The Development and Crises Management of the Banking Sector

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Abstract

The main purpose of this paper is to systemize the restructuring and management methods in banking crisis with the help of topic-related literature; consider the options of applying them in practice and observe the use of these instruments.

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1. Introduction

Banks have the central role in the economy. They execute transmission, hold people’s savings, and finance the development of business and trading. That is the reason why banks are in the elevated attention of the public and the government.

The name bank has come from an Italian word “banca” or “banco”, i.e. the table, where the Italian currency exchanger allocated his coin platter in the medieval times. In the 12th century Genuas named the currency exchangers “bancherii”. The word “pankrot” has come form the word “banca”, because the “banca” of the currency exchanger who betrayed the trust was broken – “banco rotto”.

In market economies, systemic banking problems and crises arise from time to time. A number of partly competing, partly complementary theories are trying to explain how their basic macro-economic causes have been developed. Some theories emphasize on the importance of exogenous shocks (absolute and relative prices, wars,
recessions abroad), others focus on psychological factors (euphoria, myopia, herd behaviour, cognitive thresholds) or speculative behaviour (rational bubbles, deficient governance), still others consider government interference in the markets (monetary policy, change in regulations, financial liberalization, directed lending, inducements to moral hazard). Explanations for why an initial disturbance grows to systemic proportions vary from the psychological (changes in expectations or in perceptions of risk) to the institutional or technical.

2. Government Led Bank Restructuring

The main causes of banking insolvency in transitional economies are the large amount of bad assets inherited from the command economies and a continuous extension of new bad loans. While part of the productive capacity in these countries was inefficient at the new set of relative prices, many enterprises become nonviable and national wealth and income thus prove to be lower than previously believed and the available data continues to show.

Other causes which are likely to have contributed to the banking problem include insufficient management and staff skills, slow adoption of stricter lending standards, unclear principles of governance (particularly in state banks), risk concentration, insider and speculation (particularly in private banks). Such inefficiencies tend retard economic recovery, since the available funding of banks may be used for new credits to old problem enterprises rather than to more profitable, new ones (adverse selection). Therefore, avoidance of new bad credits is as important as getting rid of old ones.

As a result of bank failures and lower level of savings intermediated through the banking system, it may prove difficult for some solvent enterprises to find adequate funding from other banks at interest rates merited by their credit histories. Thus some viable, but illiquid enterprises will fail. As a result of these developments, production and demand may fall, thus adversely affecting the wealth and incomes of the remaining enterprises and households.

It is extremely difficult to estimate the likelihood of cumulative effects on economic activity, in practice. The adequately detailed knowledge of cumulative effects can be assumed to increase with:

a) the balance sheet size of the defaulting bank or enterprise;
b) the lack of alternative sources of enterprise funding (securities market or government);
c) the amount of inter-enterprise financing or arrear;
d) the absence of an efficient market for the assets of defaulting enterprises;
e) uncertainty among savers about the financial situation of banks and their major customers, or about the restructuring policy to be followed by the government.

When the risk of cumulative macro effects is judged to be serious, at least larger banks should be rehabilitated or merged rather than closed or allowed to fail. Care should be taken that the merger should not threaten the viability of an existing bank that was judged to be viable prior to the merger.

Recent systemic banking problems in several market economies have shown that well-designed banking supervision is insufficient to prevent unsound lending practices. Historical experience from previous periods of financial unrest indicates that reliance on market discipline alone is often insufficient as well. This experience suggests that the fact how well risks are understood and managed in the financial
markets and among authorities may be more important than the way how financial discipline is enforced.

During the restructuring process itself, care should be taken to avoid additional costs, either in the form of new unsound loans, excessive transfer of both on- and off-balance sheet risks from banks to the government, or operational costs in the banks themselves.

Risk-sharing and operational responsibility for workouts also causes the receiving bank to have an interest in preserving the credit relationship with salvageable customers.

When applying these principles, it should be kept in mind that conditions in the transition economies do not yet fully conform to those generally underlying economic policy recommendations in most market economies. In particular:

a) market failures are commonplace because markets where assets are priced and traded are virtually non-existent or small in relation to bank portfolios, while publicly available information is scarce and unreliable;

b) substantial parts of the enterprise sector may not yet qualify for funding on normal commercial criteria;

c) government financial resources are small compared to needs;

d) Institutional and economic shocks may be larger and more rapid than in mature economies;

e) the supply of skilled and motivated personnel is limited and under extreme pressure from competing demands.

