

Financial Sector Reform after the Crisis

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Good morning. It is a great pleasure and honor to be participating in this conference on financial sector reform.

Let me note for the record that these remarks are my own—they do not necessarily represent the views of the Fund or its Board.

Ten years ago, this region was in the midst of a severe financial crisis. The value of the domestic currencies of many East Asian countries was dropping precipitously, banks and their financial affiliates were facing severe funding problems and rising defaults, and foreign short-term capital, which had fueled the booming East Asian economies, was in retreat.

It was a rough period for everyone involved, but one in which we all learned a lot. I was at the World Bank during the crisis and am particularly grateful to the Japanese authorities who quickly recognized the magnitude of the problem in East Asia, the need to support a rapid strengthening of the Bank's crisis management capacity, and the importance of bringing in outside experts to help the Asian countries work through their problems. The region, and its financial sector, emerged stronger and wiser.

Background

The origins of the financial sector crisis in East Asia have been described in numerous speeches and studies. Prior to the onset of the crisis in early 1997, East Asia had benefited from a long period of high and sustained economic growth—what was described at the time by the World Bank as the “East Asian Miracle.” These benign economic times had fostered an environment of greater risk taking by both banks and their borrowers:

1. Banks and corporations had come to rely on short-term foreign currency loans to fund longer-term illiquid domestic projects such as real estate development and manufacturing—both of which generated receipts in domestic currency. This created both a maturity mismatch—borrowing short to lend long—and a currency mismatch.
2. This borrowing strategy was facilitated by explicit government policies of very tightly managed exchange rates – banks and corporate borrowers felt comfortable taking on unhedged foreign exchange positions.
3. Banks were permitted by their supervisors (and by their own internal risk guidelines) to maintain large credit exposures to borrowers affiliated with the banks. Often these

loans were not at arms length—rather they were connected lending, a universal source of problems in banks.

4. The credit culture was weak, in part fostered by the benign economic conditions and in part due to the lending culture in some of the countries. Banks were more forgiving of weak borrowers, who often had loans rolled over rather than placed in default.
5. Risk management systems within the banks were underdeveloped. Often bank management, bank shareholders, the bank's counterparties, and bank supervisors were not aware of the level and source of risks being assumed by the bank. This lack of information made dealing with the banks, once they ran into trouble, problematic.
6. A related problem was that there was a general lack of transparency in the financial sector—neither supervisors nor the market had access to timely reports on banks' balance sheets and exposures.
7. Bank supervision, in many East Asian countries, was weak and some bank owners had significant political influence.
8. Finally, many Governments in the region had for decades implicitly insured deposits by stepping in whenever necessary to protect against bank failures. As a result, there was minimal market differentiation among banks or market discipline imposed on banks that took on high levels of risk.

These benign times came to an end in mid-1997, when the Bank of Thailand was forced to abandon its fixed exchange rate to the dollar.

Financial sector in East Asia is much stronger today

Since that time, countries in East Asia have made significant progress in addressing many of these weaknesses. The financial sector is healthier and the bank supervisory regimes have been strengthened. Government macroeconomic management has significantly improved, countries have adopted floating exchange rate regimes and there is a much greater level of transparency.

Many of the major weaknesses revealed by the crisis in the regulatory and supervisory framework have been addressed. Today, bank supervisors in the East Asian countries have embraced the Basel Core Principles. They have strengthened their supervisory policies and regulations, built up their supervisory capacity, and require banks to hold higher levels of capital.

Banking fundamentals have also been strengthened. Underwriting standards have been raised and risk management policies introduced. Bank capital levels and bank earnings are substantially higher in all five of the East Asian countries that experienced the crisis. Banks and their supervisors are preparing for adoption of Basel II with a much greater emphasis on

risk-based supervision. Corporations, which had been at the center of the crisis, have deleveraged.

I believe that the chances of another financial crisis occurring along the lines of that experienced in the mid-1990's are much lower today. But unfortunately, history has shown us that business cycles and economic downturns are a natural phenomenon. Hence, banks in the region will undoubtedly in the future be faced with asset quality problems and earnings pressures. It is also likely that when problems arise, they will come from new and unexpected areas.

