Annex III

Developments in Emerging Market Banking Systems

The turbulence in global markets in the aftermath of Russia's devaluation and unilateral debt restructuring imposed severe pressures on most systemically important emerging market banking systems, which was reflected in weaker earnings and asset quality. Many Asian and Latin American banks experienced substantial cuts in international interbank credit lines and losses in international repo lines, but their domestic deposit bases proved resilient to the turbulence in 1998—in many cases aided by extensive government guarantees. Banks' responses magnified the transmission of the external liquidity squeeze to local capital markets and the real economy, as they scrambled to restore the liquidity of their balance sheets shifting funds away from the corporate sector and into government securities. Losses in some banks' securities portfolios were followed by increased delinquencies in their loan portfolios owing to a deteriorated operating environment.

Emerging market banking systems outside of Asia weathered the consequences of capital outflows reasonably well, but the recovery of the domestic credit cycle has been elusive—with the exception of some central European banks. Most banks in emerging Asia remained focused on restructuring their bad loans, and uncertainties about the creditworthiness of the (unrestructured) corporate sector kept lending flows subdued. The lack of progress in corporate debt restructuring across the region remains one of the key risks to the strengthening of banks' balance sheets. The largest banking systems in Latin America have shown an enhanced ability to withstand the external liquidity squeeze, but the pronounced slowdown in economic activity has not yet been fully reflected in banks' balance sheets and is leading to further consolidation in the systems. The healthiest banking systems in emerging Europe have continued to attract sizable capital flows and to expand credit to a fledging corporate sector, as competition grows and foreign banks contribute to a more stable and efficient financial intermediation.

Most emerging market banking systems strengthened their regulatory and supervisory frameworks and many are in the process of phasing out full deposit insurance schemes. Following the imposition of extensive guarantees in the wake of financial crises, many emerging market banking systems are considering or have even announced effective timetables to limit the coverage of these guarantees. Large losses in Latin American banks' securities portfolios led to some degree of regulatory forbearance in the immediate aftermath of the Russian unilateral debt restructuring, but regulators moved subsequently to enhance regulation on the classification and valuation of securities, as well as on capital requirements for market risk.[1] Emerging markets in central Europe have strengthened their regulatory frameworks, but significant challenges remain as they face the prospect of full capital account liberalization and contemplate joining the EU. In particular, capital adequacy requirements need to be broadened to include market risks and off-balance-sheet exposures, which are growing in most countries.

Asia

Bankers and government officials in the Asian crisis countries are dealing with the task of bank restructuring and recapitalization, as the credit cycle lags relative to the recovery in financial markets and capital flows. Different countries have followed diverse approaches to financial sector restructuring, but results have been slower than expected. Korea and Malaysia have followed more interventionist approaches to financial restructuring that are producing balance sheet results faster than in Thailand, which has followed more market-driven changes that are likely to prove more resilient. The former countries, which forced banks to reserve/write off nonperforming loans or to sell them to asset management companies, have made substantial progress in strengthening banks' balance sheets and have successfully encouraged mergers and acquisitions. Both countries also have fairly effective bankruptcy and foreclosure laws, but concerns remain about the extent and depth of their achievements in corporate restructuring—especially among Korean *chaebol*. Analysts worry that the rapid results of this strategy may lead to a recurrence of problems and further rounds of recapitalization. Indonesia has closed several banks, but widespread insolvencies and low loan recoveries are hampering progress in financial restructuring. Foreign participation in bank recapitalization has not been large and more government support than originally expected has been needed. Despite the recovery in financial markets and economic activity in most of the crisis countries, the turnaround in the credit cycle has yet to happen and asset quality is only now starting to bottom out.

China has began to set up individual asset management companies to tackle the bad loan problems of the state banks and while the bankruptcy of GITIC has reduced foreign banks' exposures to mainland borrowers, Hong Kong SAR banks have continued to handle the deflationary pressures well. Banks in Singapore are preparing to face increased competition after the authorities' gradual move to liberalize the banking sector.

Indonesia

The resolution of the insolvent Indonesian banking system has left the government as the owner of more than 80 percent of the system's assets and the implied costs—currently estimated by rating agencies at more than 50 percent of GDP—could continue to escalate

[1] See IMF (1998) for the importance of securities in emerging market banks' portfolios and for related innovations in market risk regulation.

unless a forceful loan collection strategy is implemented. The authorities announced a bank recapitalization program in August 1998, which was refined in December 1998. The plan aimed to recapitalize state and local government banks and those private banks that had met minimum capital requirements and had fit and proper managers and shareholders, a viable business plan, and owners that could supply 20 percent of the costs of recapitalization. On March 14, 1999, the authorities announced that 38 banks would be closed, 7 would be taken over by the Indonesian Bank Restructuring Agency, and 9 private banks would be recapitalized. The government will subscribe for up to 80 percent of the banks' rights issues by issuing bonds and the original shareholders will subscribe to the other 20 percent and will have an option to buy back the government shareholding within three years at cost plus a premium (based on an average bond yield). The banks also signed performance contracts that stipulated that banks would reach a capital adequacy ratio of 8 percent, return on equity of 20 percent, and nonperforming loans of less than 5 percent by 2001. Analysts perceive these targets set by the central bank as too optimistic. While the merger of four state banks to create Bank Mandiri—which will have 30 percent of the deposit market—is moving ahead, the restructuring of three other large state banks and 12 Indonesian Bank Restructuring Agency banks has been delayed. In their latest letter of intent to the IMF, the authorities stated that the large state-owned banks would start proceedings against their 20 largest debtors by end-August, 1999, and a consistent strategy to improve loan recoveries includes the closely intertwined task of accelerating corporate restructuring (see Box A3.1).

The successful completion of the second interbank debt exchange is expected to contribute to the restructuring of the banking system, but foreign participation in the bank recapitalization process has been minimal so far. The Indonesian authorities and the Bank Steering Committee reached an agreement on a second interbank exchange offer on March 29, 1999, and most of the $3.8 billion of Indonesian bank external debt due through December 2001 has been rescheduled under better terms than the first exchange. Of the eight private banks that had deposited additional capital under the recapitalization program, only one included the entry of a major international bank. However, some market participants believe that this particular transaction could provide a significant psychological boost to the recapitalization process, and two foreign financial institutions have reportedly expressed an interest in taking a stake in another of the medium-sized private banks. Two large banks that were nationalized last year are slated for privatization in the second half of 1999.

Korea

The Korean authorities have completed the initial stages of the process of recapitalization and restructuring of the banking system, but much remains to be done, in particular on corporate debt restructuring, the cleanup of nonbank financial intermediaries, and the efficiency of the intermediation process. After the closure of five insolvent banks and their absorption by healthier institutions, six other commercial banks were persuaded to merge in 1998 and a four-bank merger was completed in early May 1999—to bring the

Box A3.1. Corporate Debt Restructuring in Asia

Corporate debt restructuring is an essential complement to bank recapitalization, and slow or uneven progress in either one is likely to lead to renewed financial distress and continuing vulnerability. Two factors that make corporate debt restructuring in Asia a major challenge are the lack of an institutional framework to address the issue and the systemic nature of the problem—related to the large number of cases and the involvement of foreign creditors.