These special features tend to constrain the systemic bank restructuring strategy. The market value of bank portfolios must, for a time, be established more by forecasting and evaluating business plans, than by the evaluation or sale at existing prices. Banking problems are unlikely to be resolved all at once, because values are difficult to establish and may change rapidly; furthermore, the lack of properly trained staff may imply lax credit and risk management policies. Banks may have to become intimately involved in the economic rehabilitation of their customer in order to adequately judge their creditworthiness. This may require banks to accept substantial equity stakes in their customer enterprises. There could, in this case be a danger of close bank-customer relations causing additional prudential problems.

While systemic restructuring with little government involvement and large depositor losses run the risk of reducing economic activity and confidence, a policy of substantial government poses other dangers to economic stability.

The maximum government debt level marking the start of a debt spiral is positively related to the national income growth and negatively related to the interest rate. Inflation will not affect the maximum level of domestic debt in the long run, because, for its part, it will tend to raise both nominal interest rates, and nominal GDP growth rates by similar amounts.

In reality, the government must take adequate account of the large uncertainties involving future growth and interest rates. A sustainable, safe level of debt is, in practice, therefore not likely to be very high in transition economies until they achieve a stable path of economic growth. Moreover, the fiscal imbalance in these countries is already typically very large. This limits the amount of funds, which can be earmarked for systemic bank restructuring costs. The actual extent of government financial support to the banking system is likely to depend on a number of factors:

a) the gap between possible and needed government support;

b) expected effects on the confidence of depositors and bank creditors;
c) expected moral hazard effects;
d) assessed cumulative economic effects;
e) political cost considerations.

The larger these factors are, the fewer bases there are for a substantial financial involvement of the government.

Any government support has to be borne by present and future taxpayers and receivers of government services. If the systemic restructuring exercise is properly conducted, only past unavoidable losses have to be borne because no bank will receive unmerited support, and the remaining banks will have a sufficient flow of profits to survive on their own. Subsequently the income and wealth of future generations will be higher than that of the present one. This could be an argument for transferring at least part of the burden to the future.

If government funds or guarantees provided are insufficient to cover the costs of bank restructuring, depositors and other bank creditors must certainly lose all or part of their assets. Enterprises and bank, which nevertheless remain solvent and profitable, will buy the assets of failed ones, “restructuring” them in the process. The role of the government will then be to ensure that this process remains legal and orderly. Costs may be high, since viable enterprises may also founder and solvent buyers may be “fit and proper” bank managers or owners; in the latter case it is the duty of the banking supervisory authority to refuse such buyers access (BIS Policy Papers, 1999). There is, therefore, a risk that some of the remaining banks will prove unprofitable and eventually insolvent, causing the second wave of systemic banking problems. In the long run, however, the economy will not necessarily be worse off, provided that the government can retain depositors’ confidence in the banking system and ensure that the manager and owners of surviving banks are prudent, fit and proper. The political pressures on the government, to avoid letting bank creditors pay the restructuring costs up front, may be strong in the short and medium term.

A stable banking system is also a precondition for normal inter-bank markets to develop, and, accordingly, for the central bank to conduct monetary policy using indirect instruments. Banks that are solvent and profitable will provide only limited unsecured lines of credit to banks perceived as weak, causing the inter-bank market rates to become segmented and volatile. Changes in the rate for central bank finance could affect the solvent banks in the system very modestly, since their marginal funding rates may be systematically lower than those of more risky banks needing marginal funds. This could weaken the monetary transmission mechanism from banks to their customers. The decision on which banks to rehabilitate should, therefore, be taken as soon as possible, in order to normalize the inter-bank and money markets.

During the restructuring exercise, both sound and unsound banks may experience an acute liquidity crisis, if creditors withdraw funds or avoid renewing credits due to declining confidence. The first line of defence is the central bank, which stands ready to provide funds against full collateral as the lender of the last resort. If funds are withdrawn from the domestic market in large enough amounts, such credits may threaten domestic monetary stability, currency convertibility or both.

This situation is extremely awkward, because it may force the government to choose between allowing an immediate financial crisis to develop and guaranteeing the liabilities of the banking system as a whole. The potential macroeconomic problems generated by a financial crisis are substantial. On the other hand, the potential costs of such a guarantee may well, particularly in less wealthy economies, exceed sustainable limits on government debt. When problem loans are large, it is quite possible that such a
promise cannot be kept without danger of entering a debt spiral. Deciding on a course of action is made more difficult by the fact, that the possibility of government insolvency certainly may be freely debated in the marketplace.

