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A Practical Guide to Managing Systemic Financial Crises: A Review of Approaches Taken in Indonesia, the Republic of Korea, and Thailand

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A Practical Guide to Managing Systemic Financial Crises

A Review of Approaches Taken in Indonesia,
the Republic of Korea, and Thailand

David Scott

The World Bank
East Asia and Pacific Region
Financial Sector Group
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Abstract

Scott examines experiences in Indonesia, the Republic of Korea, and Thailand in confronting systemic financial crises during the 1990s. He draws on the knowledge and experience of World Bank staff who managed the Bank's financial and technical assistance to those countries. In reviewing the principal actions taken by the governments to resolve the crises, the author describes key challenges that governments face in tackling crises, defines basic guidelines and principles for responding to those challenges, and proposes steps to improve the ability of governments to deal with crises when they do occur, as well as to mitigate the risk of crises in the first place. Scott addresses matters such as the provision of liquidity, institutional arrangements for crisis resolution, use of public funds, diagnosis of problems, resolution,

recapitalization, restructuring of banks, privatization of banks, restructuring of troubled debt, and use of asset management companies. He goes on to develop the conceptual underpinnings for two fundamental improvements in crisis management practices, one to develop an explicit, comprehensive crisis resolution strategy, and the second to link the provision of support to banks explicitly to the actual outcomes of troubled debt restructuring. A common theme in both is to maximize the impact of public funds used in crisis resolution. Finally the author identifies steps that governments can take to mitigate the risk of crisis and be better prepared to deal with shocks should they occur, including the use of contingency planning in the context of liquidity management and intervention in weak banks.

This paper—a product of the Financial Sector Group, East Asia and Pacific Region—is part of a larger effort in the region to disseminate lessons learned during the Asian crises. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Lynn Yeargin, room MC8-158, telephone 202-458-1553, fax 202-522-3094, email address lyeargin@worldbank.org. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted at dscott@worldbank.org. May 2002. (96 pages)

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**A PRACTICAL GUIDE TO MANAGING SYSTEMIC
FINANCIAL CRISES:**

**A REVIEW OF APPROACHES TAKEN IN INDONESIA,
THE REPUBLIC OF KOREA, AND THAILAND**

David Scott

BFR

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EXECUTIVE SUMMARY

This paper examines the experiences of three Asian countries—Korea, Thailand, and Indonesia—whose governments confronted systemic financial crises during the 1990s and received substantial financial and technical assistance from the World Bank, International Monetary Fund and others to support their efforts. It draws on the knowledge and experience of the World Bank staff who managed the financial sector assistance programs in those countries as well as others who participated in those efforts.

As in many other regions, the financial crisis in Asia menaced not only the financial systems of countries but also the health of economies and the savings and well-being of citizens. The crisis served both to reveal preexisting problems and to create new ones. In retrospect, it is clear that many debtors were overextended prior to the crisis. The twin shocks of exchange rate devaluations and interest rate spikes raised the real value of debts and debt service requirements for many debtors. Many debtors were unable to service fully this increased debt burden, especially in the face of economic contraction. Banks and other financial institutions suffered a similar fate and were left economically insolvent.¹ The value of their assets was insufficient to cover their liabilities to depositors and other creditors.

The paper describes the key challenges facing governments in tackling crises, defines basic guidelines and principles for responding to key challenges, and proposes steps to improve outcomes, mitigate the risk of crises, and promote the ability of governments to deal with crises when they do occur. The focus is on the banking system, although many of the findings are relevant to the financial system more generally.

Part 1. Resolving the Asian Financial Crises

Part 1 reviews the principal actions taken by governments in Korea, Thailand, and Indonesia to resolve the crises in their countries. It briefly assesses those experiences and suggests

1. To limit repetition, this paper avoids making repeated reference to “banks and other financial institutions” and instead refers simply to “banks.” Many of the references to banks are applicable to other types of financial institutions.

guidelines and principles that either were important to the governments' accomplishments or might have produced better outcomes had they been adopted. Eight chapters cover the issues of liquidity, institutional arrangements, use of public funds, diagnosis of the problem, resolution, recapitalization, and restructuring of banks, privatization of banks, restructuring of troubled debt, and use of asset management companies.

The first issue addressed is liquidity because sporadic or widespread runs on banks are often precipitating events in a crisis.² The central bank is the first line of defense against runs on banks and may provide liquidity to the system overall or to specific banks. When the central bank's finances come under pressure or it is no longer able or willing to support banks, the government is forced to step in. Governments in Indonesia, Korea, and Thailand employed four principal mechanisms for stabilizing liquidity: government guarantee of bank liabilities, suspension of banks, nationalization of banks, and temporary capital controls. The paper observes that in certain crisis situations broad bank liability guarantees may be unavoidable, but they should be designed carefully to limit their potential negative consequences. Nationalization of banks similarly may be necessary and can be effective in stemming runs. In contrast, the mere suspension of banks experiencing runs can contribute to uncertainty and exacerbate liquidity pressures on other banks.

Concurrent with taking urgent steps to stabilize liquidity, governments need to lay foundations for managing the crisis, a task that may involve years of work. The challenge facing governments is significantly managerial in nature, and steps can be taken to ensure that appropriate institutional arrangements are in place for competent crisis management. It is important to strike a balance between the political and technical work of crisis resolution, including the delegation of authority and responsibility to technical experts. This balance can be achieved by forming a special-purpose crisis management team with adequate skill, experience, capacity, and funding.

² The paper returns to the issue of liquidity in Part 3 in the context of steps that can be taken to mitigate the potential for liquidity shocks to precipitate crises.

In a crisis, government likely will seek to salvage the financial system and to protect some or many depositors. The central bank and the deposit protection entity (where it exists) may not have sufficient resources to absorb the costs of doing so and the government likely will have to arrange a (substantial) financing package. Public funds may be required to finance the repayment or transfer of deposits of failed banks, the purchase of assets from banks, the purchase of bank equity capital, and the fulfillment of commitments under guarantees granted in the course of supporting and reprivatizing banks. Public funds also will be required to finance the operations of the crisis management team, particularly the cost of skilled staff, advisors, and other contracted professionals. Government should ensure that the initial financing package is of sufficient size to be credible to the markets while maintaining the flexibility to provide additional financing should it be required.

An early task of the crisis management team is to assess the scope of problems facing individual banks and the financial system overall. An accurate diagnosis is necessary to determine appropriate mechanisms for resolving distressed banks, to determine the amount of support required by banks that are salvaged, and to estimate the aggregate financing needed to resolve the crisis. Lessons of experience in this regard are that existing accounting and regulatory information is substantially misleading and that the crisis management team will have to devote substantial time to developing and analyzing a substantial amount of information necessary to support sound decisions.

To a large extent, the actions discussed to this point are geared toward laying a solid foundation for the resolution, recapitalization, and restructuring of banks. Systemic crises may well have left banks so insolvent that they cannot earn a profit and therefore have no means to internally rebuild capital. Governments must act to solve this problem in order to stem the growth of losses. Alternative means are available for resolving deeply insolvent banks when existing shareholders do not supply sufficient new capital, including liquidation, assisted acquisition, and nationalization. Resolving banks by means of assisted acquisition or nationalization entails recapitalization and restructuring. The principal goal of recapitalization is to restore banks' cash-based profitability, and the principal goal of restructuring is to enhance banks' potential to achieve sustainable cash-based profitability. Under certain conditions forbearance from official resolution action might be appropriate, but forbearance gives rise to risks that must be controlled.

The paper suggests that the investment of public funds by the three governments in resolving banks could have been better leveraged to attract private sector capital into banks.

In tackling a crisis, the government may acquire ownership interests in banks in exchange for equity capital support. A key task for the crisis management team is to develop a privatization plan with the goal of returning governance and ownership of the banks to the private sector as quickly as possible. In the countries examined, unrealistic expectations regarding the value of banks and unwillingness to accept foreign investment in large banks proved to be formidable impediments to privatization.

One of the key challenges in bank resolution and privatization is to restructure the troubled debt held by banks. Policies, procedures, and skills that ensure prompt recognition of troubled debts and maximize collection are key to restoring and sustaining bank profitability and solvency. Despite considerable debate regarding the soundness of the strategies employed by the three governments, the paper suggests that these governments could have done more to avoid cosmetic restructuring and ensure that genuine debt restructuring took place, in part by taking a more proactive role in debt restructuring when the government was a significant shareholder in the bank.

In the context of a systemic crisis, asset management companies are potentially an important tool for reducing the cost to government of crisis resolution. Asset management companies can be used to maximize the value of banks and bank assets and to accelerate the process of bank recapitalization, restructuring, and privatization. The three governments proved largely ineffective in achieving these objectives because of political interference, lack of a clear mandate and defined goals, and weak institutional capacity including limited private sector involvement.

Part 2. Improving the Efficiency of Crisis Resolution

Part 2 develops the conceptual underpinnings for two fundamental improvements in crisis management practices. One measure is to develop an explicit, comprehensive crisis resolution strategy. The other is to link the provision of support to banks explicitly with the actual outcomes of troubled debt restructuring. A common theme is to maximize the impact of public funds used

in crisis resolution.

Explicitly defining a comprehensive strategy is essential because it enables the crisis management team to integrate the components of its work and to think through the strategic elements before taking significant actions in any one area. Acting without an overall strategy leads to mistakes and limits the options available in the future. The principal elements of a comprehensive strategy are a long-term vision, concrete goals, clear operating principles, and a realistic assessment of the problem. Obtaining political consensus on these elements is essential.

The second improvement is to link the provision of financial support to banks with the outcome of corporate debt restructuring. Government financial support is a tool for promoting constructive debt restructuring and for controlling the costs to government. It should have two goals. The first is to remove the incentives that bankers and debtors have either to delay restructuring or to engage in cosmetic restructuring and to create incentives for both parties to engage in constructive debt restructuring. The second is to ensure the prudent use of the financial support that government will provide and better control the potential moral hazard inherent in providing that support. This can be accomplished by (a) making the financial support to banks contingent on bankers' performance in restructuring debts and achieving specific outcomes and by (b) having the crisis management team monitor and ratify debt restructuring decisions made by the managers of banks receiving public support. Political consensus is key. If the political will exists, the challenge will be to assemble a crisis management team with the capacity to design, organize, and implement the approach.

Part 3. Mitigating the Risk of Crisis

Part 3 draws on the experiences in the three countries and elsewhere to identify steps that government can take to mitigate the risk of crisis and be better prepared to deal with shocks should they occur. Undertaking formal contingency planning before a shock occurs will help the authorities and banks to identify the types of actions that may have to be taken in such a situation as well as the skills, policies, and processes required to support those actions. This part discusses contingency planning in the context of liquidity management and intervention in weak banks.

One key to mitigating the risk of crisis is to ensure that banks have the capacity to deal

with liquidity shocks. To promote bankers' ability to weather shocks, supervisors can ensure that bankers have in place adequate risk management regimes and engage in contingency planning for the eventuality of a sudden and significant unexpected shock. Supervisors also can prepare themselves to closely monitor banks that experience liquidity shocks or problems. It is important for the relevant authorities (supervisory authorities, the central bank, and the deposit protection agency) to be prepared to play their respective roles in resolving a bank experiencing prolonged liquidity problems. The central bank should not be forced to provide liquidity to a bank due to the authorities' inability to implement a resolution mechanism.

Another key is to strengthen the legal, regulatory, and supervisory regimes to promote the prompt resolution or exit of weak banks, including giving advance consideration to forbearance policies. Not having in place policies for explicit forbearance in the event of a shock may lead supervisors to grant implicit forbearance, which can lead to further systemic deterioration and crisis. Government also can ensure that bank resolution mechanisms operate as intended by employing both post-mortem exercises subsequent to bank failures and formal contingency planning exercises. Engaging in contingency planning tests the authorities' likely response to a sudden shock and identifies policy and operational weaknesses before they are exposed in practice.

PART 1. RESOLVING THE ASIAN FINANCIAL CRISES

At the core of resolving a financial crisis is solving the financial problems of banks and their major debtors, specifically illiquidity and insolvency. In general, the challenge for governments is to restore the performance and stability of core elements of the banking system, to get the economy quickly back on track, and to minimize the long-run fiscal costs of doing so.

Governments in Indonesia, Korea, and Thailand issued extensive guarantees of financial institution liabilities, both on and off balance sheet, either early on (Thailand, Korea) or in response to continued panic among depositors and others (Indonesia). These decisions had important implications for the nature of the task that governments faced in resolving the crises and constrained the use of possible policy options. Specifically, the guarantees limited the ability of governments to allocate losses to bank claim holders and set the governments on a course either to provide substantial support to banks, in the case of Korea, or to grant forbearance to existing owners, in the case of Thailand. In examining the approaches taken by the three governments, this paper takes as its starting point this particular context; it does not examine the potential consequences and implications of a hypothetical decision not to afford broad protection to financial institution claim holders.³

Part 1 reviews and assesses the principal actions taken by governments in Korea, Thailand, and Indonesia to resolve the crises in their countries. It draws on those and other experiences to suggest basic guidelines and principles that either were important to the governments' accomplishments or, had they been adopted, might have improved the outcomes. The chapters in part 1 address subjects in the rough chronological sequence in which they confront authorities in a crisis. Each chapter provides a brief introduction to the topic, describes and assesses country experiences, and closes with suggested guidelines and principles.

3. Note that some researchers have found that granting extensive guarantees contributes to higher resolution costs (Honohan and Klingebiel 2000).

CHAPTER 1. STABILIZING LIQUIDITY

Financial crises typically are triggered by runs on banks and a flight of funds from the financial system as a whole and from the country. Runs on banks usually involve the withdrawal of domestic deposits and cuts in domestic interbank and international funding lines. Runs also can involve the withdrawal of funds that are placed in off-balance-sheet instruments known as trust accounts, money desks, mutual funds, and the like, but that have deposit-like characteristics in that the bank is legally or feels morally liable for maintaining the value of the claim. In effect, these deposit substitutes often are used to circumvent regulations (reserve requirements, for example), but the public makes little distinction between them and deposits.

Additional pressure on bank liquidity arises when borrowers draw down lines of credit, perhaps anticipating that those funds will not be accessible in the near future, or when holders of financial assets (such as equity and debt securities) sell those assets and withdraw the proceeds from domestic banks.

Through the process of contagion, funding pressures can spread from the weakest banks to the strongest. Foreign banks and state-owned banks typically benefit from the initial stages of this flight to quality, but if confidence is not restored quickly, even those institutions can come under liquidity pressure.

Central banks are, of course, the first line of defense in dealing with runs. Among the international financial institutions, the International Monetary Fund is principally responsible for advising central banks in fulfilling their role of lender of last resort while simultaneously maintaining monetary control. This chapter focuses on stabilizing bank liquidity and not on monetary management as such.

Central banks work to stabilize liquidity by providing liquidity to the system overall or to specific banks. They use tools such as open market operations, discount window lending, repo and reverse repo operations, overdraft (unsecured) lending, and reduced reserve requirements to supply liquidity. When the efforts of the central bank prove insufficient, the government is forced to step in. The three Asian countries covered in this paper employed four principal mechanisms

during the crisis: guarantee of bank liabilities, suspension of banks, nationalization of banks, and imposition of temporary capital controls.

Country Experience

All three countries issued extensive bank liability guarantees. Korea and Thailand issued such guarantees quickly after funding pressures emerged in banks, while Indonesia did not do so until the banking system was near collapse. In Korea, the government guaranteed banks' international liabilities in August 1997 in response to cuts in international funding lines. In November 1997, the Korean government fully guaranteed all bank deposits for a period of three years.⁴ These measures, along with the adoption of a sound macroeconomic program, helped to stabilize liquidity.

In Thailand, the guarantee took the form of an August 1997 amendment to the Bank of Thailand regulation making the Financial Institutions Development Fund responsible for insuring the repayment of principal and interest to depositors and creditors of financial institutions experiencing financial problems. The guarantee covered all deposit-taking institutions other than the 58 finance companies previously suspended (see below).

In contrast with governments in Korea and Thailand, the Indonesian government did not initially adopt a comprehensive guarantee. Prior to the crisis, Indonesia had no explicit deposit insurance, yet most deposits were perceived to be covered by an implicit government guarantee. However, when the government closed 16 nonviable banks in November 1997, it announced that it would only guarantee repayment of small depositors (up to Rp20 million per depositor per bank). Closing the banks in the absence of a broader deposit guarantee reflected the belief that market-based solutions are the most efficient approach and the least expensive for taxpayers. In fact, these closures gave only limited protection to deposits. Coupled with uncertainty regarding how the limited guarantee would be honored, political tensions over the state of President

4. In effect, the government fully guaranteed virtually all unsubordinated liabilities of financial intermediaries, including life insurance companies. At that point, the Bank of Korea was providing substantial domestic and foreign currency liquidity support to banks (and other financial institutions). Foreign currency support was provided by depositing a substantial portion of the countries' foreign currency reserves with domestic banks.

Suharto's health, uncertainties regarding his impending reelection, and growing fears over the country's corporate debt and banking sector problems, the closures contributed to the widespread panic that led to deposit runs on many private banks.

By end-November 1997, Indonesia's private banks had lost some 12 percent of their rupiah deposits and 20 percent of their foreign currency deposits. Roughly two-thirds of the country's private banking system (representing half of the entire banking system) experienced deposit runs. Bank of Indonesia began supplying liquidity in large amounts to keep banks afloat and protect the integrity of the payments system, but this did not stave off the panic that had set in. Deposit outflows continued throughout December 1997, financed in large part by Bank of Indonesia liquidity support. In January 1998, the rupiah fell to an all-time low against the dollar, and there were stampedes in Jakarta as shoppers rushed to hoard food and withdraw cash from the banks. Demonstrations and protests shook the country, as the effects of economic turmoil filtered down to the population.

By January 1998, with the economy in free fall and market confidence all but lost, the risks of moral hazard paled in comparison to the risks associated with not attempting to fashion a safety net. A presidential decree establishing a more extensive guarantee scheme was promulgated, but it did not specify which instruments would be covered, under what circumstances payments would be made, and which agency would implement the guarantee, among other matters. The decree represented, in effect, a broad government commitment to guarantee all third-party depositors and creditors. In practice, the government honored the commitment by providing sufficient liquidity so that all banks (no matter how insolvent) would be able to meet all claims (whether legitimate or not) in the clearing and settlement system.⁵

Korea and Thailand suspended specific banks in an effort to stop runs. Suspension meant that banks were temporarily closed for business, including for deposit withdrawals, pending a decision on their viability. (See box 1 for a further definition of suspension and other terms used

5. This liquidity support ultimately reached some Rp144 trillion, of which a subsequent audit deemed approximately 95 percent to have been subject to "abuse." The government and Bank of Indonesia reached a negotiated settlement that avoided the need to recapitalize the central bank.

in this paper.) In Korea, 14 small merchant banks were suspended in December 1997.⁶ In Thailand, 58 finance companies were suspended in the second half of 1997. A number of these finance companies happened to be subsidiaries of banks.

Box 1: Definition of Failure Resolution Mechanisms

Financial institution insolvency and failure can be dealt with using a number of different mechanisms. The following terms and definitions are used in this paper.

Liquidation is a legal mechanism under which an insolvent institution is closed, its license is withdrawn, and its assets are sold or collected over time to meet the claims of depositors and other creditors. The applicable legal regime may be the general bankruptcy law or a special regime for financial institutions. The extent of court involvement varies from country to country. Where deposits are insured, the deposit protection entity pays insured claims in advance of the sale or collection of the assets.

Assisted acquisition, also known as business transfer (Korea) and purchase and assumption (United States), is a mechanism under which an insolvent institution's license is withdrawn, and some of its assets and liabilities are sold to one or more other financial institution(s). Most commonly, insured deposits are transferred to (assumed by) the other institution, with payment to that institution made in the form of cash or official debt (for example, bonds issued by the deposit protection entity and guaranteed by the government), perhaps along with some of the failing institution's assets (for example, branches). This resolution mechanism can minimize or eliminate potential disruption of service to depositors. Depending on the development of the markets and the extent of preplanning by the authorities, it is possible to arrange the sale of a large portion of a failed bank's assets and liabilities in this manner.

