled with fear of the political fallout from a crisis also contributed to the absence of fast and decisive action. The ongoing political uncertainties eventually led to a change in both the leadership of the government and the central bank. The authorities also relied on the failed banks themselves to propose their own rescue packages. The absence of serious attempts to manage loan portfolios of banks under moratoria weakened creditors’ morale; and by not enforcing penalties on some banks, incentives to maintain reserve requirements and other prudential norms weakened for all banks. This was not incentive compatible, and in the end further weakened the financial position of the institutions in question.

Thus, although the width and depth of the problems were recognized early in the crisis, the initial response was limited to a case-by-case approach and concerned only with mitigating the most pressing liquidity needs. No action was taken to assess the broader solvency issues and formulate steps toward a recovery of the system as a whole.

**C. Comprehensive Approach to Resolution**

By mid-1996, when banks holding more than three quarters of the systems’ assets and liabilities were insolvent or undercapitalized, it became clear that a resolution of the banking crisis would require a strategic plan. Key issues to be decided included whether to rehabilitate or liquidate banks in difficulties, the cost sharing of any rescue operations between shareholders and the government, as well as new “rules of the game” to minimize the likelihood of a recurrence of such problems.

**Resolution strategy**

After considering a number of options, the government decided in September 1996 to adopt a plan based on the following three principles: first, that no bank would be allowed to operate unless it met the capital adequacy requirement by the end of 1996; second, that any capital support from the government had to give the government a commensurate portion of share capital and voting rights as private contributors, ensuring that existing shareholders could not benefit unduly from a bank’s rehabilitation; and third, that any government support credit to commercial banks by kronor 37.5 billion, equivalent to more than 40 percent of reserve money outstanding at the beginning of the period.
was to be conditional on change of the top management of the bank. These principles translated into the following plan:

**Measures on individual banks**

- Aura Bank was to have its license revoked and be relicensed as a bank under the name Turto Bank with limited bank powers. The new bank’s sole purpose was to become the asset management company (AMC, see below) for assets purchased from banks undergoing restructuring using public funds and be 100 percent owned by the government.

- Regular bankruptcy and liquidation procedures were to be initiated for Vakaru Bank.

- Innovation Bank was to be restructured by the end of 1996. If it failed to do so, the bank’s license was immediately to be revoked and bankruptcy procedures initiated.

- Litimpex Bank had been allowed to restart operations on June 10, 1996 as the BOL had determined that the bank met all prudential regulations. Certain safeguards, however, were put in place. The BOL was to examine Litimpex during October 1996 and in the event the bank failed to meet all prudential rules, the BOL was committed to immediately revoke its license.

- The State Commercial Bank and the State Savings Bank had already been recapitalized by the state, and the value of the stock of existing shareholders had been appropriately diluted. The two banks’ bad loan portfolios were to be bought by the AMC and the government was to make a specific public commitment to privatize the banks in the near future.

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51 The presumption was that a bank’s managers were responsible for the difficulties of the bank and should not be given a chance to repeat these mistakes using taxpayers’ money. Removal of management was also meant to send a strong, discipline-enhancing message to other bank managers.

52 For a summary of the role of individual banks in the banking crisis, see Appendix II.

53 This decision was made without an inspection or independent verification.

54 The Agricultural Bank was already in the process of being restructured and was therefore not included in the bank restructuring plan.
Legal and regulatory changes

- The law protecting all creditors in a bank had recently been amended by parliament, allowing the government to recapitalize a bank if at least 40 percent of the large private deposits were converted into equity by December 1, 1996.

- The government committed itself to pass new laws and regulations which were to set new “rules of the game,” minimizing the possibility that similar problems were to recur. These included abolition of all socially- and politically-based lending; redefinition and tightening of lending limits to connected parties; strengthening personal liability of bank board members for deficient application of prudential regulation; lowering large exposure ratios and expanding the definition of borrower; revision of capital rules to comply with Basel standards; introduction of International Accounting Standards for all regulatory purposes; facilitation of foreclosure; revocation of the provisions in the Civil Code protecting in full individual depositors in the state-controlled banks. The government was to actively seek foreign participation in the banking market. Parliament also passed a law allowed foreign banks to open branches or affiliates in Lithuania.

The asset management company\(^\text{55}\)

- In order to allow banks to reorient their businesses away from collecting on bad loans, as well as in the hope to maximize loan collection, the government decided to centralize loan collection in an asset management company (AMC). It was hoped to minimize the time needed for the AMC to be operational by using an existing failed bank as the shell for the AMC, an approach sometimes called “hospital bank.” Aura Bank was chosen for the purpose and was renamed Turto Bank after it assumed its new role. The asset transfer relied on government injections in the form of special treasury bills, which would be given to the ailing banks in exchange for the bad loans that would be handed over to the asset management company.

Depositor protection

- No specific arrangements for depositor protection were put in place at the time of the design of the bank restructuring plan. The legal arrangements in place included a complete guarantee (under the Civil Code) of deposits in the three state-owned banks, as well as a scheme protecting deposits in private banks up to 4,000 litai (equivalent

\(^{55}\) For details see Appendix III
Implementation

The process of banking sector rehabilitation has, in its broad outline, followed the initial plan, albeit with some delays and modifications.

Regarding the state banks, which continued to dominate the system, rehabilitation and privatization proceeded more slowly than had been hoped for. There were no transfers of bad loans to Turto Bank, the asset management company, until the second quarter of 1998, which left the banks concerned weak and undercapitalized.\(^{57}\) In an effort to assist the Agricultural and the State Commercial Banks, parliament passed a law in March 1997 exempting these banks from penalties arising from the noncompliance with prudential regulations. In the meantime, the authorities made several failed attempts at privatizing the State Commercial Bank, followed by the final closure of the institution in March 1998. In modifying the original plan, the privatization of the Agricultural Bank and the State Savings Bank were delayed for several years. The remaining private banks were profitable and in compliance with prudential regulations following the restructuring.

In the area of depositor protection, the authorities on several occasions during the crisis augmented the coverage available to depositors (see above), and on the basis of these laws all depositors in banks that failed prior to 1997 were paid in full, with coverage provided by the budget. The total of the proposed bank restructuring plan was estimated to be roughly $261 million (3.5 percent of GDP), and a significant part of the cost was to be covered by special Treasury securities.

D. Epilogue

Indicators of financial sector health (Table 6), most notably the sharp increase in bank deposits, show that by end-1997 significant progress had been made in overcoming the banking sector crisis. Nevertheless, domestic and international challenges remained that had a potential to endanger previous gains, including the high level of nonperforming loans. Further events showed, however, that the system remained stable, even in the face of further challenges.

\(^{56}\) These were provisions of the deposit insurance law of December 1995. The law initially only covered deposits in domestic currency, but an amendment passed in February 1996 extended coverage to deposits in foreign currency.

\(^{57}\) In early 1998, state banks held more than 50 percent of all deposits, but less than 3 percent of the capital of the banking system.
Table 6. Lithuania: Indicators of Financial Sector Soundness and Market Development

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Capital Adequacy</td>
<td>10.5</td>
<td>10.8</td>
<td>14.0</td>
</tr>
<tr>
<td>Returns on equity</td>
<td>-9.1</td>
<td>-8.3</td>
<td>3.4</td>
</tr>
<tr>
<td>Excluding State Banks</td>
<td>15.4</td>
<td>10.8</td>
<td>5.9</td>
</tr>
<tr>
<td>Growth of deposits (annual rate)</td>
<td>-5.0</td>
<td>34.0</td>
<td>30.0</td>
</tr>
<tr>
<td>Growth of private sector credit (annual rate)</td>
<td>-4.0</td>
<td>19.0</td>
<td>26.0</td>
</tr>
<tr>
<td>Borrowing by banks from nonresidents/total liabilities</td>
<td>3.0</td>
<td>6.0</td>
<td>8.0</td>
</tr>
</tbody>
</table>

Source: BOL and IMF.

1 Operating banks. March 1998 excludes the State Commercial Bank.

2 The methodology for calculating the ratio was adapted to international norms in the first quarter of 1997.

One challenge included renewed banking sector problems in 1997. It appears, however, that the shift to limited deposit insurance—where the new depositor protection regulations are based on EU standards, with a maximum of 25,000 litai per depositor—has served well to improve confidence. The new regulations were successfully applied in the case of Taurobank, which failed in July 1997. The limited amount of deposit coverage did not lead to any loss in confidence in the remainder of the system, although a “flight to quality” continues to be noticeable.

The second challenge was the 1998 Russian crisis, which caused a deep recession in Lithuania. The decline in output notwithstanding, bank performance did not deteriorate in the process. Since that time, the momentum for privatization has resumed. The Development Bank and Savings Bank were privatized in 2001; there was a tender also for privatizing the Agricultural Bank in 2001. Lithuania is now preoccupied with putting in place a prudential framework compatible with EU accession, which is likely to take place within a few years.

58 Under the rules, domestic currency deposits are protected up to a maximum of 25,000 litai; including 100 percent coverage up to 5,000 litai; 90 percent between 5,000 litai and 10,000 litai; 60 percent between 10,000 litai and 25,000 litai.
IV. MONGOLIA: THE 1996 BANK RESTRUCTURING OPERATION

Mongolia is geographically the largest but economically the smallest of the countries considered in this study. Many of the population of 2½ million still follow a traditional lifestyle, and measured income per head is only about $400 a year. The formal sector is dominated by the production of primary products, notably copper, cashmere, and gold, the prices of which can be volatile. Mongolia, while always formally independent, was closely integrated into the Soviet economic system, and formerly received large subsidies from the Soviet Union. The country was therefore very badly affected by the collapse of the Soviet economic bloc and the break-up of the Soviet Union. Real GNP declined substantially between 1989 and 1992, and near-hyperinflation prevailed. However, by 1993, output had stabilized and new enterprises began to be established, especially in the gold mining, retail, and trade sectors (Table 7). Inflation moderated, although it remained high (at about 50 percent per year) and volatile. The national currency, the togrog, has been allowed to float, although the authorities have occasionally intervened and during some periods stabilized the rate.

