CHAPTER THREE

Government Failure in Finance

SINCE THE ADVENT OF BANKING, BOTH IN NORMAL TIMES and in times of crises, governments have taken ownership positions in banking either deliberately or indirectly as a result of a banking crisis. Instances of failed state ownership of banks, privatization followed by crises, and at best limited success in bank restructuring have occurred with sufficient frequency that a reconsideration of government's role in these related areas is overdue. Although many governments have retreated somewhat in their ownership stake in the banking sector in recent decades, government bureaucrats remain active in banking, and in the wake of crises regularly increase their involvement significantly, often for lengthy periods. Yet new research shows that, whatever its original objectives, state ownership tends to stunt financial sector development, thereby contributing to slower growth.

The stable and efficient provision of financial services—regardless of who owns the financial firms providing them—is a realistic goal for all countries, the achievement of which necessitates that governments focus on what they do best. The previous two chapters set out an ambitious agenda for government's role in laying the foundation and creating the regulatory superstructure for sound finance for development. This agenda will be difficult to achieve if the authorities' attention is absorbed by tasks in which they do not have an advantage, notably permanent or temporary ownership of banks, especially when the latter role conflicts with their position as regulator.

Whereas the previous chapter treated how governments should respond to handle market failures, this chapter reviews the evidence on and makes recommendations on government's failures in owning and restructuring banks. Government failure as owner is attributed to the incentives imposed on it by the political process. The few cases of more successful

Government ownership of banks tends to stunt financial sector development—

—as the political process distorts incentives
state banks appears to be linked to a stronger institutional environment and dispersed political powers. Without these advantages, authorities in developing countries generally need to reduce their ownership role, consider creative ways to use the private sector during crises, and focus on their agenda as provider of infrastructure and as regulator. Paradoxically, just as it may take a crisis to induce governments that are already in the sector as owner to get out of it, so too can crisis bring in— as temporary owners— governments that previously retreated or were not active in banking. When large systemic crises do occur and the government acquires an ownership stake, or otherwise takes control, strategies to secure its prompt and early exit should be part of the initial intervention design.

This chapter first reviews the arguments and evidence on state ownership of banks, combining both cross-country evidence with that of some individual country cases. It then turns briefly to a discussion of and evidence on the sequencing of bank privatization. Privatization without the necessary institutional framework has led to crisis and fiscal costs and thus should be tailored to country circumstances. A credible policy of preparing some banks for sale, coupled with new entry, including by foreign private banks, while improving this framework, appears to be sensible in weak institutional settings.

The chapter then turns to governmental failures as temporary owner during restructuring. Not surprisingly, some of the same principles adduced to the state’s behavior as a long-term owner of banks also are applicable to this issue. Indeed, in times of crisis, bank restructuring is an opportunity for significant injections of fiscal resources, and it is important not only to limit the cost to taxpayers and the economy from the injections themselves, but to avoid reliance on bureaucrats to identify ‘winners and losers.’ Working with the market again emerges as a key consideration for a strategic crafting of government’s response.

Bureaucrats as Bankers?

Despite much discussion and some highly publicized increases in private sector activity in most countries’ banking systems, more than 40 percent of the world’s population lives in countries in which the majority of bank assets are in majority-owned state banks (figure 3.1). A glance at the map suggests that government ownership tends to be greater in poorer countries, as confirmed in figure 5 of the Overview.
The incidence of state ownership has declined since 1970 (figure 3.2), but with the largest decreases in high-income countries. Over 30 developing countries, as of the late 1990s, continued to have over half their banking system assets in majority state-owned banks. Given that control is possible even with a lower share of ownership, these figures necessarily represent a lower bound on state control.

State ownership in banking continues to be popular in many countries for several reasons. First, proponents of state control argue that the government can better allocate capital to highly productive investments. Gerschenkron (1962) was among the first to make the case that in a weak institutional environment, private banks would not be able to overcome the deficiencies in information and contracting, or that it would take too long to do so. In the 1950s and 1960s, when many were looking for ways to have developing countries “take off” into self-sustaining...
growth, state ownership of the banking sector appeared to be the way to do it, a view that some may continue to hold. State ownership also makes appropriation of the surplus from finance (financial sector taxation) and directing credit much easier.

