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Session I: ***An Overview – What are the issues?***

Financial Restructuring in Asia: the Remaining Challenges

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[1] The view expressed here are solely those of the author and do not neceesarily represent the views of the International Monetary Fund nor those of other members of the IMF staff.

Introduction

Financial crises are, unfortunately, not uncommon; three quarters of the countries in the world have experienced some form of systemic banking crisis in the last twenty-five years.[2] Nonetheless, the crisis, or succession of crises, that enveloped a number of Asian countries in the second half of 1997 was remarkable. It is still too soon to tell the whole story, although a number have tried. To-day, I want to describe briefly what went wrong and why, to relate what has been done to put it right in the immediate aftermath of the crises, and then discuss what remains to be done.

What went wrong?

The causes of the crises varied from country to country and were many. They have been described in detail elsewhere[3] so I will simply identify a few of the factors that were particularly significant in Asia, although to a greater or lesser extent they were factors significant in many other financial crises in other countries at other times. Perhaps the two most important were the excessive indebtedness of corporate borrowers, in part resulting from the low profitability of those borrowers on the one hand, and the support, sometimes explicit but more often implicit, of governments on the other. It was this support that allowed corporate indebtedness to reach such heights. It is difficult to say which factor came first, but clearly the two factors contributed to the excessive leverage and a lack of profitability of the corporate sector and led to an increased vulnerability on the part of the financial sector.

In addition, banks in many Asian countries had, at that time, a very limited exposure to the personal sector; damage to their corporate portfolio then was critical and, in many cases, fatal. This factor was emphasized by the relative lack of development of other sources of capital. Most Asian countries had thriving equity markets but they were usually quite thin and trading was dominated by a handful of issuers. Bond markets, as is true in many mature industrialized countries, were relatively undeveloped, especially for non-financial corporate borrowers. Indeed this could be said, until quite recently, for almost all countries except the United States where the tradition of a corporate bond market is well established. But the risk in many Asian countries was particularly heavily concentrated in the banking system.

A by-product of the implicit government support for the banking system was a lack of developed risk management skills in the banks. In essence, if the government was shouldering the risk, then banks had less need to assess credit risk themselves. Banks became willing acceptors of much higher gearing ratios in their clients than banks in other countries, where reliance could not be had on government support, would be prepared to tolerate.

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[2] See *Bank Soundness and Macroeconomic Policy* by Lindgren, Garcia, and Saal, IMF, Washington, 1996.

[3] See, for example, *Financial Sector Crisis and Restructuring: Lessons from Asia* by Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo, IMF, Washington, 1999, as well as *Financial Restructuring in East Asia: Halfway there?* By Claessens, Djankov, and Klingebiel, World Bank, Washington, 1999

For the same reason, disclosure was often at a primitive stage. There was a lack of interest in banks' financial statements because depositors believed that they encountered no real risk in amassing claims on the banking system. This led to the preservation of poor accounting practices, and a lack of rigorous audit procedures, as well as poor governance both of banks and of their corporate borrowers. It also led, more seriously, perhaps, to a lack of interest in the supervisory process. Consequently, assets tended to be overvalued, provisions became inadequate, and capital was, therefore, consequently overstated. Moreover, even where supervisors might have become aware of the potential for risk, they were unable to persuade governments that they should take strong and unpopular actions. The interests of borrowers and shareholders tended to prevail.

The imbalances accumulated over time. As the deterioration both in the soundness of the corporate sector, and in its derivative, the soundness of the banking sector, the cost of dealing with the problem mounted and the politically difficult decisions became harder to take. In some countries, the extent of the problem was not appreciated, or was even denied. Hence the crisis, and a succession of crises among countries in similar positions, became almost inevitable.

The outcome is well known. Starting in Thailand and spreading to Indonesia, Korea, Malaysia, Japan, the Philippines, and eventually Taiwan, Province of China, investors began to worry not so much that governments would not come to the rescue but that their resources and political will might not be able to hold the shaky edifice up. Confidence eroded rapidly, and spread from one country to the next. Investors and creditors, began to be suspicious of all countries in the region and began to curtail their exposures. As a result, the implicit costs became explicit. Of course, in some countries, such as Malaysia, the infrastructure was stronger, reforms had already begun to be put in place, and the extent of the process was less pronounced. But in others, especially Indonesia, the extent of deterioration was so severe that a major political upheaval was necessary before corrective polices, which were extremely painful, could be enacted.