Until 1990 Mongolia had a pure monobank system, without even the specialized banks found in other socialist countries. In 1991 new banking and central banking legislation was passed, and the monobank was broken up into six institutions: Mongolbank, which is the central bank; two banks serving mostly retail clients and some enterprises, namely Ardyn Bank (also known as People’s Bank) and Cooperative Bank; two banks that concentrated on enterprise financing, namely Insurance Bank and the Bank of Investment and Technological Innovation (BITI); Agricultural Bank, which was represented mostly in rural areas; and Trade and Development Bank (TDB) specializing in foreign currency operations. All of the commercial banks except TDB were partially privatized already in 1991. Ownership became diffuse, although state enterprises gained dominant influence, especially in BITI. In addition to the descendants of the monobank, eleven new wholly private banks were founded during 1991–96. The data in Table 8 show that the banking system as a whole was highly concentrated, and certain individual financial institutions retained near-monopolies in their respective areas of specialization.
Table 7. Mongolia: Selected Economic Indicators, 1993–98
(in percent except where indicated)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (in billions of togrog)</td>
<td>166</td>
<td>283</td>
<td>429</td>
<td>587</td>
<td>759</td>
<td>876</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>-3.0</td>
<td>2.3</td>
<td>6.3</td>
<td>2.4</td>
<td>4.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Nominal GDP growth</td>
<td>251.4</td>
<td>70.4</td>
<td>51.5</td>
<td>36.8</td>
<td>29.3</td>
<td>15.4</td>
</tr>
<tr>
<td>CPI inflation (period average)</td>
<td>268.4</td>
<td>87.6</td>
<td>56.9</td>
<td>46.9</td>
<td>36.6</td>
<td>9.4</td>
</tr>
<tr>
<td>(end of period)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Broad money (in billions of togrog)</td>
<td>43</td>
<td>77</td>
<td>102</td>
<td>128</td>
<td>170</td>
<td>167</td>
</tr>
<tr>
<td>Growth in broad money(^1)</td>
<td>227.6</td>
<td>79.5</td>
<td>32.9</td>
<td>25.8</td>
<td>19.8</td>
<td>8.8</td>
</tr>
<tr>
<td>Broad money/GDP</td>
<td>25.7</td>
<td>27.1</td>
<td>23.8</td>
<td>21.9</td>
<td>22.4</td>
<td>19.1</td>
</tr>
<tr>
<td>Bank claims on nongovernment sector (in billions of togrog)(^2)</td>
<td>31</td>
<td>52</td>
<td>62</td>
<td>76</td>
<td>70</td>
<td>99</td>
</tr>
<tr>
<td>Claims on nongovernment/GDP</td>
<td>18.4</td>
<td>18.5</td>
<td>14.4</td>
<td>13.0</td>
<td>9.3</td>
<td>11.3</td>
</tr>
<tr>
<td>Reserve money (in billions of togrog)</td>
<td>14</td>
<td>29</td>
<td>38</td>
<td>51</td>
<td>65</td>
<td>73</td>
</tr>
<tr>
<td>Money multiplier</td>
<td>3.0</td>
<td>2.6</td>
<td>2.7</td>
<td>2.5</td>
<td>2.6</td>
<td>2.3</td>
</tr>
<tr>
<td>Money market interest rate</td>
<td>629</td>
<td>180</td>
<td>150</td>
<td>109</td>
<td>46</td>
<td>23</td>
</tr>
<tr>
<td>Exchange rate (togrog per U.S. dollar)</td>
<td>395</td>
<td>414</td>
<td>474</td>
<td>694</td>
<td>813</td>
<td>915</td>
</tr>
<tr>
<td>Gross international reserves including gold (U.S. dollar millions)</td>
<td>65</td>
<td>92</td>
<td>115</td>
<td>98</td>
<td>138</td>
<td>123</td>
</tr>
<tr>
<td>International reserves/reserve money</td>
<td>179.9</td>
<td>131.4</td>
<td>145.0</td>
<td>132.8</td>
<td>173.7</td>
<td>153.8</td>
</tr>
</tbody>
</table>


\(^1\) Adjusted for temporary increase in broad money at end-1997.

\(^2\) Includes nonperforming loans.
Table 8. Mongolia: Structure of the Banking Sector

<table>
<thead>
<tr>
<th></th>
<th>Loans</th>
<th>Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>Share</td>
</tr>
<tr>
<td></td>
<td>(in billion</td>
<td>(percent)</td>
</tr>
<tr>
<td></td>
<td>togrog)</td>
<td></td>
</tr>
<tr>
<td>October 1996</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ardyn Bank</td>
<td>32.0</td>
<td>37.6</td>
</tr>
<tr>
<td>Insurance Bank</td>
<td>6.3</td>
<td>7.4</td>
</tr>
<tr>
<td>BITI</td>
<td>18.5</td>
<td>21.7</td>
</tr>
<tr>
<td>Agricultural Bank</td>
<td>10.0</td>
<td>11.8</td>
</tr>
<tr>
<td>TDB</td>
<td>9.1</td>
<td>19.7</td>
</tr>
<tr>
<td>Eight small banks</td>
<td>9.2</td>
<td>10.8</td>
</tr>
<tr>
<td>Total</td>
<td>85.1</td>
<td>100.0</td>
</tr>
<tr>
<td>February 1997</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Savings Bank</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Reconstruction Bank</td>
<td>6.6</td>
<td>13.4</td>
</tr>
<tr>
<td>BITI</td>
<td>17.1</td>
<td>34.8</td>
</tr>
<tr>
<td>Agricultural Bank</td>
<td>4.6</td>
<td>9.3</td>
</tr>
<tr>
<td>TDB</td>
<td>9.2</td>
<td>18.7</td>
</tr>
<tr>
<td>Eight small banks</td>
<td>11.7</td>
<td>23.8</td>
</tr>
<tr>
<td>Total</td>
<td>49.2</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Memo item:
Loans at MARA          | 30.0

Source: Mongolbank and staff estimates.

The central bank developed comparatively quickly. It introduced reserve requirements in 1991, when interest rates other than on household saving deposits were also liberalized, but bank-by-bank credit ceilings were retained. Liquidity was provided to commercial banks under different facilities to accommodate their short-term liquidity needs to refinance their longer-term lending, and to finance lending to preferred sectors. In 1993 Mongolbank began auctioning short-term bills as a means to withdraw liquidity and in 1995 began auctioning refinance credits. The payment system was modernized starting in 1992 so that by 1996 most payment orders were being cleared within two days of submission. Some preliminary prudential regulations, notably on capital adequacy, were issued already in 1992, and a system of on- and off-site inspection established. Subsequently, prudential regulations were extended and strengthened. However, resource limitations, and the poor record keeping and internal controls at the commercial banks limited the effectiveness of supervision. When
breaches of regulations were uncovered, Mongolbank was often unable or unwilling to impose sanctions or to force bank management to take corrective action.

A. The Deterioration in Bank Soundness

It became apparent already in the early 1990s that the banking system was not functioning satisfactorily. In 1994 the government forced BITI to take over a small bank and Ardyn Bank had to take over Cooperative Bank. BITI and Ardyn Bank were never compensated for implied reduction in their net worth, although they did receive special refinancing loans from the Mongolbank. This episode does not appear to have been decisive in undermining the soundness of these banks, but the strategy of merging weak banks proved at best a means of gaining time. By 1995 a report by an outside consultant who had inspected Ardyn Bank concluded that it was already insolvent and continuing to lose money.

The causes of the poor performance of banks were manifold. The macroeconomic conditions faced by the banks made sound operations difficult enough: inflation and interest rates fluctuated sharply, and many established enterprises suffered sharp drops in output. Bank management seems often to have been of poor quality or self-serving: reportedly insider lending was widespread, and banks were unwilling or unable to collect on many loans. Banks frequently preferred to capitalize interest on nonperforming loans rather than reveal the extent of losses, and may have made new loans to loss-making enterprises in the hopes of keeping them going and eventually recovering something. These adverse tendencies were compounded by certain government policies, notably the requirement that banks lend to certain privileged sectors and enterprises whose survival was judged to be of strategic or social importance. Such so-called inherited and directed credits were often extended on noncommercial terms, with little expectation that they would be repaid. In addition, banks reportedly came under political pressure not to force large employers into bankruptcy. Moreover, a minimum deposit interest rate was set with the aim of limiting dollarization and capital flight. At least during certain periods, the minimum rate was so high that banks attracted more funds than they could use to finance reasonably safe and viable projects.

During 1996 the state of the banking system began to deteriorate more rapidly. Several banks started to fail to meet prudential norms, credit ceilings, and reserve requirements, sometimes for extended periods. On occasion depositors were unable to withdraw funds on demand, and either had to pay a fee or received only payment orders that could not be cleared and that circulated as a means of payment. Among the major banks, Insurance Bank nearly ceased operating, and Ardyn Bank, Agricultural Bank, and BITI experienced periods of illiquidity and admitted to significant losses. On-site inspections by Mongolbank and reports by external bank auditors revealed an increasingly alarming picture of nonperforming loans, operational ineptitude and, in some banks, managerial complacency.

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59 Another small private bank closed because it failed to meet the increased minimum capital requirement.
For example, during the first nine months of 1996 Ardyn Bank repeatedly failed to meet reserve requirements, and suffered a decline of Tog 6 billion (approximately $12 million at the time) in its liquid assets, but the bank extended Tog 4 billion in new loans and continued to spend large sums on the construction of a headquarters building.

Mongolbank felt obliged to provide these banks with liquidity through the extension of ever-larger loans. These loans were not backed by collateral, nor were bank managers required to take immediate action to prevent the recurrence of illiquidity. In addition to explicit credits, some banks were exploiting delays in the clearing system to make payments even when they had no funds available. The government treasury operations were also affected because government deposits at commercial banks became unusable and some enterprises had difficulty paying taxes.60

The mounting difficulties of the banking system are illustrated in Figures 1 and 2. The real money stock, as measured by broad money deflated by the Consumer Price Index, fell during the course of 1996, but real currency in circulation increased.61 Thus, enterprises and especially households were fleeing the banking system. Bank liquidity, and especially bank reserve deposits with Mongolbank were also declining. The fall would have been greater and faster but for the extension of ever-larger refinancing credits from Mongolbank, and the build-up of government deposits at the commercial banks.

The situation of one small bank, Central Asian Bank (CAB), deteriorated to the point where in June 1996 Mongolbank decided to close it down. The value of the bank’s deposits amounted to Tog 1,139 million (approximately $2 million at the then prevailing exchange rate), owed to about 3,000 mostly small depositors. Although there was no deposit insurance in Mongolia, the authorities announced that depositors would be compensated for losses up to Tog 100,000, even though interest accrued in 1995 and the first half of 1996 was annulled.62 The assets of CAB were found to have been almost entirely worthless, and indeed it was very difficult to identify assets because the bank had been run in a chaotic manner.