Many countries have moved ahead in improving the institutional framework and the degree of government involvement in the restructuring process differs across countries. Most countries are following a market-based, voluntary approach to debt restructuring, where the government plays the role of a facilitator of both formal and informal debt workouts. Formal debt workouts require an effective bankruptcy procedure, that is, one that has clear liquidation and rehabilitation procedures, where the latter attempts to maximize the ex post value of the firm while preserving the ex ante bonding role of debt. The presence of an effective bankruptcy system creates appropriate incentives for debtors and creditors to reach out-of-court (or informal) debt restructuring, and most Asian countries have adopted variants of the so-called “London Approach” to facilitate voluntary debt workouts in an environment where courts lack the experience or resources to handle a large number of cases. Government agencies coordinate, mediate, and arbitrate (and sometimes even dictate) negotiations between debtors and creditors, encouraging also the use of standard agreements to speed up the process. In Korea, the government has played a much more direct role than elsewhere, imposing quantitative targets for the deleveraging of corporates and using its increased position as bank shareholder to encourage restructuring by withholding credit.

A fundamental problem with the voluntary market-based approach is that the London rules were not designed for systemic corporate debt crises, and a case can be made for a bigger government role and a limited use of taxpayer resources in resolving the corporate debt problem (such as the provision of guarantees on exchange rate risk). While this may create moral hazard, there is also the need to recognize that overburdened debtors and creditors have little incentive to arrive at voluntary agreements when the debt overhang problem is related to macroeconomic developments beyond their control. This was recognized in the restructuring of corporate debts in Chile and Mexico in the early 1980s and is behind the government exchange rate guarantees of the Indonesia Debt Restructuring Agreement.

The establishment of an adequate institutional framework is just a first step toward an efficient debt-restructuring process, and implementation is critical. The extent of progress is small relative to the severity of the underlying problems, which makes banks weak and vulnerable to future shocks. In what follows, we briefly describe the main features of the Asian crisis countries’ frameworks for corporate debt restructuring and the extent of progress.

Indonesia

Indonesia has moved to increase the flexibility of a comprehensive framework for debt restructuring that has so far shown few concrete results. A framework for the voluntary restructuring of corporate debt—the Jakarta Initiative—was announced in September 1998 to complement the Indonesia Debt Restructuring Agency (INDRA) scheme and the amended bankruptcy law. The INDRA scheme provides exchange rate risk protection to private debtors who agree to restructure their external debts, while the Jakarta Initiative provides a set of principles to guide and streamline out-of-court corporate restructuring. In late March 1999, the authorities announced modifications to the INDRA scheme to make it more attractive, including an extension of the deadline for entry to end-1999, which remove election-related uncertainties, cap debtors’ annual payments to INDRA during the grace period, and reduce the minimum maturity for rescheduled foreign debt if the original debt is reduced through debt forgiveness or debt-equity swaps. As of end-April, 170 companies owing $20.6 billion in foreign currency debt (an estimated 28 percent of the total corporate external debt) had signed up with the task force in charge of managing the Jakarta Initiative, although only 16 firms had reached agreements in principle and just 4 had standstill agreements. A recent Supreme Court ruling in favor of creditors has reduced negative market perception of the implementation of the bankruptcy law, but market participants are skeptical about many more deals being settled before the elections. Analysts worry that if it takes too long to make further progress on debt restructuring through this largely voluntary process the government might be forced to adopt a more interventionist role.

Korea

Corporate restructuring in Korea is proceeding on two separate tracks: (1) a debt workout framework for the smaller *chaebol* and other large corporations, which follows the London Approach in its voluntary and extrajudicial nature; and (2) a different approach for the top five *chaebol*, that relies on heavy government involvement. A Corporate Restructuring Agreement has been signed by 200 financial institutions, under which the institutions agree to follow specific procedures for debt workouts—including an automatic standstill on debt repayments and emergency (syndicated) loans—and to subject themselves to binding arbitration by the Corporate Restructuring Coordinating Committee. Lead banks or groups of institutions holding more than 25 percent of a corporation's debt can form a creditors' committee and the lead bank—assisted by a group of foreign advisors—negotiates with the debtor corporation. The authorities negotiated with the top five *chaebol* the so-called "big deals"—swaps of subsidiaries and affiliates—and, more recently, Capital Structure Improvement Plans, designed to reduce the number of subsidiaries and affiliates and to reduce their total debt-to-equity ratios to below 200 percent by the end of 1999.

The results so far under this framework are mixed, showing some progress with the smaller *chaebol* under the voluntary debt workout framework and little progress with the top five *chaebol*. As of end-December 1998, workouts for 45 companies had been agreed under the Corporate Restructuring Agreement, but a number of weaknesses emerged from the completed workouts—including concerns about the quality of the due diligence and workout proposals, the banks' reluctance to disclose information and fully integrate their foreign advisors in the process, and the low level of debt write-downs. The unwinding of cross-guarantees has proceeded rapidly but the "big deal" swaps and other aspects of the restructuring of the top five *chaebol* have faced a series of economic and political hurdles and progress has been slow. The authorities' success early in the year in forcing one *chaebol* to comply with the terms of its "big deal" obligations, by ordering the *chaebol*'s principal bank to suspend its credit lines, is encouraging, but rating agencies remain uncertain whether similar results can be achieved for the others. As of December 1998, the debt-equity ratio of the top 30 *chaebol* had declined to 380 percent (and that of the top five to 335 percent), from 519 percent in 1997, but rating agencies have suggested that substantive deleveraging and restructuring has not yet occurred and that it is likely that the banks will bear a disproportionate share of the debt-reduction burden.[1]

Malaysia

The legal framework in Malaysia is relatively effective but only a few cases have been resolved so far. Following amendments to Section 176 of the Companies Act in late 1998, a series of loopholes have been tightened, and creditors now have a reasonably effective legal framework to work out debt problems. Previously, a highly leveraged company could seek protection against its creditors without the creditors' consent or even knowledge. A company now applying for protection under Section 176 would first have to seek the consent of creditors amounting to more than 50 percent of its liabilities. Arrangements would have to be formalized within a stipulated period, and creditors' rights have been greatly enhanced (with debtors facing stricter requirements in terms of disclosure and asset sales during the 60-day standstill period). Despite the creation of a Corporate Debt Restructuring Committee to encourage informal debt restructuring arrangements, as of mid-March 1999 only 48 companies had applied for such arrangements and only two restructuring plans have been implemented. As of end-June 1999, the committee has been able to implement a total of 10 debt restructuring plans.

[1] See, for instance, Moody's (1999a).

Thailand

The institutional framework for debt restructuring has recently been strengthened in the context of a mostly voluntary, market-based approach. The new Bankruptcy Law, approved in April 1998, has recently been strengthened, with the approval of amendments to remove uncertainties on the degree of protection afforded to new money and the establishment of a specialized bankruptcy court. Also, creditors' rights legislation has been amended, with a view to facilitating foreclosure on assets. The creation of a Corporate Debt Restructuring Advisory Committee and the introduction of intercreditor and debtor-creditor agreements is expected to speed up out-of-court debt restructuring. The intercreditor agreement provides a model for an arbitration panel to seek consensus on a restructuring plan when there is agreement of at least half the creditors holding more than 50 percent of total outstanding debt (but less than the 75 percent required under the Bankruptcy Law). Under the debtor-creditor agreement, individual debtors are encouraged to sign debtor-creditor mediation contracts, whereby a legally time-bound resolution process automatically triggers intercreditor arbitration contracts. This contract-driven process is intended to result in debt restructuring or automatic filing for liquidation within six months: much of the restructuring completed so far has taken more than a year to accomplish.