Second, there is the concern that, with private ownership, excessive concentration in banking may lead to limited access to credit by many parts of society. Indeed, one argument often heard in developing countries is that governments are reluctant to privatize because it would lead to a concentration of credit at the expense of many groups in their country. Third, a related popular sentiment—reinforced by abuses at and governance problems of private banks in many countries—is that private banking is more crisis prone. Rather than allocating resources wisely, such failures as Barings Bank and Long-Term Capital Management (LTCM—a hedge fund whose risky strategy was funded and mimicked by banks) suggest to some that private banks will be more concerned with gambling, a belief reinforced by postprivatization crises in countries such as Chile (in the early 1980s) and Mexico (in 1994).

A return to the focus of the previous chapter on incentives, however, makes the first point debatable, because bureaucrats do not face incentives designed to reward efficient resource allocation. Elected officials tend to be motivated by securing their political base and rewarding supporters, a role that could conflict with that of resource allocation. And all three arguments are very much empirical propositions.
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Until recently, the primary evidence on this issue has been anecdotal. Although poorly regulated private banks have incurred large losses that are passed on to depositors or, more frequently, to taxpayers, some of the largest losses in history have been incurred by state banks. Two famous and long-established banks, Crédit Lyonnais (nationalized by the French government in 1945 and privatized in 1999) and Banespa (purchased in 2000 by the Spanish bank BSCH, but previously owned by the State of São Paulo in Brazil), for example, each ran up losses estimated in the range of $22–28 billion under government ownership. It is now possible, however, to go beyond isolated case studies. Systematic analysis of available cross-country data indicates that state ownership, especially in low-income countries, is bad for financial sector development and stability, as well as for economic growth.

The key study, that of La Porta, López-de-Silanes, and Shleifer (2000), uses data from private industry sources covering the 10 largest commercial and development banks for each of 92 countries for 1970 and 1995, and finds that greater state ownership of banks in 1970 is associated with less financial sector development, lower growth, and lower productivity, and that these effects are larger at lower levels of income, with less financial sector development, and with weaker property rights protection. Since they are using state ownership in 1970 to explain subsequent financial sector development and growth, there is no possibility that the latter is causing the former. Also, in explaining growth, they control for a wide array of institutional variables. La Porta, López-de-Silanes, and Shleifer find that the channel from state ownership to lower growth is through the impact on productivity. State banks do not generally allocate capital to its highest use. Based on earlier research (chapter 1), through this channel, growth must be reduced as well, and they find no offsetting influence of state ownership on capital accumulation.

La Porta, López-de-Silanes, and Shleifer show that the effects of increasing private ownership are not only statistically significant, but economically meaningful as well. For example, the fitted regression line suggests that, had the share of government ownership in Bangladesh been at the sample mean (57 percent) throughout the period from 1970 instead of at 100 percent, annual average growth would have risen by about 1.4 percent, cumulating to a standard of living more than 50 percent higher than it is today. Although this projection holds other measured variables equal, applying the guidance of box 1.1, it needs to be noted that the implied privatization would also have had to be

The data are convincing: bureaucrats generally are bad bankers—particularly in less developed economies
supported by the necessary institutional underpinnings emphasized below, a significant omitted variable in their approach. Using a different data source, Barth, Caprio, and Levine (2001a,c) show that greater state ownership of banks tends to be associated with higher interest rate spreads, less private credit, less activity on the stock exchange and less nonbank credit, even after taking account other factors that could influence financial development. Thus greater state ownership tends to be anticompetitive, reducing competition both from other banks and from nonbanks. Barth, Caprio, and Levine also note that where state ownership is greater, the number of applications for bank licenses that are rejected tends to be higher and there are fewer foreign banks. With less competition, it would be surprising if greater state ownership led to a wider availability of credit, and La Porta, López-de-Silanes, and Shleifer instead find that the larger the share of credit going to the top 20 firms, the greater is state ownership.