The failure of CAB contributed to a growing public distrust of the banks. Doubts about bank soundness became manifest in a number of forms: the real stock of togrog deposits began to fall; the exchange rate depreciated rapidly; TDB, which has a good

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60 The government held deposits at commercial banks in order to facilitate the disbursement of expenditures. The illiquidity of government deposits was exacerbated because an enterprise with an account at an illiquid bank could satisfy its tax obligations by transferring funds to the government’s account at the same bank.

61 The movements were not monotonic, in part due to strong seasonal influences.

62 During 1997 the depositors successfully lobbied parliament to grant them full compensation.
reputation, experienced a strong inflow into dollar-denominated deposits. There was however no acute run on the banks. The injection of liquidity by Mongolbank and falling demand for togrog-denominated assets accelerated the depreciation of the exchange rate, and led to a revival of inflation.

B. Initial Attempt at Restructuring

By mid-1996 the authorities clearly recognized that the state of the banking system was poor and deteriorating rapidly. The largest bank was illiquid, insolvent, continuing to lose money, and apparently under management that had no intention of altering its strategy. Of the other major banks, one was inactive and entirely illiquid, and two were technically insolvent and in breach of several prudential regulations. Only one major bank seemed to be on a sound footing, largely because of its very tight specialization in foreign exchange business. Many of the small banks were of dubious viability, but because their combined market share was less than 10 percent they were of little systemic importance. The available estimates of the magnitude of the losses were very approximate and probably too optimistic, but indicated that the negative net worth of certain banks was already large.

A broad section of the population and most enterprises were already affected by the dysfunction of the banks, and would be exposed to large losses should the banks fail. Disintermediation, principally in the form of dollarization, was continuing. The rule of law was being undermined as borrowers were not sanctioned for nonpayment; banks were restricting access to deposits and not paying penalties on breaches of regulations; and the Mongolbank was effectively compelled to extend liquidity-support loans to banks without the safeguards required by the new central bank law. The extension of liquidity-support loans, the disregard of reserve requirements, and the breakdown of the use of deposits as a means of payment undermined the implementation of monetary policy. Fiscal policy was also affected because many government deposits were effectively blocked in illiquid banks.

In late August the authorities began planning a comprehensive strategy to deal with all problem banks. In particular, they decided to move first against Insurance Bank, which by that stage was described as “comatose.” Insurance Bank was widely known to be insolvent, and therefore its closure was expected to be met with little political opposition from vested interests, nor sharply to weaken confidence in other banks. Insurance Bank was also relatively small, so that the logistics of its closure would be manageable and the total volume

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63 The position of TDB was in some regards analogous to that of Bulbank in Bulgaria (see above).

64 Table 9 below presents estimates of the magnitude of losses at the two most insolvent banks once these had been validated. Ex ante estimates made before the closures in 1996 were of similar magnitude.
of losses acceptable even if the government ended up bearing a disproportionate share of the burden.

While Mongolbank was in the midst of the preparations for the closure of Insurance Bank, Ardyn Bank applied for an additional liquidity support loan. The authorities realized that Ardyn Bank was also in a very precarious situation and decided to move against it immediately.

The implementation of this decision turned out to be difficult. It was hard to find anyone to assume the responsibilities of conservator. Eventually someone was appointed for Ardyn Bank, and officials entered both banks on September 18. There was no immediate public announcement of the action, nor any explanation of what would happen to the public’s deposits or whether the banks would continue operating. Indeed, debate on these issues continued among the authorities even after the seizure of the bank. In practice household depositors were allowed to make withdrawals of up to Tog 100,000, and enterprises apparently could make withdrawals freely. Mongolbank supported Ardyn Bank with new liquidity-support loans at favorable interest rates.

The conservator for Ardyn Bank resigned after three days, citing a lack of official support for her actions. Ardyn Bank management had attempted to undermine her authority, and the existing staff had been hostile and uncooperative, while the conservator did not have available the support staff necessary to effect control of Ardyn Bank’s numerous activities, which were often run with little systematic documentation. The practical difficulties of the operation combined, and the political pressure that Ardyn Bank management was able to exert forced the authorities to yield. Control was restored to the old management in both banks. The Governor of Mongolbank publicly apologized and resigned shortly thereafter.

C. The Bank Closure Operation

The collapse of the attempt in September to place two problem banks in conservatorship did not cause the authorities to abandon strong action as politically impossible or resign themselves to “muddling through” in the hope that a general economic recovery would lift the strain on the banks. Rather, the experience led them to the conclusion that a more thought-through and well-organized strategy was necessary.

The authorities also recognized that they faced several constraints on their approach to bank rehabilitation. Implementation capacity was extremely limited. The central bank had only a handful of staff with training in financial analysis and on-site supervision. No pool of trained accountants and auditors, let alone receivers, was available in the country. The authorities had experience only in the closure of one small bank (CAB), which had turned out to be a drawn-out and laborious exercise. Skills in bank management and operations were also in short supply, and it was unclear whether the authorities could identify and attract the ablest bank managers. The judiciary and the legal profession were not fully familiar with market-based economic concepts and in particular banking practice, and in any case the courts were overburdened and reputedly liable to be open to influence.
The nongovernment sector generally could not be relied upon to discipline bank management or provide new capital, even if the banks were economically solvent. Rather, the nongovernment sector relied critically on the banking system to provide transaction services, extend loans, and offer savings instruments. The government also relied on the banks to conduct its business. In this sense the continued functioning of a banking system represented a kind of "public good." Any costs incurred in maintaining this public good would have to be born at a time of great fiscal stringency, as the government faced myriad spending demands, diminished revenue, and limited financing.

Under these circumstances the authorities realized that they would have to seize back the initiative in rehabilitating the banking system. The government, including the central bank, would have to initiate intervention and in the end bear much of the financial burden involved. Any action to intervene in the troubled banks would have to be as comprehensive and rapid as possible. The constraints on implementation capacity implied that efforts would have to be concentrated on the most urgent problems; the resolution of less immediately threatening problems, and many of the specific issues that would arise from intervention would have to be delayed in the interests of decisiveness. The rehabilitation strategy would also aim to reestablish respect for the rule of law and to restore the effectiveness of monetary policy.

The strategy worked out in November 1996 was designed to accord with these principles. During the initial operation attention would focus on the two large banks that were in the worst condition, namely Ardyn Bank and Insurance Bank. Together, these banks accounted for 45 percent of deposits and loans. Both would be closed and liquidated by receivers. The accounts of their household depositors would be immediately transferred to a new "narrow" bank, the Savings Bank that would hold only safe assets. The accounts of their enterprise depositors in good standing would be transferred after being partially written down, together with nonimpaired loans, to a new commercial bank named Reconstruction Bank (RB). Their impaired loans would be transferred to a collection agency, the Mongolian Asset Realization Agency (MARA). This phase of bank restructuring would be financed by the issue of government bonds. The two other large problem banks (BITI and Agricultural Bank) would be obliged to sign Memoranda of Understanding (MOUs) with the government and the Mongolbank under which they committed themselves to raise capital, streamline operations, and improve their loan portfolio according to an ambitious timetable. Initially the small banks would be largely ignored. Subsequently attention could be directed toward recovering loans and strengthening financial discipline on both banks and borrowers, and improving the operational capacities and financial strength of the banks. Still later decisions would be needed on the further restructuring of the entire banking sector, for example, through additional closures, mergers, and eventually privatization.

The initial operation was planned in detail so that it could be carried out as rapidly and smoothly as possible. The steps that had to be executed included the following:
Organizational and legal issues

- A small high level committee with representatives of the ministry of finance, Mongolbank, and the Prime Minister’s office was formed to coordinate the preparation and implementation of the operation. As far as possible the plan of the operation was kept confidential so that the management of the targeted institutions would have less chance to prepare a defense or plunder their banks. However, other ministries and key parliamentarians were informed of the strategy so as to build consensus.

- A number of legal issues had to be resolved in preparing the closure operation. New laws on banking and the central bank had been passed in September 1996. It was verified that according to these laws the Mongolbank had the power to close a bank, appoint a receiver, and withdraw a bank license without necessarily first consulting existing shareholders or attempting to rehabilitate the bank through the appointment of a conservator. Mongolbank’s actions could not be halted by a restraining order, but they could be challenged in court ex post.\(^65\)

Institutional restructuring

- The Savings Bank was registered as a company and granted a bank license by Mongolbank after submitting the legally required documentation, including a business plan. The Savings Bank was designed to be a “safe haven” for household depositors, whose savings would no longer be illiquid or in danger of forfeiture, and who would continue to need transaction services. To this end the Savings Bank received household deposits as its only liability and was given only safe assets, specifically government restructuring bonds, Mongolbank bills, cash in vault, reserve deposits, and real property. Therefore, the Savings Bank needed only the minimum allowable capitalization (Tog 400 million), which was provided by the government. It was assigned most of the branch network and nonmanagerial staff of the closed banks and open as soon as possible after the closing operation. Managers for the Savings Bank (and the other new institutions) had to be recruited, which proved difficult given the small pool of experienced bankers in Mongolia.

- Likewise preparations were made to establish the RB. The RB received the verifiably performing loans of the failed banks and the (written-down) deposits of enterprises that were not in arrears. In this way those enterprises did not suffer an immediate liquidity squeeze or a disruption of payment services. The enterprises could transfer their business to other banks, but that process would be drawn out because banks in Mongolia prefer to build up familiarity with clients over time. As the value of the

\(^{65}\) In most jurisdictions the victims of inappropriate official action may claim damages but the action is not undone. Mongolian law and precedent in this area was evolving.
transferred deposits exceeded that of the good loans, the RB also received enough restructuring bonds to ensure its adequate capitalization (its initial capital was Tog 1.8 billion). In addition, the RB took over all foreign operations of the failed banks, including a small volume of household foreign currency deposits.