The 'Asian Myth'

One of the reasons that the imbalances to which I have referred continued so long is that Asian economies, especially the higher growth economies, were believed to be different from the rest of the world. And because the imbalances were allowed to continue that meant that the crisis when it came was especially severe. It is worth looking at these alleged differences. First, Asian economies were believed to have benefited from very high investment rates. Investment often approached 30 percent of GDP as compared with figures that rarely exceeded 20 percent in more mature industrialized economies. But it turned out that much of this investment, at least towards the end of the boom, was not really investment at all. The assets acquired in several countries, such as Japan and Thailand, were real estate for which there was no demand, and may never be a demand. We have all seen the empty office buildings and hotels constructed in this period. In the National Income accounts this appeared as investment, but it was in large part in assets that have not generated any economic return. It would have been better classified as consumption. In some countries,

particularly Korea, the investment was in industrial capacity much of which again failed to produce an economic return and now has to be scrapped. The overcapacity in semi-conductors is a classic case. Again, this is consumption by another name.

The second 'myth' is that Asians were extremely high savers. The obverse of the high investment rate was a very high personal savings rate, reflected in a very high ratio of bank liabilities to GDP. In Malaysia and Thailand, private sector claims reached 150 percent of GDP, and in Korea and Japan the figure was not far short of 200 percent.[4] Again, this turned out to be ephemeral. Many of the assets in the banking system that represented claims against the fictitious investment I have described had to be written off. A consequence was a reduction in the value of the banks' liabilities that exceeded bank capital. In practice, in the vast majority of cases, depositors did not suffer any direct loss. The loss was made good, in part by shareholders of banks, but in many cases, and to a much greater extent, by governments. So the cost will eventually be born by taxpayers, even though it will be spread over many years as the initial cash outflows have been funded by issues of longer tem debt. Some have argued that the major impact of the Asian crisis was a destruction of wealth, but in fact one can argue that the wealth never really existed in the first place.

The third 'myth' is that these governments had pursued prudent fiscal policies with low or negative borrowing requirements. A contrast was often drawn between Asian countries, whose economies were based on personal hard work and thrift, and countries in Latin America and elsewhere whose economies had been supported by excessive government expenditure leading to a rapid growth in the public debt. However, as we have seen, the private sector edifice was often made possible by government support, often implicit, or where explicit not always fully recognized. If the governments had had to construct accounts on a commercial basis and had had to recognize these contingent 'off balance sheet' liabilities then this would have been clear. But for the most part they used common cash accounting methods and these implicit contingent liabilities remained hidden. What happened during the crisis was that these contingent liabilities became 'on balance sheet' obligations as governments had to issue various forms of debt in order to pay for the losses in the banking system, and, in some cases, indirectly, for the losses in the non-bank corporate sector; as a result debt to GDP ratios have risen sharply to levels common elsewhere. This has been particularly evident in Korea and Thailand.

The fourth 'myth' is that these economies had relatively healthy current account balances, or at least modest deficits. They were earning their way in competitive export markets. However, it seems that in many cases exporting companies' ability to compete in international markets was enhanced by their access to credit in amounts that industrial companies would not have found available in countries where there was less official support of the financial sector. In some cases, for example the Korean *chaebol*, companies were able to expand aggressively without much financial constraint as a result. Now that that support is being withdrawn, the exporters are finding that they have to rely more on equity and debt at market prices, and the pressure to increase profit margins is compelling.

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[4] See Claessens and others cited in footnote 3 above.

What was done?

