



Bank Reforms

Lessons from International Experience

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Outline

- ◆ IMF and China
- ◆ China's bank reform challenge
- ◆ Common themes from international experience
- ◆ Case studies-Poland and India
- ◆ Lessons for China

IMF and China

- ◆ China does not borrow from IMF
- ◆ But IMF provides advice on
 - macroeconomic policy
 - reforms, e.g. banking and interest rate reform
 - technical issues, e.g. budget and tax reform
- ◆ Annual Article IV mission provides vehicle for policy advice and IMF surveillance

China's Bank Reform Challenge

- ◆ On bank reform “China is engaged in a last ditch battle that we can not afford to lose”—Premier Wen Jiabao
- ◆ Sheer size of banks (credit about 150 percent GDP) makes success of reform imperative
- ◆ Progress has been made
 - improved bank supervision and regulation
 - NPLs have been reduced
 - two pilot banks undergoing reform and recapitalization
 - performance targets and guidelines for reform set for these banks

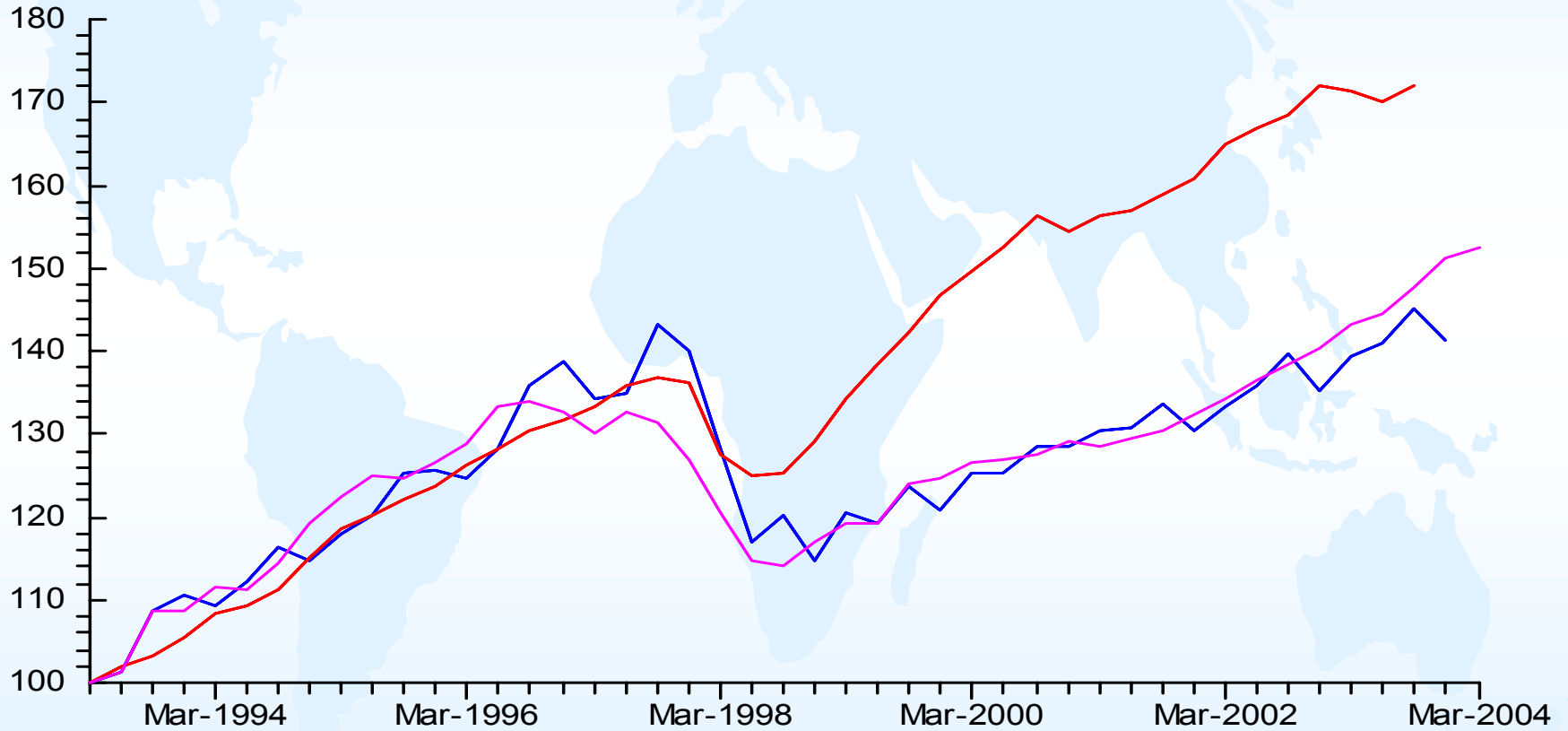
International Experience



- Since 1980, $\frac{3}{4}$ of IMF members had banking stress
- Banking crises are very costly
- For example, 1997-98 Asian financial crisis countries had sharp reduction in GDP