- Under the agreed strategy the MARA would receive the impaired loans of the failed banks and try to recover as much as possible. The aim was not only to minimize the cost of the bank restructuring operation, but also to set an example of financial discipline and the enforcement of loan contracts. It could use a number of techniques to recover loans, including netting loans against deposits, renegotiating loans, seizing collateral, and initiating bankruptcy proceedings. It had been proposed to make MARA an incorporated public enterprise, which would have facilitated the extension of performance-based contracts to MARA staff and enhanced its commercial, nonpolitical nature. The authorities opted instead to make it a government agency so that its actions carried the official imprimatur. It was made answerable to the ministry of finance, which set for it an ambitious timetable for loan recoveries. It was given a separate budget, which went largely for personnel, establishing regional offices, and the storage and deposing of collateral (some of which consisted of livestock).

 Allocation of assets and liabilities

- Once appointed, the responsibility of a failed bank's receiver was to the creditors of the failed institutions, but according to the new laws he could satisfy classes of creditors by making payouts based on the estimated value of remaining assets, rather than on final verified amounts. The new laws also specified a certain schedule of priority for creditors, according to which the claims of high-priority creditors such as household depositors would be met to the full extent possible before any payout could be made to others. Mongolbank had estimated that the remaining assets of the failed institutions were sufficient to cover all household deposits, and indeed households were given immediate access to the full value of their deposits. The estimated remaining assets did not fully cover enterprise deposits, but were instead allocated pro rata: the value of enterprise deposits in Ardyn Bank were written down by 20 percent and those in Insurance Bank by 50 percent. The same rule was applied to the deposits of local government and the social security and pension funds. This allocation relied upon Mongolbank acknowledging that its claims on the failed banks were loans rather than deposits and thus of lower priority, and the central government accepting the role of residual claimant who bears the risks in case the value of loans turns out to be less than first estimated.66

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66 The Banking Law gave equal priority to the repayment of claims on all juridical persons. The government waived its possible right to be considered a juridical person on a par with enterprises.
Several transactions were necessary to transfer the assets and liabilities of the failed banks to the new institutions while ensuring that all parties fulfilled their respective fiduciary responsibilities. The core of these transactions was that the receivers would sell nonperforming loans to MARA in exchange for restructuring bonds; the receivers could then transfer to the Savings Bank togrog household deposit matched with an equal value of assets in the form of bonds, reserve money, and real property; the receivers could make a similar transfer to the RB of enterprise business (deposits of enterprises in good standing, loans to them, foreign currency denominated assets and liabilities, other assets needed for operations, and a balancing value of bonds). In this way the receivers could discharge their duty as rapidly as possible. In practice, a number of rounds of transactions were necessary before all balance sheets of all institutions were brought in order, for example, because it took some time to identify and assess all the loans recorded in the rural branches of the failed banks. To facilitate transactions, it was necessary to issue a larger volume of bonds than was eventually needed for the restructuring. However, since any excess would be distributed among wholly government-owned institutions, it did not constitute a net increase in government debt.

The specification of the restructuring bonds needed to be adapted to circumstances, in particular the absence of a functioning bond market and the prevalence of high and very variable inflation and interest rates. In the initial period the bonds were issued with a maturity of just one month, with an assurance from the ministry of finance that they would be rolled over; the interest rate was set each month at a level slightly above the then current Mongolbank bill rate, which serves as a guiding rate in the economy. In this way the new banks could at least break even while offering attractive interest rates, and the budget would not be burdened with very high interest costs indefinitely if rates fell. During the first half of 1997 the rate was always set at 4 percent per month. The authorities decided to make the bills in general nonnegotiable and available only to banks.67

The government decided to use the same bonds to fulfill its pledge to compensate commercial banks for losses on inherited and directed credits. The government accepted that it was responsible for these quasi-fiscal operations, and therefore agreed to swap bonds for inherited and directed credits in all banks. The amount involved was togrog 7.7 billion ($11 million) at the end of 1996.

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67 It was initially planned to make the bonds negotiable and of longer maturity in order to facilitate the further restructuring of the banking system, but the restrictions remained through 2001.
**Intervention procedures**

- Mongolbank made a number of special provisions to anticipate the possible effects of the bank closures and the opening of new institutions. A large volume of cash was distributed to Mongolbank branches so that withdrawals from reliquidified deposits could be met. Once the restructuring bonds were distributed banks were informed that, at least for a limited time, they would be rediscountable at face value with Mongolbank. In this way the new banks, and other commercial banks that received bonds in exchange for inherited and directed credits, could acquire the liquid resources to comply with reserve requirements. Several commercial banks, including some nonintervened banks, made extensive use of this facility in the months following the closing operation. Mongolbank also monitored developments in the foreign exchange market closely for signs of a run on the currency, but none emerged.  

- The actual closing operation was logistically challenging. The operation started shortly before the close of business on Friday, December 13, when the banks would be relatively empty of clients and few transactions would be under way. About 900 officials were deployed to enter all the nearly 100 branches of Ardyn and Insurance Banks simultaneously. These officials showed their credentials and required all senior bank management to leave the premises immediately before they could seize physical or financial assets or destroy records. The officials then set about securing property and means of payment. It was recognized that nonmanagerial staff would be needed to reconcile loan records and to start the operations of the new banks. They were therefore offered new employment contracts, which were almost universally accepted.

- Officials and some bank staff then worked through the weekend to identify the banks' assets and liabilities and organize the opening of the new institutions as soon as possible. Meanwhile the operation was explained to the public, who were reassured that all would be “business as usual” by Monday. According to the original plan the Savings Bank and the RB would initially operate out of the same premises and with the same staff, who would have had to identify household and enterprise clients and complete correspondingly different payment orders, etc. This proved impractical, and instead on Monday morning Ardyn Bank branches opened as the Savings Bank, and Insurance Bank branches opened as the RB; later the branches and other facilities were divided more rationally. The public response was indeed muted, with only a small surge in withdrawals, and the exchange rate remained stable. Depositors at

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68 In the months before closure, the failed banks had run up large short foreign exchange positions in an effort to remain liquid, and the RB would have had to buy foreign exchange for restructuring bonds had the currency begun to depreciate sharply following the closure operation in order to avoid incurring large losses.
Insurance Bank were reportedly pleased to have received anything, while enterprise depositors at Ardyn Bank complained only moderately about the write-down of their deposits. An effort by Ardyn Bank management to organize a strike by employees fizzled out. Ardyn Bank management also initiated court action against Mongolbank, which was eventually quashed.

D. Follow-Up

Much time and effort was required to sort out the final balance sheets of the failed banks and the initial balance sheets of the new institutions. Revised, ex post estimates of the losses, shown in Table 9, were obtained in June 1997. According to these estimates, the total losses were approximately as large as had been estimated in November 1996, but only after numerous positive and negative adjustments had been made. For example, liabilities increased due to the recognition of certain amounts payable or in transit as deposit claims, but assets were increased by income accrued in 1996. The estimates are based on certain, perhaps optimistic, assumptions about how much MARA would be able to recover from the impaired loans that it had taken over.

Table 9. Mongolia: Estimated Bank Losses and Their Allocation
(In billions of togrog)

<table>
<thead>
<tr>
<th></th>
<th>Ardyn Bank</th>
<th>Insurance Bank</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total loss to allocate</td>
<td>26.3</td>
<td>12.0</td>
<td>38.3</td>
</tr>
<tr>
<td>(as percent of 1996 GDP)</td>
<td>(4.9)</td>
<td>(2.3)</td>
<td>(7.1)</td>
</tr>
<tr>
<td>Government</td>
<td>16.2</td>
<td>7.5</td>
<td>23.6</td>
</tr>
<tr>
<td>Government deposits</td>
<td>0.6</td>
<td>2.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Other</td>
<td>15.6</td>
<td>5.5</td>
<td>21.0</td>
</tr>
<tr>
<td>Mongolbank</td>
<td>4.8</td>
<td>1.5</td>
<td>6.3</td>
</tr>
<tr>
<td>Enterprises</td>
<td>2.2</td>
<td>1.4</td>
<td>3.7</td>
</tr>
<tr>
<td>Offset to nonperforming loans</td>
<td>1.0</td>
<td>...</td>
<td>1.0</td>
</tr>
<tr>
<td>Deposit write-down</td>
<td>1.3</td>
<td>...</td>
<td>2.7</td>
</tr>
<tr>
<td>Shareholders</td>
<td>3.0</td>
<td>1.2</td>
<td>4.2</td>
</tr>
<tr>
<td>Others</td>
<td>...</td>
<td>0.5</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: Mongolbank and staff estimates.
Some of the revenue drain may be offset if the new institutions pay dividends or when they are eventually privatized. Interest paid on the bonds held by Mongolbank should also return to government in the form of dividends, and Mongolbank initially at least voluntarily accepted to hand back 80 percent of any interest it received, and interest due was not always paid in cash. However, Mongolbank itself suffered large losses which left it undercapitalized.

MARA was not expected to recover very large amounts from the nonperforming loans that it was given, in part because many of the borrowing enterprises ceased to exist. By June 1997 it had recovered Tog 1.3 billion and seized approximately Tog 2.0 billion in collateral, while incurring expenses of only about Tog 100 million; the overall recovery rate was about 17 percent. One of the purposes of MARA was to set an example of financial discipline by pursuing defaulting borrowers by all legal means, and in this it has reportedly been diligent, within the limits set by an inadequate court system.

In the initial aftermath of the closing operation the situation in the banking system remained generally calm, and there were signs of a return of confidence. The real money stock recovered in 1997, led by a rise in the real value of deposits at commercial banks (Figure 1). The exchange rate displayed some turbulence in the second quarter of 1997, which may largely be attributable to uncertainty surrounding presidential elections, but it was stable over the summer of 1997 after appreciating from its lows in May. Inflation in some months had been negative, albeit due in part to seasonal factors.

Aggregate bank liquidity was adequate, although certain banks were on occasion illiquid (Figure 2). Among individual banks, the Savings Bank lost deposits in the second quarter of 1997 after it lowered interest rates on deposits, but recovered them when it restored rates. In some months it and RB failed to meet reserve requirements, in part because the government was occasionally late in paying interest on the restructuring bonds, and therefore Mongolbank waived penalties on the reserve shortfall. The process of dollarization was not reversed; dollar-denominated deposits at TDB, which was seen as the soundest bank, continued to grow rapidly in the first half of 1997. Some of this trend may be viewed as a stock adjustment as enterprises and households adjusted their portfolios once all deposits became freely available.