Progress has been slow, but the authorities have taken further steps to accelerate corporate debt restructuring. As of end-April 1999 about 48 percent of the total nonperforming loans had entered the restructuring process but only about 15 percent had been successfully restructured. While no comprehensive database on the terms of the restructuring is available, anecdotal evidence points to small debt reductions for the case of extension in maturities and discounts of about 30 percent in the case of debt-to-equity conversions (reaching as high as 80 percent in at least one prominent case). To accelerate the process, the Corporate Debt Restructuring Advisory Committee has extended its mandate to take on additional cases, has introduced abbreviated versions of the intercreditor and debtor-creditor agreements to cover small firms, is in the process of hiring its own advisors and professional mediators—deal-makers—to guide debtors and creditors toward early settlement, and has eased rules on the classification of restructured loans. Also, the Stock Exchange of Thailand has announced that listed firms under rehabilitation have until the end of the year to reach agreements with creditors before they risk being delisted.

number of commercial banks to 17 (from 27 in December 1997).[2] The government spent W 41 trillion last year (and plans to spend another W 23 trillion this year) to rehabilitate the banking system—roughly half spent in nonperforming loan purchases and the other half used to pay for deposits and inject new capital in restructured banks—to own more than 90 percent of the equity of the second- and third-largest banks. Korea's Financial Supervisory Commission estimates that nonperforming loans amounted to 7.4 percent of outstanding loans at the end of 1998 after the Korea Management Corporation (KAMCO) purchases of bad loans.[3] Bank analysts estimate that the actual nonperforming loan ratio is much higher and, more important, is likely to increase once corporate restructuring takes hold, loan classification is tightened to reflect capacity to repay, and public guarantees for small- and medium-enterprise loans are limited. Banks are downsizing, cutting costs (employment is down by a third and a number of branches were closed), and effecting some changes in management. However, building up risk management and credit assessment skills will be further hauled by the resources involved in the process of corporate restructuring (see Box A3.1).

As foreign confidence in the Korean economy improved in the first half of 1999, the external funding profile of the banking system strengthened considerably. Rollover rates for financial institutions' term loans continued to increase in 1998 and net flows turned positive in January 1999 for the first time since the crisis began. The improved short-term external liquidity position allowed the banks to repay $3.8 billion in one-year foreign debts rescheduled as part of the March 1998 landmark agreement with 134 foreign creditors. Foreign ownership in Korean banks has increased and will continue to drive the reform process. However, as of June 1999, negotiations to sell two large nationalized banks had not been concluded. Apart from strategic foreign investments in nationalized and private banks, foreign ownership of shares in many of the top-tier banks exceeds one-third of total shares.

Malaysia

The Malaysian authorities have moved decisively to restructure the banking system, have established a coherent approach to financial sector restructuring, and are moving rapidly to implement it. However, some analysts remain concerned about the loosening of prudential requirements and moral suasion to expand lending in a still over-leveraged environment. The

[2] Aside from closing 16 out of 30 merchant banks, the authorities closed several insolvent insurance companies, securities firms, and investment trust companies, and some forty credit unions. Many others were placed under rehabilitation plans monitored by the Financial Supervisory Commission, but the restructuring of the nonbank financial system remains incomplete.

[3] As of end-February 1999, KAMCO had purchased W 44 trillion of loans for W 20 trillion, a 55 percent discount. Total disposals and collections were just W 1.7 trillion, but the agency has so far recovered more than it had paid on the most desirable properties.

condition of the banking system deteriorated quite rapidly during 1998, and by end-1998 the nonperforming loan ratio reached 20 percent—using the three-month default period and including loans sold to Danaharta, the government-run asset management company. The combined efforts of Danaharta (which by end-June had bought about 30 percent of the banks' nonperforming loans), and Danamodal (which has recapitalized 10 banks) have contributed to the rehabilitation of the banks and the investors' perception of the country and its banking system. Some analysts believe the 37 percent average discount on the purchase of nonperforming loans[4] has been fairly generous, but the authorities are confident that the discount will be moving up as the acquisition phase is completed. Banks are allowed to amortize the resultant losses over a maximum five-year period, and Danaharta will attempt to restructure the acquired bad loans and if possible avoid auctioning them off at an early stage—with a view to maximizing the recovery value of its assets. Although shareholders absorbed losses before receiving Danamodal's funds, the authorities have been more cautious about removing managers—owing to the relative lack of local banking skills—and are hoping to use their role as strategic shareholders to effect internal changes in banks' lending and risk management practices. In early April, the central bank announced new regulatory measures, including higher capital adequacy ratios for banks with higher risk profiles, disassociating banks from entities (such as securities houses) not supervised by the central bank, disallowing lending to controlling shareholders, intensifying on-site bank examination, and reviewing the performance of bank directors and managers biannually. Market participants worry that the latter could be used to press banks to meet the targeted 8 percent lending growth, a potentially dangerous goal in the context of prescribed maximum lending margins and overleveraged corporations.

Thailand

The severe recession and liquidity squeeze suffered by the Thai corporate sector in the aftermath of the financial crisis, together with a breakdown in the repayment culture, have led to large operating losses and a massive deterioration in Thai banks' asset quality. Nevertheless, nonperforming loans seem to have peaked in February–March 1999, when they reached 52 percent of total commercial lending. The deterioration in economic conditions has been exacerbated by the weak legal infrastructure which gives creditors scant power over delinquent debtors. The weak legal environment has allowed even healthy borrowers to avoid repaying loans, the so-called "strategic nonperforming loans." Analysts estimate that while roughly 40–50 percent of the banks' nonperforming loans are distressed but fit for restructuring, 30 percent of nonperforming loans are not, and about 20–30 percent are "strategic" nonperforming loans that could easily become performing with a tightening of the legal/judicial environment. To speed up the debt restructuring process (see Box A3.1), the Bank of Thailand has relaxed the rules on the classification of nonperforming loans: instead of waiting for three months of renewed debt service on a restructured loan, these will now be classified as normal as soon as the loan restructuring is approved. While this relaxation

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[4] The discount is 61 percent if one large loan bought for a nominal amount is included.

should encourage debt restructuring, analysts fear that it may not resolve the bad loan problem and runs the risk of encouraging banks to disguise loan restructurings as a way of avoiding loan loss provisioning, without regard to the debtor's repayment capacity. The Bank of Thailand has introduced safeguards to prevent such potential abuses in the reclassification of restructured loans, such as requiring that restructurings be done under the Corporate Debt Restructuring Advisory Committee framework or through the judicial courts.

Progress in bank recapitalization has been relatively slow, but a successful initial deal under the state-supported capitalization program and other private initiatives may serve as blueprints for other banks to follow.[5] However, the banking system remains very weak, and current levels of capital and reserves are considered to be far short of the amount by which loans will have to be written down—especially in the mid-sized and intervened banks.[6] So far, only three of Thailand's smaller banks have been successful in forging partnerships with foreign banks, as the privatization of three nationalized banks—originally scheduled for March 1999—was delayed to decide the details of the guarantees to be offered to cover nonperforming loans. The government is committed to sell the three banks in the next several months. During the first quarter of 1999, the three largest private banks raised capital using hybrid financial instruments in an attempt to avoid the loss of control (see Box A3.2). In late April, the country's fourth-largest bank completed a landmark $1.8 billion capital-raising deal whereby the government matched the share purchases of private institutional investors to become the largest shareholder in the bank.[7] Provisioning levels would be raised after the capital injection, reducing the dilution born by the original shareholders.

China

The Chinese banks' asset quality continued to deteriorate in 1998 and the authorities are trying to hold back the rise in nonperforming loans by creating asset management companies in the four state-owned commercial banks. Analysts believe that the four state-owned commercial banks' financial fundamentals have continued to deteriorate in 1998 as a result of falling profitability—which hinders loan provisioning and write-offs—and

[5] Thailand has made substantial progress in cleaning up the finance companies, and asset sales are well advanced.