Last, state ownership appears to heighten the risk of crises. Admittedly, though Barth, Caprio, and Levine identified a positive impact of state ownership on the probability of a banking crisis, this impact was not statistically significant with their data. But La Porta, López-de-Silanes, and Shleifer found that greater state ownership is correlated with various measures of financial instability. And, applying a logit model to the La Porta, López-de-Silanes, and Shleifer 64-country data set, Caprio and Martinez-Peria (2000) are able to show that greater state ownership at the start of the 1980–97 period was associated with a greater probability of a banking crises and (with far fewer observations) higher fiscal costs.

The above evidence is consistent with the theme of the last chapter on incentives. Rather than responding to principles of profit maximization, governments tend to be responsive to various interests, and especially to bolstering their support (box 3.1). Indeed, even within the gamut of state ownership, there is some evidence that form matters: Cull and Xu (2000) find that in the 1980s—when direct government financing was more available—Chinese state bank bureaucrats did a superior job allocating credit compared with government agency employees, that is, bank finance was allocated more in line with firm productivity than were direct transfers. One possible reason: these state bankers were paid bonuses related to the profitability of the bank. A contributing factor may have been the availability of direct budgetary funds to meet government agencies' needs, implying less pressure on state banks to engage in

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State ownership tends to reduce competition—

— limit access to credit—

— and may heighten the risk of crisis
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Box 3.1 Political economy and financial policy

Most prescriptions for financial sector policy implicitly envisage a government that seeks to achieve the common good, but this picture neglects both the incentives facing political actors and the political structures within which they operate. Even if they are not motivated by personal financial objectives, these actors are everywhere concerned with their political futures, and are therefore often beholden to sectoral interests. The extent to which sectoral interests hold sway over the decisions of political actors depends, in turn, on the political rules within which they operate, and perhaps also on social norms (cf. North 1999).

The nexus between the political arena and special interests in the financial sector can be especially close if only because (to quote Willie Sutton, that notorious bank robber of the 1940s) finance “is where the money is.” All too often it has been the self-interest of government decisionmakers that has created and sustained the distorted incentives in the financial sector that have led to crisis, or even to the diversion of resources of state-controlled financial institutions to political or personal ends. What hope is there that good financial policy will be adopted if it is against the interest of the powers-that-be?

The persistence of a dysfunctional regulatory approach may thus be partly explained by politicians, as well as official regulators, having been “captured” by those they should be regulating. Regulatory policy is then more easily seen as operating in the private interest rather than that of the general public. ¹

Analyzing the role of political economy in influencing the worldwide shift toward financial liberalization, Kroszner (1998) has pointed out the way in which shifting technologies that alter the relative bargaining power of different interest groups, or the policy preferences of existing interest groups, can be influential in determining actual policy changes.²

Likewise, employing the same data on fiscal costs discussed in the text below, Keefer (2000) has recently explored the deeper political determinants, both of the fiscal costs of banking crises and of the propensity to exercise regulatory forbearance during crises. His hypothesis is that socially costly government forbearance action to shore up the financial system under its current management, or to allow the pursuit of risky behavior, may be adopted by politicians in order to ensure financial or political support from these interest groups, especially if political structures are weak. He provides evidence suggesting that at least in less financially developed economies, checks and balances (as quantified in Beck and others 2000) do help to reduce both the fiscal costs of financial crisis and the probability that forbearance will be exercised.

Political economy analysis of such issues is clearly only beginning, but promises to be a fruitful area of research whose results will help ensure that government power is not misused in the regulation of finance.

1. Revealing the influence of contrasting political interests in different U.S. states, Kroszner and Strahan (1999) show that legislators from states with many small banks opposed the extension of interstate banking.