As an example, look at the current problems in North America and Europe sparked by problems in the subprime portion of the U.S. residential mortgage market. Before last year, this sector, which represents 10 percent of the U.S. residential mortgage market, had received little attention from bank management, supervisors, or bank analysts. Today, the subprime mortgage debacle is on the front page of every business newspaper in the United States.

Financial sector has become more complex and no less risky

In my remarks today, therefore, I'd like to focus not on the past, but rather on the supervisory and regulatory infrastructure challenges going forward.

In the 10 years since the crisis, the financial sector has become much more complicated. There is much greater financial sector integration across different lines of business and across national borders. The tools of finance — the lending and investment products and risk-mitigation tools — have become more complex, both for the lender or investor and for the borrower. The supervisory and accounting professions have attempted to keep up with these changes—the supervisory core principles for banking, insurance, and securities supervision have each been revised, and a more sophisticated, but also more complex capital rule has been developed and new international accounting rules have been issued. The result is that the financial sector has become more challenging for all parties. I'd include in this list the managers of financial institutions, financial supervisors, audit firms, borrowers and investors, as well as related parties such as credit rating agencies, financial analysts, and lawyers.

Despite these regulatory and accounting initiatives, which were taken to better reflect the changes occurring in the financial sector, it is unlikely that we will ever develop sufficiently comprehensive and forward looking regulations and risk management systems, or ever be able to hire enough competent bank supervisors, to prevent bank insolvencies. Business cycles and foolish lending and investment decisions will persist. To use the parlance of the day, fat tail events—low probability/high impact events – while thankfully rare, will continue to occur.

In the US financial sector, major problems in the banking sector used to occur on average every 7 -10 years. Generally, the source of the problem came as a surprise each time to the supervisory community. One year it might be energy lending or interest rate risk arising from mortgage finance. The next time, the problem might be in commercial real estate lending or agricultural lending. Good times were accompanied by record bank profits and financial innovations that often appeared to be too good to be true. These were followed by greater risk taking, falling risk premiums, lowered underwriting standards, and a level of complacency on the part of both bank management and supervisors that is difficult to prevent. The challenge we all face is developing regulatory and banking systems that are resilient enough to get through such events without their leading to a general financial sector crisis.

So what can be done to prepare for the inevitable downturn when it comes?

Let me start with two observations:

First, countries within Asia are very different. Cultural and institutional differences, and the pace of economic and financial development, vary widely across the region making any generalizations inaccurate.

My second observation is that most of the challenges I will list this morning are common in other regions. Bank supervisors and central bankers in Europe and North America are today struggling with many of these same challenges. The fact that these challenges are common to supervisors across the globe, however, makes them no less critical. And while I will make references to banking supervision, many of the same issues apply to insurance and securities supervision.

So how well prepared are the East Asian financial sectors for an economic downturn? What areas could be strengthened during these benign times to strengthen the resiliency of the system?

Let me review four areas – credit culture, supervisory capacity, bank capital, and resolution frameworks – that I believe are worthy of greater attention. These are certainly not the only areas that are important but I believe in the context of a discussion of the East Asia experience of 10 years ago, they should be a priority.

1. The first critical component of a resilient banking system is a strong credit culture. Given the reliance in so many Asian countries on bank lending, improving the credit culture needs to be a high priority.

One indicator of a country's credit culture is the speed with which problem loans are resolved. The level of each member country's nonperforming loans to total loans is reported every six months in the Fund's Global Financial Stability Report (GFSR). A review of the ratios in countries that went through the crisis shows that while the ratios are coming down – from an average of 22% in 1999 to under 10% last year, nonetheless, NPL levels remain stubbornly high in several of the countries despite the strong economic conditions of the past few years.

Carrying such a high level of NPLs is expensive, reduces the overall level of competitiveness of the economy, and may be at odds, over time, with development of a more robust and dynamic economy able to absorb shocks. And from a financial stability perspective, the warehousing of NPLs means that when the economy turns down in the future, banks and the government will be in a much weaker position to absorb new losses.