[6] See Moody's (1999b).

[7] Private investors were given warrants that allow them to buy shares from the government in three years at a prespecified price.

Box A3.2. Hybrid Instruments in Asian Bank Recapitalization

Capital inflows to Asia's banking sector have slowed to a trickle since the currency crises and banks have struggled to satisfy capital adequacy requirements while facing a mountain of bad debts to write off. With the primary equity markets no longer available as a cost-effective source of capital and the controlling shareholders unwilling to dilute their holdings, the largest Thai private banks have developed innovative solutions—including Stapled Limited Interest Preferred Securities (SLIPS) and Capital Augmented Preferred Securities (CAPS)—to replenish their capital bases. Other Thai banks followed the lead of the large banks, and analysts expect the issuance of similar hybrid capital instruments to become a popular route for banks to recapitalize in other Asian countries.

Both types of instruments have essentially the same structure: each one combines noncumulative preferred shares with nondetachable (straight or convertible) subordinated debt. In one prominent case, a fixed coupon of 22 percent is paid on the subordinated debt. The preferred shares pay a return to investors only if the bank has positive retained earnings and pays a dividend to ordinary shareholders, up to a maximum of 23 percent of the face value of the shares.[1] The bank has the option to repurchase the subordinated debt at the end of the fifth year. If the bank does so, then it has the option to repay the preferred shares at par. The result of this rather complex structure is that investors would receive a minimum return of 11 percent and a maximum return of 22.5 percent; both tranches are equally valued at issuance.

The issues have been aimed at individuals with a high net worth who already have deposits at the bank, although the institutional investor base is also expected to expand. The good reception that the instruments have received indicates that there is a ready retail investor base for high yield securities. Bank deposit rates have fallen to such low levels that depositors have been ready to switch into these instruments which offer better returns—up to 600 basis points over deposit rates, even if the risks are considerably higher. Indeed, while public guarantees are in place for depositors and senior creditors, the position of subordinated creditors and preferred shareholders has generally been left unprotected. A key risk is that the bank comes under regulatory control and, as a result, there is a write-down of common and preferred equity. Institutional investors have also demonstrated an appetite for the instruments and the Life Insurance Association of Thailand has already received in-principle approval from the authorities for bank-subordinated debt to qualify as reserves for insurance companies.

The Basel Committee on Banking Supervision advises that hybrid equity instruments should account for no more than 15 percent of a banks' Tier 1 capital but analysts do not view these instruments as pure capital. In October 1998, the BIS included noncumulative preferred shares as qualifying as Tier 1 capital up to 15 percent of the total minimum, but each country is free to define its specific capital requirements and the Bank of Thailand has said that banks will only be allowed to issue SLIPS/CAPS in an amount up to 33 percent of total Tier 1 capital. Analysts and rating agencies see these instruments as a temporary measure that will eventually be replaced by pure equity within five to seven years, when the banks would be able to obtain a better price in a friendlier capital-raising environment.

[1] Provisions for loan losses are only shared with the SLIPS/CAPS holders when Tier 1 capital falls below 4.25 percent—the minimum regulatory requirement.

continued policy lending.[8] While there is a perception outside China that the country is making little progress on financial reforms, the authorities have taken their most aggressive step to date to stem the rising nonperforming loans: the establishment of asset management companies to repackage and sell the problem loans of the big four banks. In a pilot scheme, China Construction Bank's nonperforming loans will be sold to Cinda Asset Management, which was established in April to either collect what it can from these loans or repackage them and sell them off at a discount. The government has reportedly given Cinda the power not only to force the restructuring of state-owned enterprises—including forcing lay-offs—but also to convert unpaid debt into equity—although enabling legislation has yet to be enacted. However, analysts have raised doubts about whether China has the financial infrastructure to enable the asset management companies to work properly, and foresee problems in the valuation, pricing and management of the assets. Also, even if the asset management companies were to relieve the banks of their old bad debts, preventing them from generating new problem loans would be a more difficult task. To improve asset quality and profitability, the four banks will sign "governance contracts"—setting out performance goals and supervisory boards—and are in the process of developing new accounting systems, setting up risk management divisions, and cutting back branches and employment.

The closure and bankruptcy of GITIC prompted a reduction in foreign banks' exposure and an increasing differentiation between sovereign and nonsovereign entities in China, but, despite the external financing pressures, the domestic deposit base remained stable. Foreign creditors have complained of a lack of transparency in the liquidation of GITIC (see Box 3.4, Chapter III) and are calling for a clear definition of repayment priorities. Several other ITICs have encountered liquidity pressures in recent months and total ITIC external debt—including GITIC—is estimated by the authorities at $12 billion—but analysts estimate it could reach $20 billion with the inclusion of unregistered external claims and guarantees. However, only about 20 ITICs (out of a total of 240) have borrowed abroad and the ITICs together account for only about 5 percent of total assets of the financial system. The People's Bank of China has announced that the ITIC sector will be restructured through mergers and the reduction in the scope of ITICs' operations. There have been reports of a migration of corporate deposits from small and medium-sized financial institutions to the large state commercial banks, but domestic deposits in the system as a whole have continued to grow.

[8] While the People's Bank of China estimates nonperforming loans to be 20 percent of total loans, most analysts believe the actual figure is significantly higher. To better gauge the banks' asset quality, this year the People's Bank of China will require them to reclassify their loans into the standard five categories, but officials have not made public the results of banks that experimented with the plan last year in Guangdong province. Also, RMB 270 billion of Special Treasury Bonds have been issued to recapitalize the four state-owned commercial banks.

Hong Kong SAR

The exposures of banks in Hong Kong SAR to the ITICs appear to be manageable and those to the property sector are beginning to recover. Moreover, these risks have to be judged relative to the banks' individual strengths: while nonperforming loans jumped in 1998 to 5.1 percent of total loans—from 1.8 percent in 1997—the average capital adequacy ratio stood at a healthy 18.6 percent by end-1998. The direct exposures of the Hong Kong SAR banks to mainland China entities are relatively small (around 4.5 percent of total assets) and market participants estimate that the indirect exposures (through a slowdown in mainland China) are unlikely to do more than slightly delay the recovery in Hong Kong SAR. The property market appears to have bottomed out in the first half of 1999 and, in particular, residential prices—where the majority of the property exposures are—have rebounded since the last quarter of 1998 (see Figure 3.10, Chapter III).

Singapore

Singapore's banks were adversely affected by the Asian financial crisis and the authorities have moved ahead with reforms to enhance financial sector transparency and position the financial sector for the next wave of regional growth. A sharp increase in nonperforming loans combined with conservative provisioning contributed to a large fall in profits in 1998. The authorities have been promoting consolidation in the sector, and two mergers last year saw the number of domestic banks decline to five. In 1998, the Monetary Authority of Singapore raised disclosure standards for banks and announced plans to fully liberalize the banking system within five years. In mid-May 1999, the Monetary Authority removed the 40 percent cap on foreign investors' total shareholdings in local banks, and over 1999–2001 the authorities will issue up to six licenses to foreign banks to designate them as "qualified full banks", allowing them additional branches and automatic teller machines. Singapore will also raise the number of restricted banks from 13 to 18 by 2001, while offshore banks will gain greater flexibility in Singapore-dollar wholesale business—including larger lending limits and freedom to engage in Singapore-dollar swaps. Meanwhile, the Monetary Authority of Singapore is expected to further ease capital adequacy requirements—currently at 12 percent of risk-adjusted assets—to boost the attractiveness of Singapore to foreign banks and to enhance domestic banks' regional competitiveness.