Table 8 shows that the structure of the banking industry in Mongolia was indeed transformed. No one bank is as dominant as Ardyn was before, although certain banks retain near-monopolies in their respective segments of the market. The small banks and TDB have expanded their balance sheets and gained market share at the expense of both the successors to Ardyn and Insurance Banks and also the distressed Agricultural Bank and BITI that are subject to MOUs.
Figure 1. Mongolia: Real Monetary Aggregates
(deflated by end-1995 CPI)

Figure 2. Mongolia: Bank Liquidity
(percent of bank deposits)

Source: Mongolbank, and staff estimates
E. Epilogue

It was realized at the time of the 1996 operation that the Mongolian banking sector would require substantial further restructuring. Indeed, the subsequent period was marked by the continued severe distress of some banks and the reemergence of large losses, which necessitated a second round of closures in 1999.

Two developments constituted the principal hindrances to the emergence of a sound financial system. First, the two banks under MOUs, namely Agricultural Bank and BITI, failed to meet their commitments, and in particular failed to raise sufficient new capital, improve credit quality, and reduce costs. Second, RB soon went beyond its original mandate and became a universal bank, taking deposits and expanding lending rapidly. Much of this lending seems to have benefited well-connected parties, and prudential supervision was clearly inadequate. At a macroeconomic level, Mongolia was severely affected first by the Asian financial crisis, which caused the prices of its main commodity exports to fall sharply, and then by two years of exceptionally harsh weather. In these circumstance, the share of loans in the banking system that were nonperforming rose to over 30 percent in 1998, and eventually almost all loans in the portfolios of RB and BITI became delinquent. The banking system made losses, and capital was eroded almost to zero; the losses of RB, Agricultural Bank and BITI in 1998 are estimated at Tog 4.1 billion, Tog 5.1 billion, and Tog 12.0 billion, respectively, totaling about 2.4 percent of GDP or more than 20 percent of total lending to nongovernment.

An initial attempt in 1998 to merge RB with a private bank, Golomtbank, was reversed due to political opposition to the way the transaction was carried out. However, in early 1999 RB, BITI, and Agricultural Bank were put into conservatorship, under which they could take no new deposits and grant no new loans. In the fall of that year, RB and BITI were placed in receivership and their licenses revoked; their residual assets were eventually passed to MARA. Agricultural Bank had to be preserved in order to provide financial services to the population and government in the countryside. New, foreign-led management was installed, and an effort undertaken to reduce operating costs. Also in 1999, four small private banks went into voluntary liquidation, and three others voluntarily ceased banking operations.

By mid-2001 there were 13 banks operating in Mongolia. TDB was the largest, with more than 40 percent of all assets in a relatively well-diversified portfolio. TDB at this point appeared to be profitable and well capitalized. The Savings Bank was the second largest institution and held a majority of local currency deposits. However, its capital base was weak, the quality of its loan portfolio was not assured, and it remained dependent on the maintenance of an adequate spread between the interest rate it paid on deposits and that it received on government securities, which still made up three quarters of its assets. Nonetheless, it was marginally profitable and liquid. The privately-owned Golomtbank had the third largest share of assets in the system. Agricultural Bank was just profitable after it resumed lending to small rural borrowers and the new external management made progress in limiting operating expenses, but it still has negative capital. The banking system as a whole appears to be sounder and more commercially oriented than before, but remains
vulnerable to the exogenous macroeconomic shocks to which Mongolia is especially prone, and loan quality must remain a concern.

V. COMMON TRENDS IN THE BANKING CRISSES AND THEIR RESOLUTION

The previous chapters identified a number of similarities, and also key differences, between the three countries being studied, both with regard to banking sector developments and to the ways in which the authorities addressed the problems.

A. Sources of Banking Sector Distress in Transition Countries

Initial development of the banking sector under transition

In all three countries the banking sectors had evolved out of the monobank systems that had operated throughout most of the planned economy period. As the socialist system was dismantled, development of the banking sector derived from two sources: first the establishment of banks out of the monobank; and second, the development of a private banking sector usually through the liberalization of banking laws in order to allow the entry of new banks. Already toward the end of the socialist period there were moves, particularly in Bulgaria, toward setting up a two-tier banking system through the carving out of a central bank and a number of commercial banks from the monobank. These commercial banks were generally not in competition with each other, since they were all state-owned and generally servicing specified sectors of the economy. Each country had an Agriculture Bank, an Economic (and/or Industry) Bank, and a Foreign Trade Bank. In all cases households saved predominantly through the Savings Bank, which during the socialist period had been used to finance the budget.

The private banking sector was formed on the basis of lax licensing procedures, and low capital requirements. With banking supervision barely functioning at this time, there was little pressure on these banks to develop sound banking practices after their establishment. The result of this initial liberalization was in most cases the creation of significant numbers of mostly small banks, often established largely in order to generate funds to lend to the owners’ other business interests—these were therefore essentially “pocket banks,” operating without the constraints of operative insider lending, or large exposure limits.

In all these countries there was a substantial decline in economic activity in the first few years of the transition, reflecting a weakening in performance of the enterprise sector, particularly in the heavy industry sectors—these were often the main customers of the state banks, which were still the dominant element in the banking systems. With lending continuing to these sectors, often at the insistence of the government, there was a marked increase in nonperforming loans in these banks’ portfolios. Indeed, the political influence on lending decisions increased as the fiscal position deteriorated, generally following the collapse of traditional sources of government revenue and the rapid accumulation of debt on the first few years of the transition. With governments no longer able to lend freely to
favored sectors, the authorities relied on the banks for quasi-fiscal purposes. The banks’ portfolios thus became determined by political rather than commercial considerations.

Meanwhile, the absence of any understanding of risk among depositors meant that high interest rates attracted depositors largely regardless of the riskiness of the institution.\textsuperscript{69} With no financial institution having failed in the pre-transition period, there was an expectation of implicit government protection of depositors. Without high deposit rates being associated with greater riskiness, owners and managers raised rates they offered depositors above economic levels, further increasing the fragility of their institutions.

\textbf{Poor infrastructure}

In the period of central planning, the countries’ accounting systems had been designed with the primary objective of monitoring achievement of the targets of the national plans. National accounting systems designed within this framework differed substantially from international accounting practices, with the banking sectors particularly affected by these differences. With no accrual accounting, and no proper accounting treatment for delinquent loans, the deteriorating position of the banks was not immediately obvious. High inflation in most of the countries for much of the transition period meant also, given existing accounting regulations, that valuation gains—for instance from foreign exchange positions—gave the impression of continuing profitability while the underlying position of the banks was already deteriorating markedly. There was a lack of understanding of the purposes of transparent accounting, i.e., that financial statements should reflect the real developments, and that there would be substantive consequences from these statements.

The inadequacy or absence of minimum capital requirements contributed to the proliferation of small and vulnerable banks. The lack of appropriate prudential regulations, in particular the inadequate loan loss classification and provisioning regulations, distorted the banks’ reporting of their positions. There was widespread decapitalization of the banks, as owners paid themselves dividends on the basis of reported income and unrealized revaluations.

The supervisory expertise at the central banks was severely limited—there had been no experience of operating supervision in a market environment, the central banks had limited supervisory authority, and they had few resources to build up a capacity quickly. The importance of the function was not generally recognized; neither the managers of the state-owned banks nor the owners of the private banks had any desire to see the role of the supervisors enhanced, and in the event of confrontation it was unlikely that the bank would face a challenge.

\textsuperscript{69} This factor facilitated the development of unregulated institutions outside the formal banking system. Of the countries in this study, Bulgaria was the most affected. Elsewhere, Albania and Romania experienced systemic and political crises following the exposure of pyramid schemes among nonregulated institutions.
supervisor (a low-paid state functionary) would carry the necessary authority to challenge the banker. In practice the supervision function was generally exercised largely through the off-site and mechanical monitoring of compliance with regulations (a natural follow-on from decades of monitoring plan implementation). Even when appropriate regulations were in place and transgressions were identified, there were few instances of penalties being levied.

Underlying these issues was the political and economic power of the banks’ owners and managers. These were frequently among the most powerful individuals in the country. At a time when the establishment of the rule of law was by no means secure, these individuals rarely felt that they had much to fear from the legal process. There were also frequent conflicts of interest, for instance, with politicians linked to the banks.

The role of banks as intermediating resources between lenders and borrowers was limited, with bank failure being the consequences of inadequacies in performing this intermediation, was not fully appreciated or institutionalized. Thus, in none of these countries was there a suitable exit mechanism in place. Without the prospect of such sanctions, the incentive for bankers to discipline themselves in the rates they offered depositors or pursue nonperforming debtors was limited.

Similarly, on the borrowers’ side there was no traditional repayment culture. In centrally planned economies, credit management was essentially a bookkeeping exercise, designed to monitor compliance with the plan, rather than itself determining the allocation of resources. With banks not perceived as intermediaries of funds, nonrepayment was not seen as implying a real loss of resources to the original lender or to a potential alternative user of the funds. Meanwhile, with enterprises under severe strain in facing the challenges of the transition, debt repayment was frequently not seen as a priority. Indeed, with many of the credits in the state sector having been determined on noncommercial grounds in order to foster other goals, such as the preservation of employment in those sectors, with the economies continuing to decline, nonrepayment of debt was seen as a valid way to avoid disruptive adjustments.

None of the countries had an adequate legal framework, in particular as regards the authority of the central bank in enforcing supervisory requirements. Licensing was frequently the responsibility of a different agency, and with no viable exit strategy and derisory maximum penalties available, there were few sanctions available to the central bank. Bank insolvency laws were nonexistent, and general insolvency laws barely tested. As insolvency cases came to court, judges frequently showed themselves sympathetic to the debtors.

Linked to this was the lack also of a functioning collateral law. Thus, even when a debtor was in default and had pledged collateral there was no certainty that the banks would be able to seize the collateral. In any case, for many borrowers there was little collateral available, apart from real estate—which frequently had minimal value in the transition conditions.
Commercial banking expertise was often in short supply. A few bankers had had international experience and in some cases demonstrated considerable success for their banks even while the overall banking system of the country was in deep distress. Mostly, however, state bank managers were government functionaries, sometimes redeployed from sectors where they had gained no financial expertise. Private bankers might have had some corporate experience, but they too had frequently not worked in commercial banks. Once banks started getting into trouble, authorities tried replacing managements, but this was largely a game of musical chairs. In Lithuania, for instance, there were several periods of rotation of management around the state banks. Each time the “new” management could disclaim responsibility for the problems in the bank they had just entered, while escaping also from responsibility for the problems of the banks they had just left.