The story of the immediate responses to the crisis in most Asian countries has been frequently told. To summarize here, the first step was to identify and repair the banks' capital positions, in other words asset values had to be written down and the economic capital position of the banks exposed. In many cases, existing shareholders were not able or willing to produce the resources to fill the gap, and a number of major banks in several crisis countries had to be taken into public ownership, while smaller institutions were closed or merged with larger institutions. In other cases, where the deficit was very large, this meant wiping out the existing shareholders. In some cases a partnership of existing shareholders and the public sector was formed with public capital conditional on private shareholders doing their part. In some cases, as in Japan, the government was anxious not to take full control and injected funds by way of preferred equity or subordinated debt. In many cases, the full cost of the asset revaluation was not immediately apparent, or at least was not fully recognized, and a second or third recapitalization has had to take place. Indeed, the overall cost was often two or three times originally conservative estimates. This failure to recognize the true cost resulted from deficient accounting and disclosure arrangements and inadequately staffed supervisory authorities. Valuing assets, especially non-traded assets, is largely a matter of judgment and often there was little experience on which to base that judgment. Sometimes, of course, the costs were overestimated as accounting firms hired to establish the costs felt a pressure to overestimate the write downs where there were doubts about the value of assets, and especially collateral, during the recession.

The second step was to repair the balance sheets of corporate borrowers. These were made worse by the recession that accompanied the financial crisis, and which led to a marked reduction in corporate cash flow. This proved much less easy to do than restructuring financial institutions. Ideally, the two processes should take place concurrently. In practice, corporate restructuring has tended to follow the restructuring of financial institutions. Corporate restructuring is most efficiently handled by the company's creditors, but if they too are in a weak state then their ability to drive the restructuring processing is itself impaired. It was also the case that where the government took a lead role in the restructuring process, its ability to do that in the corporate sector proved much more difficult than in the financial sector where governments have more control, because banks are licensed and supervised. It was also more difficult to value non-financial businesses where there are a much wider variety of stakeholders, creditors, shareholders, employees and customers, with an interest in the outcome. For all these reasons, corporate restructuring has proved a protracted process and is far from complete, especially where business as well as financial restructuring of the company was involved.

The third step was to improve the arrangements for prudential supervision. Where this involved simply changing the rules, this can be a straightforward process. At least, that was true once the authorities had accepted the need to recognize losses and recapitalize banks. But often, in the meantime, there was a tendency to exercise forbearance by adjusting the requirements gradually in order to mitigate the social and budgetary costs. In the end, however, most governments have realized that confidence would only return when the full

rigor of sound prudential requirements was implemented. There has been much debate as to whether there was a credit crunch, in the sense that viable borrowers were deprived of credit and this factor prolonged the recession. Although the evidence is not conclusive, most commentators seem to believe that the decline in credit that accompanied the crisis owed more to a fall in demand than to supply constraints.[5] The first and most immediate task was to introduce meaningful loan classification and provisioning rules, and conservative minimum capital adequacy requirements. But many other rules were also tightened up; in particular, large exposure limits, connected lending rules, FX position limits, and limits on maturity mismatches. In addition, it was often necessary to empower the supervisory authorities to enforce compliance with these prudential requirements more effectively. The more difficult part, however, is to institute a move from an emphasis by supervisors on compliance with regulations to the critical assessment of risk. This requires a broad and deep change in the culture of supervision and often in the political and constitutional position of the supervisory authorities. In some countries, Korea and Thailand, for example, part of the problem lay in the limited ambit of the supervisory authorities which permitted the development of quasi-banking institutions not subject to the full force of the supervisory processes applied to banks. It was necessary then to extend the ambit of supervision; in some cases, this has led to the establishment of unified regulators responsible for the supervision of all financial institutions. This has happened in Japan, Korea, and prospectively, in Indonesia

The fourth step was to improve the legal and accounting infrastructure. This involved insolvency reform, the adoption of internationally recognized accounting standards, the adoption of more effective external auditing arrangements, the adoption of better asset valuation rules, especially for real estate, and so on. It also involved changes to the way these laws were administered. Often this required the setting up of separate commercial courts, and the training of those who act in those courts including the judges. Part of the asset quality problem often lay in the inability of banks to enforce security. Essentially, this meant that, at least in part, apparently collateralized lending turned out to be unsecured. A 20 percent haircut on an asset may be sufficient if the bank could sell it immediately. But if it takes two years to do so, clearly the time value of money is such that a provision that may be adequate in a country where creditors can enforce their rights effectively and speedily, may be totally inadequate in countries where no such certainly exists.. Again, the changing of rules and laws is the easier part. More difficult is the required changes in the ways the new rules are implemented.