Maximum effort should be expended on clarifying the extent and limits of the banking problem, on implementing policies, supporting capital investment in the banking sector, and on policies improving the cash flow of problem enterprises. As soon as possible, the authorities should, thereafter, announce which banks will be rehabilitated and how the liabilities of both these and other banks will be treated.

If the risk of a general liquidity crisis is modest and far in the future and the economic and social effect of it are judged to be small (as unlikely case), the authorities should avoid a general guarantee. If the macroeconomic consequences of a liquidity crisis are judged to be serious and imminent, while the government’s room for indebtedness is sufficient, the government could, for the foreseen time of the restructuring, publicly announce that bank liabilities will be honoured on time.

Primarily a microeconomic issue, the overall sequencing of bank and enterprise restructuring has important macroeconomic consequences as well. It is sometimes argued that the banking system should be restructured and privatised first, to be thereafter able to take sequencing, which, however, have undesired effects on the real, particularly in transitional economies, where the number of insolvent enterprises is large and enterprise evaluation skills are scarce. Once banks have been restructured, they should be required to take account of only commercial considerations. They will, accordingly, at their own discretion, force insolvent enterprises into liquidation, mergers or bankruptcy rather than into rehabilitation. If all banks choose to do this simultaneously, they may easily, though inadvertently, contribute to a systemic crisis rather than prevent it.

To avoid such credit-induced reduction in the supply of goods and services, recapitalization and privatisation should take place only after bank assets have been thoroughly evaluated during the bank restructuring process. During the relatively short evaluation period however, finance will have to continue to be provided even at the risk of such loans, for instance:

- simply retaining fictitious value on bank balance sheets, eliminating the need for any wealth transfers in short term;
- supporting banks directly and without strict preconditions, but avoiding stringent restructuring measures among insolvent customer enterprises.

Because no restructuring is taking place, future earnings of the enterprise do not rise, profits do rise, and there is now a genuine accumulation of new problem loans in the banks. The ultimate cost of bank restructuring will steadily grow, but government-funding requirements will temporarily remain modest and limited to the amount of bank support needed in any one year. As long as depositors and other creditors remain willing to fund the bank, no acute problem may arise, since few assets have to be sold to raise cash. As soon as bank creditors have safer investment alternatives available, their withdrawal of funds from insolvent banks causes liquidity, earnings and solvency problems, which are likely to be much larger than before.

When restructuring individual banks, it is important to evaluate both the value of the core banking operation and the value of the assets that have caused the problems. The term core banking operations refers to the banks’ main strategic focus and internal processes under normal conditions, as well as the basic services the bank provides and its portfolio of performing loans and deposit base that form the basis for the capacity of its earnings. The core bank refers to the core banking activities excluding the problem
asset portfolio. When the capacity of earnings of the core bank is discussed, the financial impact of the problem portfolio is isolated. The combined analysis gives an idea of the size of the “hole” in the balance sheet (the negative net worth), its changes over time and whether or not the institution will be viable in the long run with or without a major restructuring. The result of the financial analysis and the resources available will determine how the restructuring ultimately is carried out. (Cheng, 1994)

The analysis of the core banking activities will show the current capacity to carry losses through positive cash flow and earnings, and the potential for improvements of the operations to increase the future capacity. The critical component in the combined analysis is the valuation of the problem loans and the underlying collateral. This will be the dominating factor in determining the size of the “hole” in the banks’ balance sheet and the financial resources needed for the restructuring. The “hole” is defined as equivalent to the amount of resources required to bring a bank’s capital up to adequate prudential standards, after all loan provisioning and write downs are fully accomplished and all the seized collateral against problem loans has been liquidated. The result of the analysis will help to clarify the available options and indicate how costs are to be distributed among stakeholders.

When restructuring a banking system, the same approach can in principle be applied. The only difference is that several banks have to be examined and treated at the same time. It is not obvious that all banks should continue operation after a systemic crisis, and there are also limits to what can be handled by the government. A strategy has to be developed that addresses issues like-priorities, principles for support and timing. Such a strategy would support individual decisions by the government and promote consistency and thereby mitigate the uncertainty for other players in the market.