For instance, the first entry of foreign banks into several emerging markets has often been restricted to merger and acquisition, thereby securing the capital value of their remaining franchise— which might otherwise be competed away by the newcomers— for the existing owners. Likewise, when securities markets were being liberalized, partly to meet the government’s need for additional loanable funds, most emerging markets opted for the sealed-bid, first-price auctions of government paper, generally thought to be more advantageous to primary dealers at the expense of the taxpayers interests.
inefficient directed lending. Indeed as direct government financing of state-owned enterprises (SOEs) declined in the early 1990s, the linkage between the credit decisions of state bankers and productivity faded. In most settings, private banks are even more isolated from political pressures, which accounts in part for their superior performance. It is important, however, to note that in transition countries, abrupt privatization of banks is unlikely to work, as noted below, and some state ownership may be necessary as a buffer during the transition process.

The first two chapters suggested that finance, including banking, would lead to faster growth and fewer crises where the information and contracting environment is stronger and where there were sufficient, well-motivated monitors to oversee intermediaries. With greater state banking, there tends to be less demand for better information and other parts of infrastructure, and weak monitoring. Barth, Caprio, and Levine find that monitoring by the market tends to be significantly weaker with higher state ownership. Governments are exposed to an incentive conflict when they have significant state ownership, as one part of government is then charged with monitoring another, so monitoring by official supervisors can be expected to be weaker as well.

State ownership need not always be bad for growth: La Porta, López-de-Silanes, and Shleifer find that at higher per capita income levels, the negative effect diminishes to become insignificant. Germany, with a longstanding tradition of high state ownership (as of 1998, 42 percent of commercial banks assets being in state-owned banks) is a clear outlier, but several other high-income countries, such as France and Italy, had periods in which state ownership was pronounced, though both have decreased this in recent years.

Governments with greater checks and balances and better institutional development might be expected to have more positive results from state ownership, both by providing better official and market oversight of government banks. Keefer (2000) finds that better checks and balances help to reduce both the fiscal costs of financial crisis and the probability that forbearance will be exercised. The quality of information, the vigor of contract enforcement, and even the personal stigma associated with nonrepayment of debt all can be expected to affect the costs of state banking. In developing countries, state-owned banks tended to allocate credit to state enterprise, which may explain the above-mentioned finding of weak productivity, as well as the outliers. Germany, for example, has had little state ownership of the enterprise sector (outside transport and
finance), which has made it easier for bureaucrats to avoid the temptation of allocating credit to government firms. Moreover, the tough penalties in Germany for default and bankruptcy mentioned in chapter 2 help to make life easy for most banks, even those that are state run.

In sum, the data show poor performance of state banks in several dimensions. They tend to decrease financial sector development and economic growth, to concentrate credit, and to increase the likelihood and cost of banking crises. Although the findings do not demand elimination of all state ownership, the evidence is consistent with moving to sell government banks in a number of countries, especially where they dominate the sector. While it remains possible for developing countries to find ways to limit the damage done by state ownership, limiting such ownership itself will likely be easier to implement than the many institutional and political reforms needed to limit the abuses and inefficiencies of state banking.

Privatizing Banks

Evidence from countries that have made significant reductions in state ownership of the banking sector, though limited, confirms the above picture of the costs of state ownership, reveals the difficulty of bank privatization, and contains lessons for how it might be better conducted. The most detailed examination is for Argentina, which has seen a significant decline in the degree of state ownership—from about 50 percent of banking system assets in 1990 to half that level in 2000—and is consistent with the cross-country evidence. Clarke and Cull (1998) provide simulations of the present value of savings from privatizing Argentina’s provincial banks and found impressive gains. Even if nothing were recovered from the residual entities that took over loss-making loans at the time of sale, and basing the simulations on the period 1991–96 (a time of general economic expansion when the banks should have been earning profits), the savings amounted to one-third of a typical province’s public expenditure and could have financed its 1996 deficit for 12 years. Somewhat more realistic assumptions on recoveries put the savings at more than half government expenditure, and this with a high discount rate. Stated differently, the cost of retaining governmental ownership was large, and the cost of these injections, in combination with the discipline associated with the convertibility plan, led to privatization efforts.
As seen in figure 3.3, prior to privatization, Argentine provincial banks were having serious difficulties: nonperforming loans (NPLs) were high and increased further after the preprivatization audits (mandated for banks accessing the Fondo Fiduciario, box 3.2). After the audits, and as a part of the actual sale, essentially all NPLs were removed from the balance sheet. Subsequently, the share of NPLs rose again, but only to levels comparable to the better private banks in Argentina. Since then, the privatized banks have remained more or less on par with other private banks on NPLs (although NPLs in 2000 have gone up at all private banks because of the general economic slowdown).