Nationalization is a mechanism under which the government assumes (temporary) ownership of an insolvent institution. The institution's license is not withdrawn, and it remains open for business. Nationalization can be engaged in under various labels. Nationalized banks were considered "intervened" in Thailand and "taken over" in Indonesia. The term "nationalized" was used in Korea.

Conservatorship is a period of temporary government control during which management may be removed and shareholder rights at least partially and temporarily constrained. It is not a resolution mechanism, but rather an interim step.

Suspension was used in the three countries covered in this paper. Under suspension, an institution is closed for business (perhaps with limited exception, for example, for limited deposit withdrawals), yet its license is not withdrawn pending further analysis of its solvency. In this

6. Of these, 12 eventually lost their license, and their assets and liabilities were transferred to a newly created government-owned bank under assisted acquisition transactions. See chapter 5.

sense, suspension is not a resolution mechanism, but only an interim step. Suspension is the Asia crisis involved limited numbers of banks. In other countries, suspension has involved all banks (sometimes referred to as a general *bank holiday*).

Initially in Korea, and later in Indonesia, the government nationalized banks to help stabilize liquidity. By early 1998, Korean authorities had completed the nationalization of Korea First Bank and Seoul Bank, both large, nationwide banks, in response to runs triggered in part by rumors that the banks were to be closed.⁷ In Indonesia, the authorities used this technique to deal with massive outflows of deposits from Bank Central Asia immediately after widespread riots in May 1998. Thailand nationalized several banks and finance companies in 1998, but not in the context of efforts to stabilize liquidity. Similarly, Korea nationalized more banks in the fall of 1998 due to their insolvency and not in response to runs.

To help stabilize foreign currency funding, Thailand and Indonesia employed limited, temporary capital controls. Thailand limited local currency lending to nonresidents offshore, while Indonesia imposed limits on forward sales of foreign exchange by domestic banks to nonresidents. In Korea, the government kept the capital account open and alleviated international funding pressure by reaching agreement with foreign banks in late January 1998 to roll over short-term debt (Lindgren and others 2000).

At the outset of the crisis, in none of the countries was the deposit insurance entity (in the case of Korea) or the bank supervision authority in a position either to put banks in liquidation and immediately begin repaying protected deposits or to effect the prompt transfer of deposits from a failing bank to a more sound institution under an assisted acquisition transaction. In Indonesia, for example, closures were hampered by the lack of a legal framework adequate to deal with bank resolutions. Under the existing regulations, once a bank was closed and its license was revoked, it was liquidated under the company law. This required the shareholders, not the supervisor or another authorized government agency, to form the liquidation team and supervise

7. As of the end of 1996, Korea First Bank had 403 domestic and 20 foreign offices. Seoul Bank had 355 domestic offices and six foreign branches, two foreign agencies, two representative offices, and subsidiaries in Hong Kong and Luxembourg. Each bank reportedly had more than 5 million customers.

the liquidation and deposit repayment process. Absent the necessary legal and procedural tools, uncertainty persisted and contagion spread.

Assessment

The ability to restore depositor confidence so as to stabilize liquidity rapidly can be an important milestone in minimizing the damage caused by financial crises. The relatively positive results in Korea and Thailand stand in contrast to the experiences in Indonesia (and more recently Ecuador). A key distinguishing characteristic seems to be the relatively early adoption of extensive bank liability guarantees in Korea and Thailand and the limited credibility of the guarantee eventually adopted in Indonesia.

In principle, offering extensive bank liability guarantees should have been avoided, since they limited governments' flexibility in allocating losses and may well have undermined incentives for markets to monitor banks in the future. In practice, however, given the systemic nature of the crises and the ensuing loss of confidence, governments may have had few other options than to offer a broadly based guarantee of many or most bank liabilities.

The guarantees in Korea and Thailand seem to have been effective in stabilizing domestic currency funding, but they were less effective with respect to foreign currency funding, especially from foreign sources. The experience of Indonesia (and elsewhere) suggests that the extent to which such guarantees inspire the confidence of claim holders depends on a number of factors, including whether the guarantee is codified in law, perceptions regarding the government's financial capacity to honor the guarantee, the past record of government in meeting its commitments, as well as the perceived credibility of the government's overall response to the crisis. Regardless, guarantees may not be effective if there is a loss of confidence in the national currency.

By issuing a broadly based guarantee of bank liabilities, governments made more concrete their contingent liability for claims on banks and potentially expanded the scope of that liability. The mechanisms by which governments met their commitments under the guarantees influenced their cost. Three mechanisms were used in Asia, two effective and one less so. Putting failed banks into liquidation and repaying protected deposits or transferring deposits to other banks were

effective means. The third mechanism, used in Indonesia, was to provide extensive liquidity support to help open private banks meet the guarantee. The Indonesian experience suggests that this mechanism is to be avoided. A related lesson from Indonesia is the potentially high cost of not having appropriate controls on the use to which liquidity support is put.

Although suspension seemed to be an expedient means for dealing with runs, the experience in Korea and Thailand suggests that it can exacerbate uncertainty and precipitate more runs. The case of Thailand also suggests that suspension can encourage willful default by debtors otherwise able to service their debts. There the suspension of 58 finance companies resulted in a wave of business failures, as some firms lost access to their deposit accounts and lines of credit. Depositors in other deposit-taking institutions, including commercial banks, apparently foresaw the potential suspension of their institution and began withdrawing deposits as a preventive measure. Similarly, debtors apparently foresaw the loss of access to lines of credit and ceased repayment of debts so as to conserve working capital, leading to the so-called strategic defaulter phenomenon. In addition, borrowers of some suspended finance companies who had been servicing their loans ceased debt repayments, an action apparently consistent with the loss of access to their deposit accounts and reinforced by the failure of suspended finance companies to issue payment notices.⁸

Nationalization proved an effective means for dealing with runs. Of course, nationalization brought with it a wide range of responsibilities for government, which are covered in chapter 5.

Finally, Asian governments were slow to address the policy and procedural implications of ensuring their ability either to pay out deposits in banks put into liquidation or to transfer protected bank deposits to other banks. Had they performed better in this regard, they might have been better able to reduce uncertainty and stem runs on banks.

8. These lessons would appear to apply to another means sometimes used by governments (most recently in Ecuador) to deal with runs: "freezing" deposits in open banks by placing restrictions on deposit withdraws.

Guidelines and Principles

Broadly based guarantees should be avoided, where possible, because they increase government's contingent liability and likely increase moral hazard.⁹ Where they are employed, they should be crafted carefully to limit their scope and cost. When issuing a broad guarantee, government should attempt to exclude certain classes of liability holders (bank shareholders and subordinated debt holders, for example). They should avoid guaranteeing instruments such as mutual funds and trust accounts. There also may be considerable scope not to guarantee claim holders of certain peripheral nonbank institutions.

The three countries took several steps to limit the moral hazard inherent in guarantees. In all three countries, the expanded liability guarantee was explicitly temporary.¹⁰ In Indonesia and Thailand, interest rates on protected deposits were capped relative to an established index rate so as to prevent weak banks from aggressively bidding up their price.

Regardless of the scope of government undertakings to protect depositors or others, their credibility depends on whether policies, procedures, and institutional capacity are in place to meet those undertakings. When funding pressures are brought to bear on banks, government should move rapidly to evaluate existing arrangements and strengthen them where necessary.

Finally, suspending banks can exacerbate uncertainty. Perhaps the best means to avoid the need to rely on suspension is for government to have the ability to intervene and rapidly resolve banks experiencing runs.

In summary, the following guidelines and principles are applicable to stabilizing liquidity:

- Limit the scope of guarantees.
- Limit the moral hazard inherent in guarantees.

9. The degree to which government's contingent liability under a guarantee actually materializes will be determined, to a perhaps significant extent, by the quality of its crisis management response, which is the general focus of parts 1 and 2 of this paper.

10. This, then, raised the challenge of how to roll-back the guarantee.

- Put in place the means to meet deposit protection commitments promptly.
- Take steps to avoid the suspension of banks.

CHAPTER 2. MAKING INSTITUTIONAL ARRANGEMENTS

Concurrent with taking urgent steps to stabilize liquidity, the government needs to begin laying adequate foundations for resolving the many financial and structural problems that the crisis has created, revealed, or exacerbated. It needs to move quickly to organize an extraordinary, comprehensive solution to these problems. The challenge is significantly managerial in nature. For that reason, a key step is to ensure that strong institutional arrangements are in place. Making institutional arrangements involves striking a balance between the political and the technical work of crisis resolution. It involves delegating authority and responsibility to technical experts. It involves ensuring that the necessary technical expertise is mobilized and managed effectively.

Effectiveness in dealing with a financial crisis depends on the response of the top political authorities. One critical factor is the cohesiveness of the political response. Crises are best resolved when political differences can be set aside in the interest of restoring confidence in the near term and efficiently solving serious financial and structural problems over the medium and longer terms.

Even where a sufficient degree of political cohesiveness can be achieved, the top political authorities will feel threatened by the crisis and will have to respond to pressures from any number of vested interests. For this reason, they likely will seek to oversee and influence the government's response and to be seen as in control of the situation. However, to be most effective, the government's response needs to be seen as objective, fair, and free from inappropriate political inference. The institutional arrangements should be designed to balance these needs.

Effectiveness in dealing with a financial crisis also depends on the technical capacity and competence of the individuals responsible for carrying out the wide range of specialized tasks involved in crisis resolution. These tasks are discussed in detail throughout this report. Summarizing briefly, they include gathering, verifying, and analyzing information; preparing financial projections; formulating and evaluating options for the investment of public funds;

making investment decisions (granting or denying public support to banks, for example); defining specific terms and conditions for support; negotiating contracts; designing reporting requirements and systems; monitoring performance against contract terms and other benchmarks; and enforcing contracts. These tasks likely will have to be performed over a period of time measured in years. The institutional arrangements will have to provide the managerial and organizational capacity necessary to carry out this work professionally.

In each country, practical means need to be found to accommodate politicians' need to provide leadership in a crisis and to feel comfortable in their ability to oversee government's response, while at the same time ensuring that the work is done expeditiously, professionally, consistently, sustainably, and in a fair and objective manner. This paper elaborates one means that may have broad applicability: specifically, explicit delegation of the work of crisis management to a technically competent government team, a *crisis management team*, where the ongoing role of the political leadership is to oversee the work of the team.¹¹ Clearly delegating responsibility to a crisis management team has several key advantages. It publicly identifies the locus of responsibility for dealing with the crisis. It consolidates decisionmaking and promotes the government's ability to speak with one voice, two objectives that can be critical to the effectiveness of government's response.

To provide for oversight, the crisis management team would best report to some form of governing body. This governing body might consist of representatives of senior political interests and perhaps the private sector. The governance arrangements should be designed so that the crisis management team is seen as operating largely independently of inappropriate political interference. It should operate transparently, reporting publicly on the results of its analyses, on its decisions, and on its actions, to the extent practical. The combination of reporting to the governing body and to the public would allow interested politicians, affected parties, the public at large, and the domestic and international media to judge the performance of the team; over time it would contribute to restoring confidence and building public support for resolution actions. It also would allow politicians to deflect some or much of the potential criticism and lobbying that

¹¹ This section is based on advice provided by the World Bank to the Korean government at the outset of the crisis.

otherwise would be directed at them. To a significant extent, the heat could be shifted to the crisis management team.

The crisis management team could be conformed around one or more of the permanent official agencies of government. This likely would involve temporarily streamlined operating and decision-making procedures. In some instances conforming the team around existing agencies may not prove satisfactory due to institutional weaknesses, rivalries among agencies, or conflicting responsibilities that cannot be overcome practically. In those cases the crisis management team might be conformed as a specific-purpose, temporary entity outside these agencies. This structure could serve to overcome institutional weaknesses and rivalries and better insulate crisis resolution activities from other responsibilities and potential conflicts of interest.¹²

Country Experiences

The three countries covered in this paper employed various institutional arrangements for resolving the crisis. In Korea, the government assigned responsibility for crisis resolution, including both the financial and corporate sectors, to the Financial Supervisory Commission (FSC), the body created in April 1998 to oversee the planned Financial Supervisory Service (FSS), which was to be launched in early 1999 to integrate all functions of financial sector supervision. The government designated a high-ranking and capable manager, who later became finance minister, to chair the FSC and serve simultaneously as governor of the FSS. A cabinet committee chaired by the president of the republic, including the FSC chairman, provided oversight of and direction to the FSC in its financial and corporate restructuring activities.

While the Korean Deposit Insurance Corporation (KDIC) continued to report to the Ministry of Finance and the Economy, the FSC chairman became a member of the KDIC board. The Korean Asset Management Corporation (KAMCO) reported directly to the FSC. As is discussed in more detail in chapter 4, KDIC and KAMCO were the principal vehicles for financing crisis resolution. The FSC determined the use of public funds in consultation principally with the Ministry of Finance and the Economy. The FSC also coordinated the activities of

¹² For an in-depth case study of the challenges in orchestrating the political and technical work of crisis resolution see De Krivoy (2000).

Hanaerum Bank, a so-called “bridge bank” temporarily established by the government to acquire and liquidate the assets and liabilities of insolvent merchant banks.

In Thailand, the central bank was assigned primary responsibility for crisis resolution. The Bank of Thailand’s Financial Institutions Development Fund provided financial and managerial assistance to banks facing difficulties. At the same time, the minister of finance played a key decisionmaking role, in particular with respect to the use of public funds. In addition, the government established by emergency decree the Financial Sector Restructuring Authority (FRA) as an independent state agency to oversee the rehabilitation or liquidation of the 58 finance companies suspended in 1997 and the Thai Asset Management Corporation as the buyer of last resort for the lowest-quality assets that did not receive reasonable bids in the FRA auctions. In mid-1998, the Corporate Debt Restructuring Advisory Committee (CDRAC) was established within the Bank of Thailand to enable viable debtors to continue business operations and promote fair and equitable debt repayment to creditors.

In Indonesia, a presidential decree in January 1998 established the Indonesian Bank Restructuring Agency (IBRA) to be responsible for crisis resolution, including the financial and corporate sectors. IBRA’s mandate was defined broadly to include supervision and restructuring of the most illiquid and insolvent banks (including determining the best means for resolving unsound banks), assumption of the claims deriving from Bank of Indonesia’s extensive emergency liquidity support to banks, administration of depositor and creditor guarantees, management and sale of assets (including loans) acquired in the course of bank resolution, and the privatization of banks acquired in the process.

Assessment

While the relatively strong performance of Korea in dealing with the crisis attests to the soundness of the institutional arrangements put in place, as a crisis management team Korea’s Financial Supervisory Commission suffered certain weaknesses. One apparent weakness was that coordination between the FSC and the Ministry of Finance and the Economy was not publicly perceived as seamless, suggesting failure to create a truly integrated crisis management

structure.¹³ This inherent structural weakness had a cost, as the government was unable to act decisively and to speak with a single voice.¹⁴ When some of these differences became public knowledge, they set back the government's efforts to restore domestic and international confidence and contributed to uncertainty.

A second and less ambiguous weakness was that Korea's FSC also was responsible for financial sector supervision. The dual roles of crisis resolution and financial sector supervision can give rise to serious conflicts of interest.¹⁵ The conflicts relate both to the supervisor's prior involvement in permitting the financial system to fall into crisis (and thus its incentives to underestimate or at least underreport the scope of distress) and its responsibility for effectively supervising the system going forward.¹⁶

The third weakness with Korea's FSC was the manner in which it was financed. The FSC's limited budget precluded its ability to attract to the crisis management team some of the top talent in the country, including private sector experts such as corporate financiers and lawyers. Rather, it had to rely mainly on seconded public sector employees.

In Thailand, similar weaknesses existed. First, although the Financial Institutions Development Fund played a major role in the resolution process, the Thai minister of finance himself also was a key decisionmaker. Although it was essential to have the minister involved, his

13. To some extent, potential conflicts between FSC and the Ministry of Finance and the Economy were mitigated by the nature of the FSC's staffing, which included a substantial number of the ministry's secondees.

14. One notable example is the privatization of Korea First Bank and Seoul Bank, where the Ministry of Finance and the Economy may have hampered efforts to sell the banks by claiming, in effect, that they were worth more than buyers were willing to pay. Its position may have reflected, at least in part, a conflict of interest arising from its earlier role in nationalizing and recapitalizing the banks and its claim at that time that the banks had been restored to health.

15. This was evident in the Mexican crisis of 1994–95.

16. In Korea, several factors mitigated against the potential damage that these conflicts can cause. One was the internal separation of responsibilities and personnel between the crisis management unit and the supervisory function. A second factor was the fact that the FSC was created during the crisis and its leader came from outside the existing supervisory agencies. As such, the FSC was somewhat insulated from the past actions of the Bank of Korea and the Ministry of Finance and the Economy in supervising the financial system. It could assert that it was not acting under any pressure or incentive to cover up past mistakes. Nonetheless, its role as crisis manager will undermine its ability to supervise the system to the extent that banks are not fully restored to health.

involvement did not necessarily facilitate or accelerate the decisionmaking process, given his need to attend to numerous other priorities. His direct involvement, with only limited delegation of authority, may have slowed the process. Second, communication and coordination impediments between and within the Bank of Thailand and the Minister of Finance delayed the implementation of crisis resolution measures. Third, having a single institution responsible for resolving finance companies instead of two (the Financial Sector Restructuring Authority and the Asset Management Corporation) may have resulted in more value being realized in the disposition of their assets, since under Thailand's dual-entity arrangement the FRA did not have the power to restructure debts, but rather was limited to selling them. It took considerable time to establish the entity and organize the sales, during which no restructuring took place. Finally, the resolution of distressed banks was hindered by the conflict inherent in the Bank of Thailand's roles of supervisor of financial institutions, decisionmaker on forbearance or the provision of public support, and manager of the liquidation of closed banks. Bank of Thailand's multiple responsibilities may have created incentives not to accept the insolvency of a bank or act to close it and rather to acquiesce to a proposed recapitalization plan in hopes that the bank would recover with time.

Institutional arrangements in Indonesia suffered more severe weaknesses. The decree laying the groundwork for IBRA was vague. To overcome this shortcoming, it was necessary to amend the Banking Law to establish the agency. Yet the amendments merely made reference to the possibility that such an agency could be established. The operating parameters for IBRA were not issued until February 1999, more than a year after it came into being. During this period, it had four chairmen and was unable to take effective action. Even after IBRA was established, ultimate authority continued to vest in the country's president, so that effective decisionmaking was substantially influenced by political considerations. IBRA's legal standing was, in fact, challenged in the courts. Although IBRA's powers ultimately were upheld, the court strongly suggested that they should be enshrined in law. Yet at the time of this writing, the government has not moved to strengthen IBRA's legal standing.

The decision to give IBRA supervisory responsibility over banks transferred to it also was costly. Bank of Indonesia sought to regain control over the supervisory function, and a climate of

distrust and lack of cooperation was fostered between the two institutions, which continued to hamper effective crisis resolution for some time.

To strengthen coordination among the various government agencies so as to eliminate legal and institutional impediments to bank restructuring and drive the reform process forward, the Financial Sector Advisory Committee was established in mid-1998. The committee comprised the coordinating minister of economy, finance, and industry, the finance minister, the development planning minister, the minister for industry and trade, the governor of the Bank of Indonesia, and the head of IBRA. The Financial Sector Advisory Committee remained dormant, however, and was succeeded in 1999 by the Financial Sector Policy Committee, comprising the same membership. In part under external pressure, the Financial Sector Policy Committee functioned better and served to decide all financial sector resolution activities. As a result, coordination and consensus among the various official bodies improved.

Guidelines and Principles

Formation of a specific-purpose, temporary crisis management team should be considered. Key objectives would be to consolidate responsibility, promote consistency of work and decisions, provide for the necessary specialized skills, and insulate the work from other official responsibilities and related conflicts of interest. The team might explicitly have a limited life to provide incentives to conclude the work in a timely manner and not prolong its existence unnecessarily.

The governing body of the crisis management team would encompass both key political interests and the private sector. The governing body should harmonize political interests and mitigate the impact of differences of opinions among the permanent official agencies of government. Finance ministries, prime ministers or heads of state should play a leading role.