All government decisions, including the decision of doing nothing, will affect the long-term structure and effectiveness of the banking sector. In a systemic crisis, changes in this structure will be necessary and will take place with or without the government’s involvement. If government funds are to be used, priorities have to be established by the authorities that will for a long time directly affect the industry. Institutions that are likely to contribute to a dynamic development of the industry and those that are large deposit takers and lenders to important growth sectors of the economy, will have the first priority in the overall bank support process, while other institutions that have a limited impact on the system as a whole, should be given a lower priority. Some banks will merge and others will be closed in an orderly manner to minimize the total costs of restructuring the banking industry. It is therefore important to analyze which possible structural changes would enhance the future effectiveness of the industry and which measures should be avoided. A sector-wide perspective on issues like future competition and availability of different products for various customer segments and geographical areas, are important as a basis for the decision process. This analysis should play an important role in determining how the restructuring of individual institutions is carried out.

In the case of a systemic banking crisis, it is not easy to determine what can be considered as a strategic activity and how the treatment of one bank might affect other banks and other sectors of economic activity. Nevertheless, given the budgetary and managerial constraints, the government must set priorities in deciding which activities and entities are the most important and urgent to protect.

One way to approach the problem is to develop a step-by-step process structured in such a way that these general issues can be addressed (Figure 1). Questions
including which banks will receive support, which will be denied and who will be responsible for handling the problem assets must be covered. The objective should be to offer the policy-makers flexibility, both financially and operationally. The quality of the process and its results should be such that a good foundation for decision-making is offered and that reasonable acceptance can be gained from stakeholders and others. (Commercial Framework for Private Sector Development, 1995)

**Figure 1. BANK RESTRUCTURING: A STEP-BY-STEP PROCESS (Commercial Framework for Private Sector Development, 1995)**

3. The Bank Restructuring Instruments

Most instruments are applied on the level of individual banks. The choice and mix of instruments are designed to address systemic distress and will differ from those used for individual problem banks. Individual problem banks can be closed or rehabilitated by using instruments that may not work in a systemic context. First, and most importantly, a systemic approach will require a vision or strategy, outlining the choice and mix of instruments to be used. In devising an overall strategy, the authorities have to pay particular attention to the fiscal, monetary and other macroeconomic implications of individual instruments applied to many banks. By contrast, the macroeconomic dimension is a minor issue when dealing with individual problem banks. Secondly, systemic strategies need to take into account the policy preferences for a future banking structure. To the extent that the authorities want to maintain or establish a competitive and primarily privately owned banking system, the techniques employed for bank restructuring should reflect this preference. With individual problem banks, the future
banking structure would not be called into question when the authorities assume
temporary ownership, sell, merge or close individual banks (BIS Policy Papers, 1999).
The range of instruments that governments have invented to address systemic banking problems is broad and it would be impossible to provide a complete survey. It is
important to note that it is impossible to provide a complete survey. It is important to
note that in many instances seemingly novel instruments backfired for rather predictable
reasons. The major risk inherent in most instruments for bank restructuring is that
government intervention exacerbates the existing problems.
The authorities will, nevertheless, need to consider a fairly wide range of
instruments in order to distribute the cost of bank restructuring and to provide
appropriate incentives during the restructuring process.
During systemic bank restructuring, the government has the option to acquire
or expand ownership in problem banks, or to isolate and assume control over problem
assets. Some problem banks will remain solvent and in private hands but will be judged
by banking supervisors unable to continue operations independently

If the value of the bank were negative, any prospective buyer would have to be
paid to take responsibility for the bank. Paying a prospective buyer to assume
operational responsibility may be a policy option if the government does not want to get
directly involved in this aspect of bank restructuring. Governments must ensure that any
prospective buyer meets the same strict requirements as any investor or group of
investors must meet to obtain a bank license.

When a problem bank has a positive net value and is small, the authorities may
try to find a private buyer. Dependent on the value of such a bank to the prospective
buyer, the cash payment to the government may be either positive or negative. Owners
may retain some or all of their equity but bank creditors do not carry any cost; the cost
to the government is likely to be small in any case.

If the combination of bank value, low risk and payment is attractive enough, a
payer may be found to take over all the responsibilities for managing the good and bad
assets of the problem bank. The main objective of this arrangement would be to sell the
entire bank, including all of its assets, and to negotiate with the acquirer the fair value of
the assets rather than assets, which would be taken over.

Merger may be a form of a partial sale of non-viable bank to a strong bank. A
merger between a strong and a weak bank frequently leads to the weakening of the
strong bank. To the extent that the authorities directly or indirectly pay the acquiring
bank for saving the bank through the merger, the design of the merger contract would
need to carefully avoid the associated incentive problems (Compendium of document
produced by the Basle Committee on Banking Supervision, 1997).