Obviously these wide ranging programs of reform have worked best where the political leadership of the country is strong and when it appreciated the need for reform at an early stage. Paradoxically, this political support was often easier to achieve when the crisis itself proved particularly severe. The contrast between Korea and Japan is striking. The former suffered a particularly savage crisis when the country's foreign exchange reserves ran out and banks were no longer able to fund themselves in foreign markets. The need for action was clear and the incoming government accepted the challenge quickly and effectively. In Japan, the country's foreign reserves remained very high and pressure for change was less

[5] See page 51 of *IMF-Supported Programs in Indonesia, Korea, and Thailand,* by Lane, Ghosh, Hamann, Phillips, Schulze-Ghattas, and Tsikata, IMF, Washington, 1999.

compelling. The symptoms of the disease still persist and those who want change, including the present government, are finding it more difficult to achieve. The consequences have been a prolonged period of very limited growth and declining asset prices, with persisting credit losses in the banking system.

The remaining agenda

Many countries have made very substantial progress in reforming their financial system. Dramatic results have been achieved and this has greatly contributed to the rapid rebound of many Asian economies from the crisis. Corporate profitability has improved, the banks' asset quality and profitability has likewise improved and financial systems have become much more resilient. What then remains to be done? As I have already indicated progress has been uneven. In part this reflects the fact that in some countries the crisis was more severe than in others and the challenge the greater. But it also reflects the fact that in some countries the infrastructure improvements required were more far reaching and this is taking longer to achieve. It also reflects the realities of political life. Many of the necessary reforms threaten powerful economic interests which can only be overcome over time and often at considerable political as well as economic cost. The social dimension is also important; many of the reform programs have involved massive lay-offs.[6]

Profitability

One of the principal causes of the weaknesses that occasioned the crises was a lack of profitability in the corporate sector. This contributed to a high dependence on debt financing and a consequent erosion of credit quality, This in turn led to heavy credit costs and a decline in the net income of the financial sector. It was this that eroded the capital base of the financial system. In Japan the process continues, as the recent financial statements of the banks demonstrate. In some countries the recovery in profitability has been quite dramatic, led by a recovery in demand, at first mainly external but then also domestic. In some case this was stimulated by exchange rate adjustments which contributed to a rapid recovery in exports, and this in turn has fed through to corporate profits. Capital structures could then be rebuilt, both by retained earnings but also by attracting new capital which was possible once investors could be assured that their investment would be adequately remunerated.

A recovery in profitability was also helped by removal of the 'zombie' firms that had been able to continue to produce, even though they were in fact insolvent or barely solvent, because the banks continued to support them. It is clear that the presence of such firms can have a damaging effect on the profitability of solvent firms; their removal, therefore, enables price adjustments to be made so that the capital involved can be remunerated and further capital raised as needed.

But much remains to be done here. Even in the more successful recovery countries, such as Korea and Malaysia, corporate profitability, and hence financial system profitability,

[6] Employment in the Korean banking industry has fallen by more than 30 percent.

after taking account of credit costs, is still low by comparison with major markets. The benefits of increased profitability are hard to exaggerate. More profits brings a bigger opportunity to invest in developing new products and services. It attracts capital and new investment, both domestic and foreign, and provides the engine of economic growth and hence well being. But curiously, profitability hardly merits a mention in some commentaries on the Asian crisis.

Competition

One of the aspects of many Asian financial systems before the crisis was a lack of competition. In part this reflected the fact that financial institutions are regulated businesses. This means that entry is often effectively restricted and, more important, so is exit. There may be price competition but often not much product or service competition and very little innovation. Lack of competition demotivates and the result is featherbedding, expensive services (sometimes the expense is not apparent as it is disguised by subsidies) and a failure to provide the financial services the economy needs. Alternatively, as we have seen, competition took the form of new unregulated intermediaries whose activities helped to erode the viability of regulated entities.

One of the problems in managing a crisis is, of course, that the need to raise profitability implies that, at least in the short run, competition is restrained so that the surviving players, often weak themselves, can build up capital and managerial strength. The last thing a convalescent financial system needs is more competition. But there comes a point when competition is necessary to stimulate growth of a financial system so that it can continue to meet the ever changing demands of its customers.. A young fruit tree needs protection until it reaches a certain size, particularly in inclement weather. But when it reaches adolescence some pruning is healthy and will stimulate faster growth. When the tree is bearing fruit then quite drastic pruning is helpful. So with financial systems. At first some protection may be needed, but after a while competition provides a healthy stimulus.