The governing body should delegate in explicit terms the responsibility and authority for crisis resolution. Clear delegation is critical to the effectiveness of the team. Objectives and responsibilities need to be clearly defined, ideally articulated in terms of explicit outcomes, and basic principles to guide the work must be agreed.

The governing body needs to define the authority, powers, and protections available to the crisis management team and may need to codify them in law. The relevant authorities and powers are those necessary to ensure the ability of the team to undertake its work (including the power to recruit and contract outside expertise), to coordinate supporting actions by the permanent official agencies of government (including the means to arbitrate differences of opinion among those agencies and raise unresolved differences to the governing body), and to act as the chief spokesperson with respect to the actions being taken.¹⁷ The team would require legal protection for actions taken in good faith, for example, protection from unjustified lawsuits filed against individual members of the team.

The governing body needs to ensure that the crisis management team has the necessary resources to do its job. The key resource is the government financing necessary to invest in banks, repay deposits in liquidated banks, and serve as an inducement to new private capital. Failure to grant sufficient financing undermines the chances for success. The team also needs to have adequate financing for its own operations, including funds to hire experts with the necessary skills.

Central banks and supervisory agencies should play clearly circumscribed roles in crisis resolution. Due to their official responsibilities for financial sector supervision and for the lender-of-last-resort function, these agencies are usually the first to become involved in dealing with the effects of a crisis. Nonetheless, when crises become systemic, they are often not prepared to play the leading role in crisis resolution. Moreover, forcing them to do so may undermine their capacity to perform their permanent functions. Although central banks certainly will play a role, government should not compel them to bear an excessive burden in financing crisis resolution.¹⁸ A more appropriate role for a supervisory agency is as an independent check on the

17. The probable need to establish the team's authority and powers by law reflects the likelihood that the team's actions will conflict with (overstep) the legal authorities of the permanent institutions of government. In addition, special legislation also can be used to overcome weaknesses in existing legal arrangements. In some cases, effects similar to those created by these special legal powers might be achieved by executive decision. With respect to the team's dealings with the private sector (banks, bank shareholders, bank managers, and debtor firms and their owners), similar effects can be achieved by contract.

18. Assigning principal responsibility for crisis management to central banks also may increase the pressure to lend excessively, possibly undermining their finances and risking the loss of monetary control.

recapitalization transactions being organized by the crisis resolution team, much the same role that supervisors routinely play in approving changes in the control of banks or in the monitoring of agreements by banks to raise additional capital and carry out institutional improvements.

In summary, the following guidelines and principles are relevant to making institutional arrangements for crisis resolution:

- Form a specific-purpose, temporary crisis management team.
- Create a governing body for the crisis management team that encompasses key political interests and perhaps the private sector.
- Have the governing body delegate in explicit terms the responsibility and authority for crisis resolution.
- Have the governing body define the authority, powers, and protections available to the crisis management team and to codify them in law, if necessary.
- Have the governing body ensure that the crisis management team has the necessary resources to do its job.
- Ensure that the central bank and supervisory agencies play clearly circumscribed roles in crisis resolution that do not undermine their ability to perform their permanent functions.

CHAPTER 3. MOBILIZING PUBLIC FUNDS

With institutional arrangements in place, the political authorities and the crisis management team need to begin mobilizing sufficient public funds to salvage the financial system and protect depositors and perhaps other bank creditors. In a truly systemic crisis, the central bank—often the first entity that commits financial resources—will be constrained in its ability to finance significant costs by its responsibilities for monetary management. Likewise, the deposit

protection entity (where it exists) probably will not have sufficient resources to absorb all the costs. The authorities will have to arrange an extraordinary financing package.¹⁹

Beyond the initial liquidity support provided by the central bank, public funds may be used for several specific purposes. They may finance the repayment of deposits of failed banks or the assumption by more sound banks of the deposits (and perhaps other liabilities) of failed banks. They may be used to purchase assets (such as nonperforming loans) from banks and to inject capital by purchasing bank equity. They may be used to fulfill government commitments under guarantees granted and put options written in the course of supporting or privatizing banks. In connection with each of these purposes, public funds can be used to induce new private capital into the banking system. Public funds also may be required to finance the operations of the crisis management team, particularly the cost of skilled staff, advisors, and other contracted professionals (such as asset managers).

The resources mobilized under the financing package can take several forms, including cash; government notes or bonds; government guarantee of debt issued by official or quasi-official agencies such as the central bank, deposit protection entity, or asset management company; government guarantee of asset values; government indemnification against contingent losses; and government commitments to purchase assets at predefined prices (put options written). The financing package must contemplate both the cost of directly issued securities as well as the potential cost of contingent liabilities.²⁰

Country Experiences

All three countries had relatively sound fiscal and debt positions prior to the crisis and thus had more capacity to finance the cost of crisis resolution than many other countries that have experienced crises in recent years.

19. Of course, multilateral financial institutions and other official lenders can play a role in mobilizing the necessary financing package.

20 For additional considerations in mobilizing public funds see Honohan 2001.

In Korea, under an umbrella arrangement totaling KRW65 trillion, representing around 30 percent of gross domestic product (GDP), the National Assembly approved the government guarantee of debt issued by KAMCO and KDIC on three separate occasions in 1997 and 1998. This initial umbrella package eventually proved insufficient, and the National Assembly approved a second round of fiscal support totaling some KRW40 trillion in late 2000.

In Thailand, substantial fiscal expenditures were incurred for the purpose of financing liquidity support by the Financial Institutions Development Fund and for financing the August 14, 1998, financial restructuring package (the bank recapitalization program discussed in chapter 5). The legislature approved Bt500 billion in bonds for the Financial Institutions Development Fund and Bt300 billion for the August 14 recapitalization package. The cost of the blanket guarantee as well as loss sharing agreements related to the privatization of banks is yet to be determined but is expected to be high.

In Indonesia by end-December 2000, Parliament had approved the issuance of new government bonds totaling some Rp644 trillion (representing around 58 percent of GDP) for crisis resolution. Of this amount, Rp426 trillion was used to recapitalize the banking system, which included Rp282 trillion for state-owned banks. The remainder (Rp218 trillion) was used to recapitalize Bank of Indonesia to offset the losses incurred in providing liquidity support to banks under the government deposit guarantee program discussed in chapter 1. To manage the fiscal burden of such a large issuance of debt, the government phased in the recapitalization program. Private and nationalized banks were recapitalized first, and state banks were recapitalized later. The government also used a mix of fixed-rate, floating-rate, and indexed bonds to reduce the fiscal implications of the financing package.

Assessment

Securing sufficient public funds to finance resolution costs depends critically on the political leadership and on political consensus. The Korean government, in particular, was able to mobilize a significant financing package early on, signaling the government's determination to tackle the crisis. Gaining quick political consensus on a financing package helped to restore confidence by bolstering the credibility of the government's statements and commitments.

Conversely, delay in securing a credible financing package can undermine the effectiveness of crisis resolution efforts. Delay often results from a lack of political commitment or cohesion and is a symptom of weak capacity for crisis management. Delay can allow uncertainty and insolvency to persist and costs to rise.

The three governments faced a difficult challenge in determining the appropriate size of the financing package. Initially, there was great uncertainty about the scope of insolvency and the amount of financing required. The governments faced a tradeoff between speed in arranging financing (with the benefits that conveys) and certainty as to the amount of financing required.

The governments had difficulty raising additional financing when the initial packages proved insufficient. Thus government and the crisis management team need to maintain the flexibility to seek additional financing at a later date, should that be necessary, but do so without creating expectations that additional financing will necessarily be made available, which may undermine the incentives facing potential beneficiaries of support. This suggests that the initial package must be sufficiently large to be credible to the domestic (and international) market.

To the extent that assets acquired by government in the course of crisis resolution can be sold quickly, the proceeds can be used to reduce the size of the financing package. In Korea, this technique was referred to as “recycling” public support. Although a valid tactic, it raised concerns that the government would securitize assets with recourse (retaining ongoing liability for loss) rather than sell the assets back into the private sector. Moreover, unrealistic expectations regarding the speed with which assets can be sold or the values that can be obtained can render insufficient the projected financing requirements.

The financing package may have to make provisions for the repayment of central bank liquidity support. If, in the initial stages of the crisis, the central bank extended substantial liquidity support to insolvent banks, it may well have to write off that support. As in the case of Indonesia, the government may have to reimburse the central bank for some or all of those losses.

All governments used indirect methods of financing such as issuing guarantees or writing put options as a substitute for issuing direct government debt. In principle, these can be valid and useful financing techniques, particularly in the context of inducing new private capital into the

financial system. At the same time, these obligations give rise to contingent liabilities and may obscure the cost of crisis resolution. They also may lead to a breakdown in government debt management. These financial liabilities have to be identified, monitored, and managed in much the same manner as direct liabilities.

In principle, the private sector (both domestic and foreign) can provide some of the investment required to salvage core elements of the financial system and to fulfill government's commitment to protect depositors. In practice, the three governments failed to have much success in this regard.

Guidelines and Principles

Involving the political opposition in crisis management, for example by including them in the arrangements for oversight of the crisis management team, can promote political consensus on a financing package.

The special legislation needed to authorize the use of public funds on the scale required should define the basic objectives and principles for the use of those funds in crisis resolution. It can be the vehicle for establishing the crisis management team and the oversight arrangements.

The financing package needs to be of sufficient size to be credible. The markets need to be able to relate the size of the package to their own estimates of the losses existing in the banking system. The crisis management team must quickly determine a rough order of magnitude, keeping in mind the near-universal experience in other countries of underestimating the amount of financing required.

Despite best efforts, the initial financing package may prove insufficient. Although it is important to limit expectations for further financial support, it is also necessary to maintain the flexibility to seek additional financing. Commitments not to seek further financing must be avoided.

The package should make sufficient resources available for financing the operations of the crisis management team, including adequate resources to hire expert private sector advisors and practitioners. This can readily sum to several millions of U.S. dollars. Exemptions from civil

service rate and salary restrictions also likely will be a necessary part of the package.

The financial instruments underlying the financing package generally should be on market terms and conditions. For example, to restore bank profitability, notes or bonds issued to banks to pay for nonperforming loans, buy equity capital, or honor guarantees should bear market rates of interest and pay interest regularly. Those instruments also should be tradable so as to promote the ability of banks to manage liquidity and reduce the interest rate paid and thus the financing cost to government.²¹

An adequate government debt management function is needed to mitigate the risks and reduce the costs arising from the substantial increase in government debt associated with crisis resolution. It is important that the new debt issued be integrated with the regular program of debt issuance and management. Both contingent liabilities under guarantees and put options written need to be taken into consideration. The crisis can be a good opportunity to strengthen the debt management regime, including the management of maturity, refinancing, and interest rate risk.

In summary, the following guidelines and principles are intended to support efforts to mobilize public funds:

- Involve the political opposition in the arrangements for oversight of the crisis management team.
- Use the special legislation authorizing the use of public funds to define the objectives and principles for the use of those funds.
- Ensure that the financing package is of sufficient size to be credible.
- Maintain flexibility to seek additional financing.
- Make sufficient resources available for financing the work of the crisis management team.

21. At the same time, making these instruments tradable can facilitate looting by bank insiders, against which effective provisions must be made.

- Structure the financial instruments underlying the financing package to be on market terms and conditions.
- Ensure an adequate government debt management function is in place to mitigate the risks and reduce the costs arising from the government debt issued for crisis resolution..

CHAPTER 4. DIAGNOSING THE SCOPE OF FINANCIAL PROBLEMS

In a crisis, it is important to differentiate between banks that are winners and those that are losers. The winners are those banks that, in relative terms, have the best management, governance, finances, and operations. The losers are those banks that have unsuitable shareholders, poor governance, unqualified, reckless, or criminal managers, have become insolvent, or have poor business prospects.

Simultaneous with supporting action necessary to secure a financing package, the crisis management team needs to begin diagnosing the scope of problems facing individual banks and the financial system overall. The team requires accurate information to determine appropriate resolution mechanisms for distressed banks and to estimate the potential requirements for financing crisis resolution. This diagnostic work is of particular importance in determining the amount of support required by individual banks.

The team likely will learn that the authorities do not have accurate information regarding the financial condition of banks. Their basic sources of information are the accounting data prepared by banks and debtors and the regulatory indicators and supervisory analyses prepared by supervisory authorities. This information can be inaccurate even in normal circumstances, but especially in times of financial distress.

Contributing substantially to the problem of accounting and regulatory information are the incentives facing most stakeholders to underestimate the scope of financial problems, especially in a systemic crisis. Bankers who risk losing their jobs or investments should the bank be shown as economically insolvent have strong incentives to hide its actual condition from the authorities. Owners and managers of firms who risk losing control of their business or its assets should the firm be revealed as insolvent have similar incentives. Supervisory authorities, who may expect to be held accountable for the current situation by politicians, the media, and the public, have

incentives to downplay the scope of the problems. Finally, the political leaders who are asked to authorize the financing for support have incentives to minimize the problems so as to minimize (at least initially) the amount of financing required.

Accounting information suffers three weaknesses of particular relevance in a crisis. First, asset values can be overstated. The financial statements of debtors may not reflect the lower value of plant, equipment, and inventories. The balance sheets of banks may not reflect the lower value of loans, securities not marked to market, and perhaps other assets. Second, liabilities may be understated. Debtors may not disclose the true extent of their liabilities.²² Banks often are found to have undisclosed off-balance-sheet liabilities, including financial transactions engaged in as principal but inappropriately carried off balance sheet, as well as genuine contingent liabilities. Third and most critical, routine accounting information fails to identify the underlying cash flow situation of banks and debtors. Understanding cash flow is critical to valuing assets. Bankers can readily manipulate accounting information to obscure the actual cash debt service performance of debtors, which obscures the banks' underlying financial condition.

Regulatory indicators also suffer weaknesses. The regulatory indicators that receive most attention in a crisis are nonperforming loans and bank capital. Since bankers can manipulate accounting information to obscure the actual cash debt service performance of debtors, the regulatory measure of nonperforming loans can be substantially understated. In turn, the overstatement of asset values and understatement of liabilities mean that bank regulatory capital can be substantially overstated. Moreover, regulatory capital can include both equity and debt. Debt capital may contribute little to the profitability of a bank and, in practice, can contribute to an erosion of equity capital.²³ From the perspective of restoring bank profitability, measures of regulatory capital overstate actual capital.

The challenges arising from weaknesses in accounting information, regulatory indicators,

22. One dramatic example is Korea's Daewoo Corporation. When the conglomerate fell into bankruptcy it was discovered only over some period of time that its liabilities were not \$50 billion, as indicated by available reports, but closer to \$80 billion.

23. This occurs where, in order to achieve the narrow objective of bolstering the regulatory capital ratio, debt is issued at interest rates exceeding the marginal yield on assets.

and poor incentives are compounded by the heightened uncertainty regarding financial and real asset prices, especially during the initial phases of a crisis. Interest rate spikes, sizable exchange rate depreciation and overshooting, and near-frozen markets for assets such as land, buildings, and equipment make it difficult to gauge realistic medium- and long-term values and prices. To some extent, the uncertainties may persist sufficiently long as to undermine government's ability to determine recapitalization needs.

The likely result of these factors is a misdiagnosis of the nature and extent of the financial problems afflicting banks and debtors. It is not surprising, therefore, that early diagnoses tend to underestimate substantially the scope of the problems and the amount of financing that will be required of government.

Country Experiences

The Korean Financial Supervisory Commission attempted to develop better information on the condition of banks in at least four ways. One step was to hire international accounting firms to perform diagnostic reviews of the troubled banks. The focus was on the prospective level of asset losses as well as other financial and operational problems. This work was performed by the local affiliates of major international firms supplemented by experts from offices in other countries, especially bank supervision experts from the United States. The work was performed in two phases, first for the largest and most troubled banks and subsequently for the remaining banks. The banks themselves were required to finance the work. A second step was to require the banks to submit rehabilitation plans containing detailed information regarding their prospective financial and operating condition. Progressively improved plans were demanded. A third step was to commission a major international firm to perform an industry analysis. This work generated detailed information on the possible evolution of the post-crisis financial system that supported the valuation of financial sector business lines, for example. A final step was to commission another international firm to develop a financial analysis model that could incorporate various inputs, including the results of the diagnostic reviews and the industry analysis, and project future profitability, trends in equity capital, and equity recapitalization needs by bank.

To gain better information on the financial problems of major debtors to the financial system, the Financial Supervisory Commission also required the larger *chaebol* to enter into debt

reduction agreements with their banks. These agreements were to provide complete information regarding the liabilities and cash flows of chaebol.

In Thailand, the Bank of Thailand did not conduct or organize diagnostic reviews of troubled banks. Rather, banks were asked to conduct self-diagnostics that were then verified by the Bank of Thailand. The banks also submitted business plans to the Bank of Thailand for review. The consequences of the exercise were unexpected in that, even though no outside reviews were conducted, the Bank of Thailand received sufficient information to justify a decision to liquidate or nationalize some of the banks.

In Indonesia, independent international auditors were engaged to conduct diagnostic reviews of all banks, to determine the level of solvency or insolvency, and to judge the relative costs of resolving each bank through assisted acquisition, merger, or recapitalization and privatization. Banks were asked to prepare business plans demonstrating their continued viability. An international consultant then reviewed these plans using a financial analysis model similar to that employed in Korea.

Assessment

The experience of the three countries confirms a situation common in crisis countries. Routine accounting information was misleading and did not provide the cash flow information necessary to understand the extent of financial problems facing debtors and banks. Regulatory indicators did not reflect the true condition of banks' loan portfolios or the level of real capital. In the course of crisis resolution, significant additional liabilities of banks and major debtors were discovered. The quality of information submitted by poorly governed banks and banks with extensive insider lending was judged to be particularly poor.

In principle, the steps taken by the Korean government provide a fairly good example of the general approach a government can take to overcome information deficiencies in a crisis. Bankers were required to provide detailed information regarding banks' prospective viability. International experts were hired to assess banks' condition, especially loan quality. International experts also were hired to prepare a forward-looking assessment of the post-crisis operating environment of the financial services sector, which provided a context in which to judge banks'

prospective viability. A model based on experts' experiences in other crisis countries supported this financial analysis. In practice, there were shortcomings. For example, the assessments performed by international experts suffered due to unrealistically short deadlines and the lack of sufficient financing for the necessary work.

It can be argued that, regardless of the steps taken to gather information and build analytical capacity, governments cannot match the private sector in judging the prospective viability of banks. To leverage the analytical capacity of the private sector, governments have to build mechanisms to attract private sector capital at the time of government investment in salvaging individual banks. Although the three countries took steps in this direction, in practice none achieved this objective.

Guidelines and Principles

Although significant uncertainties are inevitable in the early stages of a crisis, it is essential to invest in information gathering and analytical capacity. It also is important to ensure that the persons responsible for gathering, verifying, and analyzing this information do not have incentives to underestimate the extent of the problems. This, in turn, has implications for the organization and staffing of the crisis management team.

Gaining a first-cut assessment of the scope of the problem of individual banks is necessary to estimating the overall size of the problem and to prioritizing resolution efforts on those banks incurring the greater ongoing losses.

To support the investment of public funds, focus should be placed on the amount of equity capital required by banks. It is important to distinguish between regulatory and economic capital. Regulatory capital can include debt instruments that do not contribute significantly, if at all, to bank profitability. The principal focus should be on equity capital. Key information should include not only the range of losses likely to be incurred under troubled debt restructuring but also the range of losses likely to be incurred under bank operational restructuring. For ascertaining potential losses to be incurred in troubled debt restructuring, information on the cash flow situation of major debtors is required.

In summary, the following principles and guidelines are intended to inform the efforts to

diagnose the scope of financial problems:

- Make an early and significant investment in information gathering and analysis.
- Ensure that those responsible for gathering, verifying, and analyzing information do not have incentives to underestimate the extent of the problems.
- Perform triage in order to have a first-cut assessment of the scope of the problem of individual banks.
- Focus on the amount of equity capital required by banks.

