ADB INSTITUTE TOKYO
ASIAN DEVELOPMENT BANK INSTITUTE

Workshop on Banking Supervision

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Executive Summary

If there is one good upshot of the current crisis, it is that it highlighted the urgent need for strong financial systems in Asia. Indeed, it had been argued that the Asian crisis fundamentally stemmed from policies that encouraged imprudent lending and excessive risk-taking that made East Asian financial sectors susceptible to adverse shocks. The post-crisis era will see the emergence of a new Asian financial structure that mitigates financial systems' vulnerability. In this new structure, a much improved bank supervision and regulatory framework

How can East Asia better its supervisory and regulatory framework? Learning from other countries' experiences - their successes and failures in actual supervisory strategies - is always one of the best and fastest ways to learn. With this idea, the Asian Development Bank Institute (ADB Institute), the Federal Reserve Bank of San Francisco, and the Pacific Economic Cooperation Council, in cooperation with the Asian Development Bank, the Asia Foundation, and the Philippine Foundation for Global Concerns organized a "Workshop on Banking Supervision." This event, held in San Francisco on October 8 and 9, 1998, brought together a distinguished group of central bankers, banking supervision policymakers, deputies from finance ministries, academics, and representatives from regional financial institutions and think-tanks from the Asia-Pacific region. Part of a broader series of ADB Institute's programs on financial sector strengthening, the Workshop on Banking Supervision aimed to develop practical and workable recommendations for Asian delegates to take back to their respective countries.

The workshop consisted of presentations by international banking supervision experts combined with interactive discussion sessions in smaller groups. The first presentation drew a perspective on banking crises as an international phenomenon, largely stemming from greater financial innovation and liberalization. The next two sessions addressed the issue on how to stabilize and restore confidence once a crisis occurs: What are the parameters for the lender of last resort? How to best conduct the resolutions of failed financial institutions? The last plenary session dealt with post-stabilization measures such as restructuring and recapitalization of banks. The summary that follows presents the highlights of these presentations.

To optimize interaction and sharing of experiences, the participants broke into discussion groups of about six to eight individuals. Each group discussed and reported to the entire group two out of six topics deemed critical in handling banking crises, namely: a) parameters for the role of lender of last resort; b) handling of nonlocal currency claims; c) differentiating institutions for access, pricing, and collateral on emergency liquidity funding; d) identification and disposal of bad assets; e) corporate governance; and f) packaging of banks for sale and related transactions.

In brief, the group discussions tackled the following issues:

a) Identifying parameters for the role of lender of last resort: Under what circumstances does the central bank assume the role of lender of last resort? What are the limits of liquidity support? What are the different mechanisms that the Central Bank utilizes to carry out its role? At what rate of interest should it lend?

b) Handling nonlocal currency claims in a crisis situation: Does the monetary authority handle nonlocal currency claims differently from local currencies in terms of guarantees extended, controls on foreign-exchange sales, etc.?

c) Differentiating institutions for access, pricing, and collateral on emergency liquidity funding: Which institutions are eligible for liquidity assistance? What are the criteria in determining the interest rates to be charged? What are the channels for extending emergency liquidity funding?

d) Identifying and disposing bad assets: How are nonperforming loans classified? What are the guidelines for setting aside provisions for nonperforming loans? What are the mechanisms available for banks to write off their bad assets? What new policies are being adopted to address the lack of transparency issue?

e) Defining corporate governance: What is meant by governance? How do the central banks deal with inadequate disclosure, internal audit, and cross-holding of shares? How extensive/intensive are both on-site and off-site bank examinations conducted? Are the Basle Core Principles for Effective Banking Supervision adhered to? What are the regulations in place for bank directors, officers, and stockholders who are availing themselves of a loan from their bank or subsidiary bank? Are there prescribed limitations on bank exposures to certain sectors, e.g., real estate?

f) Packaging banks for sale and related transactions: How are banks valued? What is the process or sequence in packaging banks for sale? What are the roles of the different institutions involved in the process? What are the criteria for rehabilitating financial institutions or closing them altogether?

International Perspective on the Banking Crisis

Dr. Guillermo Escude, Head of Research of the Banco Central de la Republica Argentina, stressed that because of asymmetric information between borrowers and lenders, banking systems are prone to runs and instability. Government guarantees help provide some solidity to the financial system; unfortunately, it can also lead to undue incentives for banks to take risks, so-called moral hazard problems. Drawing on the Argentine experience of banking crises, he discussed the fundamental lessons learned from the tequila crisis of 1994-95 and the subsequent changes that have been made in the country's financial system. He argued that these past reforms have helped cushion the impact of the Asian crisis on the Argentinian economy.