Latin America

In most Latin American banking systems, the extent of reforms after the Tequila crisis—including increased foreign ownership—and the commitment to improvements in prudential supervision and regulation have served to enhance the resilience to external liquidity pressures and domestic volatility. Although Brazilian banks were most affected by the retrenchment of international banks from Latin America after August 1998, banks in Argentina and Mexico also suffered external liquidity pressures as well as a flight to quality that concentrated external flows in the largest banks. The reductions in international interbank exposures, and subsequent pressures in currency and securities markets, led to losses in the banks' securities portfolios that were absorbed through a reduction in earnings and the equity accounts—and, in the case of Mexico, through regulatory forbearance and central bank support. The persistence of high real interest rates and of the recession has reversed the recent recovery in asset quality across the region, but analysts believe most large banks have adequate capital bases to withstand the increases in delinquency rates. Nevertheless, foreign banks with operations in the region remain extremely cautious about lending decisions, and have reportedly shelved expansion plans to the middle market and consumer sectors and focused on consolidating big corporate clients, asset management, and private banking activities.

Argentina

While Argentine banks faced liquidity pressures from cuts in international interbank credit lines and losses of repo lines following the Russian crisis, the deposit base remained relatively stable even after Brazil's devaluation. This was in sharp contrast to the experience during the Tequila crisis, when the Argentine banking system lost nearly 20 percent of its deposits. This stability reflected a number of factors. There has been a drastic improvement in prudential regulation since the Convertibility Plan was introduced, with capital adequacy requirements exceeding minimum Basel Committee recommendations, much improved disclosure and oversight, and liquidity requirements amounting to 20 percent of deposits and other liabilities of less than 90 days residual maturity.[9] Moreover, as banks became increasingly concerned about spillover effects from Brazil, they sharply increased their holdings of liquid assets to levels above those required by official liquidity requirements. Despite the difficulties associated with maintaining the external contingent repo facility (see Box 3.8, Chapter III), the facility enhanced the perceived liquidity cushion for Argentine banks since it would allow the central bank to make credit lines available to domestic banks in times of a severe liquidity crisis. Also, the periodic disturbances since the Tequila crisis generated several flights to quality that resulted in a concentration of deposits in the top-tier banks that are mostly foreign-owned institutions.[10] Finally, a number of banks have been forced to close since 1997, and the authorities have shown an increasing capacity to respond quickly to these situations—particularly in finding buyers to take over the banks' branch networks—avoiding spillovers to other banks and providing further resilience to the system.

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[9] See IMF (1998) for a description of the main aspects of Argentina's BASIC (bonds, auditing, supervision, information, and credit rating) approach to banking oversight, which combines aspects of the conventional approach to regulation and supervision, with the monitoring and discipline imposed by the market (including the use of credit rating agencies).

[10] The top 10 banks accounted for 69 percent of total deposits at end-1998, compared with 50 on the eve of the Mexican crisis, and foreign banks hold about 40 percent of total deposits.

In addition to building up their liquidity positions, banks responded to the combination of reduced external credit and greater market volatility by reducing the flow of domestic lending. What lending did take place was directed to the top corporates, which had for some time been directly accessing international capital markets. This re-intermediation of the top corporates through the domestic banking system has continued to squeeze the small and medium-sized enterprises that have all but lost access to private credit. The pronounced slowdown in economic activity has not yet been fully reflected in banks' balance sheets, and nonperforming loans increased slightly to just above 10 percent at end-December 1998 from 9.5 percent in September 1998.[11] Banks with significant exposures to securities faced a reduction in earnings or deferred the losses by shifting securities into investment accounts. In response to these developments, a few weak banks being taken over were allowed some time to bring their liquidity requirements up to the norm. In a further strengthening of the regulatory framework, capital requirements for market risk and changes to the accounting standards for securities—initially scheduled for 1998 and aimed at the elimination of the "available-for-sale" account—were implemented on March 1, 1999. The requirement that banks issue 2 percent of their liabilities as marketable debt securities was also implemented on that date, and banks that were unable to issue such securities at that time incurred an increase in both liquidity and capital adequacy requirements of 1 percentage point each.

Brazil

The generalized reassessment of international banks' exposure to emerging markets strongly affected the external liquidity position of Brazilian banks, but the pressures somewhat subsided after the arrangement of an IMF-led financial package in mid-November 1998 and its revision in mid-March 1999.[12] Following a gradual process of reduction in international banks' exposures to Brazil in the third quarter of 1998, the process intensified between mid-October and mid-November 1998, and rollover rates on interbank credit lines for a group of 10 large international banks declined to less than 20 percent. The process of reduction in interbank exposures was particularly pronounced for international banks with significant local operations, a result of head offices' reduction of funding to local offices on concerns about a possible forced rollover. The announcement of the details of the authorities' IMF-supported adjustment program in mid-November allied these concerns and rollover rates on interbank credit lines increased to more than 70 percent in December. The uncertainties surrounding the devaluation of the real prompted another reduction in the rollover of interbank credit lines to around 65 percent in January and February 1999, but in

[11] Net of provisions, nonperforming loans increased from 3.2 percent of total loans to 3.5 percent, over the same period. Moreover, banks continue to be well capitalized, with the capital adequacy ratio (calculated according to Basel rules) steady at 19.8 percent—well above international standards and the requirements of local legislation.

[12] Total BIS reporting banks' exposure to Brazilian banks was reduced by $5.6 billion in 1998, with $5.2 billion of that reduction happening during the second half of the year.

mid-March the authorities obtained assurances from several creditor banks on the maintenance of their interbank and trade credit lines to Brazilian borrowers for at least six months at levels outstanding at end-February 1999. Also, some large Brazilian banks regained access to the international bond market, with issuance rising to $850 million in the first half of 1999 (through end-May) compared to $2.2 billion in the same period of 1998 (and just $130 million in the second half of 1998).

Brazilian banks have weathered the economic downturn and market volatility reasonably well and, although analysts expect a deterioration in their financial fundamentals, most market participants perceive systemic risks to be relatively low. Most Brazilian banks adopted a cautious approach to new lending in response to the poor operating environment in 1998, and applied surplus liquidity to building up holdings of high-yielding short-term government securities. Nonperforming loans rose from 6 percent of the total loan portfolio in mid-1997 to 9.5 percent by end-1998 but the level of provisioning remained above 120 percent of total nonperforming loans. Most banks were protected against the devaluation by means of hedge mechanisms and long U.S. dollar positions, and recorded extraordinary profits during the first quarter of 1999.[13] The ratio of nonperforming loans is expected to increase, especially in those banks with large U.S.-dollar-indexed leasing and consumer portfolios, and rating agencies worry about the repayment capacity of banks' borrowers and the fact that debt refinancings may not be adequately captured in the delinquency ratios. However, total loans account for a small part of the loan portfolio and banks continue to report capitalization in excess of both BIS and local requirements,[14] which may cushion them against the expected increase in delinquencies. Considering the fact that banks are the main holders of government securities, with nearly 60 percent of the total stock, some analysts continue to perceive a government debt restructuring as the main risk to the banking system—but attach a very low probability to such event. Other analysts do not believe that there is any imminent risk of default by the federal government.

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[13] Two wholesale banks suffered significant losses due to large short-dollar positions on the futures exchange. One failed after the devaluation, and the other is undergoing voluntary liquidation. Also, some highly-leveraged (domestic) hedge funds suffered severe losses in January, but this had a marginal effect over the banking system, in part owing to the implementation of Chinese walls after March 1998; in the case of one large bank, management decided to reimburse investors after several lawsuits were filed against the bank's asset management company.