CHAPTER 5. RESOLVING, RECAPITALIZING, AND RESTRUCTURING BANKS

To a large extent, the actions discussed to this point are geared toward laying foundations for successfully resolving, recapitalizing, and restructuring banks and the banking system. Systemic crises may well lead to losses of a magnitude that results in bank insolvency, where the value of liabilities exceeds that of assets. These losses can result in a situation where the bank, absent an increase in equity capital, cannot earn a profit and therefore has no internal means of rebuilding capital by retaining earnings.

Promptly *resolving* insolvent banks is essential. The longer insolvent banks remain freely engaged in business, the greater is the disruption to the performance of the financial system and the higher are the potential costs to resolve them. Managers of insolvent banks tend to undertake risky transactions for personal gain or in the hope that high returns will restore bank solvency. They often bid aggressively for deposits in an effort to stave off illiquidity. Higher resolution costs can arise through a number of mechanisms, including excessive overhead expenditures, losses arising from new loan disbursements to distressed borrowers,²⁴ underpricing of new business, the costs of financing nonperforming loans, and looting.²⁵

24. This is distinct from simple rollover of principal and capitalization of unpaid interest into the principal balance.

25. Allowing insolvent banks to continue in business also may make monetary management more difficult.

The goal of *recapitalizing* banks is to restore sustainable cash-based profitability. It is not sufficient to provide capital in an amount that satisfies a regulatory capital requirement if the bank will continue to operate at a loss, insidiously eroding that capital. It similarly is not sufficient to provide capital in an amount that restores accounting-based earnings when those earnings are not likely to be realized in cash within a reasonable period of time. Recapitalization can be viewed as complete only if sustainable cash-based profitability is reasonably assured in the medium term.

The principal goal of *restructuring* banks is to enhance their potential to achieve sustainable cash-based profitability. Bank restructuring therefore is an important complement to recapitalization. Although the crisis will contribute to bank insolvency, it also will reveal preexisting poor financial performance such as chronically low or even negative earnings. Restructuring can involve a large number of actions designed to strengthen bank profitability, usually including refocusing business strategies, downsizing operations (such as reducing staff, selling businesses, and closing offices and subsidiaries), repricing products, and upgrading institutional capacities (such as the capacity to manage risk and perform internal and external audits). Bank restructuring also entails restructuring troubled debts, the subject of chapter 6.

Responsibility for recapitalizing a bank must reside in the first instance with its shareholders, particularly where there is a controlling group of shareholders. Bank supervisors and the crisis management team may employ a range of practices to motivate shareholders to recapitalize the bank. These practices ultimately are based on the potential to suspend and revoke the shareholders' ownership rights.²⁶

Should existing shareholders prove unable or unwilling to recapitalize, the remaining private sector solution is to seek new investors. One possible means is to use the threat of loss to force unsecured creditors of the bank to convert their claims into equity. Another means is to seek new investors willing to recapitalize the bank.

Should the private sector fail to recapitalize adequately, the government can step in to resolve the bank. In essence, government can apply three basic mechanisms to resolve an

26. These practices often takes the form of formal agreements (potentially legally binding) between the shareholders or their representatives and the bank supervisory authority, such as memorandums of understanding.

insolvent bank: liquidation, assisted acquisition, and nationalization (refer to box 1 for the definition of these terms). Each has different implications for bank recapitalization and restructuring. Often they are used in combination. Government may employ some form of conservatorship to oversee bank operations pending execution of a definitive resolution mechanism.

Liquidation does not involve recapitalizing and restructuring the bank; rather it involves winding up the bank's operations. Government financial support may be required to support the repayment of protected deposits and claims. Shareholders lose their investment, and some creditors likely incur losses. Capacity and costs are removed from the banking system.

Assisted acquisition involves the transfer of some or all of the insolvent bank's liabilities, assets, and operations to another bank or financial institution. For example, the transfer of deposits may be financed in part by the simultaneous transfer of certain assets of the insolvent bank, such as sound financial assets (government securities, for example) or physical assets (branch offices, equipment). Any shortfall in assets is filled by government financial support to the acquirer. The assets of the insolvent bank that are not acquired by other institutions typically are liquidated to repay creditors' claims that were not transferred. As with liquidation, shareholders lose their investment, and some creditors likely incur losses. No recapitalization is required, although government financial support may be needed to finance the transfer of liabilities and protect against contingent liabilities. The acquiring institution undertakes any required restructuring. Assisted acquisitions can be a good means to reduce the overall cost structure in the banking system, while minimizing the disruption to users of financial services that is inherent in bank liquidation.

Nationalization typically involves the temporary assumption of ownership rights and responsibilities by government. In principle, shareholders lose their investment, but in practice they may retain some (greatly reduced) equity claim.²⁷ Government assumes responsibility not only for recapitalizing the bank but also for exerting governance and overseeing bank

27. Most commonly, this may be so due either to legal limitations on the ability to write off shareholders entirely or to a tactical decision intended to mitigate the potential for legal action by existing shareholders.

restructuring pending reprivatization. For that reason, nationalization represents a substantial challenge to the capacity of the crisis management team, although some of these responsibilities can be subcontracted to others.

In practice, there may be limits on the extent to which government can employ liquidation, assisted acquisition, and nationalization as mechanisms for resolving insolvent banks.²⁸ Its option in this case is to leave existing shareholders in control by granting temporary *forbearance* from resolution action. In effect, government chooses some winners among the existing banks and shareholder groups and allows time for a private sector solution to be organized before a public sector resolution is undertaken.²⁹ This usually involves a phase-in of full enforcement of capital adequacy, asset classification, and asset provisioning rules. It might also involve a simultaneous tightening of those rules.

There are many possible variations on and combinations of the manner in which these alternatives, including forbearance, can be employed. For example, government might finance the assisted acquisition of an insolvent bank by a financially weak yet well-managed bank, while simultaneously supporting the recapitalization of the weak bank itself (in effect, a partial nationalization). Or the government itself might charter a new bank (often referred to as a bridge bank) to engage in assisted acquisitions of certain liabilities and assets of insolvent banks.

Country Experience

In Korea, the government relied principally on assisted acquisition and nationalization to resolve insolvent commercial banks. Two large banks that were disproportionately exposed to chaebol that fell into bankruptcy in 1997 were nationalized early in 1998 in reaction to emerging deposit runs (Korea First Bank and Seoul Bank). Top managers were removed or reassigned, and the new managers were instructed to cut costs substantially. Eventually, 51 percent of Korea First

28. Extensive liquidation may be too economically or politically disruptive and may actually destroy value, assisted acquisitions may be constrained by a lack of qualified buyers, and government may be unwilling or unable to assume responsibility for governance of all banks that would otherwise be nationalized.

29. The strategy is that government will achieve better outcomes (for example, quicker action, lower long-run costs) by allowing shareholders of certain banks to retain governance responsibilities and an ownership stake.

Bank was sold to new investors, who took over governance and management responsibility. After attempts to privatize Seoul Bank failed, management of the bank was contracted to a major foreign bank.

Five smaller banks were wound up in July 1998 by means of transferring their assets and liabilities to other banks under assisted acquisitions.³⁰ Assisted acquisitions covered all assets and liabilities to ensure that there would be no disruption of business for bank customers. Shareholders lost their investment, but creditors were protected. The five acquiring banks had significant foreign shareholding stakes and were considered to be among the best-managed banks in Korea. They had access to Bank of Korea liquidity support to minimize the disruption of banking services for customers of the failed banks. They also received a put option on nonperforming loans and KDIC capital injections to maintain their capital levels at pre-acquisition levels.³¹

Later in the year, after further analysis, the government nationalized three more large banks, while insisting that they merge.³² The KAMCO agreed to purchase 80 percent of the combined banks' nonperforming loans. The KDIC agreed to inject equity capital in exchange for more than a 90 percent stake in the banks, raising the banks' Basel regulatory capital ratio to 10 percent after projected increases in loss reserves for further loan deterioration. The government also provided financial support for the acquisition of two troubled banks by two healthier banks, although in amounts much less than in the case of the nationalized banks. As a condition for granting public support, the FSC imposed performance contracts containing severe terms on the top management of the banks to promote restructuring. Managers were most successful in their efforts to reduce staff expenses and close or sell branches. On average, Korean domestic banks reduced staff personnel costs around 35 percent and reduced the number of branches 20 percent.

30. In the terminology used in Korea, these were referred to as "business transfers."

31. In supporting the acquisition of troubled banks by healthier banks, as in the case of the five smaller banks, the FSC committed to maintain the merged banks' capital at the pre-acquisition level of the acquiring bank.

32. Two large banks—CBK and Hanil—merged to form Hanvit Bank, while a third large bank—Cho Hung—agreed to merge with two smaller banks. Mergers were required, in part, to generate public support for the use of taxpayer funds in recapitalizing banks, under the notion that merger involved a cost to the bank.

The FSC had indicated its desire to attract private sector capital to complement public funds invested in banks. The government of Korea liberalized applicable regulations to permit 100 percent ownership of a bank by a foreign financial institution. Nonetheless, the government was unable to attract private capital at the time of taking a resolution action due to its apparent failure to acknowledge the reduced value of banks and to articulate clearly to potential investors the terms and conditions under which public support would be available.

The Thai government relied on a combination of approaches, including nationalization, capital support, and forbearance (through phased-in provisioning requirements) in its efforts to resolve the banking sector crisis. After suspending the 58 finance companies in mid-1997, the Bank of Thailand committed to a policy of recapitalization of the core banks. The strategy was based on a progressive strengthening of provisioning requirements designed to prompt banks to obtain fresh capital. By the end of 1997, 56 of the 58 suspended finance companies were closed, and Bank of Thailand had signed recapitalization memorandums of understanding with the weakest banks. By May 1998, four critically undercapitalized banks unable to meet recapitalization deadlines had been nationalized, along with seven finance companies. Another two banks and four finance companies were nationalized in August 1998, and another bank was nationalized in July 1999. In all cases, shareholders of nationalized banks were written down to a negligible interest in the bank.

To facilitate recapitalization of the banking sector, the Thai government announced the Financial Sector Restructuring Program in August 1998, centering on two capital support facilities (the so-called Tier 1 and Tier 2 support programs). Under the Tier 1 program, the government would match on a one-to-one basis private investors' fresh capital to help recapitalize banks that agreed to provision immediately for their potential loan losses. To implement this, the banks were required to adopt loan classification and provisioning rules that otherwise would become fully effective at the end of 2000 and to constitute the necessary loss provisions. Under the Tier 2 program, with the goal of facilitating economic recovery, the government would inject nontradable debt qualifying as regulatory capital into banks meeting specified corporate debt restructuring and new lending targets. The programs were voluntary, and most private banks viewed them as a last resort because they feared that accepting public investment would be perceived as a sign of weakness by the market and would invite government interference in

management.

In order to recapitalize without having to join the government program, Thai banks resorted to raising regulatory capital from the market, including through innovative debt agreements called SLIPS and CAPS, which were short term and high cost. By June 2000, Thai private banks had raised from private investors over Bt300 billion in Tier 1 capital (including traditional common stock and more exotic debt-like instruments) and Bt58 billion in debt qualifying as Tier 2 capital. Although significant unrealized losses remained on the balance sheets of some banks, regulatory forbearance allowed them to delay loss recognition such that they did not have to recapitalize quickly and sufficiently. One form of explicit forbearance, the phase-in of required loss provisions over time, ceased at the end of 2000. However, other forms of explicit forbearance (for example, the immediate release of existing provisions at the time of debt restructuring) and widespread, but less transparent, implicit forbearance (for example, generous valuation methodologies and tolerance of cosmetic restructuring) remain in place.

The Tier 1 program was accompanied by strict conditions intended to motivate bankers to raise capital from the private markets without matching public money. Fear of having to join the program and thus risk government interference in management indeed did catalyze the private banks to seek capital from the market. In some cases, this resulted in improved bank governance, although in others (where shares were sold widely to small investors), it did not.

In Indonesia, the government quickly decided to recapitalize all state-owned banks, regardless of cost. For the private banks, however, the government sought to preserve a small core of the best banks, for which it developed a recapitalization program. Those banks with a capital adequacy ratio above 4 percent were deemed healthy and ineligible for public assistance. Thirty-eight banks with a capital adequacy ratio between 4 percent and minus 25 percent and with a viable business plan were deemed eligible for assistance.

Under the terms of the recapitalization program, which sought to raise Tier 1 regulatory capital to 4 percent of risk-adjusted assets, private owners were required to contribute a minimum of 20 percent of the total cost of recapitalization, and the government would provide the

remainder. In recognition of its substantial investment, the government was to be granted preferential treatment in the event of liquidation of the bank and in the receipt of any dividends.³³ Recapitalization agreements to be signed with the banks were to include provisions limiting the government's involvement in daily bank operations, creating incentives to induce private owners to participate in the program, and encouraging compliance with the business plan targets and prompt repayment of the government's support.

Under the terms of the recapitalization agreements, private owners were granted the opportunity to buy back the government's shares within the stipulated three-year period of the business plan, provided there was no unresolved material breach of the business plan and provided the government was fully compensated, with interest, for its investment. Any sale of the government's shares within the three-year period would require prior approval of the private owners, who would be given preemptive rights. At the end of the three-year period, the government was to grant private owners the right of first refusal to purchase its shares, after which the government's shares would be sold in the market. In addition, the private controlling shareholders who provided the additional equity would be issued a certificate entitling them to benefits from recoveries on nonperforming loans transferred from the bank to IBRA.³⁴

The contract also included financial and operational targets for each bank and its managers; these targets were based on the business plans as well as the actions that bankers were to take to meet those targets. Furthermore, the contract identified relevant management positions, the holders of which would be responsible for ensuring compliance with the contract. Failure to meet the minimum financial or operational targets set out in the contract (including targets for the reduction of nonperforming loans) would result in regulatory actions against the bank, its controlling shareholder, or management. These actions could include the dismissal of commissioners or directors or the exercise by Bank of Indonesia or IBRA of their powers to assume control of management of the bank. Although Bank of Indonesia was not a counterparty

33. However, it was not anticipated that the banks would pay dividends during the period of government ownership, since earnings would need to be retained in order to reach an 8 percent capital adequacy ratio.

34. Under the terms of the program, problem loans were written off entirely and transferred to IBRA at no cost. IBRA nonetheless booked the assets at face value, as is discussed in chapter 8.

to the contract, as bank supervisor, it had responsibility for supervising all banks and for monitoring compliance with the contracts.

As the recapitalization agreements were being finalized, some of the banks experienced sporadic deposit runs. The authorities, in a premature move to demonstrate the commitment of banks' shareholders, invited the owners of the nine banks to sign preliminary investment contracts at a signing ceremony in Jakarta held on April 15, 1999, to which the press was invited. Not all the counterparties to the contracts attended, and the content of the contracts became public. Not only did some contracts remain unsigned, but also the terms of the contracts immediately gave rise to market questions regarding the government's ability or willingness to fulfill its commitment to provide new capital. This called into question the credibility of the recapitalization program.

The owners of the nine banks were given until April 21 to place their 20 percent portion of the recapitalization in an escrow account with Bank of Indonesia. The total amount was based on end-December 1998 estimates of required new capital. Eight banks met this requirement.³⁵ The owners of the ninth bank (Bank Niaga, one of Indonesia's large banks, with more than 458,000 accounts) were unable to provide the necessary capital, and the bank was nationalized.³⁶ Another problem now arose. Revised audits conducted by independent auditors as of end-March 1999 showed significantly higher recapitalization requirements for the remaining eight banks, reflecting the losses that these banks had incurred since December, which arose mainly from ongoing excessive expenditures for premises and staff and the carrying costs associated with nonperforming loans. Under the terms of the contract, the controlling shareholders of the eight banks were obligated to increase their capital contribution to 20 percent of the updated recapitalization requirement. They were given a deadline of June 30, 1999. In the event the banks'

35. The controlling shareholders of Lippo, BII, and Universal—all three listed banks—conducted rights issues between January and April to raise the required capital. The controlling shareholders of Bank Bali, also a listed bank, signed an agreement with Standard Chartered, which provided the necessary capital. The shareholders of Bukopin, Artamedia, Patriot, and Prima Express, all four of which were unlisted, also provided funds amounting to 20 percent of the recapitalization amount.

36. Thus almost seven months after the process of selecting banks for joint recapitalization was initiated, and at the end of a time- and resource-intensive process of evaluation, only eight of 38 potentially qualified banks had reached agreement for joint recapitalization.

shareholders did not provide the additional funds and the government committed itself to increasing its own shareholding, as necessary, to ensure that banks reached the required 4 percent capital adequacy ratio. In effect, all nine banks were nationalized.

Assessment

The experiences of Indonesia, Korea, and Thailand underscore what has been learned in crises elsewhere, chiefly that bank resolution, recapitalization, and restructuring are monumental tasks presenting substantial challenges that governments are hard-pressed to tackle. Three years after the outset of the crisis, many banks in all three countries continue to exhibit substantial weaknesses. The persistence of these problems might call into question governments' overall performance in bank resolution.

In all three countries, bank shareholders were reluctant to recapitalize insolvent banks. For widely held banks with no controlling shareholders, such as the large Korean banks, this probably was inevitable. It was less so in Thailand and Indonesia, where many banks had controlling shareholders. There, governments nonetheless were largely unsuccessful in motivating shareholders to recapitalize.³⁷

Similarly, shareholders and governments had limited success in raising capital from new investors. New investors were unwilling to accept the risk of loss of their investment, and governments generally offered insufficient protections against this outcome. Only in Thailand was an explicit program of matching government assistance for new investment publicly announced, but shareholders were left in a position to take the decisions, which probably undermined the program. The potential hostility of existing management and staff also deterred new investors in some countries (for example, Indonesia). The public sector thus became the principal source of new equity capital in the short run.

The governments made use of the full range of resolution options, including liquidation, assisted acquisition, and nationalization. More use probably could have made of liquidation as a resolution mechanism. In general, liquidation is appropriate for banks that can be wound up

37. This also occurred in Mexico in the mid-1990s.

without significant economic or political implications and where there is not substantial franchise value. The governments' lack of capacity to promptly pay out protected deposits may have constrained the authorities' use of liquidation. Failure to invest sufficiently in information gathering and analytical capacity may have led to overestimation of franchise value.

The ability to use assisted acquisitions by domestic banks as a resolution mechanism was limited in practice because there were few sound domestic banks to which to transfer the liabilities (and assets) of insolvent banks. Even where this resolution mechanism was employed, such as in Korea, banks were reluctant to undertake the acquisitions because they would distract managers and perhaps present unacceptable financial risks.

Governments probably could have done much more either to use assisted acquisitions by foreign acquirers or to induce foreign acquirers to participate as partners in bank nationalization. Had they had more success in this regard, governments would have substantially reduced their burden in bank governance and restructuring oversight and would have attracted more private sector capital. These types of public/private joint ventures were not achieved for several reasons. A fundamental impediment was the failure of governments to define and communicate the financial and other support they were willing to offer, which itself derived in part from their inexperience in soliciting and concluding complex transactions of that nature, an institutional weakness that was not overcome with the crisis management arrangements that the governments put in place. Uncertainties regarding valuations and contingent liabilities, denial of the probable extent of value impairment, and political and public opposition to allowing foreign control of major banks were additional impediments.

Even if governments had been more successful in forcing existing shareholders to inject capital and in using public funds to attract domestic or foreign private sector investment, and if they had made greater use of liquidation as a resolution mechanism, nationalization probably still would have been employed as a key resolution mechanism in all countries, especially for larger banks. To the extent that private sector solutions cannot be achieved and forbearance for existing shareholders is not warranted, nationalization often was required to salvage core elements of the banking system. Nationalization brought with it major responsibilities for bank governance and restructuring oversight that, given the weak condition of many of these banks, governments have

struggled to fulfill.

A shortage of public funds for recapitalization was a key constraint to the overall bank resolution program in all three countries. Lack of adequate resources created incentives to manipulate the outcomes of diagnostic work (or fail to initiate it). It led to the failure to provide sufficient new capital to restore and sustain the profitability of nationalized banks, which in turn undermined incentives for bankers to undertake operational and troubled debt restructuring. It likely played a role in the failure of government to offer adequate protections to new private investment in troubled banks.