Particularly in Bulgaria, considerable hopes were placed at the outset on the prospect that the newly-arriving foreign banks would boost the commercial banking culture for the sector as a whole and would thereby stimulate also the domestic banks quickly to make themselves competitive in international terms. However, evidence for a significant knock on effect during this phase cannot be found. The foreign banks were able to restrict themselves to “cherry-picking” the most profitable business, largely trade finance and a small number of flagship customers. They thus dampened the profitable opportunities open to the domestic banks. Perhaps even more seriously, they could identify the best local staff and were able to outbid domestic rivals. In most cases, even during the worst phases of the banking crisis, the foreign banks did well.

Many of these developments and characteristics are not unique to transition economies, but are found in some degree in most countries that suffered a banking crisis. This similarity exists because severe banking crises are predominantly caused by distress at the corporate level, which translates into credit risk, and such distress can arise in any economy. Thus, banking crises are often proceeded by a fall or marked slowdown in output, large variations in relative prices, and sharp fluctuations in inflation and real interest rates, all of which adversely affect the ability of borrowers to service their obligations. At a structural level, many banking crises can be traced to an excessive dependence of banks on corporate owners, or to politically-motivated lending to nonviable projects. Furthermore, the inadequacies of the legal framework and the judicial system in transition countries have parallels elsewhere, in particular with regard to the enforcement of property rights and the collection of collateral and the resolution of bankruptcies.

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70 Bulbank, the largest bank in Bulgaria, and TDB in Mongolia are examples.
Emergence of banking sector problems

While problems in the banking sector had been building up for some time, they became evident as the economies started to stabilize, decapitalization reached its natural limit, and international accounting and provisioning standards were applied. With inflation slowing markedly, and currencies no longer depreciating so rapidly, it was no longer possible for banks to live off their unrealized exchange rate gains.

Public awareness of the weakness of the banks developed when the authorities took their first partial measures to address the banking system problems. In Mongolia a small bank was closed; in Bulgaria the authorities tried to introduce a limited explicit deposit insurance scheme. The unthinkable quickly came to seem possible, and even likely—banks might be closed, and people might lose money.

With a loss of public confidence in the weakest banks—or those perceived to be the weakest or with least hope of a government bail-out—liquidity problems emerged. To some extent the situation was kept in check by the fact that the bulk of household savings remained in the respective Savings Banks, so that there was no total panic, but there was nevertheless an atmosphere of surly disgruntlement. The central banks tried to alleviate the liquidity problems by financing the banks in difficulty, but the absence of adequate monetary instruments meant that there was little attempt (or ability) to sterilize such intervention. Monetary control was rapidly lost, the exchange rate depreciated, and inflation accelerated. Moreover, the liquidity support was generally provided unconditionally, and the affected banks made no adjustments in their behavior. With no restoration of public confidence, the banks' liquidity problems continued to mount, exacerbating the loss of monetary control.

Especially in Bulgaria and Mongolia, the systemic nature of the banking system problems became evident through breakdowns in the payments system. In Bulgaria at the beginning of 1996 substantial and unprecedented arrears emerged in the interbank clearing, reflecting burgeoning liquidity weaknesses in a number of banks and passing them on across the system. The public's understandable "flight to quality," with withdrawals from banks already suffering liquidity pressures, reinforced the liquidity problem. Although some of the withdrawn deposits were placed into the stronger banks, much went into the foreign exchange market, worsening the liquidity situation for the system as a whole. Banks without immediate liquidity problems sought to build up their own liquidity to protect themselves in anticipation of a further spreading of the crisis. In addition, the interbank market quickly

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71 This does not imply that, had there been no move to international standards of accounting and prudential norms, there would have been no crisis. Banking problems were growing and would have emerged sooner or later anyway. Continued opaqueness in the financial system might have delayed the crises for a while, but would have made them correspondingly larger and harder to deal with once they had finally emerged.
segmented, with sound banks willing to trade only among themselves and the other banks dependent on the central bank to provide them with their liquidity needs.

Problems emerged in both the private and the public banks, although observers frequently attributed the weaknesses to one or other of the sectors. Governments paid more attention to addressing and reviving the state banks, since they were the owners, and these banks were systemically the most important. The banking crisis led—at least temporarily—to a resurgence in the share of the banking sector owned by the state.

B. Implementation of Banking Crisis Resolution

The countries considered here all made initial attempts to deal with the weakness in their banking sectors. However, these initial attempts, and especially the first attempts to close the weakest institutions, generally ended in failure and confusion. The authorities were hindered by the absence of a recognized legal framework, the lack of precedent, their own inexperience, the fear of losses among the banks’ customers, and the political strength of owners or managers. In Mongolia, after one major bank was initially closed, the central bank governor reopened the bank and apologized to owners and staff. In Bulgaria, advance notice of the closures was given to banks’ owners, and the banks’ vaults were found to be empty once the authorities finally entered the premises. Also, the initial closures clearly did not address all the weak banks in the system, leading to pressures for—and expectations of—further bank closures in the near future.

The later and more successful attempts at dealing with systematic banking crises in these countries were characterized by their comprehensiveness and decisiveness. The authorities proved ready to close even very large institutions, to incur considerable costs, and to change the institutional framework supporting the banking sector. In most cases the weak surviving institutions were put under a much tighter oversight from the authorities, often involving memoranda of understanding and management changes—in part to mitigate the moral hazard effect of providing public support to insolvent institutions. The surviving banks’ activities were curtailed, and reporting requirements

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72 In Bulgaria, the state banks’ financial position was dominated by assessments of the value of the government bonds that had been placed in them following earlier recapitalization exercise. As the crisis intensified, these bonds became totally untradeable, devastating the assets side of the banks’ balance sheets.

73 “Open-bank-resolution” (where a bank stays open for business while it is being intervened), such as practiced in some developed countries to deal with banking problems, was only a limited feasible option in these countries, given the scarcity of high-quality replacement management to run many banks under restructuring, and the absence of much good business within these banks to provide the core for the banks’ revival.
enhanced, with the expectation of a turnaround of financial prospect and an ending of flow losses. In the event of insolvency, banks were recapitalized with government bonds, or their bad loans were bought by the government and placed into a newly formed AMC.\textsuperscript{74}

The authorities also committed themselves to requiring strong efforts from the banks and the newly-established agencies to intensify loan collection, in part to recoup some of the government's outlays on the restructuring, and in part to avoid the moral hazard that debtors might think that the bankruptcy, or restructuring, of their creditor might relieve them of their obligation to service their debts. In Lithuania and Mongolia centralized asset management agencies were introduced; in Bulgaria the authorities maintained a decentralized approach. In all cases the pressure on debtors was intensified.

The process was made possible by the passage of supporting legislation, either immediately before the interventions (as in Mongolia) or rapidly thereafter (as in Bulgaria) to enhance the authority of the central bank, and to facilitate the process of liquidating insolvent institutions. In Mongolia the clear specification in the new legislation of the respective priorities of the claims of the various creditors of the banks formed the basis of the authorities' full protection of household deposits in the winding up of the major insolvent bank and the establishment of a successor institution. Prudential and accounting regulations were revised, so that the authorities could obtain a true picture of the state of the banks and provide appropriate remedies, and so that public confidence in the surviving institutions would be restored.

Meanwhile, in belated recognition of the costs of a weak banking system, tighter prudential requirements were placed on the surviving banks—for instance, capital adequacy requirements were brought to international levels—and central banks' supervision departments were enhanced. In Bulgaria the supervisors were given autonomy from the rest of the central bank, to minimize the risk of political interference. More staff were recruited to supervision departments, and enforcement of prudential requirements was taken much more seriously. There was also some recognition of the problems of conflict of interest. Restrictions on insider lending and large exposures were introduced and enforced. Politicians were disbarred from bank ownership—and a strong emphasis was placed on privatization to get the state out of the banks altogether.\textsuperscript{75} In addition, licensing requirements were tightened, and minimum capital requirements increased, to avoid further weak new banks entering the

\textsuperscript{74} In Lithuania the process was not completed for several years. Although an AMC was established as part of the crisis resolution in 1994, the authorities subsequently did not allocate the funds for transferring the assets out of the weak banks, so the AMC remained an empty shell, with the staff seeking therefore instead to obtain contracts to manage institutions' assets on a fee basis.

\textsuperscript{75} This has proved to be a protracted process, in part because of the time taken to reestablish sufficient confidence in the surviving banks in the aftermath of the crisis.
market—and also to provide those interested in entering the market to purchase an existing institution.

The authorities also recognized the need to create a commercial banking culture. Collateral laws were passed; efforts were made to develop financial markets, including treasury bills, in part to create a supply of collateral that could support lending activity.

Overall, while there were broad similarities in how the countries handled their banking systems, there were also differences. Bulgaria had the highest level of banking sector intermediation of any transition economy, at the same time as it already had a huge fiscal burden. In the depth of the crisis, it would have been almost impossible for the authorities to issue any further government debt at any price. This severely constrained the authorities' ability to take a large share of the burden in addressing the banking sector losses, and thus led to a higher burden being borne by households and enterprises, in large part through the erosion of the bulk of banks' domestic currency liabilities through inflation. In Mongolia, by contrast, with bank intermediation only a small part of the economy, the magnitude of insolvency was much smaller relative to GDP, and the fiscal situation not in quite such dire straits; hence, it was possible to protect a much larger section of the public (i.e., all households and small enterprises) and to rely more on the issue of government securities.

In all cases the restoration of confidence after the crisis involved also macroeconomic stabilization; indeed, the longer term success of Bulgaria and Lithuania in recovering from their banking crises may be considered to derive in large part from their adherence to their macroeconomic stabilization programs over the ensuing years. In all three cases the banking crisis led to changes in the government. In both Bulgaria and Lithuania they unfolded in the context of far-reaching institutional changes, with the central banks starting to operate according to currency board principles. In the case of Bulgaria in particular the ability of the authorities to intervene in the banking sector through providing liquidity support was drastically curtailed, with support severely limited quantitatively by the amount of resources available in the banking department of the central bank, and institutionally by requiring that the head of supervision certificate that he considered that the liquidity support being provided was needed to combat a systemic threat.