[14] By end-August 1998, the concept of Tier 2 capital was introduced and could be counted towards meeting the capital adequacy requirement of 11 percent of risk-weighted assets. The authorities are committed under the IMF-supported program to adopt capital requirements for market risk and to implement a forward-looking loan classification system.

Chile

The low reliance of Chilean banks on short-term external financing shielded them against the external liquidity squeeze affecting most markets in the region, but the combination of a tightening of domestic liquidity and a sharp deterioration in economic activity damaged the banks' asset quality. To prevent a sharp peso depreciation following a severe terms of trade deterioration, the monetary authorities increased interest rates several times in the first three quarters of 1998, which adversely affected those banks whose liabilities reprice faster than their assets. As a result, profitability in the banking system fell during 1998, while lending increased only slightly and nonperforming loans increased to 1.5 percent in 1998 (from 1 percent in 1997). Nevertheless, provisions rose to 147 percent of impaired loans and the system capital adequacy ratio reached 12.5 percent of risk-weighted assets. Moreover, banks tightened underwriting guidelines and restricted lending to high-risk sectors such as consumer and middle-market. In response to market volatility, new regulations were introduced to allow banks to classify securities as held for trading (with unrealized gains and losses charged to earnings) or held to maturity (with unrealized gains and losses charged to equity), while all securities of less than one year maturity are marked to market.

Mexico

The Mexican banking system had a diminished role in the transmission of the international liquidity squeeze because its role in the credit process continued to shrink, and losses in securities portfolios prompted further official support for the sector. As the financial intermediation activities of the Mexican banking system stagnated after the crisis of the mid-1990s and gradually shifted offshore and to nonbank financial intermediaries, banks focused on purchasing government securities and only recently started to lend to the upper segment of the corporate sector. Also, banks had gradually extended the duration of their securities portfolios in the first half of 1998, demonstrating limited concern about downside risks. As interest rate spreads on emerging market securities widened in the aftermath of the Russian unilateral debt restructuring and the central bank tightened monetary policy, domestic interest rates rose sharply, and the ensuing losses in banks' securities portfolios wiped out the capital of some institutions and prompted the authorities to allow retroactive changes in the classification of securities in banks' portfolios—from trading (marked-to-market) to investment accounts (valued at cost). In addition, the central bank engaged in floating-for-fixed-rate swaps to reduce the banks' interest rate exposure. It is widely believed that these swaps were carried out at subsidized rates. In the event, the subsequent turnaround in interest rates did not help the banks since they had given up the upside potential of their original positions.

After four years of extensive government support, many Mexican banks are still in a weak position, and a rapid recapitalization of the system is critical to help offset the incentives created by unlimited guarantees and regulatory forbearance. The approval in

December 1998 of the IPAB Law[15] allows banking reform to go forward by providing a clearer institutional framework to address bank problems and a timetable for the phasing out of unlimited guarantees (see Box A3.3). During 1998, banks continued to be hampered by both economic and political factors, and profitability remained very low. While asset quality has improved since the Tequila crisis, bankers reported that during the past year, expectations of a further bailout program led debtors to reduce their debt-service payments, and past-due loans edged up to 11.3 percent of total loans by end-December 1998—from 10.7 percent at end-June 1998.[16] Analysts argue that if banks fully provisioned and used international best practices for the classification of loans, several banks would be insolvent and others seriously undercapitalized. In April 1999, the Bankers Association estimated that the industry must boost overall capitalization by at least $5 billion over the following 12 to 24 months to complete the unfinished cleanup of loan portfolios and to build up an adequate capital base to resume normal lending operations. More recently, Moody's estimated the capital gap of the system to be about US$13 billion.[17]

In conjunction with the IPAB Law, the authorities approved the *Punto Final* program, which provides government-subsidized debt relief for mortgage holders, small and medium-sized businesses, and agricultural and fishing entities.[18] Mexican banks have a large share of their assets frozen as a result of the FOBAPROA programs, and IPAB is set to convert the illiquid FOBAPROA notes into liquid securities. Also, the Law has lifted foreign ownership constraints in Mexican banks—prompting talk of a merger between the country's two largest banks—and has paved the way for the resolution of some smaller banks.

[15] Under the law passed in December 1998, the Fondo Bancario de Protección al Ahorro (FOBAPROA) liabilities were transferred to the Instituto de Protección del Ahorro Bancario (IPAB), which will have two units: one charged with liquidating the assets currently in the hands of FOBAPROA and another that will be responsible for deposit insurance.

[16] Salomon Smith Barney (1999).

[17] Moody's estimates of economic capital in the Mexican banking system make a series of adjustments to reported capital, including: (1) a more realistic view of certain impaired assets; (2) adding the unreserved portion of past-due loans; and (3) adjusting assets downward for intangibles and deferred tax credits. The agency believes that the estimates are conservative, and the exclusion of franchise values in the calculations is based on the severity of the legacy of impaired assets and the very weak capital-producing earnings after the 1994-95 crisis (see Moody's, 1999c).

[18] Borrowers that are current or bring their accounts current by end-September 1999 will qualify for discounts of 45 percent for small business loans, 50 percent for mortgages, and 60 percent for farm and fisheries loan balances up to specified ceilings.

Box A3.3. Deposit Insurance: Issues for Emerging Markets

Recent developments in emerging market banking systems have led to a reassessment of the optimal design of bank safety nets, in particular deposit insurance systems. Several academics and rating agencies have stressed that moral-hazard-driven lending played an important role in the Asian banking crises, adding to the existing evidence that explicit deposit insurance increases the probability of systemic banking problems.[1] In part recognizing this role, many of the countries suffering from recent banking crises are considering or even have effective timetables to limit the coverage of their deposit insurance systems. In addition, the results of a recent survey suggest a trend toward the adoption of explicit deposit insurance systems, to make them compulsory (to avoid adverse selection), funded (but, in most cases backed up by governments) and to have risk-based pricing—all elements that improve the incentive effects of the deposit insurance system.[2] However, despite some convergence to best practice among the emerging markets, improvements are still needed in many countries, and several proposals to improve the deposit insurance system have emerged.

Full Coverage During Crises and the Moral Hazard Issue

The immediate consequences of recent banking crises seem to support a strengthening of guarantees during crisis periods, but doubts remain on the feasibility of ameliorating the moral hazard effects during and after a crisis. The example of Indonesia, where the closure of only a few banks—when the solvency of many others was questionable on the basis of information available to depositors—led to bank runs, would suggest that less-than-full insurance under incomplete information on banks' asset quality may be quite costly. However, private information about banks' assets is one key feature of banking, and the historical evidence suggests that the emphasis on the fragility of banking systems in the absence of a government safety net may be overstated.[3] Moreover, full coverage during crises means that guarantees are strengthened precisely when incentive problems are worse—that is, when banks' capital is very low. Also, a tightening of supervision and regulation to prevent the "gambling for recovery" of insolvent banks may be economically undesirable and politically infeasible, as it would require banks to either raise capital in a very difficult environment or reduce loans in a procyclical way.

The recent experience of Mexico and Turkey provide clear examples of the problems created by extensive guarantees several years after a crisis. Both countries suffered severe banking crises in 1994–95 and established full deposit guarantees thereafter. The incomplete cleanup of their banking systems has meant that, as the international capital markets dried up last year, some small and insolvent banks raised interest rates to levels substantially above that of interest rates offered by larger and relatively more solvent banks.[4] As the distortionary effects of the former banks' pricing behavior in the interbank and money markets grew, the government reportedly provided assurances of official support in the case of one Mexican institution to ensure the availability of credit lines, and many Turkish banks were placed under enhanced surveillance.