The appropriateness of forbearance in dealing with insolvent banks has been the subject of much debate. Forbearance for insolvent banks runs counter to generally agreed principles of insolvent bank resolution dictating that shareholders lose their investment with a consequent loss of control. The risk is that banks will remain in the hands of shareholders who may have no capital at risk and thus have poor incentives. Although implicit forbearance was granted in each country, in Thailand forbearance was explicit. The judgment seems to be that it was preferable to keep shareholders in place rather than have the government nationalize and run the bank. Part of the rationale related to the perceived weak capacity of government. Government did not consider it feasible to make institutional arrangements to undertake the governance and management responsibilities inherent in nationalization.

The structure of explicit forbearance in Thailand had consequences for incentives in the debt restructuring process. Forbearance there involved phased-in provisioning requirements, but no adjustment to the regulatory capital rule. In principle, an equal outcome could have been achieved by forbearing on the capital rule, but not the provisioning requirements. By forbearing on the provisioning requirements, government may have inadvertently created incentives to delay genuine debt restructuring, which would have resulted in immediate recognition of losses in excess of the (reduced-by-forgiveness) provisioning requirement. See chapter 7 for more details on debt restructuring.

Guidelines and Principles

Government should take aggressive action to promote recapitalization by existing

shareholders. Standard supervisory methods for promoting recapitalization (such as restricting new business or dividend payments or removing top managers) have limited effects in a crisis. The credible threat of immediate suspension or revocation of shareholders' ownership rights, even where supported by adequate legal infrastructure (law, judiciary), may not be sufficient. In addition, government can investigate transactions involving bank insiders for evidence of impropriety and illegality, and prosecute offenders. It can use the tax regime to create incentives for recapitalization, for example, allowing the full deduction from taxable income of losses to be taken in the context of debt or operational restructuring and offering generous tax-loss carry-back and carry-forward provisions.

The choice of alternative resolution mechanism (liquidation, assisted acquisition, and nationalization) should be based, in principle, on an assessment of cost. The crisis management team will need to define least-cost decision criteria and make a quantitative analysis. For larger banks, the decision criteria also will need to take into consideration potential systemic implications.

Public funds should be leveraged to attract equity financing from the private sector for assisted acquisitions or as a participant in nationalization. Securing investment of new private capital at the time of bank resolution can be particularly advantageous to the extent that new investors can assume responsibility for bank governance and thus for overseeing restructuring. For example, government can provide protections for new investment of necessary capital in the context of assisted acquisitions. In nationalizing banks, government can attract equity capital from new investors in an amount sufficient to warrant granting primary responsibility for governance to those investors, even though they would hold only a minority equity interest in the bank.

Nationalization carries significant risks that need to be actively managed. The risks are those commonly associated with public bank ownership (political interference in lending decisions, for example), combined with government's limited expertise in overseeing operational and troubled debt restructuring. These risks and capacity limitations may be mitigated somewhat by making the institutional arrangements noted in chapter 2 (assuring the organizational and technical capacity of the crisis management team). Government also can contract for professional management of nationalized banks (as in the case of Korea's Seoul Bank).

The risks in granting forbearance are high, and government needs to mitigate those risks. Forbearance often simply delays required action, adds to costs, and raises the potential for political interference. To mitigate these risks, forbearance should be granted only under defined rules, should be transparent (and thus explicit), and should be subject to close monitoring. For example, forbearance might be granted only to banks meeting specific eligibility criteria, such as being relatively well managed and having a controlling shareholder or group of shareholders able to exert positive governance over managers and to contribute financially to bank recapitalization. Transparency in the process of granting and monitoring forbearance would include announcing eligibility criteria, disclosing the analytical basis for decisions, and publicly reporting on performance. Government must make provision to carefully monitor the behavior of managers of the banks benefiting from forbearance. Enforcement of breach of agreements (especially to raise new capital within specified periods of time) should be swift and resolute.

Recapitalization should take the form principally of equity capital. The principal goal of bank recapitalization is to attain sustainable cash-based profitability in the medium term with reasonable assurance. Focusing primarily on restoring regulatory capital or accounting-based earnings is likely to result in insufficient recapitalization. To restore cash-based profitability, new equity capital will be required. Debt qualifying as Tier 1 or Tier 2 regulatory capital may do little to restore profitability and may actually undermine it.

Before investing new equity capital in a bank, the government should conduct rigorous analysis of prospective profitability. This requires analyzing the evolution of the bank's business under different scenarios and the resulting earnings projections. It requires both bank-specific and overall industry analysis inputs. As a condition for receiving financial support, bankers should be required to provide all necessary information required to perform the analysis.

Recapitalization should be accompanied by aggressive restructuring. Aggressive restructuring can lower long-run recapitalization costs (initial outlays less the resale value of the equity interest) by improving the core profitability of the bank. Recapitalization must take into account the costs that will be incurred in operational restructuring (such as severance payments) and the losses that will be incurred in restructuring troubled debt. Bank restructuring should involve substantial downsizing and refocus operations on more profitable lines of business.

Recapitalization should involve sufficient new equity capital so as not to create the expectation of further rounds of public support. Adoption of this principle is intended to ensure that bankers (and, under extraordinary circumstances, perhaps shareholders) have incentives to maximize the use of public support, principally by undertaking aggressive restructuring. Attempting to implement this principle in practice is a significant challenge for government, since it requires making a judgment (supported by rigorous analysis) of recapitalization requirements in an environment of information constraints and significant uncertainty. In practice, governments rarely attempt to implement or succeed in implementing this principle, which may be one reason why granting multiple rounds of support to banks is common.

When uncertainty is high, steps may be needed to insulate a bank against further major losses. To increase the probability that the new equity capital will result in sustainable profitability, government should attempt to insulate the bank from the significant adverse effects of lingering uncertainty. The most common example pertains to large debtors or groups of debtors, where uncertainties regarding possible losses inherent in debt restructuring will have a material impact on the ability of government to ascertain the amount of new equity required to restore sustainable profitability. Government can use at least two types of mechanisms to mitigate these uncertainties and to attract private capital to participate in bank recapitalization (see box 2).

Box 2: Mechanisms to Mitigate the Effects of Uncertainty and Attract Private Capital

Interest rate spikes, sizable exchange rate depreciation and overshooting, near-frozen markets for physical assets, as well as general macroeconomic uncertainty can make it difficult to determine the appropriate amount of capital a bank requires in order to reestablish sustainable cash-based profitability. To recapitalize banks adequately but not excessively, the government needs tools to constrain the effects of uncertainty.

One mechanism is to sell to a government-owned asset management company the debts giving rise to excessive uncertainty, eliminating future risk to the bank arising from these debts and thereby eliminating the source of uncertainty. In this case, bank managers would have no future responsibility for restructuring the debts. (Against a decision to sell the debts to an asset management company must be weighed considerations such as the impact of severing the bank relationship on the value of the debts. See chapter 8.)

A second mechanism that can be used when banks retain the debts is to issue a government guarantee to, in effect, constrain uncertainty regarding the range of possible outcomes in debt restructuring. One example would be where government provides a guarantee against losses in excess of a predetermined amount. Another example is where banks establish a

subsidiary to which the debts are sold (for example, a so-called “bad bank”), but where the value of the subsidiary’s asset portfolio benefits from some form of government guarantee. There are many possible variations on this type of mechanism.

In effect, these mechanisms for eliminating or constraining uncertainty can overcome an information constraint that otherwise may undermine the implementation of support to banks. They allow for the adequate recapitalization of banks with government support, while permitting additional time to determine the outcomes of the restructuring of certain debts. They can be particularly useful for inducing new strategic investment by the private sector as part of the provision of government financial support.

In summary, the following principles and guidelines are intended to inform the process of resolving, recapitalizing, and restructuring banks:

- Take aggressive action to promote recapitalization by existing shareholders
- Base the choice of resolution mechanism (liquidation, assisted acquisition, and nationalization) on an assessment of least-cost
- Leverage public funds to attract equity financing from the private sector for assisted acquisitions or as a participant in nationalization
- Actively manage the risks associated with nationalization
- Take steps to minimize the risks associated with granting forbearance
- Have recapitalization take the form principally of equity capital
- Base the government’s decision to invest new equity capital in a bank on rigorous analysis of prospective profitability
- Ensure that recapitalization is accompanied by aggressive restructuring
- Ensure that sufficient new equity capital is involved in recapitalization so as not to create the expectation of further rounds of public support
- When uncertainty is high, take steps to insulate recapitalized banks against further major losses.

CHAPTER 6. PRIVATIZING BANKS

The preceding chapter described how the government may acquire an ownership interest in banks in conjunction with the provision of equity capital support. A key task for the crisis management team is to develop an exit plan for those ownership positions. The basic goal is to return the governance and ownership of banks to the private sector as quickly as possible. Early privatization should be pursued for at least four reasons.

First, early privatization can demonstrate the resolve of government to do what is necessary to restore the financial and operational soundness of the banking system. This can give an important boost to domestic and international market confidence and reactivate the functioning of the banking system. It also can stimulate more investor interest, which can increase competition and raise values.

Second, privatization can reveal the true condition and value of the bank and, by extrapolation, can help the crisis management team and others in government to diagnose more accurately the depths of the problems facing other banks and their major debtors. It creates a market test that provides valuable information not obtainable by other means.

Third, experienced and well-qualified private sector owners and managers with capital at risk are likely to do a better job than government in carrying out the operational and troubled debt restructuring necessary to achieve sustainable profitability. Investors able to exert professional governance and bring to bear expert management likely will upgrade strategic and business planning, risk management practices, and internal controls. These practices and technologies eventually can be transmitted to other banks.

Finally, the authorities can use the transparency arising from selling banks to informed investors to test the veracity of their supervisory, accounting, and auditing processes for measuring and reporting the condition of banks. They can use this information to improve regulation and supervision.

There are several alternative means for selling government's ownership stakes in banks. In general, stakes can be sold via a formal auction process, via direct negotiations with an interested buyer, or via the sale of shares on a stock exchange. In circumstances where government has

provided support to a bank while allowing shareholders to retain an equity interest and role in governance, the shares might be sold back to those shareholders.³⁸

Bank privatization via auction or direct negotiation requires that potential purchasers have access to the information necessary to perform due diligence. An auction will have to accommodate the information needs of several interested investors. Providing for the conduct of due diligence is not necessary when government's stake is sold on a stock exchange. Rather, the listing requirements of the exchange need to be fulfilled.

To upgrade the governance and management of a bank and promote sound operational and troubled debt restructuring, potential purchasers should be strategic investors with demonstrated experience in operating banks or other significant financial institutions. In a systemic crisis, this may well imply the acquisition of domestic banks by foreign investors or financial institutions.

Although the crisis management team may be responsible for organizing the process of bank privatization, the bank supervisory agency will have to be involved as well. Consistent with international standards of effective bank supervision, supervisors will need to vet the potential acquiring shareholders and new senior management team. They also should vet the financial terms of the transaction to satisfy themselves that the post-privatization bank is adequately capitalized and meets other prudential standards.

Country Experiences

In Korea, the government nationalized a number of large insolvent banks beginning in early 1998 and immediately launched a process for privatizing them.³⁹ This involved several steps. To oversee the privatization process, the government formed a steering committee chaired initially by a senior staff of the Ministry of Finance and the Economy and then by a senior staff of the Financial Supervisory Commission when it was created in April 1998. The committee initiated a process to evaluate and select investment banks to market the banks and assist the

38. This might be the case where government has financed the assisted acquisition of an insolvent bank by a financially weak yet well-managed bank, while simultaneously supporting recapitalization of the weak bank itself.

39. The two banks nationalized in early 1998 were subjects of the initial privatization process.

government with the sales. An international accounting firm was contracted to generate and organize the information necessary to support due diligence. An independent international consultant was hired to provide general advice and support to the government, especially in clearly defining its privatization objectives, managing the process of contracting with the investment banks, and agreeing on the overall structure of transactions that would be acceptable to government.

Although the originally stated intention was to privatize the banks through a transparent international auction, that process broke down. Apparently, the investment bank's estimated value of the banks to be sold did not meet government expectations. When the banks were first nationalized and partially recapitalized, the authorities publicly declared that the banks were fully recapitalized, which may have unrealistically raised expectations. There also were concerns about the structure of the deal proposed by the investment bank, especially about the contingent liabilities that government likely would have to accept. In the end, the one privatization transaction that was achieved, involving the sale of 51 percent of Korea First Bank, was concluded via direct negotiations between the purchasers (a private investment group) and the government.

In Thailand, the sale of some nationalized local banks to foreign banks, which for the first time were granted the right to operate full branch networks and to raise local funding, was a significant milestone for the financial system. Sales were conducted by sealed bids followed by direct negotiation with the winner.

Although foreign banks are not expanding aggressively due to the lack of sound lending opportunities, competition among banks has intensified. The entry of global banking networks with local distribution capacity, the rising costs of information technology and multiple distribution channels (branch, telephone, Internet), scarce management talent, competition from nonbanks, and declining margins throughout the region have increased competition. These forces may favor further consolidation.

In Indonesia, the government nationalized 13 banks in all. Four large, but severely insolvent, banks were nationalized early in the crisis. Another nine were nationalized as a consequence of the failure of the private bank recapitalization scheme (see chapter 5). IBRA has

merged nine of these banks into a single bank (Bank Danamon).

Privatization results to date have been limited to the partial privatization of Bank Central Asia, where Parliament approved the sale of up to 40 percent of the government's shareholding in two tranches—30 percent through a strategic sale and 10 percent through a public offering. The divestment of 51 percent of the government's holdings in Bank Niaga also was approved. In addition, Bank Mandiri—the state bank formed by the merger of four state banks—has announced its intention to sell a minority interest in the fourth quarter of 2001.

Assessment

The slow progress in selling nationalized banks in the countries covered here suggests that bank privatization presents difficult challenges for governments. Although part of the challenge is procedural, much of it relates to unrealistic expectations and failure to lay the necessary political groundwork to build a consensus for privatization.

Unrealistic expectations by senior politicians, government officials, and the public may be the most formidable threat to privatization. These groups often lack a clear understanding of market-based valuation principles and practices, which consider not only the finances of the bank but also the country's legal and judicial regimes, overall business environment, tax laws, and other factors that weigh on the potential risk-adjusted return on an investment in a bank. Although they may genuinely believe that the government's stakes in banks are worth far more than potential investors' valuations, these beliefs rarely are supported by hard financial analysis. Yet from the experiences of the countries reviewed here, these expectations clearly can undermine bank privatization.

Laying the political groundwork to facilitate privatization would have helped. For example, the costs associated with continued government ownership of banks was not made clear in any of three countries. Similarly, the potential benefits of foreign entry for domestic users of financial services were never widely advocated. Steps such as these would have helped to overcome political resistance to privatization.

Guidelines and Principles

It is important to consider the consequences for privatization when providing interim support to nationalized banks. Publicly proclaiming that partial recapitalization has restored the bank to health (likely done in an effort to restore market confidence, but implying full recapitalization) can undermine the ability of government subsequently to privatize the bank, since the investor's due diligence will reveal that further government support is required. The authorities will be constrained by their prior public statements and will have incentives to delay privatization in the hope that the condition of the bank will improve and the gap in valuation will diminish. The opposite is more likely to occur.

It also is important to lay the political groundwork to support privatization. The crisis management team needs to have a political strategy to support privatization. In part, this includes promoting realistic expectations regarding the value of nationalized banks among top political authorities and the public. It also means promoting an understanding of the costs of prolonged government ownership, in terms of not only fiscal costs but also the scope and quality of financial services.

The structure of the deal can be used to mitigate the potential consequences of unrealistic expectations. One means is by structuring transactions with upside potential for government. Another is by offering guarantees that can boost the headline sales price.

Privatization by means of selling shares on the stock exchange should be approached with caution. Weaknesses in the listing requirements of a stock exchange can mean that selling shares will result in insufficient disclosure of the bank's financial condition, in particular the adequacy of equity capital to support the risks run by the bank. As a consequence, it is unlikely that the bank will be adequately recapitalized prior to sale, a fact that investors eventually will discover, to the discredit of government. Moreover, in many countries, the resulting widespread bank ownership may not provide for adequate bank governance. Banks sold in this manner may be left poorly governed and managed and financially vulnerable.

Financial crises provide unique opportunities to achieve higher levels of professional ownership of banks, while at the same time reducing costs to government and reducing institutional demands. Selling banks to investors with the capacity and resources necessary to ensure the sound governance and management of the bank in many instances may imply increased

foreign entry. The potential benefits and drawbacks of foreign entry continue to be the subject of much debate. Nonetheless, it seems clear that increased ownership of domestic banks by world-class international financial groups has important benefits.⁴⁰ To the extent that foreign capital can substitute for public sector capital in recapitalizing core elements of the banking system, the up-front cost to government of financing crisis resolution can be reduced. To the extent that foreign financial groups can assume governance responsibilities, the institutional burden on the crisis management team can be reduced.

In summary, the following guidelines and principles are intended to improve the privatization of banks:

- Consider the consequences for privatization when providing interim support to nationalized banks
- Lay the political groundwork to support privatization
- Structure the deal to mitigate the potential consequences of unrealistic expectations
- Approach with caution privatization by means of selling shares on the stock exchange
- Seize the unique opportunities to achieve higher levels of professional ownership of banks, while reducing the costs to government and the demands on its institutions.

CHAPTER 7. RESTRUCTURING TROUBLED DEBT

One of the most critical, yet difficult, tasks involved in bank recapitalization and restructuring is the restructuring of troubled debt. Troubled debt restructuring should be a routine function for banks, an integral part of the lending business. Prudent bankers act aggressively to minimize losses when debtors are unable to meet the contractual terms of their obligations.

40. Among these benefits at the bank level are improved governance, strategic, and risk management practices and higher standards for accounting, auditing, disclosure, and transparency. The bank supervision function can be strengthened as a result of the bilateral arrangements with the home-country supervisor of the acquiring bank. Even though foreign banks may serve only a limited segment of customers, at least initially, countries in which foreign banks have a meaningful presence tend to have better banking services and more resilient banking systems.

Policies, procedures, and skills that ensure prompt recognition of troubled debts and promote actions to maximize collection are key to sustaining bank profitability and solvency.

Although debt restructuring is never an easy process for either bankers or debtors under the best of circumstances, if it is addressed sufficiently early, bankers and the shareholders and managers of firms can have incentives to work together to achieve mutually beneficial restructuring outcomes. Bankers typically employ options such as those set out in table 1 in order to improve long-run collection and salvage the profitability of the customer relationship.

Table 1: Basic Options for Restructuring Troubled Debts

| <i>Option</i> | <i>For firms</i> | <i>For banks</i> |
|---|---|---|
| Extend principal and interest maturity (due date) | Reduces debt service (cash flow requirements) over the near term, with no effect on profitability and no effect on capital. | For firms with temporary problems that can service all accumulated debt. Bank incurs no economic loss. |
| Reduce interest rates | Reduces debt service, improves profitability, and increases capital. | For viable firms unable to service all accumulated debt. Bank recognizes an economic loss over time in accounting terms. |
| Accept equity in lieu of debt repayment (debt-equity swaps) | Reduces debt service, improves profitability, increases capital, and changes ownership structure | For viable firms with prospects for recovery. Bank immediately recognizes a likely economic loss in accounting terms when equity is recorded at minimal value. Increases the potential to exert governance over firms, but creates potential conflicts of interest with the bank as owner and creditor. Creates upside potential to participate in firms' recovery. |
| Accept assets in lieu of debt repayment | Reduces debt service, reduces assets, and may increase capital. | For downsizing or nonviable firms. Bypasses weak foreclosure framework. Requires management of real estate, plant, equipment, and so forth. |

| | | |
|--|---|--|
| Forgive a portion of the debt (debt write-downs) | Reduces debt service and increases capital. | For firms unable to service all accumulated debt, where repayment of remaining debt is more certain and exceeds the anticipated proceeds from liquidation. Bank immediately recognizes an economic and accounting loss without the potential for recovery. |
|--|---|--|

The nature of the contracting environment in a country can substantially influence the incentives facing banks and debtors. Especially important are contract enforcement provisions such as foreclosure and bankruptcy. Where lenders are unable to execute liens on collateral or force debtors into bankruptcy, debtors may have incentives to avoid constructive debt restructuring, and lenders may have few incentives to pursue it.