The authorities may chose to close problem banks that have no systemic
importance and are unlikely to be profitable even when re-capitalized. These are likely
to be small banks with large shares of problem assets and little management skills. In
this case the government may leave both owners and creditors to absorb the losses.
Liquidation may be an important instrument when there are many small non-viable
banks in the system. In most central European countries, liquidation does not appear to
be a promising approach for resolving systemic problems, because of the concentration
of banking assets in large problem banks.

In some countries, the authorities have supported “twinning arrangements”
between domestic and foreign banks. Such arrangements have been aimed at
transferring know-how and providing technical assistance directly between the foreign
bank and domestic problem bank. However, since twinning arrangements are largely a
one-way street with transfers from the foreign bank to the domestic problem bank, a
profitable foreign bank would only be interested in investing in twinning arrangements
if it acquires the option to purchase the bank at a later stage. In this case the foreign
bank might consider the twinning process as a test phase for a future planned take-over
rather than a long-term strategy to restructure a bank.

To discourage “wait and see” tactics, the government reserves the right to
terminate the auctions with some points left unused. After the auctions are completed,
stock certificates will be sent to the winning bidders. The new owner will elect the boards
of directors, who will supervise the restructuring at their enterprises.

When a bank’s capital has eroded, the bank owners operate under perverse
incentives. If the bank has some capital left, some ownership should remain. Having
lost most or their entire stake in the bank, gambling or “looting” the bank at the expense
of creditors becomes a rational strategy for the existing owners. Government
intervention is, therefore, necessary to remove the previous owners to prevent further
losses. The same dynamic is at work when a significant number of banks in the system
are technically insolvent. The authorities in many central and Eastern European
countries have noted this problem and have, therefore, intervened to contain further
damage. In a systemic context, where new owners are not easily found, the authorities
must often resort to the second best alternative for replacing owners. Previous
ownership rights are eliminated but any revenues that may result from the recovery of
the impaired assets, carved out the rehabilitation agency, will be shared with previous
owners.

When the net value of a bank is positive, the authorities may allow the bank
owners the option to take the initiative to save the bank. Additional capital infusions
from the owners would be used, to offset further losses and rebuild solvency. While this
accordion principle is at work, the present shareholders are adding funds to the bank to
prevent bankruptcy and, hence, to protect their ownership. Preventive recapitalization
procedures can be spelled out explicitly in the banking law, to force bank owners to call
a shareholders meeting under specified conditions, to ask shareholders to replenish the
capital. When the bank’s shareholders do not agree on replenishing the bank’s capital
funds, bank management can be forced to enter into negotiation with the bank creditors,
offering the creditors several options for revising contracts. If no agreement is reached
with the bank creditors, the bank will be put into liquidation. Such preventive measures
were written into the Chilean law, following the banking crisis in early 1980s (Federal
Deposit Insurance Corporation, 1997b).

One intention of the Chilean authorities was to force the banks to take “self
help” measures and to ensure that the bank owners and uninsured creditors would be
actively involved in this process. The system was designed to reduce the government’s
involvement in the bank resolution process. However this procedure has not been tested
in a systemic context. For this instrument to work, owners must have both a sufficient
supplies of funds and confidence in their ability to find management that will return
profitability to the bank.

Attracting new private shareholders by the existing shareholders, while a bank
is in difficulties, might grant new owners priority over the old owners, creating two
classes of shareholders. Thus, the existing shareholders could be excluded from
dividend payments for some time or until certain condition are fulfilled. Alternatively,
the old owners might transform their shares into certificates while new shares are sold to
new owners. The old owners’ certificates would have symbol value first, but could be
exchanged for a modest number of shares at a later time when the bank has returned to
profitability. In such cases, all old owners lose their ownership rights for a time, and may also lose part of their capital.

Banks should periodically conduct an independent review of the adequacy and integrity of their risk management process. Such reviews should be able to relevant supervisory authorities (Principles for the Management of Interest Rate Risk January 1997 BIS). Under these methods of bank resolution, unprotected bank depositors would lose some or all of their claims during liquidation procedures. During reorganization, and even during liquidation, bank depositors are often protected from losing their deposits even if the bank is technically insolvent. The existence and rules of any deposit protection scheme determine the minimum amount of protection granted, but governments have in practice frequently extended a greater protection for social, economic, or political reasons. Contagion effects are one important limitation to apply any instruments that target depositors.