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[1] See, for instance, Corsetti, Pesenti and Roubini (1998) and Demirgüç-Kunt and Detragiache (1998).

[2] See Garcia (1999).

[3] See Kroszner (1998).

[4] Over the last year, the smaller lower-tier banks in Turkey were reportedly offering dollar-interest rates of over 20 percent a year, while the top-tier banks were paying rates under 10 percent.

Limited Deposit Insurance and the Exit Issue

In an attempt to balance the benefits of avoiding bank runs and the costs of increased risk taking, many countries have limited deposit insurance coverage. Indeed, 62 out of 68 countries surveyed in Garcia (1999) already cover only a fraction of the depositors' accounts, on the grounds that large, informed depositors would exert market discipline on the banks. Also, all of the Asian crisis countries—which are excluded from the survey—as well as Mexico, have announced their intention to limit the coverage of their deposit insurance schemes.[5]

Although a precommitment to limit deposit insurance in countries that already have an explicit deposit insurance scheme entails some risks, it also helps focus reform efforts and muster the support to effectively clean up the system and make it more transparent. Japan is an example where the expectation that the full guarantee of deposits will be eliminated by 2001 has contributed to refocus attention and efforts on restructuring and recapitalization of the banking system (see Annex II). In end-May 1999, Mexico announced that it will phase out unlimited deposit insurance from 2003—when the government expects to complete the cleaning up of the banking system—to guarantee deposits of no more than about US$100,000 by 2005.

While there is some evidence that depositors in emerging markets do exert some sort of discipline on banks, the small extent of depositor losses in recent crises and the strengthening of safety nets casts doubts on the credibility of just limited support in the event of a recurrence of crises. Empirical evidence from Argentina, Chile, and Mexico suggests that depositors (both small and large) do punish banks that take excessive risk, by withdrawing their funds.[6] However, many depositors in these countries had suffered losses from previous crises—usually derived from delayed payments after a deposit freeze—and analysts worry that the lack of meaningful losses in recent crises, combined with a more explicit and credibly funded deposit insurance scheme, may weaken depositor discipline. Moreover, the savings and loan crisis in the United States vividly showed how depositor discipline, and even that of regulators, cannot be fully trusted.

Alternative Proposals

Several alternative proposals for the reform of deposit insurance schemes have been put forward, and they can be broadly classified into three groups or approaches.

The *early intervention/closure approach* has the advantage of maintaining (and strengthening) the existing banking and deposit insurance structures, but critics note that the approach's main flaw is that it relies only on regulators to enforce discipline on the banks. The proposals are inspired by the U.S. experience after the Federal Deposit Insurance Corporation Improvement Act and the Chilean Banking Law of 1986, which attempts to enact clear, explicit principles for a timely regulatory intervention of troubled banks.[7] The principles include prompt corrective action from the banks to restore capital to the required regulatory ratios and a precise specification of several alternative closure and recapitalization mechanisms. The main problem with this approach is that it relies only on bank regulators to identify undercapitalized banks and to enforce regulations,

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[5] The convergence of limited deposit insurance to the same *level* of deposits in the EU has meant that poorer countries, on average, would offer higher coverage in relationship to income than richer countries. Hence, countries with potentially weaker banks could be subject to a higher moral hazard problem.

[6] See Martinez and Schmukler (1999).

[7] See Benston and Kaufman (1997).

while experience in many countries has shown that regulators are not immune to political pressure that may exacerbate incentive problems and fiscal losses.[8]

The *functional approach* is based on the view that there are significant costs in maintaining the current institutional structure. It holds that an efficient solution is for commercial lending to be financed by standard instruments such as debt, preferred stock, and equity, and for deposit insurance to be limited to institutions or accounts that collateralize demand deposits with liquid, riskless securities—such as U.S. treasury securities.[9] This proposal is similar to the "narrow-banking" proposals, but allows institutions that take transaction/demand deposits to also engage in other financial activities, including risky lending. It avoids the difficulties inherent in an effective mark-to-market of the early intervention/closure proposals, but is subject to the credibility problem that, in the event, other liabilities used to finance loans may end up also being fully guaranteed by the government.

The *market-discipline approach* attempts to combine government deposit insurance and regulation, with monitoring and discipline imposed by the market.[10] The key to this approach is to require banks to maintain minimum ratios of subordinated debt relative to insured deposits, such that private agents that do not share on the upside of bank risk-taking behavior have an incentive to constrain that behavior. The proposal requires that the subordinated debt be rolled over gradually—to avoid sudden rollover crises and allow time for corrective action; that it be subject to a maximum spread over a riskless instrument; and that it be held by parties unrelated to the bank holding company or the government—preferably, by foreign banks or institutional investors. Argentina has implemented some of the elements of this proposal, together with the requirement that banks obtain and make publicly available ratings from two well-established private rating agencies.[11] Although some Argentine banks have had difficulties issuing such subordinated debt, this was a result of the currently difficult international environment—which has restricted access to most private entities—and the good reception of the Thai hybrid capital instruments—which include a subordinated debt component (see Box A3.2)—suggest that it may be feasible for emerging markets to follow this approach.

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[8] See Calomiris (1999).

[9] See Merton and Bodie (1993).

[10] See Calomiris (1997, 1999).

[11] The recent proposals to modify the Basel Accord incorporate the use of credit ratings for all sovereign lending and for a limited amount of corporate lending (see Chapter IV).

Venezuela

Instability in international markets, coupled with political uncertainties and tight monetary policy, precipitated an economic slowdown and a relatively pronounced deterioration in Venezuelan banks' asset quality, which is likely to accelerate the consolidation of an overbanked banking system. Although loan growth was very strong in 1997 and the first half of 1998, it slowed down considerably during the second half of 1998 as interest rates peaked and macroeconomic conditions worsened. Asset quality deteriorated, with nonperforming loans increasing to 5.5 percent by end-1998, up from 2.8 percent at end-1997.[19] The ratio of provisions to nonperforming loans fell slightly to 123 percent of nonperforming loans while the capital adequacy ratio increased to 17.7 percent by end-1998—from 133 percent and 16 percent, respectively, at end-1997. The deterioration in asset quality was larger in some small and medium-sized banks with sizable consumer loan portfolios, which continue to represent the system's main weakness. However, analysts believe that, given the structural improvements, this weakness would be more likely to intensify the trend to consolidation rather than provoke a systemic crisis.[20] The ratio of net worth to risk-weighted assets was 15.9 percent in March 1999, and liquid assets (reserves at the central bank, holdings of central bank paper and net foreign assets) represented 36 percent of banks' total deposits. In addition, the authorities have taken measures to help accelerate the consolidation and have continued to improve the revamped regulatory and supervisory framework—including the marking to market of securities and inflation-adjusted accounting. Still, the system continues to be relatively inefficient, owing in part to high reserve requirements and deposit insurance contributions, as well as a recently approved tax on bank debits.

Central Europe

After 10 years of transition in the region, restructuring and privatization have strengthened the banking systems in Hungary and Poland more than that in the Czech Republic. The three banking systems continued to receive sizable foreign capital inflows, but exposures to Russia uncovered the fragilities of the largely state-owned Czech banks and have prompted the authorities to relaunch the bank privatization process. Capital

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[19] The deterioration in asset quality continued in the first quarter of 1999, with nonperforming loans increasing to almost 7.3 percent of total loans by end-March 1999, while provisioning fell to 102 percent.