The usual role of government in troubled debt restructuring is to provide an enabling environment. Debt restructuring negotiations and decisions are left to bankers and debtors. Providing an enabling environment involves establishing guidelines for accounting treatment (such as when income and losses are to be recorded), regulatory treatment (loan classification, provisioning, and disclosure requirements), and tax treatment (such as the deductibility of loan write-offs from taxable income and the taxability of write-offs for firms). It involves adopting sound bankruptcy and foreclosure laws and putting into place the necessary public institutions to support use and enforcement of those laws. Beyond this, government involvement will be limited to overseeing bankers' performance in restructuring debts as part of routine bank supervision.

In certain situations, the authorities (usually central banks or bank supervisors) may become more active in facilitating the conclusion of a debt restructuring agreement. This may be the case for large, complex, systemically important, or politically sensitive firms indebted to a large number of banks. Governments use techniques such as the so-called "London rules" for motivating and coordinating restructuring actions by bankers and debtors. In essence, these techniques involve a standstill period that allows bankers and debtors to negotiate what is essentially an out-of-court restructuring. Rules governing parties' conduct during the negotiation and voting procedures for approval also are likely to be included.

In systemic crises, where large numbers of banks and debtors are experiencing severe financial (and operational) problems, the incentives facing bankers and debtors may well change, with neither party willing to restructure troubled debts. Managers of banks that may be revealed to be insolvent in accounting or regulatory terms as a result of the losses they would incur under debt restructuring may either delay restructuring or engage in cosmetic restructuring that defers recognition of the inherent economic losses (see box 3). Similarly, debtors that may well be insolvent under the contractual terms of their debts may have few incentives to enter into restructuring negotiations that may reveal insolvency, require the sale of assets to raise cash, or result in foreclosure or bankruptcy. Moreover, suspecting that banks are economically insolvent, debtors may see no long-term relationship value (especially the possibility of new loans) in continuing to service their bank debts. Debtors may conserve cash for internal working capital rather than service their debts.

Box 3: Common Forms of Cosmetic Restructuring

Cosmetic restructuring essentially postpones the recognition of losses and can take many forms. Most common is the deferral of required debt service payments by granting extended grace periods but where the debtor is unlikely to be able to make the payments. Another is to remove the weak asset from a bank's books, while retaining the ultimate credit risk (by, for example, selling debts to bank-owned or bank-funded affiliates like so-called "bad banks"). A third common form is the transfer of debts to government-owned asset management companies "with recourse," where the originating bank retains some or full responsibility for losses. Conversion of debt into equity carried at inflated values is a fourth common form. Finally, it is not uncommon for bank managers to engage in reciprocal transactions with managers of other banks for the purpose of postponing the recognition of losses.

Government action in response to a systemic crisis can compound this problem. Action that increases uncertainty (for example, by suspending, but not resolving, banks) or demonstrates indecisiveness (such as failing to determine the disposition of assets in banks to be closed) can further undermine the basic credit culture in a country. Asset resolution processes that allow defaulted debtors to buy back their debts at low prices have a similar effect. Ill-designed programs for reducing nonperforming loans can encourage debtors to default.

Regardless of their cause, these types of breakdowns in the normal debt restructuring process can be costly. For banks, the suspension of debt service by even a small number of debtors can result in negative cash flow, contribute to bank illiquidity, and drive up funding costs

(see box 4).⁴¹ This growing illiquidity reinforces banks' unwillingness to lend to any firm, further curtails the availability of credit in the economy, and may lead to a larger than necessary decline in output.⁴² The failure of debt restructuring to proceed also may delay necessary operational restructuring by banks and firms.

Box 4: When Bank Cash Flow Turns Negative

Table B4.1 depicts the financial structure of a sample bank. Given this financial structure and the annual level of non-interest earnings and non-interest expenses, table B4.2 depicts the point at which the suspension of debt service can cause the bank's cash flow to become negative under different interest rate scenarios, expressed as a percentage of total loans. For example, in a market where the average asset yield is 20 percent and the average cost of funds is 15 percent, cash flow can be negative when debtors cease meeting interest payments on 22 percent of total loans.

In a systemic financial crisis, the stakes for governments therefore become much greater, and it may no longer be in government's best interest to limit its role to creating an enabling environment. It may become appropriate, perhaps urgent, for government to take a more active role in promoting debt restructuring.

Government can have at least four goals in more actively promoting debt restructuring. One is to stem the flow of new finance to nonviable firms, since this flow may well increase bank losses.⁴³ A second is to promote the operational restructuring of debtors so as to improve profitability, solvency, and liquidity. A third goal is to prevent a general deterioration in credit discipline among debtors as a result of widespread inaction by bankers. Finally, government might wish to ensure that the debts of sound but overly indebted corporations are restructured in order to prevent excessive liquidations of firms, although in practice this is rarely a threat.

41. Banks will respond to the cash flow problem by bidding more aggressively for funding, raising deposit rates. This increases the carrying costs associated with debts on which debt service has been suspended, accelerates the decapitalization of banks, and raises government's contingent liability as the guarantor of bank deposits. By putting upward pressure on market interest rates, it also may increase government's own financing costs.

42. Declining output, in turn, reduces tax revenues, increases social expenditures and tensions (such as those arising from higher unemployment), and worsens the condition of banks and firms, further raising potential costs for the government. A downward spiral may ensue.

A more active role for government in promoting debt restructuring can involve establishing incentives for bankers and debtors to engage in debt restructuring, such as preferential tax or accounting treatment of losses. It can involve adopting more strict prudential regulations addressing debt restructuring (such as loan classification and provisioning rules) and aggressive enforcement efforts. It can include regulating the financial structure of firms. Government can act directly in debt restructuring by leveraging its ownership interests in banks (either public banks or those in which it has acquired an ownership interest in exchange for financial support) or by creating a public asset management company that purchases debts from banks. In general, the governments of Korea, Thailand, and Indonesia employed all these roles in a variety of forms and combinations.⁴⁴

Country Experiences

The Korean government took a multipronged approach to corporate restructuring. First, the most troubled chaebol were forced into court-supervised insolvency during 1997 prior to the onset of the crisis. Second, the government adopted regulations requiring chaebol to, for example, reduce their debt to equity ratios to 200 percent and eliminate cross-guarantee of affiliated firm's debts. Third, the government required the five largest chaebol to agree to capital structure improvement programs with their lead creditors, tightened exposure limits, and investigated improper transactions among related affiliates within each chaebol. And fourth, for the less troubled groups from among the second tier of chaebol (the "6-64"), the government promoted bank-led out-of-court debt restructuring by orchestrating a corporate restructuring agreement among local financial institutions. This agreement, which was signed by nearly all Korean financial institutions, set a two- to five-month timeline for concluding debt workout agreements, designated a lead creditor, established a creditor standstill period, and set a 75 percent threshold for creditor approval of workout agreements. A Corporate Restructuring Coordination Committee was formed to provide guidance and arbitrate differences between creditors.

43. Bankers may have incentives to provide new finance to nonviable firms so as to obscure the debtor's true financial condition.

44. For a detailed treatment of the troubled debt restructuring process in the three countries, see Mako (2001).

The Korean government used KAMCO initially as a means to remove nonperforming loans from the portfolios of all banks (and some other financial institutions).⁴⁵ Over time, KAMCO was used more selectively to purchase nonperforming loans from troubled banks benefiting from government support. See chapters 5 and 8.

In Thailand, the government relied on bank-led, out-of-court restructuring. Initially, the government promulgated principles modeled on the London rules and established the Corporate Debt Restructuring Advisory Committee (CDRAC), representing debtors and creditors. Later, through CDRAC, the Bank of Thailand promulgated workout contracts between debtors and creditors specifying timelines for progress on reaching workout agreements and requiring creditors to pursue court-based remedies in cases of failure to make satisfactory progress. The role of the Financial Sector Restructuring Authority was limited to bundling and auctioning the assets of closed finance companies. The government created a public asset management company to serve essentially as a buyer of last resort for finance company assets, with the intention of creating competition for the assets and preventing them from being sold for too low a price. Later, Thailand promoted creation of asset management companies by banks and established other government-owned asset management companies (see chapter 8).

In Indonesia, the government's strategy for corporate restructuring had a number of components. The Indonesian Bank Restructuring Agency acquired most of the nonperforming loans of state-owned banks and private banks benefiting from government support. It was felt that this specialized institution would be able to realize greater value from the assets than would the bankers. The government also introduced the so-called Jakarta Initiative Task Force (JITF) to facilitate non-IBRA corporate restructuring. JITF was geared toward restructuring involving mainly foreign creditors. It was intended as a one-stop shop that would serve as an efficient interface for the various government agencies with a role in authorizing and executing debt restructuring. Modeled on a program used in Latin America, the government established the Indonesia Bank Restructuring Agency to protect creditors and lenders against foreign exchange

45. KAMCO is a government-controlled entity. The government and a public bank (Korea Development Bank) own 69 percent of KAMCO, with the remaining shareholdings spread among 32 other Korean financial institutions.

risk, in effect guaranteeing the availability of foreign exchange to service restructured debts.⁴⁶ The government also sought to improve the bankruptcy process.

Assessment

Korea's performance has been distinguished by the ability of creditors to put a number of chaebol into receivership and gain control of the affiliates of one of the top five chaebol (Daewoo), thus demonstrating that no chaebol is "too big to fail." When the Daewoo crisis broke in mid-1999, creditors resorted to a package of rate reductions, term extensions, grace periods, and debt/equity conversions to stabilize \$80 billion in Daewoo debt, while proceeding with the breakup and sale of the chaebol. Quick agreement among bankers and nearly 20 of the second-tier chaebol helped to restore financial stability. These involved roughly a 4:1 mix of debt restructuring and corporate "self-help" (such as asset sales). Less progress has been seen with the weaker second-tier chaebol, which are in "workout." Although there have been some sales of businesses and real estate and some additional changes in management, Korea's workout chaebol have yet to undertake deep operational restructuring. Indeed, 17 companies entered second-round workouts by mid-2000—with further extensions of terms and grace periods, rate reductions, and additional debt/equity conversions. Overall in Korea, debt levels have not been substantially reduced, and many firms continue to be unable to meet accrued interest payments.⁴⁷

Corporate restructuring in Thailand has been stymied by the country's weak insolvency and foreclosure regimes, which left almost no incentive for debtors to cooperate with voluntary workout efforts. The Financial Sector Restructuring Authority's limitation on the management of assets and its lack of super-administrative powers further encouraged the rise of "strategic defaulting." Corporate workouts picked up momentum in 2000, but the emphasis was on extensions of maturity and some modification of interest rates, with little evidence of operational restructuring. Creditors have gained some successes in bankruptcy court, notably control over Thai PetroChemical's \$3 billion reorganization, suggesting that there may be some long-term

46. Only one borrower used this program, which, being judged not successful, was terminated.

47. In the summer of 2000, the government announced a second round of financial restructuring aimed, in part, at resolving these firms.

deterrent benefits from the crisis, but even that case is still a question.

To date, Indonesia has achieved neither financial stabilization nor operational restructuring. IBRA has assumed responsibility for some Rp256 trillion in face value of loans, the bulk of which is represented by just 21 politically well-connected obligors. IBRA is committed to restructuring 70 percent of these loans by the end of 2000. The quality of the recently announced restructuring of several large corporate debtors (for example, Texmaco), however, is not encouraging. Lengthy maturities (12–15 years) coupled with long grace periods (up to eight years for principal) raise concerns about the true economic viability of the underlying firms. Since mid-2000, however, there has been a surge in debt restructuring deals coming out of the JITF, as fatigued creditors and debtors have attempted to normalize their relationships in the face of macroeconomic recovery. Like the IBRA restructurings, the JITF restructuring agreements heavily emphasize rate reductions, term extensions, and grace periods.

Overall, there remains considerable debate regarding the soundness of the debt restructuring strategies employed by the three governments. A final conclusion can be drawn only after the passage of more time. One key question is whether governments have done enough to leverage public funds as a means to change the incentives facing bankers and debtors to promote constructive debt restructuring. This question is explored in chapter 10.

Guidelines and Principles

Early steps to upgrade the legal framework and judiciary processes may be required. Weak regimes for bankruptcy and foreclosure may provide incentives for bankers and debtors to avoid participating in restructuring negotiations and may distort the outcomes of restructuring. They may increase losses for banks and for government. If improvements cannot be made directly to the permanent legal regime, temporary powers might be granted under special legislation adopted for tackling the crisis.

London club-type approaches (moral suasion) may not work well in markets with weak legal regimes. Without the threat of a credible alternative such as bankruptcy, borrowers have little incentive to undertake and conclude debt-restructuring negotiations. London club-type approaches provide a good guide to the organization of negotiations, information requirements,

and obligations of the various parties to the negotiation. To be truly effective, however, they need enforceable timelines and credible alternative actions that will lead to a worse outcome for all participants.

A key challenge for the crisis management team is to adopt and monitor controls on cosmetic restructuring. One goal is to control the abuse of grace periods for interest and principal payments. Normally, grace periods should be limited to reasonable periods of time—say, less than two years—and should be granted only to debtors able to demonstrate that their cash flow problems are only temporary and that they can service the debt in full under its restructured terms. Controls also should be placed on equity valuations to ensure that debt/equity swaps are not used to avoid loss recognition. Unless the equity of the company is actively traded and a market price is readily determined, it should be booked at a negligible value. Transfers to affiliated companies or transfers to third parties with recourse (continuing liability for loss) should not be permitted to reduce the required levels of loss provisions.

Banks should be inhibited from refinancing unsustainable levels of corporate debt. A common source of higher costs to government is the continuing provision of finance to firms unable to repay the new credit. These funds frequently are squandered or looted.

When government has substantial ownership interests in banks, it must act as principal in the debt-restructuring process. Promoting sound debt restructuring is a key element of government's role in exerting governance over the banks it has nationalized. The crisis management team needs to ensure that bank management is operating under clear guidance and to monitor bankers' performance. There is considerable risk of political interference in debt restructuring decisions. This, again, emphasizes the importance of making up-front institutional arrangements for crisis management that serve to insulate the technical work of crisis resolution (see chapter 2).

Effort should be made to ensure that debts are restructured before debtor cash flow is exhausted. One shared goal of the debt restructuring process is to salvage as much value as possible. When firms with valuable facilities and operations exhaust cash flow (and are unable to pay for salaries, supplies, facilities maintenance, and the like), there may be significant destruction of value. This fact highlights the importance of obtaining information on the cash flow

situation of large debtors (see chapter 4).

Shareholders of firms unable to service their debts and requiring debt relief should be made to bear significant losses. If many otherwise sound firms are unable to service their debts fully, debt restructuring may well imply debt relief to firms, which benefits shareholders. In these cases, firm shareholders cannot be immunized from loss; rather, they should be made substantially poorer.

The domestic financial system should be inhibited from refinancing the foreign debts of firms. Substantial pressure may be brought to bear on government to see that foreign creditors are repaid by means of new credit obtained from the domestic financial system, deepening the losses for domestic banks and for government. The crisis management team and government need to ensure that losses are allocated appropriately to foreign creditors.

Operational restructuring is a key component of debt restructuring. Successful troubled debt restructuring is more than simply a financial engineering exercise. Debtor operational restructuring usually will be required so as to increase the capacity to service debt and minimize losses to debtors, banks, and government. This has clear implications for the base of skills necessary for banks and the crisis management team.

In summary, the following guidelines and principles are intended to improve the restructuring of troubled debt:

- Upgrade the legal framework and judiciary processes early in the process
- Have limited expectations for London club-type approaches (moral suasion) in markets with weak legal regimes
- Take steps to limit cosmetic restructuring
- Inhibit banks from refinancing unsustainable levels of corporate debt
- Have the government act as principal in the debt-restructuring process when it has substantial ownership interests in banks

- Ensure that debts are restructured before debtor cash flow is exhausted
- Ensure that shareholders of firms unable to service their debts and requiring debt relief are made to bear significant losses
- Resist pressures to refinance domestically the foreign debts of firms
- Make operational restructuring a key component of debt restructuring.

CHAPTER 8. UTILIZING GOVERNMENT ASSET MANAGEMENT COMPANIES

In the context of a systemic crisis, a government asset management company (AMC) is one means of reducing the cost to government of crisis resolution. In principle, a government AMC can maximize the value of banks and bank assets.

A government AMC can maximize the value of banks by reducing the burden on bank management, reducing risks, and improving information. Selling assets (usually nonperforming loans) to an AMC relieves bankers of further responsibility for debt restructuring, eliminates any future risk of loss arising from the assets, and makes transparent the losses inherent in the assets. Bankers, freed from the burden of restructuring the assets sold to an AMC, are able to devote their attention to other tasks. Eliminating the risks associated with the assets sold reduces uncertainty regarding banks' finances, which can accelerate the process of recapitalizing and restructuring banks, reduce recapitalization requirements, and improve the prospects for raising private capital for recapitalization.

A government AMC also can maximize the value of bank assets. One means is by bringing to bear more expert skills in the restructuring, management, and disposition of assets than individual banks are able or willing to acquire for themselves. Another means is by consolidating debts to a single troubled debtor that are held by a number of different banks. This centralizes the analysis and decisionmaking associated with debt restructuring negotiations or bankruptcy, foreclosure, or other liquidation proceedings.

The scale and scope of operations of an AMC can vary. It may have powers to restructure assets or simply to collect or sell assets. It may handle a relatively narrow class of assets—for

example, only clearly nonviable firms with no bank/firm relationship value—or only debts that can take advantage of an AMC’s potential capacity for specialized liquidation (for example, commercial real estate projects). Where a government nationalizes banks, the AMC might serve as an organizational means to handle a wider range of debt restructuring and asset sales.⁴⁸ In severe crises, where many banks require financial assistance, the large volume of troubled debts coupled with lack of bank institutional capacity may suggest a broad role for a government AMC (see box 5 for a listing of the potential purposes, benefits, and drawbacks of using government asset management companies).

48. Managers of private banks might use asset management subsidiaries in a similar manner.

**BOX 5: PURPOSES, BENEFITS, AND DRAWBACKS OF ASSET MANAGEMENT COMPANIES
IN THE CONTEXT OF SYSTEMIC CRISES**

Possible purposes

- Recapitalize banks by purchasing assets at greater than market value
- Finance support to banks, while avoiding explicit fiscal consequences (the asset management company buys assets with its own debt, which, though guaranteed by government, is not accounted as a fiscal responsibility)
- Reduce bank capital needs and bolster reported regulatory capital
- Reduce uncertainty associated with bank assets when attracting new investment or selling banks
- Serve as a repository for credits to nonviable corporations (credit risk and management responsibility are transferred to the asset management company)
- Raise additional, nongovernment finance (the asset management company issues debt to third parties)

Potential benefits

- Specialized restructuring and collection expertise
- Ability to aggregate debts from many banks into a single creditor unit
- Economies of scale
- Severance of personal or economic ties between bankers and debtors that give rise to conflicts of interest
- Special legal powers that facilitate restructuring and sale

Potential drawbacks

- Loss of asset values
- Loss of bank relationship value to firm and associated incentives to repay or restructure debts
- Loss of relevant information regarding the firm and its prospects
- Deterioration in credit culture

- Lost opportunity to develop troubled debt restructuring skills in banks
- Less expert management
- Drive for self-preservation and pressure to become a permanent (loss-making) institution
- High degree of political influence.

The effectiveness of AMCs in maximizing the value of banks and bank assets has varied in practice. Whether responsible for restructuring debts or simply liquidating assets, AMCs in a number of instances have failed to achieve the objectives for which they were established. This has been due to political interference and to weak legal and institutional environments (Klingebiel 2000).

Regardless of its scope, to be successful, an AMC needs a clearly defined mandate that is consistent with government's crisis resolution strategies. Its objectives and goals must be explicitly defined. Where possible, they should be quantified. An AMC requires clearly defined operating policies and procedures. Like any organization, the AMC needs proper external and internal governance and transparency to be credible and successful. It needs effective management authorized to make business decisions in accordance with set goals and objectives without political interference. It needs an appropriate organizational structure tailored to its scope of operation, the types of assets handled, and the resolution strategy pursued. It should have resources sufficient to build the necessary institutional capacity.