Government (along with legislators), needs to understand the importance of improving the legal and judicial infrastructure required by banks so that they can pursue troubled borrowers. Often politicians appear to be more concerned with protecting borrowers than lenders. They do not understand that periodically providing relief to debtors or dragging out the foreclosure process raises the costs to banks of granting credit and hence, results in a higher cost of credit for everyone.

And bankers need to have strong credit underwriting policies and systems in place and independent credit review functions that spot problems early in the lending cycle, and begin the process of addressing weak borrowers in advance of a default. Particularly important is that the burden for identifying problem loans rests with the bankers and not the bank supervisors. Bankers who show a pattern of not identifying problem loans early in the credit cycle must be held strictly accountable by the supervisors.

2. This leads to a second related element of a resilient banking system, which is a strong supervisory regime. As I noted earlier, each of the crisis countries has made significant progress over the past 10 years in building a more proactive and credible supervisory structure. This has been demonstrated in those countries that have had a formal financial sector assessment (e.g., an FSAP) conducted by the Fund and Bank.

But as with virtually every supervisory regime, there are opportunities for further enhancement of supervision in the region.

Building and retaining a strong cadre of experienced supervisors – which is required in today's more complex financial environment – has become a serious challenge for most supervisory agencies including those in East Asia. Supervisors need to have the resources and capacity to identify problem areas well before an institution is threatened with insolvency. Supervisors need to assess not just the performance of the bank but also the

quality of management. Does management have adequate contingency plans for funding risk and concentration risk, is management well informed and on top of the bank's on- and off-balance sheet risks?

Answering these questions requires that the supervisory agency have senior experienced staff that knows the business of banking. While this objective is easy to state, in fact, achieving it is extremely difficult. It is essential that the supervisory agency have the ability to pay competitive salaries and benefits to retain experienced supervisors, even if those salaries are well above that of the typical government worker.

As importantly, supervisors need to have sufficient legal powers and political independence to take timely and effective remedial actions against banks once problems are recognized. Management needs to believe that their jobs are at risk if they are unresponsive to supervisory guidance and that there is no recourse over the heads of the supervisors to ministers or key members of parliament. Carrying out this objective, particularly in the very large banks or when losses in the sector are minimal, may be extremely difficult. It requires strong leadership at the top of the supervisory agency, credible supervisors, and buy-in from the government officials and parliament who recognize the risk to the country of a weak financial system.

3. A third component of a resilient banking system is ensuring that banks in the region maintain a strong capital position. Capital provides that essential buffer that enables banks to absorb unexpected losses, gives banks the ability to safely expand and enter new lines of businesses, and the flexibility to continue to operate and prosper during economic downturns.

One of the lessons from countries that have gone through a financial crisis is that the biggest losses arose in banks where the owners no longer had much equity at risk if the bank failed – the bank owners engaged in a heads-I-win, tails-you (the government)-lose strategy. To avoid this, management and owners need to have a significant stake in the long-term preservation of their institution's health. From a supervisory standpoint, the CEO should have a greater interest in the viability and solvency of his or her bank than the bank supervisor. The current turmoil in bank liquidity in Europe and North America has demonstrated that when benign economic conditions come to an end, a bank that is able to demonstrate with credibility that it has a strong capital base sufficient to cover its risks will fare much better than institutions that have been skating near the edge of their regulatory capital requirement.

A review of overall bank capital levels in the GFSR shows a wide variation in bank capital levels across the East Asian region, which cannot be explained by different risk profiles. While for virtually every country the capital ratios are higher today than they were several years ago, in 2006, capital ratios ranged from a high of 11.7% to a low of 7.6%. I fully acknowledge that these ratios are merely indicative because of different ways that countries compute their capital ratios and differences in supervisory regimes. But I also have no doubt that banks that hold strong capital reserves and carry low NPLs on their books will be far better equipped to help their national economies weather the next economic downturn in the Asia.