[20] Unlike Mexico, the Venezuelan banking system recovered rapidly from the systemic crisis of 1994-95, mainly as a result of increased foreign ownership and the fact that local banks were able to recapitalize themselves due to foreign exchange gains and high margins in a negative real interest rate environment (see Moody's, 1999d).

inflows supported strong loan growth in Hungary and Poland, while competition has led to declining profits and a search for higher yields through lending to the small and medium-sized corporate and consumer segments. Losses in brokerage subsidiaries of foreign-owned banks in Hungary led to funding support from head offices in the wake of capital outflows during the Russian crisis, providing an example of the resilience afforded by this ownership structure. All countries have strengthened their regulatory and supervisory frameworks, but significant challenges remain as they face the prospect of full capital account liberalization and contemplate joining the EU. In particular, capital adequacy requirements need to be broadened to include the market risks and off-balance-sheet exposures that are growing in most countries.

Czech Republic

The onset of economic recession and exposures to Russia uncovered weaknesses in the Czech banking system and prompted the authorities to relaunch the bank privatization program and a revision of the regulatory framework. The Czech banks showed an increasing liquidity preference during 1998 and, as a result, total lending fell in real terms. Bank capital positions therefore improved, even though the operating environment deteriorated. While nonperforming loans remained stable at about 18.5 percent of total loans, the banks' average capital adequacy ratio rose to 12 percent at end-1998 from 9.5 percent at end-1997. Despite the stable asset quality, banks' profits in 1998 were negative for the second year in a row, with losses amounting to 0.2 percent of assets. This dismal performance led the authorities to relaunch the bank privatization program. Following the sale of one of the four large state-owned banks in early 1998, the government sold the fourth-largest bank in early June 1999 and announced a timetable for the privatization of the other two—to be completed in 1999. One of the latter two banks—indeed, the second-largest in the country—incurred large losses in Russian securities and derivatives markets and had to be recapitalized by the government at end-1998. The other is also likely to receive an injection of government funds to improve its risk profile in the run-up to privatization. A second revision to the Act on Banks, which strengthened bank licensing and supervision, became effective in September 1998, but more changes are needed to comply with the EU directives—especially on accounting standards. Also, in June 1998 the central bank imposed stricter loan-loss-provisioning requirements, disallowing the netting out of collateral from loans overdue more than 365 days.

Hungary

The strong growth in the external liabilities of the Hungarian banking system was slowed marginally in the aftermath of the Russian crisis, and the repercussions of the events in Russia on local capital markets demonstrated the resilience imparted by a strong foreign presence in the banking sector. Banks' foreign liabilities increased by 18 percent (adjusted by the forint depreciation) in 1998, despite declining marginally in the period after the Russian crisis. The Russian crisis and its spillovers to Hungarian money and capital markets resulted in a decrease in profits and substantial shifts in banks' balance sheets. The share of foreign currency assets rose to 36 percent of total assets at end-1998—roughly the same as that of foreign currency liabilities—from 30 percent at end-June 1998, led mostly by strong growth in foreign-currency-denominated loans. Also, the share of government securities increased to 14 percent of total assets, from 11 percent at the end of the first half of the year. Banks experienced a significant decrease in profits, owing to a deterioration in the quality of their portfolios, the introduction of country risk provisioning, and losses in trading and brokerage operations. Problems at banks' brokerage subsidiaries, as a result of defaults of highly leveraged retail investors,[21] did not lead to many closures, as parent banks—including the head offices of many foreign banks, which dominate the Hungarian banking sector—transferred funds to support their securities subsidiaries. Brokerage losses and the failure of the second-largest retail bank—which was recapitalized by the authorities at year-end—prompted changes to a still well-regarded supervisory and regulatory framework.

Poland

International bank exposure to Polish banks increased during 1998, in part owing to the stable bank relationships with western European banks and the prospects of EU accession, and contributed to strong lending growth. Strong capital inflows led to persistent excess liquidity in the banking system, which was offset by central bank sterilization and through the maintenance of high reserve requirements. Combined with strong competition, this fueled aggressive credit growth—especially in foreign-currency-linked loans to (generally unhedged) borrowers; strong growth in off-balance-sheet activities, albeit from very low levels; and a 35 percent decline in net profits. Restrictions on foreign participation in the banking sector were lifted early last year, and as of end-1998 foreign banks with wholly owned subsidiaries or major equity stakes in privatized banks accounted for 44 percent of total share capital. Foreign ownership is bound to increase substantially with the privatization of the country's largest bank by mid-1999 and that of the last of the nine regional banks later in the year. As a result of the growth in off-balance-sheet positions, the authorities have introduced prudential regulations to limit derivative transactions to 30 percent of equity and have extended solvency requirements to encompass counterparty risks related to off-balance-sheet positions. Although securities are almost one-third of the banks' balance sheet, no capital adequacy requirements for market risk have yet been implemented. Also, while the Polish banking system is evolving rapidly toward a universal banking model, financial sector supervision in Poland is not carried out on a consolidated basis.

[21] Prior to the summer of 1998, retail investors made substantial profits through carry trades conducted through the currency futures markets, which allowed them to profit from the interest differential (adjusted for exchange rate changes) with very low margins. The Russian crisis and its spillovers to Hungarian money and capital markets led to the failure of six brokerage houses.

Turkey

The Turkish banking system faced increased funding and credit risks during 1998, owing to curtailed access to international funding by the lower-tier banks, higher domestic interest rates, and an economic downturn. However, the strength of a core group of well-managed top-tier banks, the treasury's readiness to accept high interest rates, and the stability of the depositor base allowed the banking system to weather the global crisis well. Despite substantial capital outflows in the aftermath of the Russian crisis, external liquidity pressures abated in the last quarter of 1998, and international syndicated loans to the top-tier Turkish banks were rolled over at a higher-than-expected rate. The predominant reason for the renewal of credit lines was relationship banking with international banks, aided by the sophisticated and flexible risk management of the top-tier banks and the treasury's readiness to accept high interest rates in the scheduled bills and bond auctions.[22] The high domestic interest rates have raised questions about the dynamics of the government's debt, but this has so far not been a key concern with the domestic investor base. Domestic depositor confidence was supported by the blanket guarantee of deposits, which allowed some smaller banks and the state-owned banks to offer above-market interest rates to attract deposits (see Box A3.3). Despite concerns about the available resources of the deposit insurance fund, the interventions in two banks that experienced runs were relatively smooth, and some twelve unidentified banks have reportedly been on the treasury's watchlist of financially weak institutions. The maturity mismatch in the sector is not large—except for a few banks that rely heavily on repo transactions—but the large currency mismatch remains a source of concern, despite the tighter regulations that attempt to bring the open positions to 30 percent of equity. As the economy slowed down, asset quality—widely perceived to be overestimated[23]—deteriorated, with the biggest credit risk being the concentration of intragroup lending and guarantees that are not readily apparent in the analysis of banks accounts. Market analysts see the approval of a new banking law that calls for the establishment of an independent bank supervisory body as a crucial step toward reforming the Turkish banking system.

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[22] Turkish banks are the treasury's largest creditors as they hold an estimated three-fourths of the lira-denominated government debt. Because of the importance of government securities in the banks' portfolios, any disturbance to the domestic treasuries market entails serious liquidity risks for the banks.

[23] The real level of problem loans is estimated to be a multiple of the banks' reported ratio of 2 percent of total loans, once restructured credits and bad loans to state enterprises are included.

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