An AMC might be granted special powers to overcome deficiencies in the legal framework and judicial processes. Such powers can enhance the AMC's ability to restructure assets more quickly and to maximize recoveries. It also might be granted extraordinary powers to hire and compensate staff outside the normal civil service limitations.

Country Experience

In Korea, KAMCO was created in the early 1960s to collect troubled debts for banks in return for a fee. In late 1997, the government created within KAMCO the Fund for Resolution of Nonperforming Loans, with initial capital contributions by the commercial banks, the Korean

Development Bank, and the KIDIC. This fund, to be managed by KAMCO, was used to acquire nonperforming loans from bank and other financial institutions. Twice in 1997 and again in 1998, the National Assembly authorized KAMCO to issue government-guaranteed bonds to finance these acquisitions.

Between November and December of 1997, KAMCO purchased half the qualifying nonperforming loans of commercial, merchant, and specialized banks.⁴⁹ The principal purpose was to improve these institutions' reported financial statements, including the regulatory measure of capital. Initially, no substantive conditions were imposed for restructuring or recapitalization in conjunction with these purchases. The government of Korea revised this policy in early 1998, and thereafter purchases of nonperforming loans were limited to banks whose recapitalization and rehabilitation plans were approved, usually in the context of government acquisition of an ownership stake in the bank.

KAMCO acquired thousands of individual assets, principally operating and closed-down factories and commercial real estate. Except in the case of Daewoo, it played little role in corporate restructuring. Assets were originally acquired at above-market prices, but eventually at approximate market prices, on average at around a 60 percent discount from face value. In many instances, the selling banks retained some contingent liability for loss. KAMCO collects, sells loans, and forecloses and sells collateral. It also engages in financing transactions (securitizations) in order to raise additional cash to finance more purchases. Under these transactions, KAMCO and the originating banks retain contingent liabilities for loss on the assets securitized. KAMCO uses similar mechanisms to form joint ventures with private firms that have asset management expertise. The joint ventures give the joint venture partner contract management responsibility and give KAMCO the ability to participate in any increase in the value of the assets.

In Thailand, banks and the government tried to manage nonperforming loans through several types of AMC's. A 100 percent government-owned AMC was created in 1997 specifically as a bidder of last resort for the assets of 56 liquidated finance companies. Another state agency,

49. At that time nonperforming loans were defined as collateral-backed loans in which interest payments are overdue for six months.

the Financial Sector Restructuring Agency (FRA), conducted the sale of those assets in a series of auctions. The government AMC was allowed to bid competitively in the second round of bidding of assets only if the private sector did not meet the reserve price in first-round bids. This AMC issued debt not guaranteed by government to pay the FRA for assets purchased. Its mandate was to preserve capital and to sunset, but management took a lenient approach to debt workouts.

The Financial Institutions Development Fund set up two other asset management companies to manage nonperforming loans of individual state-owned banks. A group of private third-party asset managers were to manage tranches of nonperforming loans on behalf of one AMC. When the government sold a nationalized bank, its nonperforming loans were transferred to a third AMC owned by the Financial Institutions Development Fund. The purchasing bank manages this AMC under a gain- and loss-sharing agreement, under which the purchaser shares 5 percent of gains and 15 percent of losses incurred in loan workouts.

For the private banks, the government took a market-led solution by providing public funds on a matching basis with new private capital as a last resort and by encouraging the establishment of private asset management companies. Tax disincentives for the establishment and operation of private AMCs were eliminated. However, private AMCs did not progress as hoped. Most banks established asset management companies as wholly owned subsidiaries, and the parent banks continued to bear the risk of the assets. Most asset management companies were still managed by the banks rather than by third-party specialists. The transfer price of these nonperforming loans was at book value, and auditors did not recognize these transfers as true sales.

As described in chapter 2, in Indonesia the government set up IBRA in early 1998 with a wide range of responsibilities, including that of an asset management company. IBRA in effect acquired assets from banks at face value in exchange for direct government obligations, including fixed and floating bonds and domestic currency bonds indexed to the U.S. dollar.⁵⁰ IBRA set up three operational units to manage the assets acquired: the Asset Management Credit Unit, the

50. In fact, the loans were written off by the banks, which then were recapitalized with direct government obligations (not IBRA debt). IBRA booked the assets at face value, reportedly to avoid loss recognition on the government accounts.

Asset Management Investment Unit, and the Bank Restructuring Unit.

The Asset Management Credit Unit restructured and disposed of nonperforming loans transferred to IBRA from recapitalized state-owned and private banks and from nationalized banks and banks placed in liquidation. Nonperforming loans transferred to IBRA from state-owned banks accounted for the major portion of those assets. IBRA also was responsible for disposing of a small portfolio of other assets, such as buildings, land, office equipment, artwork, and vehicles, acquired from these banks.

The Asset Management Investment Unit was responsible for recovering assets pledged to IBRA by the previous owners of nationalized banks and banks placed in liquidation to settle the owners' liabilities stemming from violations of lending limit regulations. The previous owners were asked to sign shareholder settlement agreements and to pledge certain assets to IBRA. In most cases, however, the owners were able to retain their operational control over companies whose shares had been pledged.

The Bank Restructuring Unit was responsible for managing and disposing of shares of banks recapitalized by the government. Its task was to improve performance and efficiency of banks under its control and to enhance the value of government's investments in those banks.

Assessment

In the countries reviewed here, government asset management companies have not proven to be a panacea, consistent with prior experience in other countries (such as Mexico). They have suffered a number of weaknesses, which are reviewed briefly here.

In the case of Korea, KAMCO initially was intended to strengthen banks' reported financial statements using off-budget financing, as the debts were purchased from banks in exchange for bonds issued by KAMCO. Similarly, IBRA faced problems stemming from a lack of political consensus regarding its intended role, as well as an inability to recognize losses, a weak and ineffective legal and judicial climate, and continued political interference. Maximizing the value of the acquired assets was a secondary consideration in both countries when the AMCs first began acquiring assets.

In Indonesia and in some instances in Thailand, the loans were acquired at book value, which created incentives to hold rather than dispose of the assets, in order to avoid recognition of the loss. This impeded the sale of assets by IBRA. Moreover, IBRA's sales targets were driven by fiscal targets and were imbedded in IBRA's budget each year. This had the effect of setting the ceiling for sales each year. The desire to ensure the ability to meet the next year's target diminished the incentive to exceed the current year's target.

Thailand tried a number of structures for managing assets held by asset management companies, including having the AMC manage itself, contracting third-party managers, and allowing the assets to be managed by the acquirers of the originating (nationalized) bank. More time will be required to evaluate the relative performance and merits of these alternatives in Thailand.

The structure of sales transactions created problems in some instances. In Korea, the banks often retained a residual exposure to losses arising from the "sold" assets (as, in effect, did the Thai banks in selling assets to their AMC subsidiaries). The banks' full contingent liability may not be reflected on their reported financial statements. The contingent liability in principle gives rise to the need for ongoing management. Indonesia is an exception in that the selling banks retained no further liability for loss.

A weakness common in all three countries was the failure to attract and retain the best professional skills for asset management and disposition. Resource constraints and civil service hiring and compensation restrictions were part of the cause. Failure to attract professional management resulted in poorly defined strategies, weak operating policies and procedures, and other institutional weaknesses. Asset management companies are complex institutions that require a significant investment in capacity building. Building institutional capacity is difficult and costly. Among the tasks are hiring a large number of staff in a short period of time, developing policies and procedures, putting in place proper safeguards to reduce the likelihood of wrongdoing, assembling information, reviewing assets and determining a resolution strategy, contacting borrowers and negotiating repayment plans, organizing asset sales, preparing and filing litigation and other court proceedings, and communicating progress to governance authorities and the public.

These and other weaknesses in practice tended to negate the ability of asset management companies to maximize the value of banks and bank assets. Debts often were warehoused and not restructured in a timely fashion. Debtors had fewer incentives to service debts once they were transferred to asset management companies.

Guidelines and Principles

The government has to be willing to recognize the losses incurred in the crisis. The political will to recognize and finance the portion of losses that cannot be allocated to and absorbed by others is necessary to be able to create appropriate incentives for the restructuring, collection, and sale of debt.

If an AMC is used it should have a publicly defined mandate with clearly defined goals. Making the goals public can reduce the potential for political interference. Senior management of the AMC can be required to enter into performance contracts that include targets designed to achieve the goals.

When determining how rapidly to sell assets, it is important to weigh the costs inherent in holding them. Many factors must be taken into consideration. The assets must be financed, and financing costs can be reduced by rapid sale. Management costs (AMC overhead) similarly can be reduced if assets are sold promptly. By definition, ownership of assets gives rise to risks and holding costs (maintenance, insurance), which normally are transferred to others on sale. Although rapid sale into a market where uncertainty is high may mean receiving lower values, failing to sell can produce an asset overhang (substantial ownership of a class of assets by government), which can forestall the reduction of uncertainty. These factors must be weighed differently for different classes of assets. In any case, the sale must be orderly and generally should begin earlier rather than later.

It is important to craft carefully any special powers granted to AMCs. Although potentially beneficial, the granting of special powers generally will reduce debtor rights and must be viewed with caution. If granted, steps should be taken to prevent the potential for abuse, including by promoting transparency and limiting the lifespan of such powers. Permanent changes in the legal regime applicable to all debtors and creditors are preferable to temporary ones.

Private sector involvement is needed in the asset management process. Under the best of circumstances, government could arrange for the sale of assets directly to the private sector. In practice, this is difficult to orchestrate. In that case, the private sector can be tapped as managers of assets owned by government and as financing and equity partners in asset management companies. This might include the use of special-purpose vehicles in which the government may retain the right to share in ultimate recoveries. Properly structured, such vehicles have the advantage of bringing new money as well as international expertise to the restructuring efforts. They also may speed up the pace of large, complex debt restructuring negotiations by concentrating resources on a few targeted cases.

In summary, the following guidelines and principles are intended to improve the use of government asset management companies:

- Recognize the losses that have been incurred in the crisis
- Provide the asset management company with a publicly defined mandate
- Weigh the costs inherent in holding assets when determining how rapidly to sell
- Carefully craft any special powers granted to AMCs
- Maximize private sector involvement in the asset management process.

PART 2. IMPROVING THE EFFICIENCY OF CRISIS RESOLUTION

Part 1 reviewed the principal actions taken by governments in the three countries, assessed those actions, and suggested guidelines and principles that either were important to the governments' accomplishments or, if adopted, would have improved the results they achieved. Part 2 draws mainly on work undertaken by the World Bank in Korea in 1998 to develop the conceptual underpinnings for two fundamental improvements in crisis management techniques that might have substantially improved outcomes. One key improvement is to have the crisis management team develop an explicit, comprehensive crisis resolution strategy. The second improvement is to link financial restructuring more closely with corporate restructuring. A common theme in both recommendations is to improve the efficiency of government efforts by maximizing the impact of the public funds used in resolving a crisis.

CHAPTER 9. DEVELOPING A COMPREHENSIVE STRATEGY

Resolving a financial crisis is similar to dealing with an urgent and complex business problem in the private sector. As it is for managers in the private sector, a key task for the crisis resolution team is to design and execute a strategy for solving the many problems posed by a crisis.

Explicitly defining a comprehensive strategy is essential because it allows the crisis management team to avoid working in a reactionary mode, merely responding to events. The resolution process is long and complex. Some problems can be solved in weeks, some can be solved in months, and still others may require several years to solve. The problems themselves are intertwined. For example, solutions to financial problems in banks have implications for debt workouts in the large corporate sector and vice versa. Steps taken in nationalizing banks have implications for the government's ability to privatize them. The manner in which nationalized banks are privatized has implications for government's ability to raise private capital to resolve other banks. Moreover, solutions to financial problems have to be tempered by recognition of their political and social implications (for example, foreign entry or layoffs). Adopting a comprehensive strategy enables the crisis management team to integrate the various components

of its work. This form of discipline helps to ensure that the major strategic elements are thought through before significant actions are taken in any one area. Conversely, failure to develop an explicit, comprehensive strategy likely results in actions and decisions that undermine future degrees of freedom, lead to partial and false solutions, and result in higher long-run costs.

Principal Elements of a Comprehensive Strategy

Like in the private sector, the public sector approach to defining strategy involves tasks such as gaining agreement on what must be achieved, setting concrete goals, defining basic principles to govern actions, gathering and analyzing information, and ensuring that the strategy is consistent with the team's capacity to execute.

A first step in defining strategy is to obtain from senior political authorities clearly defined objectives for the crisis management team.⁵¹ The strategic objectives set out in box 6 could be adapted and elaborated based on country-specific circumstances.

Box 6: Objectives of a Comprehensive Strategy for Crisis Resolution

Restore the confidence of financial institution depositors, creditors, and investors. Restoring confidence is necessary to stabilize financial sector liquidity and to tap international and domestic private equity capital and debt finance.

Restore the solvency, profitability, and liquidity of the financial system and build institutional capacity. The economy requires the services of a sound and well-developed financial system, including better governance over firms.

Restore the solvency, profitability, and liquidity of firms. The financial system cannot be restored to health unless the corporate sector is restored to health. Efforts to fix banks while their debtors are unable to service their debts will not be durable and will prove costly.

Strengthen financial sector structure and the regulatory framework. Government action in resolving the crisis will significantly affect the structure of the financial system (institutions and markets) and can be used to correct long-standing structural and regulatory weaknesses. In financing crisis resolution, the government can create a range of liquid government debt instruments, which can encourage capital market development. Regulatory changes can be used to drive improved governance and greater market discipline.

51. Depending on the nature of the institutional arrangements (see chapter 2), the relevant senior political authorities may well be conformed as the governing body for the crisis management team.

Minimize losses. The stock of losses will continue to grow unless action is taken to prevent it. Although some losses will be borne by the private sector (shareholders, creditors), many may accrue to the government, with significant fiscal consequences. Attempts to limit up-front fiscal outlays can lead to higher losses and long-run costs. Large up-front outlays may be required to achieve a definitive resolution. A portion of those outlays can be recovered over time. Getting the economy back on track quickly also will help to reduce the long-run costs.

Finance the losses. The government will have to ensure that adequate financing is available and that adequate instruments and markets exist.

As a complement to these overarching objectives, the crisis management team needs to agree on a long-run vision of the desired nature of finance and financial relationships in the economy. This also should be agreed with the senior political and financial authorities. The vision would give shape to the post-crisis financial system and serve as the long-run target of decisions that the team will have to take in resolving the crisis.

Armed with clear objectives and a basic vision of the future, the crisis management team then defines concrete goals for the period of their work, typically three to five years. These goals relate both to financial problems (insolvency or illiquidity among banks and debtors) and to structural problems (weaknesses that led to the problems or that will impede resolving them). The goals are shared with and ratified by the senior political authorities. The crisis management team then defines near-term objectives consistent with the goals.

A comprehensive strategy involves defining specific operating principles to guide the actions of the team. They are designed to promote transparency, to ensure fairness and burden sharing, to minimize waste, looting, and bailouts, and to use public support for banks to maximum effect. They define the basic parameters for determining who is eligible to benefit from public support. It is important to ensure that senior political authorities ratify these principles.

The strategy should be based on a realistic assessment of the dimensions of the problems. Underestimating the scope of the problems would undermine the utility of a comprehensive strategy. The lesson of experience is that problems often are worse than initially imagined. Therefore, the team's strategy should accommodate a worst-case scenario. It needs to be flexible, since it likely will need to be revised and enhanced as the work proceeds. The strategy must have sufficient flexibility to accommodate unexpected events and the discovery of more severe

problems. Even where the strategy has been formulated to accommodate a worst-case scenario, it should be validated and updated periodically by the crisis management team. In some cases, this may require modified political agreements.

Implicit in the foregoing is that both the senior political authorities and the crisis management team have distinct roles to play in developing and executing a comprehensive strategy. The senior political authorities (particularly the president or prime minister, the finance minister, and legislative leaders) need to orchestrate political consensus around matters such as overall objectives, financial sector vision, medium-term goals, and operating principles. The crisis management team handles the details of the strategy based on explicit, politically agreed guidance on these matters. It then develops strategy, establishes priorities, and defines and executes the specific work of crisis resolution. Providing explicit guidance allows the political authorities to hold the crisis management team accountable for execution and to deflect at least some of the pressure from constituencies.

Executing a Comprehensive Strategy

Putting a comprehensive strategy in place lays the groundwork for defining the work program of the crisis management team and their plan for executing the strategy, which will involve simultaneous action on many fronts. The work program defines the actions required to move from widespread bank and debtor insolvency through to the final sale of all banks, problem loans, repossessed assets, and company shares the government will come to own in the process. Also involved are the unwinding of any extraordinary government guarantee of bank liabilities and reconfiguration of the financial system in accordance with the agreed vision. The work program should be concrete, specifying what actions will be taken, by whom, and when. At the same time, the work program needs to be revised and updated constantly as the work unfolds.

A key task of the crisis management team is to maintain political consensus on the principal elements of a comprehensive strategy. This is not a one-time event. This is an important task in the context of challenges likely to confront the team, such as the discovery of more serious problems than were originally contemplated, organized lobbying by vested interests, and negative reaction to the sale of banks or firms to foreign investors.

Similarly, maintaining media and public support for the strategy needs to be part of the work program. Stakeholder groups tend to have unrealistic expectations about the speed with which problems can be solved and to anticipate misuse or unfair use of public support. The crisis management team has to have an ongoing communications program that incorporates information about the (realistic) timing of the team's work, especially key actions and decisions. To build and maintain public support, the communications program needs to demonstrate and emphasize the team's application of the principle of fairness in its decisions (highlighting the importance of having that principle agreed at the political level). Building strong public support also can be critical in keeping the program on track in the event of changes in the political leadership.

CHAPTER 10. LINKING BANK AND CORPORATE DEBT RESTRUCTURING

Government almost certainly will have to provide substantial financial support to banks in order to salvage the banking system from a systemic crisis. The process of crisis management is largely a process of maximizing the impact of support to banks. This "impact" cannot be limited to banks only; it also needs to affect corporate debts to the extent that they undermine the finances of banks.

The Korean, Thai, and Indonesian governments left debt restructuring decisions largely to bankers and debtors. The governments played a limited role and, with minor exceptions, did not explicitly link the provision of financial support to banks with the outcomes of debt restructuring. Bankers—either managers of private banks or managers contracted to run nationalized banks—were responsible for pursuing corporate debt restructuring. See table 2 for the principal features of this approach.

Table 2: Features of Governments' Approach to Debt Restructuring

| <i>Government role</i> | <i>Benefits</i> | <i>Risks</i> |
|---|---|---|
| Create enabling environment (accounting, regulatory, and tax treatment), encourage formation of voluntary creditors' committees, provide regulatory (forbearance) and tax incentives, upgrade creditor-debtor legal framework, and provide oversight via bank supervision process | Minimizes government involvement and reduces the potential for political interference | Defers losses via cosmetic restructuring, does not strengthen banks, and raises costs |

This chapter suggests a means by which government can link the provision of financial support to banks more closely with actual outcomes of corporate debt restructuring. It describes a means for leveraging the financial support that government provides to banks so as to improve the incentives for debt restructuring to occur.⁵² From a banker's perspective, the improved incentives derive principally from the fact that government provides the capital necessary to absorb the losses inherent in debt restructuring and promotes the bank's survival. From a debtor's perspective, the government provides the means to obtain needed cash flow, and perhaps debt relief, and signals the anticipated long-run viability of the bank. This can improve the debtor's incentive to engage in debt restructuring, which can preserve the bank relationship and restore access to new credit.

Underlying this approach is recognition of the fact that there is an inherent financial interdependency between restructuring debt and granting support to a bank that will be salvaged: the amount of support should be based (in large part) on the losses the bank likely will incur in constructively restructuring debts, while constructive debt restructuring is unlikely to proceed without adequate capital support. A key challenge for government is to make transparent the losses inherent in debt restructuring as a means of determining the amount of support required by banks. There are essentially two ways to make the losses transparent: either sell the debts or restructure them. The tendency is for governments to sell debts to government-owned asset management companies in order to facilitate bank resolutions, but this creates its own set of

⁵² For additional information see Scott 2000a.

problems and potential costs, as discussed in chapter 8. A key objective of the approach suggested in this chapter is to speed up the process of bank resolution and debt restructuring without transferring large volumes of loans to asset management companies.