VI. SOME LESSONS FROM THE RESOLUTION OF THE BANKING CRISSES

The characteristics of the three economies at the start of their transition from central planning, plus their initial approaches to developing a banking sector, made inevitable the emergence of serious banking sector distress at some stage. The authorities in these countries recognized the risks and the emerging crisis, but often first postponed addressing the issues or undertook only half-hearted measures.

The long delays in initiating the restructurings made the process much more costly and difficult. One reason for the delays was the absence of adequate legislation and the lack of decent accounting figures. Perhaps more important was the lack of political willingness in
that environment to confront the various interests that were defending the status quo, to allocate the inevitable costs between the affected parties, including the government, and to assume the risk that the intervention would go wrong.

Even when more forceful action was initiated, it often proved necessary to undertake several rounds of bank intervention. Such partial solutions can complicate and worsen the problem, by undermining the public’s confidence in the banking system and creating perverse incentives for banks to take excessive risks or to strip assets. By contrast, the bank resolution in Mongolia in 1996 was thorough-going, even though not fully comprehensive; it served to stop the huge flow of losses at the worst banks and restore liquidity to the deposits of households and enterprises. To some extent, undertaking partial solutions, where the authorities take into account that more may need to be done later and work to prepare for the subsequent stages, may be the best available option where information (for instance about the state of the banks) and implementation capacity is limited.

Merely intervening in the most troubled institutions and curtailing their operations is not enough, nor will such an approach command political support, because it does not contribute to the maintenance of a functioning financial system. The nongovernment sector relied on the banking system to provide transaction services, extend loans, and offer savings instruments. The government also relies on the banks to conduct its business. In this sense, the continued functioning of a banking system represents a kind of “public good” that had to be maintained. In the countries covered in this study, the large costs incurred in maintaining this public good had to be born at a time of great fiscal stringency, as the government faced myriad spending demands, diminished revenue, and limited financing.

Efforts at banking crisis resolution were successful only when it was carried out on a comprehensive basis, that is, when the authorities decided to deal with the entire banking sector as a whole and as part of a scheme that would preserve essential banking services. Restructuring is expensive, and will cause resentment, especially where fiscal constraints are very tight, as in these transitional economies. However, once one is in a crisis, these costs are largely unavoidable. Successful resolution requires a political consensus, which in turn requires that major interest groups see the need for action and the unavoidability of bearing some of the costs, yet the burden must be shared in a manner that is seen to be equitable. These efforts also had to be integrated with a program of macroeconomic stabilization.

Restructuring is primarily the responsibility of the government. The costs of restructuring, as well as the range of skills required, are well beyond the capacity of the central bank. Furthermore, the government must take the political decision as to how the costs of bank resolution are to be distributed. The government needs to coordinate closely with the central bank, for instance in the drafting of the relevant legislation, but with so much public money at stake it is clearly in the lead. Both Bulgaria and Lithuania established high-
level coordinating committees, involving both the government and the central bank, that had overall responsibility for the restructuring.76 Such coordination can frequently be critical.

Certain traditional approaches to banking sector weaknesses showed themselves to be largely useless. Bulgaria and Lithuania in particular had tried mergers, but merging two weak banks only served to create one large weak bank. There are few instances of successful mergers of weak banks without very drastic concomitant measures. Similarly, although privatization can be a useful component of an overall restructuring strategy, it is unlikely to be achievable during the early stage of a restructuring. Indeed, during the restructuring the size of the state sector is likely to increase. Privatization is not sufficient to improve the condition of a bank; any privatization has to be accompanied by a range of measures to ensure appropriate bank behavior post-privatization, including strict application of fit-and-proper criteria and limits on connected lending, as private banks are far from immune from governance problems. Strong disclosure requirements are an important way to address these concerns.

Poor functioning of the court system can be a serious hindrance. The required expertise on issues that can be immensely technical was generally lacking. In addition, the judges may have political or business links or may not respect the authority of the central bank, thus undermining the central bank's ability to supervise the banking system more generally. In virtually all countries where there was systemic bank restructuring the courts effectively served to subvert the restructuring process. Addressing this problem takes time and may require a variety of approaches. One possibility is the training of expert judges to handle these types of case; another is greater clarity in the law to balance the administrative needs of the regulatory authority with the legitimate rights of those who stand to lose by this administration; another is expediting the—often very lengthy—appeals procedures, including possibly through granting direct access to the courts by a dedicated restructuring agency.77

Banking sector problems have led to a serious loss of confidence in the banking system even in those cases where depositors did not in principle lose anything. In all countries there was a significant decline in the banking sector as a share of GDP with no rapid reversal of this trend. Revival requires that the authorities accompany their bank restructuring measures with macroeconomic stabilization, and possibly even the development of a new institutional framework. In this context one can note the success in the years since the crisis of the CBAs in Bulgaria and Lithuania.

76 In Mongolia there was intensive coordination through a less formalized mechanism under the auspices of the Prime Minister's office.

77 This may be one area in which technical assistance from international sources may be particularly useful, in that legal precedent from elsewhere can provide useful guidance, although the specifics of each country's legal framework means that there will never be a "one size fits all" approach to such legislation.
The success of a centralized debt recovery strategy is as yet unclear. If a centralized agency is established, it needs to be constructed carefully—with a limited lifetime committed and professional management, direct access to the courts, and clear delineation of its functions and responsibilities.

There was a lack of understanding as to what deposit insurance could and could not achieve. Whatever one’s priorities one cannot establish deposit insurance when a system is unsound, let alone when it is in crisis. Deposit insurance is therefore an important element in seeking to ward off a crisis. None of the three countries studied had a functioning system-wide deposit insurance scheme at the outset of their crises. Protecting depositors during a banking crisis is a fiscal issue, depending on other priorities and on moral hazard concerns.

Lax licensing, and minimal initial capital requirements, may well have been a significant contribution to the banking crises. Ensuring “fit-and-proper” standards for successor owners is likely to be an integral element of recovery.

The up-front initiation of restructuring can be undertaken very quickly, as shown most clearly in the case of Mongolia. However, to complete the process takes energy and perseverance. Nonetheless, once a comprehensive restructuring has been successfully completed, prospects for avoiding a recurrence can be good, as long as bankers and their customers have been weaned away from the notion that the government will stand behind them, and will pay for everything, and if the authorities maintain sound policies both in handling the banks and the macroeconomy more generally. These lessons are not unique to transition economies, but they are most vivid where the economies were subject to exceptionally dramatic disturbances. The same lessons have been learned and relearned in the resolution of banking crises in developing and industrialized countries.

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78 In Bulgaria, the SSB benefited from an explicit government guarantee. There are important broader issues about the role of a savings bank in a transition economy, which are beyond the scope of this paper.
**Bulgaria: A Banking Crisis Resolution Facility**

While the introduction of the CBA ultimately provided a framework for the resolution of the banking crisis, as well as of the macroeconomic disequilibria, a number of alternative innovations were considered during the period of the crisis. Among these, some attention was paid to the possibility of establishing a banking crisis resolution facility. Some elements of such a facility are discussed in this Appendix.

Experience in banking crises had already shown that a comprehensive banking sector restructuring is likely to be impeded by the absence of adequate financing. While there are a number of channels, including the World Bank, for providing finance in banking sector restructuring, the time dimension of such work is frequently not commensurate with the needs of a country in banking crisis.

A banking crisis resolution facility, on the other hand, could be designed to provide contingency funds to underpin a bank restructuring package agreed in the framework of a Fund-supported program. This could help cut through the credibility gridlock and enable the stabilization of a financial system. Such a facility could be used to restore reserves in the event of withdrawal of foreign currency deposits from a banking system, to backstop depositor protection to assist bank closures, or to provide recapitalization funds to banks under certain conditions. Funding could be derived from international financial institutions and bilateral donors. Security for the fund might be enhanced by the country pledging collateral, including gold or other assets such as future privatization receipts. Similar funds were established in several Latin American countries in recent years; for instance, the program approved for Venezuela in 1995 included a facility that involved contributions from the World Bank and regional banks.

A contingency facility can have a role in a situation where the financial requirements of a policy package are uncertain, but where substantial amounts may need to be potentially available (albeit sometimes with a low probability that they will be needed), in order to prevent serious economic losses that may arise because of market action against the contingency that the required funds are not available. A parallel example is the use of foreign exchange reserves by many countries. In that regard, the currency stabilization fund put together for Poland at the start of its reform program in 1989–90 was considered some sort of precedent. One would expect that the larger the fund, and the more explicit its availability for its specified purpose, the more likely that it would not be needed. The Polish fund was not drawn upon at all during its lifetime and contributions were returned to donors—or used according to the donors' requirements—at the end of this period.

A banking stabilization fund in some ways would have been analogous to a currency stabilization fund. In Bulgaria, deposit withdrawals persisted, at least in part, because of a perception that the authorities had insufficient foreign exchange reserves to meet all their payment obligations; the demonstration of the availability of such resources might have curtailed the withdrawals. The authorities' Fund-supported program was seen as
underfinanced against a worst-case scenario. Establishing a contingency fund, hence, could reduce the risks to the Fund program.

A fund could be designed to cover various purposes—reserve replenishment in the event that reserves fall below a certain level; depositor protection (perhaps for foreign currency deposits) in the event of further bank closures; or possibly banking sector rehabilitation. The purposes need not be mutually exclusive and need not be simultaneous: for instance, one might envisage a two-year fund designed for reserves protection, at the end of which remaining amounts that contributors did not want returned could be used as “seed capital” for a properly funded depositor insurance fund, or could be used to recapitalize some banks. In any case, however, the purposes of the funds, and conditions for disbursements would need to be very closely specified in advance.

The question arises as to whether any collateral would be required for such a fund. The fund established for Venezuela under World Bank auspices (and those established earlier for Argentina and Bolivia) contained no provision for collateral. However, the provision of collateral could well entice additional donors. In the case of Bulgaria, for instance, collateral could have been provided by a gold pledge, or the earmarking of future privatization receipts. In this connection, the “big-ticket” item, under consideration at the time, would have been the telephone company. The authorities had already announced their intention to sell 25 percent of it during 1997. Receipts from such a project could be used to replenish a contingency fund or to compensate contributors, if necessary, when the fund was dissolved.