But competition to be effective implies that the fittest survive and the weakest go to the wall. But exit of financial institutions is always difficult. Whereas in many industries an unsuccessful firm can simply be allowed to fade away and ultimately be dissolved or wound up, in the financial sector, that can be messy and there is the problem of what to do with the creditors, short- and long-term. Closing banks risks contagion. Most countries have, therefore, adopted some form of purchase and assumption arrangement whereby the assets of a weak bank are transferred to a stronger bank and the acquiring bank assumes the deposit liabilities. The authorities may then make good any difference and sometimes also help recapitalize the new bank. But it is important to have some mechanism for purely private market mergers and acquisitions that will allow weaker banks to be taken over by stronger banks, thereby allowing well managed banks to survive and prosper and less well managed institutions to disappear. In most countries, such arrangements tend to take place by negotiation and are subject to agreement between the partners. In some cases, the authorities may even play a role in promoting such deals. But there is an increasing tendency for financial institutions to be subject to hostile take-over bids. These can pose tricky problems

for the authorities, both the prudential supervisory authorities and competition authorities and raise issues to do with the relationship between the two bodies.

One reform that helps promote competition is the removal of public guarantees. Many crisis countries have adopted, as a first step in restoring confidence, a blanket guarantee of all the system's liabilities. In some Asian countries, for example, Korea, these guarantees have been successfully removed and replaced with a partial deposit guarantee protecting small depositors, but leaving large creditors unprotected, at least in theory. Getting rid of the implicit guarantee, especially for banks regarded as 'too big to fail', is much more difficult and can probably only be done over time by creating credibility in the overall soundness of the system. It may be possible then to allow a bank to fail with loss to large depositors. But this requires a very robust system indeed..

Capital markets

One of the factors common to many emerging market countries is a relatively undeveloped capital market with a consequential major dependency on the banking sector for financial intermediation. Many mature industrial countries also depend largely on banks for financial intermediation and have much smaller capital markets than, say, the United States where the existence of other forms of financial intermediation can act as a safety valve when the banking system finds itself constrained in its ability to provide credit. The financial system is, therefore, better placed to absorb shocks than is a system dependent on banks alone, especially where claims on corporate customers dominate bank balance sheets. Nonetheless, banks are ideally short term financial intermediaries. Their liabilities are predominantly payable on demand or at short term and their lending facilities are also predominantly short-term. Banks can transform maturities but only up to a point. This absence of long term capital markets has tended to make borrowers dependent on short term funding and has not permitted savers the ability to choose long term assets to meet longer term needs..

This deficiency is being remedied in many countries, but the process is necessarily slow. The development of long term investing institutions, such as life insurance companies and pension and superannuation funds with long term liabilities, provides an appetite for bonds and equity which are essentially the market that borrowers with long term needs should have available to them. But to build a long term capital market needs not just legislation and infrastructure; it also needs confidence by both investors and borrowers and that takes time to build.

Infrastructure

As noted above, the infrastructure is critically important to the development of a sound financial system capable of serving the needs of depositors and borrowers alike.

The first component is an adequate legal system. I am not going to describe at length the sorts of reforms necessary in this area. But it is worth noting that it is not simply a matter of ensuring that the law itself keeps pace with the development of financial intermediation. It is also important that the law is adhered to, which means that there must be a sufficient supply of practitioners and courts available to enforce it. One aspect that is particularly important is insolvency law. Most restructuring agreements can expect to take place outside the courts but it is what happens in the courts that often dictates the sort of settlements that can be reached out of court. One factor here is the extent to which the law and those who administer the law favor creditors as opposed to debtors. Practice varies enormously from country to country, even between the major industrialized countries. English law tends to be very tough on debtors and is therefore favorable to financial institutions. Some other European countries have a more debtor friendly tradition. The United States has its chapter 11 provisions which allow the management to continue operating a business even while its debts remain unpaid and unrestructured. The US system also gives priority to lenders of new money to borrowers who have already sought protection of the courts and this factor can allow defaulting debtors time to work out their problems under the supervision of creditors. In many emerging market countries the law gives a lot of weight to the position of debtors and other stakeholders, including shareholders. This makes it difficult for banks to enforce repayment of loans and to perfect security. Indeed one aspect of financial sector reform that has achieved prominence is the fact that those countries where banks tend to rely on collateral when making lending decisions may find their faith misplaced because they are unable to foreclose on the collateral when the borrower fails to repay. A clear understanding of the respective rights of borrows and lenders is, therefore, essential.