More generally, the newly privatized banks’ balance sheets and income statements began to resemble more those of other private banks, especially in terms of their administrative costs relative to their revenues, and most importantly in terms of credit extended to public enterprises (figure 3.4, which shows the second cohort of banks that were sold between September 1995 and March 1996). This dramatic change in lending supports the finding from the cross-country research that enhanced productivity follows privatization, in that SOE credit likely represented low-productivity loans. As part of the privatization process, the shedding of staff or their more efficient employment, though less significant for the overall economy, works in the same direction.

Notwithstanding this evidence, it is unclear to what extent bank privatization will continue, or how best to foster it. Argentine provinces

Figure 3.3 Nonperforming loans, Argentina, 1991

![Figure 3.3 Nonperforming loans, Argentina, 1991](chart.png)

Source: Clarke and Cull (1999).
only began privatization in earnest when their access to cheap refinancing and covering of losses was eliminated. Even then it took a crisis to accelerate the process (box 3.2). Other countries, such as Hungary, have first recapitalized banks before concluding that privatization was necessary to limit the cost to taxpayers.

Bank privatization is politically difficult, and if the same political forces continue in place, it is not likely that it will be successful. Argentine and Hungarian authorities clearly were motivated by the costs of maintaining state ownership. As seen in box 3.3, countries often turn to bank privatization only after long delays and sometimes failed restructuring.

Beyond waiting for crises, a possible way of fostering the sale of state banks is to encourage more rigorous enforcement of prudential regulation for all banks, so that the state banks’ weaker position—and hence higher possible cost to taxpayers—will be evident, as it became in

**Box 3.2 Can bank privatization be sustained?**

Although economists always hope that their research changes the minds of politicians, the lags between the establishment of new results and policy change can be long. Why else would politicians privatize banks? After all, state ownership frequently provides easy financing of government deficits and provides a source of political patronage in the form of jobs at the state banks and access to credit.

Argentina provides interesting insights. A decade ago, all 20 provinces owned at least one of the 27 provincial banks, which were found to have generally low portfolio quality, low efficiency, and low returns. Yet these banks remained state-owned until the Convertibility Plan ended their access to the discount window and also limited central bank funding of federal deficits. Thus provincial politicians no longer could hope for cheap financing and funding of provincial bank losses. With the Tequila Crisis in late 1994, the provincial banks were affected by a depositor run, forcing a reassessment of the state ownership decision. Given the then-short maturity of Argentina’s capital markets, it would have been difficult to stretch out the financing of the bad assets in these banks, so the World Bank and the IDB helped create the Fondo Fiduciario, which extended loans to help provinces stretch out the costs of privatization, but only after the good banks—the good assets of the provincial banks—had been sold. As a result, about half the provincial banks were sold by late 1997, and by 2000 this ratio rose to two-thirds.

Still, politicians have a tendency to hang on. The weakest banks (highest NPLs) initially were the ones most likely to be privatized, and indeed postsale audits showed that their performance was worse than previously believed. On the other hand, large, overstaffed banks, which provide greater patronage, were less likely to be sold. This suggests that in countries with a few large state banks, either politicians—or their public—will have to be swayed by research results, or it will take a large crisis or significant tightening of their access to federal financing to get them to privatize.