There are also questions of governance of such a fund. In some Latin American cases the resources of the fund were given directly to the local banking authority and were exclusively under its control. In the case of Poland, however, the fund was kept outside the country and any disbursements had to be approved by a committee comprising the IMF Executive Directors of the contributing countries. One might imagine that contributors would feel greater confidence in a fund with the latter form of arrangements. Funds might be kept in an international financial institution or, say, the New York Federal Reserve, and payments would have to be authorized by a Board of officials representing contributors, with weights probably proportional to the size of the contributions.

In the event, such a fund did not materialize and has not been proposed in subsequent banking crises, although generalized “second lines of defense” were central elements in the first phase of addressing the Asian crises the following year. Among the factors against the establishment of a Bulgarian banking facility were that such a facility might reduce incentives for the Bulgarian authorities to undertake the needed banking sector restructuring, the difficulties of separating banking sector issues from macroeconomic problems more generally, and the probable lack of interest by those who might finance such a facility in light of the lack of credibility in the authorities’ commitment to reform, given their poor track record in previous years.
Lithuania: Role of Major Banking Institutions During and Immediately After the Banking Crisis

State Commercial Bank (state owned)
- Insolvent, but large institution with wide branch network. Traditionally most important source of credit (mostly directed) to state-owned enterprises.
- Weakest among the state-owned banks.
- Government issued recapitalization bonds in summer of 1996; government provided liquidity support. In March 1997 by special law exempted from penalties arising from noncompliance with reserve requirements.
- Privatization plan drawn up but after several failed attempts bank was finally closed in March 1998, liabilities and viable assets transferred to the SSB, nonperforming loans to the AMC.

State Savings Bank (SSB) (state owned)
- Insolvent, major holder of household deposits
- Recapitalization bonds issued in the summer of 1996.
- Continued to operate. Was financially weak, but met prudential regulations. Was slated for privatization in 1999 but privatization was delayed.
- Now successfully privatized.

Agricultural Bank (state owned)
- Insolvent, major lending institution.
- In March 1997 exempted from penalties arising from noncompliance with reserve requirements.
- Continued to operate. Was financially weak but met prudential requirements. Was slated for privatization in late 1998, but privatization was delayed to 2001.
- Now successfully privatized.

Aura Bank
- Insolvent, placed by BOL under moratorium.
- License withdrawn. The “shell” of the bank became the AMC (Turto Bank) in June 1996.

Vakaru Bank
- Insolvent, placed by BOL under moratorium
- Under resolution.
Innovation Bank
- Insolvent, placed by BOL under moratorium.
- Declared bankrupt. In April 1997 special law provides phased and limited deposit insurance.\(^\text{79}\)

Litimpex Bank
- Insolvent, initially placed by BOL under moratorium. Was allowed to restart operations in June 1996, albeit under special BOL supervision.
- Was later closed.

Tauro Bank
- Small private bank. Failed in July 1997
- Rapid bankruptcy procedures. Depositors compensated according to the deposit insurance law.

Small private banks
- Fourteen banks entered bankruptcy procedures before the outset of the acute crisis; the remaining eight institutions included institutions with widely differing economic standing.

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\(^{79}\) Private depositors were to receive: litai 4,000 in 1997, litai 4,000 in 1998, with any balance being paid in nontradeable, noninterest bearing government bonds. Legal entities to receive only noninterest bearing government bonds, to be reimbursed later than the bonds issued to private depositors.
Lithuania: Role and Functioning of the Asset Management Company

A key element in the bank restructuring plan was the setting-up of an asset management company (AMC), which was formally created in November 1996. This appendix summarizes the initial discussion, principles of the design chosen and operating principles of the Lithuanian AMC. It concludes with a brief summary of the implementation record to date.

Key arguments for an AMC

In deciding for an AMC the Lithuanian authorities weighed the following arguments in favor of such an arrangement:

- The bank employees who originally granted a loan should not be involved in the loan recovery, as there could be attempts to cover up mistakes made in granting the loan. Because connected lending was a problem in Lithuania, there was also fear of personal connections between the borrower and the bank.

- Equally important, banks being restructured should be forward-looking; a large proportion of the staff should not be engaged in correcting earlier mistakes.

- Some of the loans could be complicated, but as the AMC was to be staffed with a broad range of expertise, there was an expectation that there were better possibilities for the maximization of loan recoveries.

- Some borrowers might have loans with several banks being restructured. The possibilities to maximize loan recoveries should be greater if they are centralized.

Principles of design

The AMC was designed to have a finite life span of ten years. During this period it would use public funds to acquire nonperforming loans from banks that were being restructured. The principle goal of the AMC was to seek to maximize loan recoveries.

The AMC was given a number of options for dealing with bad loans. For example, a loan could be partially written-off or the interest rate lowered, if the borrower was likely to be able to service a smaller or less expensive loan. The AMC could restructure companies and sell them to potential investors, or it could merge good parts from different companies, thus making a viable company that could be sold to investors. The AMC could force bankruptcy and liquidations, or it could simply write-off unrecoverable loans completely.
Implementation: The “hospital bank” approach

Having decided upon the principle of an AMC, the authorities were contemplating the most efficient and cost-effective venue. Upon weighing the options, it was decided to use the shell (personnel, infrastructure, and expertise) of an existing bank for the purpose, an approach sometimes called “hospital bank.”

The bank chosen to become the AMC, Aura Bank, was put under administratorship in the summer of 1995 when it faced liquidity problems. It was later taken over by the government, its management was replaced, and previous shareholders lost all their rights as well as the full value of their shares. Although the financial position of the bank was very weak—almost the whole loan portfolio, amounting to litai 86 million, was nonperforming—it was chosen as the future AMC mainly because it was believed to have a fairly advanced information system, a limited number of staff, and a suitable office building.

The conversion process went as follows. Aura Bank had its bank license withdrawn and a new company, Turto Bank (Property Bank), was established. The new company was given a limited bank license, which specifically excluded collection of deposits or performance of any banking services other than those related to the collection of the transferred assets. Turto Bank was, however, allowed to borrow on market conditions from other banks in order to be able to extend credits to its customers under reconstruction. Turto Bank was given a 47 million litai loan from the World Bank out of which it used litai 44 million to satisfy the creditors of Aura Bank.

Turto Bank had a staff consisting of the former employees from Aura Bank (72) and 25 newly recruited staff, but plans existed to expand its operations to three cities and the number of employees to 200. It was receiving technical assistance from Swedish experts with experience in setting up and operating an AMC and from EC Phare.

Operating principles

Discussions with the government and the BOL were initiated regarding which loans to take over from banks being restructured. The three main criteria agreed were:

- First, the gross amount of each loan should exceed 500,000 litai ($125,000) and only loans classified as substandard, doubtful or a loss (categories 3, 4, and 5 in the loan classification system) should be transferred. However, if a borrower had loans classified as both performing (categories 1 and 2) and nonperforming, also the performing loans were to be transferred.

- Second, the value at which loans were to be transferred should be the gross value less provisioning, implying that all losses were to be taken by the bank before the transfer (i.e., loans were to be transferred at the estimated market value). After a loan had been transferred, the AMC would have 120 days to assess whether it agreed with the
valuation of a loan and, if not, enter into negotiations on the price of the loan with the selling bank.

- Third, no loan that was believed to be fraudulent or criminal would be accepted.

As one of its initial tasks, the AMC drafted a manual specifying exactly the kind of documentation and information that was to be supplied by the “selling” bank to the AMC.

**Implementation experience**

The record of Turto Bank to date falls short of what was intended at the outset of the process. According to initial plans, the first transfer of loans was to take place in late December 1996 and all transfers were to be completed before the end of March 1997. In total, loans amounting to a gross value of 800 million litai were expected to be transferred.

In spite of earlier understandings there were delays in transfers of bad loans from the state-owned banks to Turto Bank. The first transfers only took place in early 1998. Furthermore, the loan recovery rate fell far short of the margin of 10 to 40 percent that was hoped for initially. With this low recovery rate, Turto Bank to date has had only a limited impact in offsetting the overall costs of the bank restructuring.
Mongolia: Action Plan for Implementation of Bank Restructuring

Day One (i.e., day of agreement on the restructuring, around 40 days before implementation)

1. Formation of high-level committee, and working group to service committee. Determination of schedule for meetings of the committee.

2. Agree for planning purposes on target bank restructuring day (BR day).

3. Consider technical assistance needs. Request technical assistance.

4. Commission contingency plan in case BR day needs to be accelerated.

5. Confirm legal basis for the various steps of the proposed strategy.

6. Decide nature and timing of inspections of banks to be placed into receivership; if appropriate, commission program of inspections.

7. Commission drafting of documents for establishment of Savings Bank (SB), Mongolian Asset Recovery Agency (MARA), and the Restructuring Bank (RB).

8. Commission work on details of responsibilities of, and restrictions on, MARA in order to maximize loan recoveries.

9. Consider and agree draft memorandum of understanding between the ministry of finance and Mongolbank.

10. Commission preparations for publicity campaign on restructuring program.

11. Prepare identification of management and staff, and buildings and equipment, of successor institutions.

12. Commission detailed planning of modalities of BR day.

13. Prepare initial estimate of cost and timing of operation, broken down by cash requirement and size of bond issue; confirm availability of resources.

14. Prepare arrangements for eventuality of liquidity pressures before and after BR day.

15. Commission preparation of measures to enable SB to open as soon as possible after BR day.
BR day minus 7

1. Confirm BR day.
2. Arrival of technical assistance experts.
3. Review and approve work in categories 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, and 15 above. Commission any final preparatory work needed.
4. Finalize cash and bond costs to government in light of updated estimate of size of insolvency; prepare bond issue.

BR day

1. Implement receiverships.
2. Coordinated announcement by Prime Minister, Minister of Finance, Governor of Mongolbank, and Chairman of the Economic Committee of Parliament of the objectives and modalities of the restructuring exercise.
3. Implement contingency arrangements in case of liquidity pressures on surviving banks.
4. Establishment of SB and MARA. Issuance of bonds to MARA.
5. Entry into largest bank in receivership to identify assets of value sufficient to cover household deposits.

BR day plus 2

1. Issue bonds to MARA. MARA to buy assets of largest bank in receivership from receiver in exchange for bonds. Receiver to transfer bonds and household deposits to SB.
2. SB to purchase from the receiver those assets it is eligible to hold.

BR day plus 3

1. Opening of SB. SB sells banks to Mongolbank to meet required reserves.
2. MARA to begin examining loan portfolios.
3. High level committee to meet to review progress so far, and to prioritize further steps.
BIBLIOGRAPHY