Second is the need for sound accounting principles. As the Enron affair has shown, it is important that accounting principles be just that and not a detailed set of regulations that can be evaded in spirit while complying with the letter. Accountants have a saying that substance should triumph over form. In the Enron case it seems it did not. A problem for many Asian countries is that accounting standards are enshrined in the commercial code and thus become subject to legal interpretation which can prevent the substance of the principle triumphing over the legal form. Most Asian countries have now introduced extensive reforms to accounting principles, including making changes to the accounting standard setting procedures; in some ways these are even more important. Accounting standards are then no longer enshrined in the law but are set as principles by expert and independent bodies in a transparent way and can be modified as market needs change. More and more countries are also subscribing to the principles promulgated by the International Accounting Standards Board.

Perhaps more important is a mechanism for ensuring that the principles are adhered to. Fundamental here is the practice of external auditing by an expert outsider with no vested interest, other than his fee, acting on behalf of the shareholders and able to stand up to the managers of the business if needed. This, as again the Enron debacle has shown, is not always easy to achieve. One of the fundamental principles of sound auditing which has unfortunately taken some time to be adopted is the requirement that the external auditor should make a judgment as to whether the business can be held out to be a 'going concern'. The use of market valuations, including current use values for fixed assets, depends very

much on whether the business can be assessed to be a going concern and therefore likely to continue in business. If the auditor is required to make that judgment and finds that he cannot, then values will have to be adjusted to those values capable of being realized on sale. This will often remove the basis for solvency. The need for fundamental restructuring is then brought to the fore much earlier than would otherwise be the case. It is interesting that even in Japan the going concern concept is only now in the process of being implemented as a standard audit test.

Once an adequate accounting and auditing framework is established then a disclosure regime can be adopted that will have some meaning in the sense that it will enable the process of market discipline to work both on bank customers and on banks themselves. While much has been said about public disclosure by companies, it is also important that bank borrowers are required to disclose adequate information to their creditors, as without good and timely information credit risk cannot be managed efficiently. Public disclosure, on the other hand, presupposes readers of what is disclosed. There are, unfortunately, many examples of companies who have disclosed information that creditors and investors have ignored. The spread of rating agencies capable of critically examining disclosed information can be of great help to investors and creditors in this regard. Of course, small depositors cannot be expected to understand the financial statements of financial institutions to whom they entrust their savings. But what can certainly help is an inquisitive and independent press. Unfortunately, investigative journalism is not that cheap and few publications can afford to do it well. So many countries need to develop a financial press that can interpret, in an impartial way, the plethora of information disclosed by public companies. In many countries, supervisory authorities themselves collect and publish information about supervised institutions in considerable detail. The example of New Zealand deserves study. The authorities in that country require all banks to publish the detailed prudential information normally supplied confidentially to supervisors and the directors are formally obligated to attest to its accuracy.

This brings me to the question of governance. I will not need to say a great deal on this score here as William Witherell will discuss this issue, one on which the OECD have been particularly assiduous. Their code of corporate governance is now widely accepted, not just in the OECD but elsewhere, as a standard to be aimed for. It is crucial to the successful management of financial institutions as indeed for other corporate entities. External parties can do much, but if the proper checks and accountability arrangements do not exist between managers, boards of directors, and shareholders, making appropriate use of external auditors etc., financial institutions will not be liable to take the steps to design and implement strategies that will ensure they remain profitable and successful in providing services to their customers. The point of effective governance of banks is to ensure that the risks of the business are appropriately managed, both in the long run strategic sense but also on a day-to-day basis. There needs to be a framework for risk taking decisions and that framework needs to be observed. You have chosen well your first topic for surveying your members. Good risk management is vital; without it official regulation of financial institutions will be much more difficult.