Bank depositors can be divided into several distinct groups: inter-bank deposits, other major deposits and small deposits. Various instruments can be applied to include (or spare) each group from the shouldering part of restructuring costs: Inter-bank deposits are rarely protected by the government or deposit insurance, since banks are assumed to have the capacity to judge risk. During a systemic crisis, where the inter-bank market is at the risk of collapse, the authorities might encourage swaps of deposits for equity (in merger) or long-term Paper (in rehabilitation or sale). Some compensation may be necessary in order to avoid liquidity problems or a during up of Inter-bank funds.

Debt-equity swaps are a standard procedure for reorganizing non-banks. The company’s creditors are forced to accept the conversion of some of the outstanding debt into equity. The conversion lowers the company’s current interest payments and thereby helps to restore profitability. Swapping deposits for equity in a bank is substantially more difficult, because deposit facilities are an essential part of the banks’ business of providing liquidity to clients and demand deposits from the core of the payments system. In the most extreme case, if all deposits were converted into equity, the bank would have difficulty attracting new deposits. If on the other hand, the bank attempts to convert only some of the deposits into equity, depositors would assume that the liquidity of their assets is no longer guaranteed and would immediately attempt to withdraw all the other remaining deposits. To counteract deposits withdrawal, the authorities would therefore have to pronounce a general freeze of depositors’ claims. It is generally recognized that a freeze of deposits might have highly detrimental consequences for public confidence in the banking system.

Equity for bank bonds on the other hand would be a more promising instrument, because the owners of the bank bonds would usually not have additional deposits in the bank, and therefore, there would be no danger of a bank run. The effectiveness of such measures may be limited, because outstanding bank bonds may not be a significant share of the banks liabilities and hence, the interest payable on them would not produce the needed amount of relief. In any event, bond for equity swaps primarily serve as a way to avoid outright defaults on bank bonds. In practice, bondholders may be left holding equity that is of little value and not marketable.

In most countries, the authorities avoid allocating losses to small depositors, because of the adverse effects on public confidence in the banking sector and the adverse impact on the payments system and savings. Dependent on circumstances, some or all of the small deposits are protected either by a deposit protection agency, or any potential loss are funded directly by budgetary grants. In the many instances, where
there is no formal deposit insurance, deposit protection at government expense is still possible.

It is sometimes argued those government bailouts for small depositors are a counterproductive strategy, because it weakens the market discipline. On the other hand, the absence of deposit insurance may protect existing monopolies of savings banks and thus impede the development of a competitive banking market.

Whether intentionally or by default, inflationary conditions sometimes shift a major share of the burden of problem bank loans to small depositors. As inflation accelerates, banks may fail to adjust the rate of return on deposit certificates that would protect the real value of funds. Banks are able to widen their margins during the inflationary period, particularly at the expense of small depositors with undiversified portfolios, with little bargaining power vis-à-vis the bank. In addition, to their substantial costs to depositors, inflation-led write-downs also have adverse incentive effect on the owners, who would otherwise have absorbed at least some of the costs. Borrowers face major adverse incentive affects because they are relieved of their previous financial obligations “free of charge”.

Non-performing loans and insolvent borrowers are the primary contributors to systemic banking problems in transition economies. When systemic banking distress reflects major problems in the enterprise sector, by forcing bankruptcy and seizing assets of all delinquent borrowers, then some borrowers have potential for longer run viability, which will exacerbate macroeconomic problems. The closure of enterprises that might have been able to eventually repay some or all of their debt to banks will also increase the required write down of loans in the banking system and the degree of bank insolvency. Under such circumstances, the governments in countries with banking distress, stemming from widespread enterprise problems, have promoted schemes for facilitating debt renegotiations and enterprise restructuring, to salvage potentially viable enterprises and lessen the degree of losses in the banking system that must be realized. In some countries, the authorities have placed great emphasis on facilitating the process by which banks may enter into agreements with their delinquent borrowers.

The application of the act led to an excessive number of bankruptcy and liquidation proceedings. At the same time, banks were forced to write off loans to these enterprises, threatening the fragile stability of the banking sector at a time when it did not have adequate reserves to write off substantial losses. The act was modified shortly thereafter, abolishing mandatory requirements of filling bankruptcy, and making bankruptcy for delinquent borrowers subject to the approval of creditors (Federal Deposit Insurance Corporation, 1997a).

An indirect way of shifting some of the adjustment burden to the borrowers is debt-equity swaps, wherein a bank exchanges outstanding loans for equity in the borrowing company. In short term, this measure does not improve the bank’s capital ratio but may improve the changes of asset recovery and future improved capitalization. Such swaps affect adversely the bank’s liquidity position, especially as the equity shares are unlikely to trade in the secondary market, while the company is under reorganization. Debt-equity swaps should only be used if the bank has strong reasons to assume that the equity will have competitive returns in the future. Otherwise the bank would merely be swapping one non-performing asset for another.