GDP in Asian Crisis Countries

Mar-1993=100



— ID: Gross Domestic Product ... — KR: Gross Domestic Product ...
— TH: Gross Domestic Product:...

What worked in resolving bank crises in other countries?

- ◆ Diagnosis of crisis--critical first step
- ◆ Comprehensive approach—address stock of bad loans and limit flow of new bad loans
- ◆ Strengthen accounting, legal, regulatory and supervisory frameworks
- ◆ Prompt action to limit fiscal costs
- ◆ One lead agency to coordinate restructuring

What worked? (continued)

- ◆ Address management shortcomings, a contributing factor in all bank crises
- ◆ Continuous monitoring of progress toward restructuring, holding banks to a time-bound plan
- ◆ Short-term central bank liquidity support only-- limited to viable institutions
- ◆ Remove non performing loans from balance sheet of viable banks
- ◆ Enhance credit risk management at banks to address the flow problem
- ◆ Implement a loan work-out program

Special Case of State-Owned Banks

- ◆ Many countries privatized State-owned banks
- ◆ Often substantial operational and financial restructuring as part of privatization
- ◆ Government recapitalization linked to operational restructuring
- ◆ Privatization through shares sales with a strategic investor yielded best outcomes
- ◆ Many countries postponed privatization, but took steps to strengthen governance and put banks on a more commercial footing

Case Study: Poland

- ◆ Transformed from monobank system to largely privatized banking sector in less than 10 years
- ◆ Most were recapitalized and restructured prior to sale
- ◆ State recapitalization contingent on asset quality review and development of a restructuring strategy
- ◆ Banks now generally sound and more efficient.
- ◆ 11% decline in staff between 1999 and 2003 while number of branches increased
- ◆ All private banks now majority foreign owned

Case Study: India

- ◆ Early 1990s, dominated by public sector banks
- ◆ Strategy was to gradually reform public banks, without privatization, while increasing competition.
- ◆ Restructuring of public sector banks
 - Injected public funds
 - Tightened prudential standards substantially
 - Increased competition (liberalized entry rules)
 - Staff reductions and branch closures
- ◆ Outcome (CARs > 9 %)
 - Public bank assets fell (from 90% to 75 % of total)
 - None privatized, 15 of 27 have sold shares (25-45%)
 - New private banks emerged

Lessons for China



- Time-bound restructuring plans
- Commercial focus
- Market infrastructure

Time-bound Restructuring Plans

- ◆ International experience shows time-bound plans critical to success of bank reform
- ◆ Rigorously enforce performance targets and governance guidelines for Bank of China and Construction Bank
- ◆ For guidelines on capital adequacy to be reached by the 2007 target, banks need to be held accountable along the way

Commercial Focus

- ◆ Give banks a mandate to operate on a commercial basis with modern corporate governance
 - Independent boards of directors
 - Sound internal control and risk management
 - Comprehensive external audits
 - Foreign strategic investors
- ◆ Insulate them from political influence
 - Central government policy objectives
 - Local government interference
- ◆ Remove ceilings on lending interest rates to enable pricing of risk

Market Infrastructure

- ◆ Strengthen supervision and regulation
- ◆ Modernize tax regime
 - Allow banks to deduct specific loss provisions
 - Reduce or eliminate business tax
- ◆ Improve legal system
 - Bankruptcy: balance creditor and debtor rights
 - certainty in process
 - Supportive environment (auditing, accounting, credit bureaus)
- ◆ Reform State-owned enterprises, including by imposing hard budget constraints

Conclusion

- ◆ Much at stake on bank reform
- ◆ Important lessons can be learned from international experience
- ◆ Successful bank reform will also require effective macroeconomic control
- ◆ But we are confident that China will continue to successfully reform