Finally, there is the need for good quality supervision. I have deliberately left this until last, because it is worth making the point that the supervisor is the last line of protection against unsound banking. First comes the management, second the external audit function and the governance arrangements I have just referred to, third the market, through the disclosure process I have mentioned. The final check is, therefore, the supervisor. Whereas many Asian countries have very substantially improved their prudential rules and have assumed greater powers of enforcement, development of the skills necessary to build effective supervisory authorities will take much longer.[7]

Good supervision is not just an audit of compliance with some mechanical rules. It involves understanding the risks in the supervised institutions and an ability to judge the management of the institution's ability to manage those risks effectively. It needs to be forward looking so that action can be taken at an early stage in a bank's deterioration so that matters can be put right before losses have been incurred by depositors or by the taxpayer. This demands skills not often found in the public sector which in turn demands a style of management also not commonly found in government agencies. It is important that not only should supervisors have powers but they also need considerable operational autonomy so that they can do their work without pressure from interested parties or politicians. This is in many countries difficult to ensure. And legal guarantees are often not enough. When the economic interests at stake are so large, the life of a supervisor can be very vulnerable. It is clear that many Asian supervisory bodies are just beginning that process of transformation. But much has been achieved since the publication in 1997 of the *Core Principles for Effective Banking Supervision* by the Basel Committee on Banking Supervision. Since then the securities regulators and insurance supervisors have also published sets of principles as have those responsible for payments systems. The IMF and the World Bank have established their Financial Sector Assessment Program, in the course of which they now assess the extent to which countries' supervisory arrangements measure up to these and other standards. Meanwhile the FSI in Basel and other regional bodies are developing training arrangements to impart the requisite skills.

Privatization

The second topic on your agenda is the question of bank ownership so I shall conclude by saying a few words on the problems of returning banks to the private sector.

Why is it helpful that financial intermediaries should exist in private ownership? There are many countries around the world where a large part of the process of financial intermediation is carried out by institutions in the public sector. This is true in industrialized countries as well as emerging market countries. Germany and Japan, for example, have particularly large publicly owned financial sectors. The US (although some might argue that the housing agencies are a form of public sector involvement) have a tradition of leaving

[7] For more detail on both supervisory aspects and the infrastructure needed to ensure a sound financial system see *Toward a Framework for Financial Stability* by Folkerts-Landau and others, IMF, Washington 1997.

financial sector intermediation to the private sector. In many countries there are publicly owned development banks or other forms of long term credit institutions often funded directly by the government or through some form of quasi government bond financing. Others, notably some Latin American countries such as Brazil and Argentina have long-established 'national' or 'state' banks which operate as commercial banks. Others have a tradition of more specialized entities that fill gaps that the private sector allegedly cannot fill. In some cases these are designed to favor borrowers, or occasionally depositors, who are deemed to be badly served by the private sector. Although in some cases one suspects that they are badly served by the private sector because the public sector provides services at prices which do not adequately reflect the risks being run.

But in addition, during the crisis, many banks were in part or completely taken over by the state. The state in many Asian countries has, as a result, become the proprietor of a large part of the financial sector, in some cases the predominant part.[8] Quite apart from the possibility of the hidden subsidies that this involves, there is always the risk that the credit granting process will become subject to political influence (much indeed as it was in some cases before the crises, but now more overtly). More to the point, the government now faces a tricky conflict of interest between its role as owner and that as supervisor. As a result, the supervisor can call for additional capital and the owner can plead budget constraints. Similarly the supervisor may object to the owner's call for banks to lend more than might be prudent to specific borrowers or classes of borrowers. Although many are attached to the retention of at least part of the system in public ownership, most Asian countries now see the virtue of returning the ownership of a major part of the system to the private sector. In some cases this will mean the public sector will be less involved than it was before the crisis. In others it should at least result in the restoration of the situation as it existed before the crisis.

Privatization of a bank, however, needs at least two parties. There need to be buyers as well as sellers. Clearly the seller will get a better price for a bank if the bank is profitable or likely to be profitable. That factor suggests some delay is necessary before putting an institution up for sale. On the other hand, the uncertainly as to the institution's future may lead to erosion of skilled personnel and morale and that may leads to a deterioration in soundness and customer base. In such cases a speedy sale may well be beneficial to the taxpayer. Meanwhile, the conflicts of interest mentioned above will continue to apply.