When banks engage in debt-equity swap on a massive scale, they may run up against limits set in the banking law for the proportion of equity claims that may be held in their portfolio. When one bank is the major lender to an enterprise, a debt-equity swaps may constrain the bank from providing additional loans in the future, since such
lending can place the bank in conflict with prudential rules on exposure to one borrower.

A bank in distress may have outstanding liabilities both to institutions providing benefits to the bank employees (unemployment, health and pension providers) and to the employees themselves (if salaries are not paid in full on time). As banking is a labour-intensive service industry, the bank’s payroll, including benefit payments, is a high proportion of its expenses. Reducing salaries can be a useful option when there is a systemic banking crisis, since large parts of the banking system have similar problems. Exceptional talent will not be attracted by this kind of instrument, causing pay differences to increase. Alternatively, the benefit providers of the bank employees can be asked to shoulder part of the cost. These institutions might attempt to recapture some of the losses at a later date when the systemic crises are over by raising prices or reducing service. (Dietrich, 1996)

Swaps of bonds for assets have been used in many countries to free banks from sharing in the costs of non-performing assets. The state may recapitalize banks by purchasing the banks bad loans and paying for these with bonds, or by providing banks with bonds after full provisioning of their assets. Long-term government loans to banks (tier-2 capital) are another variant of this procedure. The details of such bond-asset swaps vary and in some cases they involve special bond issues, which make it possible to fin-turn their impact on bank earnings or on bank liquidity. Such bonds may be issued jointly by the government or a state property agency if the non-performing loan portfolio, to a large extent, consists of claims on typically carry long-term maturates. For example in Hungary, the government plus the State Property Agency, the State Development Institute and the Gambling Co., Ltd jointly issued bonds with a 20 year maturity to be swapped with bank assets that were classified as bad using the rules of prudential banking supervision.

In Czechoslovakia the National Privatization fund issued 5-year bonds, which were distributed to banks. Parts of the bonds were earmarked to increase the bank capital and were to be paid in cash upon redemption. The remainder was to be used by the banks to write off loans made to enterprises prior to 1990. In the latter case the bonds carried an interest rate fixed at two percentage points above the discount rate. The bonds earmarked for loan write-offs were to be exchanged for shares in the privatized enterprises in accordance with special agreements. This method benefited both the banks and the enterprises receiving debt relief. It contained an interesting incentive structure as the banks agreed to a double swap: loans written off against bonds and 5 years later a second swap of bonds against equity in the enterprises. (Commercial Framework for Private Sector Development, 1995)

This method was used in Estonia on the restructuring and merging of Northern Estonian Bank (Põhja Eesti Pank), Stock Bank (Aktsiapank) and the Baltic Union Bank (Balti Ühispank) in 1993.

Government disposal of problem assets, acquired from banks that have been closed, merged or sold, or through bond swaps for problem assets typically take place in asset management companies. Rehabilitated banks may also run their own asset management units either within the bank or as separate subsidiaries. There may be any number of such companies conducting workouts for the government, but the constraint of finding quality staff usually restricts the number to a few or even only one. While commercial banking management is focused on increasing business volume, building strong client relationships, providing excellent service and maximizing profits, “recovery management” stresses improving collateral, controlling cash flows, obtaining
repayment, controlling management and minimizing losses. The responsibility of asset management companies is to recover as much value as possible from the assets transferred to them. To succeed, the companies need an unconstrained commercial mandate to dispose of their assets in order to maximize returns. This mandate should, for instance, include freedom to sell assets to foreigners or declare enterprises in bankruptcy and seize their assets. In particular the mandate should entail that any assets should be disposed of as quickly as possible (Bonte, 1999).

Sometimes the disposal of problem assets is constrained by the government for social or political reasons (employment effects, strategic production facilities, and essential infrastructure). In such cases the government should take direct responsibility for the asset, either directly or by transferring it to a separate asset management company dealing with "soft" workouts. Such a unit should become part of the government sector and budget (Cheng, 1994).