The chapter first reviews the principal weaknesses of the approach actually taken by the three Asian governments. It then discusses the nature of the basic goals of a more aggressive approach to debt restructuring and the means to execute that approach.

Weaknesses in the Approach Taken by Asian Governments

The approaches taken by the Korean, Thai, and Indonesian governments suffered from at least three general weaknesses. First, they did not sufficiently leverage government's financial support as a means to change the incentives for bankers to restructure debts.⁵³ Providing financial support to banks without linking the new capital to explicit restructuring outcomes reduced the incentives for bankers to engage in debt restructuring, since it allowed them to write down (or create provisions for) debts without restructuring (reducing) their claim on debtors and their assets. Although the banks' balance sheets were improved, the debtors may have been left overly indebted. The financial position of banks appears to have improved, but this might be illusory.

A second weakness was that the governments, in effect, ceded to bank managers the analyses, decisions, and follow-up that would significantly influence the governments' eventual cost in salvaging the banks and resolving the crisis. This might have any number of consequences, including decisions based on insufficient information and analysis, excessive debt forgiveness to well-connected debtors, and insufficient action to ensure recovery of the remaining debt.

The third weakness was that banks received financial support without sufficient information regarding the likely extent of losses inherent in constructive debt restructuring. Given the incentives to underestimate the scope of losses, governments' initial rounds of support were

53. One exception was a program in Thailand where the government made available additional Tier 2 debt capital linked directly to the magnitude of the write-downs resulting from debt restructuring and the net increase in private lending. The program was little used, however. In Korea and Indonesia, an indirect link between debt capital and write-downs was established by linking recapitalization to performance contracts that required improved risk management capacity, including credit workouts and a reduction in nonperforming loans. But capital was provided in advance of actual performance, and little provision was made for monitoring or enforcing contracts.

insufficient, making additional rounds of support likely. This undermined the credibility of the support program and the incentives facing bankers. It delayed bank resolution and debt restructuring and raised costs.

Goals of Linking Bank and Corporate Debt Restructuring

Taking a more aggressive approach to debt restructuring is intended to promote constructive debt restructuring (in other words, to avoid both inaction and cosmetic restructuring) and to control costs to government.

The first goal is to remove the incentives that bankers and debtors may have to either delay restructuring or engage in cosmetic restructuring and to create incentives for both parties to engage in constructive debt restructuring. This has two benefits. First, it can make transparent the losses inherent in debt restructuring more quickly so that governments can ascertain the need to recapitalize banks and provide support that will restore the cash-based profitability of banks. Second, accelerating the debt restructuring process can result in more prompt restoration of the creditworthiness of firms. Restoring banks to health and making firms creditworthy lay the groundwork for a resumption of lending under market-based terms and conditions, reducing uncertainty, boosting output, reducing costs, and improving government's ability to finance those costs.

The second goal is to ensure the prudent use of the financial support that government will provide and better control the potential moral hazard inherent in providing that support. Government especially needs to avoid a situation where it has only limited information on the activities of bankers, while being forced to provide multiple rounds of financial support to them. By contractually linking support to the outcomes and performance of debt restructuring, governments can hold bankers responsible for their restructuring efforts and create better incentives for them to engage in constructive debt restructuring. It is possible to reduce not only the cost of delay but also the risk that bankers will engage in excessive debt forgiveness.

Design and Execution of the Approach

The key distinguishing features of this approach are (a) that financial support to banks would be contingent, by contract and perhaps also by law, on bankers' performance in

restructuring debts and achieving debt restructuring outcomes and (b) that the crisis management team would play an active role in monitoring and ratifying debt restructuring decisions taken by the managers of banks receiving public support. See table 3 for a summary of the basic features of this approach.

Table 3: Features of Linking Bank Support to Debt Restructuring Outcomes

| <i>Government role</i> | <i>Benefits</i> | <i>Risks</i> |
|--|---|---|
| Provide financial support to banks under contractual terms and conditions that promote debt restructuring, ratify analyses and decisions relating to restructuring of large credits, evaluate bankers' debt restructuring performance with contractual remedies for poor performance, including cessation of support, and perhaps establish a special supporting legal regime. | Leverages financial support to promote prompt debt restructuring, reduces the potential for cosmetic debt restructuring, makes transparent the outcomes of debt restructuring, and ties managers' future employment to debt restructuring outcomes. | Requires substantial institutional capacity to implement effectively Potential for political interference. |

Support to banks would be available only under contracts linking the amount and timing of financial support to debt restructuring outcomes and performance (as well as a range of other performance standards not dealt with here). The contract would provide for new capital based on the actual losses incurred in appropriately restructuring debts. To strengthen the incentives facing bankers and to control potential moral hazard, the agreed support would be disbursed in tranches based on performance.

The crisis management team would be responsible for and closely oversee the negotiation and enforcement of contracts. A key activity would be to monitor debt restructuring performance (coverage of the portfolio, policies applied, and procedures used) and outcomes (veracity of restructured financial terms and the associated terms and conditions for debtor operational restructuring). Large debtor relationships would be monitored case by case. Small loans would be monitored on a portfolio basis. The team will have to have the ability to judge the performance of

bankers in using the support provided and to insist on managerial changes where support has not been used effectively.

Support should be provided to banks only under this program. To avoid the moral hazard that might arise in granting support, in principle support should be restricted to banks that engage in constructive debt restructuring (involving concessions and loss sharing by both parties). Similarly, debt relief to firms that is enabled by government support to banks should be available only to firms that engage in constructive debt restructuring. All steps taken should avoid allowing beneficiaries of support to believe that they can obtain more support in the future. The contract for support must be seen as a one-time opportunity.

The institutional capacity necessary to design and execute such an approach to crisis resolution is formidable. On the one hand, such institutional capacity is beyond what can be realistically expected of many governments. On the other hand, the international financial community has a great deal of expertise in applying the basic elements of this approach. These are the same elements used by private sector investors. The principal constraint may be the lack of political will to take a hard-nosed approach to the provision of support to banks and to put in place the necessary institutional arrangements, in particular insulating the crisis management team from inappropriate political interference (see chapter 2). If political will exists, the principal challenge is to assemble a crisis management team with the skills and leadership capacity to design, organize, and implement this approach.

PART 3. PREPARING TO MITIGATE THE RISK OF CRISIS

Part 1 reviewed the principal actions taken by governments in the three crisis countries, assessed those experiences, and suggested general guidelines and principles that support crisis resolution. Part 2 developed the conceptual underpinnings for two fundamental improvements in crisis management practices. Part 3 draws on the experiences in the three countries and elsewhere to identify key steps that regulatory authorities can take to mitigate the risk of crisis and be better prepared to deal with shocks should they occur. The objective is to reduce the potential that shocks lead unnecessarily to systemic problems or even full-scale financial crises. The steps reviewed in part 3 can be taken today by supervisory agencies, central banks, deposit protection agencies, and financial institutions.

Shocks might involve isolated events, such as the sudden withdrawal of deposits from a bank or the bankruptcy of a large debtor. They also might be of a more systemic nature, such as major changes in public policy, significant movements in interest rates, devaluation of the exchange rate, or the collapse of real estate or equity market prices. Two relevant facts in this regard are that many shocks of this nature can be expected to occur in most markets sooner or later and that some banks will weather them, while others will not. Government can promote the ability of official agencies, financial institutions, and, most important, financial markets to deal with shocks such as these and to reduce the potential that damage will spread unnecessarily.

Part 3 advocates the use of contingency planning as a tool to improve preparedness to deal with shocks. Undertaking formal contingency planning prior to a shock will help the authorities or financial institutions to identify the types of actions that may have to be taken in such a situation, as well as the skills, policies, and processes required to support those actions. Contingency planning can lead to prompt and comprehensive action to mitigate the risks that shocks will cause unnecessary damage. The use of contingency planning is discussed in the context of the two key points of interest in dealing with shocks: liquidity management and the intervention in weak banks.

CHAPTER 11. BANK LIQUIDITY MANAGEMENT

Governments can mitigate the risk of crisis by ensuring that supervisory authorities have carefully evaluated regulations, supervisory policies, and practices applicable to the management of liquidity shocks incurred by banks. A shock involves a sudden increase in demand for liquidity by banks. Shaken depositor confidence might lead to deposit outflows. The inter-bank market might be sharply curtailed as well, limiting the role of the system itself in recycling liquidity to needy banks. Bankers need to be well prepared to weather such liquidity shocks. Their failure to be prepared can exacerbate a shock and trigger a systemic financial crisis.

Supervisors should routinely ensure that bankers and bank boards of directors adopt adequate policies and practices for liquidity management. Relevant bank policies include defining how liquidity is to be measure and limited, setting minimum monitoring and reporting standards, and determining how exceptions to limits are to be authorized. Relevant practices should include routine measurement of current and prospective liquidity under a range of possible market conditions and continuous management of overall bank (and, where appropriate, financial group) liquidity.

In addition to applying the standards of basic risk management to the policies and practices of bank liquidity management, supervisors should require bankers to prepare detailed contingency funding plans that define the manner in which they will maintain bank liquidity in the event of distress. The plan should set out the specific steps that bank managers intend to take to weather a severe liquidity shock. Although borrowing from the central bank should be seen as a last resort, bankers should be required to ensure that the assets and documentation required to support collateralized borrowing from the central bank are in proper order. Government should ensure that supervisors routinely evaluate banks' adherence to these standards as part of the supervisory process.

Supervisors themselves need to be prepared to respond to liquidity problems in banks. They need to be prepared to send staff and auditors into banks experiencing liquidity problems, and these persons need to be prepared to evaluate the bank's funding situation and to detect potential looting or other misuse of liquidity by bank insiders. Supervisors should be prepared to solicit from the bank detailed liquidity reports depicting its funding situation, likely on a daily

basis. These reports can be designed in advance, and bank managers can be familiarized with their content and use. Supervisors should be prepared to impose enforcement actions rapidly and to monitor compliance, if necessary, to stem the potential misuse of liquidity. Defined procedures for these supervisory steps can be set out in advance.

Finally, the relevant authorities (supervisory authorities, the central bank, and the deposit protection agency) each will need to be prepared to play their respective roles in promptly resolving a bank experiencing liquidity problems. A key objective is to avoid a situation where the central bank is forced to provide liquidity to a bank due to the authorities' inability to implement a resolution mechanism, such as those discussed in chapter 5. The authorities' roles include, for example, determining the condition of the bank, choosing appropriate resolution mechanisms, and promptly implementing those decisions. To mitigate the risk of crisis and enhance crisis preparedness, government should ensure that the official institutions are well prepared to play their given role in the bank resolution process.

CHAPTER 12. RESOLVING WEAK BANKS

Weak banks are like a cancer in the system. They often are irrational competitors that skew the pricing of risks and undermine systemic profitability and stability. The existence of such banks increases the potential for a shock to lead to crisis. Perhaps the most important step government can take to mitigate the risk of crisis and promote the performance and stability of the banking system is to ensure that the responsible authorities have and use the capacity to, in effect, weed out weak banks. This means ensuring that the legal, regulatory, and supervisory regimes promote the identification and resolution of weak and failing banks. The objective is to ensure that bank failures are handled in the normal course of business without disrupting the system unnecessarily.

Law and Regulation

In the context of resolving weak banks, the most relevant elements of the legal and regulatory framework are prudential regulations relating to capital and the powers of supervisors

and other relevant authorities in the event of bank illiquidity or insolvency.⁵⁴ Laws and regulations applicable to foreign ownership of banks and taxes also are relevant.

Government needs to ensure that the regulatory framework for prudential capital standards is sufficiently conservative so as to enable supervisors to take action before banks are severely insolvent. This framework encompasses prudential rules applicable to capital adequacy, asset classification, and asset provisioning, along with related regulatory accounting standards. Internationally agreed standards and principles provide a good point of reference. Taking action to strengthen the local regime can help to mitigate the potential consequences of shocks.

Laws granting powers to supervisors and other relevant authorities in the event of bank illiquidity or insolvency were deficient in each of the crisis countries addressed in this paper. A significant, yet common, weakness was the inability to suspend or terminate the ownership rights of shareholders of banks judged to be insolvent. Government can evaluate the adequacy of such powers either through actual use (trial and error) or by engaging in contingency planning. Both methods are discussed later in this chapter.

As discussed in chapter 2, the permanent institutions of government may not provide a sufficient response to a crisis, and the formation of a special, temporary crisis management team might be advisable. The powers of the team might supersede those of the legal authorities of the country's permanent official institutions. Special legislation might be required to vest the team with those powers. Getting such legislation in place in the midst of a crisis can be time-consuming and contentious. Government can avoid this eventuality by making provisions in existing law for the establishment of some form of crisis management team in the event of a systemic shock.

Foreign investors are one potentially important source of new capital for banks. At the outset of the crises, all three countries had in place legal restrictions on foreign investment in banks, reducing the potential supply of new capital to banks. Taking steps to remove legal and other impediments to foreign investment in banks can increase the potential for existing shareholders to raise new capital in the event of a shock or otherwise.

54. The judicial system, of course, can be equally important but is not addressed here.

Government can act to ensure that tax laws facilitate the investment of new capital in troubled banks. Tax-loss carry-forward provisions are a key feature of such laws. Generous carry-forward provisions can increase the return on new invested capital and serve as a useful inducement to new investment.

Supervisory Processes

As emphasized in chapter 5, shareholders and managers bear primary responsibility for ensuring the financial soundness of a bank, and supervisors must hold them accountable for resolving the bank's problems, including by injecting additional capital where required. Given the pivotal role played by capital in weathering shocks, routine bank supervision should assess not only the adequacy of bank's capital but also the bank manager's capital planning process. The capital planning process should involve a contingency planning process that assesses how bank management and shareholders would raise additional capital or reduce risks in the event of a shock.

Chapter 5 indicated that shareholders of weak banks or those that have experienced a shock are reluctant to put up more capital or to dilute their ownership interest by raising additional capital from new investors. Supervisors should have in place adequate processes that provide as much motivation as possible for existing shareholders to recapitalize their bank, should that be required. The capacity of supervisors to motivate recapitalization has four basic components. The first is diagnostic capacity, as described in chapter 4, to assess accurately and demonstrably the condition of the bank. The second is a supervisory enforcement process that progressively raises the stakes for managers and shareholders who fail to raise adequate capital within a reasonable period of time. The third is a prompt and effective process of failure resolution, as described later in this chapter, that managers and shareholders believe is likely to be triggered should the bank become insolvent or not viable. The fourth component is a referral process that submits any suspected improper or illegal activities for review and possible prosecution by law enforcement and judicial authorities. Government should ensure that supervisors' capacity is evaluated and that all four components are in place.

In the event of a shock, the supervisors will have to decide whether to grant forbearance to banks not meeting prudential standards. Government can encourage supervisors to develop their

forbearance policies in advance. Such policies should incorporate criteria for the circumstances under which forbearance would be granted and tough standards for monitoring and enforcing the terms and conditions of forbearance. Not having in place policies for explicit forbearance in the event of a shock may lead supervisors to grant implicit forbearance (for example, by failing to promptly enforce loan loss provisioning or capital adequacy rules), which can lead to systemic deterioration and crisis.

Should existing shareholders be unwilling or unable to arrange for recapitalization of the bank and should forbearance not be warranted, the responsible authorities should initiate liquidation of the bank or arrange an assisted acquisition (see chapter 5). To promote the likelihood that these resolution mechanisms will operate as intended, government should ensure that the supervisors have tested the mechanisms. One means to test them is by actually using them. For this purpose, government can promote the use of post-mortem exercises subsequent to bank failures, where effort is made to refine and improve resolution mechanisms. Improvement might involve changes to law or simply changes to the relevant authorities' policies and practices. The relevant financial sector authorities, or others, can conduct the post-mortem exercises.

A second means of testing resolution mechanisms is by engaging in formal contingency planning exercises. Engaging in contingency planning tests the responsible authorities' likely response to a sudden shock to the solvency or liquidity of a bank and identifies policy or operational weaknesses before they are exposed in practice. Contingency planning could involve testing provisions for rapidly assessing the condition of the bank, coordinating action among relevant public institutions, limiting potential contagion to other institutions within the same financial group and to unaffiliated banks, keeping senior government officials informed, and dealing with the media. A key capacity to evaluate is whether the deposit insurance agency or the government has the policies and procedures in place to repay protected deposits promptly (in the case of bank liquidation) or to arrange the prompt transfer of deposits from a failing bank to a more sound institution (in the case of an assisted acquisition). To facilitate the use of assisted acquisitions, government can ensure that the responsible authorities have designed information packages and bidding mechanisms, developed the necessary contracts, and prepared step-by-step procedures for the tasks involved in transferring deposits to another institution.

Contingency planning also might contemplate more severe circumstances, such as the sudden failure of a major bank. This exercise is more complex, since it must contemplate the possibility of temporary nationalization. The number of responsible authorities engaged in this exercise will grow, since the finance ministry will have to become more actively involved. In this contingency planning exercise, government can give advance consideration to the circumstances under which it would use public funds to salvage a bank and the policies attendant to doing so. Many of the relevant issues are discussed in chapter 5.

The Asian crises showed how lack of access to financing can constrain the ability of the responsible authorities to resolve banks promptly. The financing might be necessary to repay protected deposits in a bank placed into liquidation or to transfer the bank's protected deposits to another institution. Government should ensure that the contingency planning assesses the availability of financing in sufficient quantity. It should contemplate backup sources of financing and the related procedural arrangements.

Contingency planning should ensure that the relevant authorities have policies and procedures for making a least-cost determination of alternative failure resolution mechanisms. Government might wish to ratify the procedures and assumptions involved. This should include ensuring that a full assessment of the potential future costs inherent in government ownership can be made. Putting these in place in advance should help to mitigate the risk that the relevant authorities and government will see nationalization as, in effect, the path of least resistance in the near term, only to find it an expensive mistake in the long run.⁵⁵

⁵⁵ For more information on the use of contingency planning by bank supervisors in the context of systemic crises see Scott 2000b.

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Table B4.1: Balance Sheet of a Sample Bank

| <i>Asset or liability</i> | <i>Amount</i> |
|------------------------------|---------------|
| Asset | |
| Cash | 50 |
| Government securities | 50 |
| Corporate debt | 50 |
| Loans | 800 |
| Other assets | 50 |
| Total | 1,000 |
| Liability | |
| Inter-bank deposits | 750 |
| Short-term debt | 100 |
| Other liabilities | 50 |
| Total liabilities | 900 |
| Equity | 100 |
| Total equity and liabilities | 1,000 |
| Non-interest income | 22.50 |
| Non-interest expense | 40.00 |

The principal assumptions in this stylized example are that all interest expense, non-interest expense, and non-interest income are paid and received in cash. The bank can avoid negative cash flow only by retaining some portion of the interest earned by depositors. In other words, to avoid negative cash flow and eventual illiquidity, the bank must continuously increase deposits, either by retaining interest earned on existing deposits or by raising new deposits or other funds. As the portion of loans on which interest payments have been suspended rises above the threshold, the pressure on the bank to increase deposits intensifies. Bankers will raise deposit interest rates, which in turn will increase carrying costs on the assets on which debt service has been suspended.

**Table B4.2: Point at which the Suspension of Debt Service
Can Cause the Bank's Cash Flow to Become Negative
under Different Interest Rate Scenarios**
(percentage of total loans)

| <i>Asset yield</i> | <i>Liability rate</i> | <i>Spread</i> | <i>Nonperforming loan threshold</i> |
|--------------------|---------------------------|---------------|---|
| 10 | 5 | 5 | 38 |
| 10 | 7 | 3 | 16 |
| 20 | 13 | 7 | 33 |
| 20 | 15 | 5 | 22 |
| 20 | 17 | 3 | 11 |
| 30 | 23 | 7 | 24 |
| 30 | 25 | 5 | 17 |

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