Supervisors can play an important if not critical role in assisting bank management build and preserve a strong capital base. Because of competitive pressures facing bank management to maintain high dividend payouts, it often requires a consistent and well articulated supervisory policy covering all banks to ensure that banks within a country maintain a strong capital level. This policy must be followed by careful monitoring and attention by supervisors. It will be particularly important as countries move to implement Basel II that the supervisory review process contemplated under pillar 2, and the principle of a strong capital base, not be neglected.

4. The final element of a resilient banking system that I would like to highlight is ensuring that a country has an effective infrastructure for the orderly and low cost resolution of problem banks. The Fund's experience in a number of countries is that if a problem bank is tackled early, this can minimize the risk of a full blown crisis. Regrettably, however, we are finding that few countries, in fact, have an effective resolution framework that works as well in practice as it does on paper. We have identified three key pillars of the infrastructure required for effectively resolving an insolvent institution:

- a. First, bank supervisors need to have the authority to rapidly intervene in an institution once it is deemed to be non-viable. While such an action should be subject to judicial review after the intervention – supervisors will occasionally make mistakes -- it is important that owners not have the option of obtaining judicial injunctions to block the supervisory action from occurring. When supervisors reach the judgment that continued operation of an institution under its existing management poses an unacceptable risk to depositors, creditors, and the banking system as a whole, they should have the legal authority (and legal protection) to take control of the institution.
- b. Second, supervisors need the authority and tools in place to be able to manage the intervened bank while they decide what to do with it. They need the flexibility to be able to resolve the bank either through its sale to another institution or new owner, a partial sale of the assets and liabilities, and/or a liquidation of the bank. (This often requires access to financial resources to fill in any capital deficiency and a clear legal mandate.) Optimally a bank resolution should occur at an early point when losses at the bank are low and there are sufficient good assets to cover most liabilities.
- c. Finally, to facilitate supervisory intervention in a bank and minimize disruption to other banks and the economy at large, an effective deposit insurance scheme needs to be in place that provides timely access to funds for households and other small depositors. The objective is not necessarily to bail out all creditors of the bank – rather, the objective is to make bank interventions less costly for the public and to minimize the risk of contagion to other banks. It is unrealistic today to expect retail depositors and small businesses to track the financial condition of their bank. These smaller depositors need to be protected to reduce the political cost of a bank closing. These depositors need to be given access to their funds quickly to avoid imposing liquidity pressures on them and their community.

Conclusion

Before I close, I'd like to briefly expand on my earlier comment that the challenges facing bank supervisors in the region going forward are not unique to Asia.

The present turmoil in the North American and European banking systems and the large and unexpected losses has revealed weaknesses in those countries' supervisory regimes and infrastructure that will undoubtedly lead to changes going forward.

Questions are being raised regarding the quality of risk management and risk models at some of the major financial institutions. Were the banks' on- and off-balance sheet risks adequately disclosed. Do the banks hold sufficient capital against these risks? How well does management and the bank's board of directors understand the more complex structured products? What is the viability going forward of the "originate and distribute" model and what are the contingent risks arising from banks' management, sponsorship, and backup funding of off-balance sheet activities? What are the risks and liabilities to regulated entities from purchasing high risk loans from loan brokers that operate outside of the safeguards applicable to the regulated financial industry? Has there been too much reliance placed on the credit evaluations performed by rating agencies and the credit risk protection provided by insurance companies? How adequate are the deposit insurance schemes and the bank intervention authority of supervisors?

While again one cannot generalize across countries, virtually every one of the four areas mentioned above is under careful review by governments in developed countries because of recent problems that have arisen. Supervisors are asking what worked well in the current period and what was demonstrated to be weak.

In closing, what I find most reassuring is that the gaps in the infrastructure that I have just described are well recognized by bank supervisors in this region. The challenge in Asia, as in other countries around the world, is to build the necessary political support to address the weaknesses in the infrastructure while economic conditions remain favorable and ahead of the next downturn. At the Fund, we will do all that we can to support you in your efforts to address these weaknesses.