Bank failures can originate in the mismanagement of individual institutions or in external shocks that affect the whole system. Regardless of origin, problems show up in form of large portfolios of non-performing loans. In order to preserve the franchise values of banks or restore the capacity of the credit market, bank restructuring will be considered. Depending on the circumstances, governments may or may not be involved. Setting up an AMC can be an efficient vehicle in bank restructuring by permitting bank management to focus attention on the core business and the strategy to improve the market position and effectiveness of the normal banking operational. This focus includes building skills, processes and other measures required to meet the demand for basic banking services. At the same time, the bank will be required to improve the internal information and risk-control systems to the quality level that characterizes a sound and stable bank. The demand for improvements should come from the board of directors, the supervisory agency and the government, if the latter is involved in the restructuring. The improved transparency of the financial situation of the core bank could be expected to facilitate efforts to raise equity capital or privatize it (BIS, 1997). The AMC should be able to function independently from the bank. This is important to ensure a distinct focus on the problem assets. A traditional banking perspective, organizational structure and common instructions may not be appropriate to meet the objectives of an AMC. The management team of the AMC should be free to develop a corporate culture, necessary skills and a decision-making process adjusted for the workout. A separate board of directors and management structure, independent from the bank should be established.

A transfer committee should be established to make all the decisions that relate to the transfer of assets from the bank. This committee should also be responsible for executing the actual transfer of responsibility from the bank to the AMC. This process includes informing individual customers that their liabilities are transferred to the AMC and other measures to ensure further customer cooperation through the process. The committee should consist of members from both the bank and the AMC. The role of this committee could be to:

a) ensure that documentation of all engagements listed for transfer to the AMC is sufficient and in line with the requirements defined;

b) question specific valuations if there is reason to believe that these are based on erroneous assumptions;

c) approve the transfer or each individual engagement, leaving the AMC with the right to veto any transfer if information requirements are not met.
If the workout solution includes transfer of the assets into a long-term ownership role, the active workout is over and the role of the organization becomes the one of an asset manager. This requires different capabilities and could be done in specialized functions or subsidiaries. However, long-term considerations should not be a priority when establishing the AMC. The organization will not have time to wait for long-term development project. Thus, it becomes necessary to focus on simple solutions and basic needs. These systems can be further improved when the policies, the organization and the strategies have been more firmly established.

Making sure that problems in a single bank are detected, monitored, and solved is, typically, on of the main duties of the banking supervision authority. When serious problems simultaneously surface in substantial parts of the banking system, or when corrective action is likely to have significant domino effects, the issues have immediate relevance for those authorities responsible for economic and monetary policy as well (Dziobek and Pazarbasioglu, 1997).

Issues, which then surface, are:

- what the role of government and Parliament should be in the process;
- which authorities should be responsible and involved in which way;
- how should the necessary coordination between different authorities be arranged;
- how should workout operations be organized? Because these issues concern several often independent authorities, and because restructuring decisions have a substantial economic impact over a long time, there needs to be a large degree on consensus both in government and Parliament on the organizational set up of the restructuring effort (Dziobek and Pazarbasioglu, 1997).

Such government participation in the decision process must remain restrained, systematic and transparent. This is particularly true if government or parliament decides on special treatment for “politically sensitive” banks of enterprises, which the government may allow to continue, operate at a loss. Such units should really be funded through the budget of some ministry, and should be removed from the restructuring exercise. The authority responsible for restructuring should be asked to accept responsibility only for banks and enterprises whose problems are to be solved using strictly commercial criteria. Such commercial considerations, however, must be modified by judgement on how solutions in individual cases are likely to affect financial stability. For instance, a nonviable bank may be merged rather than closed if closure is thought likely to cause a liquidity crisis; or a marginally viable bank may be closed rather than rehabilitated if financial markets appear to accept and expect such a decision. Departure from commercial criteria should always be clearly argued and motivated to enable parliamentary supervisors to assess the decision. It should, once more, be stressed that the government must speak with one voice it takes decisions in these matters, because disagreement creates confusion and loss of confidence in the financial markets (Cheng, 1994).

1. Conclusions

We may draw some general conclusions from the study:

- The main causes of bank insolvency are the large amount of bad assets inherited from the command economies and new bad loans.
- Funds that are withdrawn from the domestic market in large amounts, may threaten the domestic monetary stability, currency convertibility or both.
A merger between a strong and a weak bank frequently leads to the weakening of a strong bank.

- Inter-bank deposits are rarely protected by the government or deposit insurance, since banks are assumed to have the capacity to judge risk.
- No performing loans and insolvent borrowers are the primary contributors to systemic banking problems in transitional economies.
- When individual banking problems occur, bank management should normally be replaced, to provide both better-quality operations and appropriate incentives to the new bank managers.

References