Moral hazard in the banking industry

Discussed ad nauseam in most conferences on the Asian crisis, moral hazard behavior of banks leading to excessively risky lending is traced to the existence of government guarantees, either in the form of deposit insurance, lender of last resort, or some other forms that signal that government money is on tap to support the system. To cope with the moral hazard problem, regulators typically impose various restrictions on asset holdings, minimum capital requirements (to force bank owners to share more of the lending risks), and regular bank examinations to monitor compliance with these regulations.

Escude held that government safety nets, in spite of their effect on risky lending, have a role to play in establishing stable financial systems. He argued that the case against safety nets in the financial system based on moral hazard considerations has been overstated, especially in the international level, where the insufficiency of international lender of last resort facilities is quite evident.

Lessons from the Tequila crisis

Reflecting on the experiences of the past banking crisis in Argentina, Escude gave insight on why the Asian crisis has had limited effects on the Argentine economy. Notwithstanding the severity of the current global financial crisis, the Argentine economy grew quite robustly amid an environment of low inflation and surging investments and exports. The effects of the present crisis on the Argentine economy has so far been limited to sharp declines in stock and bond prices and minor increases in interest rates, contrasting sharply with the economic deterioration experienced during theTequila crisis.

Escude argued that because of a strong anti-inflationary bias in Argentina, there is a strong political will to uphold the currency board arrangement. The 1994 crisis taught Argentina that the system could survive a massive capital outflow, but spotlighted the weak link in the institutional arrangement: the financial sector. Thus, efforts were directed to strengthen the banking system.

Some of the policy innovations included raising risk-adjusted capital requirements, and establishing a private deposit insurance scheme fully funded by banks. More importantly, and in order to provide a bulwark against capital flight, a systemic liquidity policy, that in times of tranquility creates the instruments that may be successfully employed in more turbulent times was implemented. Such systemic liquidity policy has many provisions which include requiring banks to obtain international contingent lines of credit and to hold a specified proportion of their short-term liabilities in prime quality foreign assets, among others. For its part, to enhance international liquidity, the Central Bank has signed a contingent repurchase agreement facility with a number of major international banks.

The aforementioned changes in regulations, as well as the openness of the Argentine economy to foreign investment have had far-reaching consequences. The banking sector had undergone major restructuring through liquidations, mergers and acquisitions, and entry of foreign banks. Likewise, the number of banks has been scaled down. Because of the many efforts at strengthening the financial sector over the past years, it has not been necessary for the policymakers to take significant action during the present crisis.

Stabilizing confidence

Once a crisis occurs, restoring confidence in the financial system rests a great deal on what the monetary authorities do as lender of last resort and on other agencies, like the Federal Deposit Insurance Company (FDIC), that are involved in the supervision and restructuring of failed banks. Mr. Lance Auer, a former officer at the Federal Reserve Bank of New York, and Mr. James Wigand, Deputy Director for Franchise and Asset Marketing at the FDIC, respectively discussed the issues surrounding the lender of last resort facility, and the different options open to regulators in the resolution of failed financial institutions.

Parameters for lenders of last resort

Auer stated that what the lender of last resort should do in crisis depends on: (1) whether the problem is one of bank liquidity or solvency; (2) whether the problem is widespread (systemic) or not; and (3) the cost involved; and (4) the targeted beneficiaries.

Determining whether the problem is one of liquidity or solvency is not straightforward given limited information. He emphasized, however, that the lender of last resort should be temporary, addressing liquidity constraints more than solvency problems. It should, moreover, be fully collateralized. Lending to insolvent banks will only put the central bank at risk.

However, if a crisis has assumed systemic proportions-i.e., affects the whole banking system-the lender of last resort facility becomes an ineffective tool and should not be used for a number of reasons. In the first place, the huge financing needs would strain the monetary system. Secondly, any lending in a system-wide credit situation would have an enormous impact on the money supply and managing the process through sterilization can be very costly. System-wide failures are better handled by government guarantees.

Resolution of failed financial institutions

Wigand discussed three related factors crucial in establishing stability and confidence in the banking system during a crisis. First, how is the failure of the financial institution to be resolved-through purchase and assumption (P&A), insured deposit transfers (IDT), straight deposit payoff (PO), or open bank assistance (OBA)? Second, what is the hierarchy of creditor claims? Third, for bad assets acquired by the government, how are they to be disposed of? All three considerations would have an impact on the cost of the resolution. Regulators should choose the option which minimizes the cost of financial crisis.