Who should buy? To whom should a government market a bank it wishes to sell? There are three categories of potential investor. First, there is the existing foreign bank. The advantage of this buyer is that a foreign bank, if it is a good one, will bring new skills and management into the market and provide a stimulus to the development of an efficient financial sector. On the other hand, a foreign bank will not necessarily have a long term commitment to the market, especially if it is a relatively small one. Or if it does it may not be interested in all the bank's business. For example, a major international bank may not be interested in the retail sector, or at least the relatively low income part. Furthermore, foreign banks may not know the market and may therefore regard the investment as relatively high

[8] In Korea, the state became the majority shareholder, or sometimes sole shareholder of five of the six large corporate lending banks, and a substantial shareholder in the sixth.

risk. Such a bank may demand a considerable concession in the price. There is also a dearth of major international banks interested in acquiring banks, especially those involved in retail banking, with operations in countries in which they do not already have an involvement.

The second category is the local corporate investor. The advantage here is that such a business will know the market place, if not the business. He will be more committed as a local investor. On the other hand, his motives may be suspect; he may seek to use the bank together with his other business interests and if the authorities attempt to erect firewalls between the two, his interest may diminish if it is believed that these firewalls are effective. For this reason, many countries do not permit such a mixture of commerce and banking or, if they do, insist on such a total separation that an acquisition ceases to make much business sense. On the other hand, a large corporate shareholder is more likely to be available to provide support, both in a managerial sense as well as a source of capital, if problems occur.

Finally, the government can sell in the domestic (or foreign) market to portfolio investors. The advantages here are that the bank remains nationally owned and that the problems of conflicts of interest between depositors and shareholders are minimized. On the other hand, there would be no controlling shareholder to whom the supervisory authority could look to for support in case of need, and the shareholders would be unlikely to exert much accountability by management. This may not matter if there is an effective public equity market; disappointing results will lead to a decline in share price which can be a powerful stimulus to a board of any company to improve management performance. An offer of shares in domestic markets (to which foreign investors could, of course, subscribe too) depends upon the capacity of that market and many Asian equity markets are already finding the supply of new stock is in danger of flooding the market. It will take time to absorb. Recent world-wide declines in equity markets, even though not fully matched in most Asian markets, have also helped to dampen demand for new issues of bank stocks.

Of course, it is also possible to envisage mixes of all three techniques with a ‘strategic investor’ holding a minority, but perhaps significantly sized, stake and an offering of equity in domestic or indeed foreign markets to absorb the rest. And the process can be spread out over time to help deal with the absorption problems. There are thus a variety of ways that governments can deal with these problems. Of course in many countries governments also have ambitious programs for the privatization of non-financial government owned entities, for example utility companies. And these may conflict with the timing of offers of shares in financial institutions in a market whose capacity to absorb new issues may be limited.

Conclusion

To conclude, there were a variety of causes of the Asian crisis of 1997-8, but failures affecting the financial systems were certainly a major part. But it was not just inadequate banks, but implicit government support, that encouraged excessive indebtedness in the corporate sector, low profitability in both companies and financial institutions, and a lack of concern about credit risk, and an inability to manage risk, in both banks and supervisory

organizations. The countries involved to a greater and lesser extent have made very substantial progress in putting matters right. But the reforms achieved so far are largely to the hardware. The software reforms have been set in train but will inevitably take longer, in some cases much longer. The two topics that the PECC Finance Forum has chosen to concentrate on are indeed the important issues. They relate first to the need to instill a credit culture in banks and in supervisory bodies. This needs improved corporate governance, a more efficient and effective infrastructure, including legal and accounting arrangements, better disclosure, more effective supervision, and a more rapid response to problems by the authorities. It also demands a fuller understanding by depositors and investors of what risk means. A good press and helpful dissemination of information by governments and supervisory bodies can be valuable here.

The countries concerned have also embarked on the long road to return the financial institutions that had to be recapitalized, and thus nationalized, during the crisis to the private sector. To do this and achieve full value and thus maximum recovery of the amounts spent will need some patience and hard work in restoring the institutions to profitability. Only when that is done will potential investors feel it worthwhile investing in such institutions. And only then will we be able to assess accurately the cost of the crisis.