Acquiring information on the specific costs involved in resolving individual banks is critical in devising the least cost arrangement for the economy. Reflecting on the experiences of the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) in resolving banking crisis, Wigand said that the least cost method had apparently been the purchase and assumption (P&A) resolution. One drawback of the P&A scheme, however, is that it usually takes time to perform due to diligence between prospective buyers and the FDIC. Given severe time constraints, a bridge bank scheme would be a good alternative. Straight deposit payoff, on the other hand, is a more costly option and should, therefore, be considered only as a last resort. Open bank assistance are generally seldom used, primarily because of moral hazard considerations. However, when there are systemic risks, this option may be chosen.

In the receivership process, the FDIC performs the twin roles of insurer and receiver. As insurer, it helps the stability of the banking system by guaranteeing the timely funding of insured depositors. Wigand gave insight that confidence is tied up with the speed with which depositors get their money. As receiver, the FDIC oversees the liquidation of banks such that it maximizes the return on assets and minimizes the loss to the insurance fund. In liquidating assets, it is important that the priority of claims be very clear.

In the area of asset disposition, the FDIC should attempt toward maximizing the present value recovery to creditors and return assets to the private sector as quickly as possible. To carry this out, several asset disposition strategies can be considered. These include selling at resolution, auction/sealed bid, securitization, equity partnerships or asset management contracting. As with its insurer role, the FDIC should ensure that creditors are paid in the shortest possible time. To ensure fair treatment of borrowers and potential investors, the regulators should see to it that asset disposition is conducted in an open competitive fashion with the highest standards of transparency and disclosure.

Bank restructuring and recapitalization

Patricia Armendariz de Hinestosa of the National Banking Commission of Mexico outlined the decisionmaking process in the course of bank restructuring and recapitalization. Drawing on the Mexican experience, she gave a general overview of the decisions regulators are likely to be faced with at several junctures in the area of bank resolutions, and a consideration of the major tradeoffs involved in such decisions. She stressed that policymakers should be cognizant that effective resolutions are complex processes and involve both across-the-board and case-to-case approaches. Furthermore, she discussed the optimal elements that make up a good infrastructure for bank resolution, an important ingredient for enhancing the resolution process as well as preventing crisis from recurring.

Prerequisites for effective bank resolution processes

In the transition between the crisis and its resolution, one of the major tasks of the authorities is to manage expectations. Unless governments are seen to be in control of the situation, volatility in the financial markets will only heighten and aggravate the liquidity positions of the banking system. To this end, well designed "safety net" systems are crucial for buying time for the authorities to properly diagnose the situation and implement the appropriate prescriptions in times of crises. The most important instruments comprising the safety-net system are: lender of last resort facilities, deposit insurance schemes, a pool of capital available for capitalizing financial institutions and the establishment of a set of solvency indicators and supervision programs. Because such instruments should be set in place in advance, it is clear that the process of stabilizing the banking systems starts even before crises strike.

Designing the safety-net system involves value judgments given the complex tradeoffs involved. For instance, in the lender of last resort, the policymakers have to decide the magnitude of liquidity assistance. Too much liquidity may tempt the banks to gamble excess cash in a moral-hazard setting but too little liquidity, on the other hand, may not solve the problem. Deposit insurance schemes, while instrumental in stabilizing a bank run situation, also involves difficult tradeoffs. Too narrow a coverage may prevent bank runs by depositors but may worsen the liquidity positions of large bank creditors. However, too large a coverage may lead to moral hazard.

Whilst across-the-board measures can help stabilize systemic banking crisis, bank resolutions are ultimately handled on an individual bank basis. Armendariz gave guidelines on the elements of good bank resolution process. As always, the starting point for this process is good diagnosis involving issues of viability, capacity for recapitalization and systems and procedures to back the resolution procedure. As prescription follows diagnosis, the specific needs and characteristic of individual banks should dictate the type of bank resolution to be adopted. The types of resolution are numerous and include the following: capitalization by original shareholders, intervention-cum-resolution, mergers, outright sale of bank, allowing bank to fail, or selling out branches.

Armendariz emphasized that an important issue to tackle in any type of resolution is the management of bad debts. As a general rule, the government must ensure that banks should have in place efficient and complete work-out procedures to handle bad debts. To this end, various arrangements can be made which includes full-risk assumption by governments, full-risk assumption by acquiring institutions as well as other arrangements. In the event that another bank is involved in the resolution process, it is critical that the good bank should not be contaminated by the risks of the bad bank.

Governments can enhance the resolution process by setting up an infrastructure that facilitates bank restructuring. The essential elements of such an infrastructure include: the auditing structure (pool of professional audit firms); training programs in bank management; development of efficient and deep capital and asset markets; and improvement of the legal mechanisms to enforce contracts; good supervisory systems with contingent programs; and access to capital for emergency situations.

Appendix - Presentation by Dr. Patricia Armendariz de Hinestrosa
Appendix - Speech by Dr. Guillermo Escude
Appendix - List of Participants
Appendix - Agenda

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