Source: Clarke and Cull (1999).
Box 3.3 The rise, reprieve, and fall of state banks in Africa

**Ghana**

Ghana started economic reforms in the early 1980s after a politically unstable period of heavy state involvement in the economy. The state-owned three commercial banks, three development banks, and the Cooperative Bank. There were also two foreign banks and a merchant bank.

All the state-owned banks were restructured and recapitalized under the financial reforms that started in 1987, with bad loans removed to an AM C. Mangement was improved through extensive technical assistance.

Both before and after restructuring, the primary function of the Ghanaian banks has been funding the deficit of central government and public enterprises (this averaged 73 percent of domestic credit in the 1990s). The very high T-Bill yields received by the banks helped offset the continued loan losses from other lending.

Even after long delays, where the same strong interests that derailed earlier reforms still dominate a country’s politics, outcomes from bank privatization will tend to be disappointing. This argues for most assistance to countries in which privatization is deemed to be politically desirable, feasible, and credible. Most African countries opted to create at least one large state bank after independence to support indigenous industries and state ventures, and to make banking services available for the broad population, including those in rural areas. In many countries these big state banks still dominate the banking sector and, after decades of politicized management and soft budget constraints, have been difficult to restructure or privatize. The disappointing results from restructuring and generally on privatization can be seen from three countries that attempted banking reform programs during the 1990s: Ghana, Tanzania, and Uganda.

(Figure 3.4 Lending to state-owned enterprises in Argentina)

Note: The second cohort of 5 banks was the first group to be sold with assistance from Fondo Fiduciario (see box 3.2).

Source: Clarke and Cull (1999).
Bank privatization has been a stop-go process, being held up, for example, by disagreement between the privatization agency and external estimates of values on the price. With the program years behind schedule, the government decided to sell some shares in two state commercial banks domestically even before finding a strategic investor. This made it difficult subsequently to reduce the price to attract a strategic investor. Eventually, in late 1996 the government dropped its requirement that the strategic buyer should be a bank, and managed to sell the Social Security Bank to a consortium of foreign investment funds. By 1998, this newly privatized bank had about 13 percent of total banking system assets.

The largest bank, Ghana Commercial Bank (GCB), continued to have problems even after the restructuring of the late 1980s. With the failure of a planned sale in 1996 to a Malaysian manufacturing firm, it remains government-controlled, with just 41 percent held by Ghanaians after the initial public offering (IPO). In preparation for privatization in the mid-1990s it was found that there were serious reconciliation problems in the accounts and shortcomings in management, and some of the loss-making branches had never been closed. In 1997 the entire senior management of GCB had to be removed in the wake of a check fraud scandal.

**Tanzania**

Tanzania was starting to liberalize after two decades of African socialism. Twelve banks had been nationalized in 1967 and merged into a dominant commercial bank, National Bank of Commerce (NBC), which had a virtual monopoly for 25 years. The only other financial institutions were a small cooperative bank, which was also controlled by the state, and a few specialized state banks for housing.

By the mid-1980s, the NBC was insolvent, illiquid, and losing money at an alarming rate. Restructuring moved a significant portion of the NPLs out of the bank, closed some loss-making branches, and retrenched staff, but operating costs as a percentage of assets doubled and spreads became negative in 1992. The bank was recapitalized in 1992, but as the losses continued to mount, restructuring intensified with an “action plan” in 1994 that changed the board of directors, curtailed lending and laid off further staff. However, the salaries of the remaining staff were doubled by the new board of directors, thus offsetting the reductions in costs. The benefits from removing bad loans to the AMC were short-lived. By 1994, 77 percent of the remaining loans were nonperforming.

In 1995 another attempt to restructure failed. Finally, National Commercial Bank (NBC) was split in November 1997 into two banks and a holding company. The NBC holding company took the nonbanking assets, for example, staff housing and the training center. The business bank, NBC-1997, took all lending and 45 percent of the deposits, and a service bank took the remainder of the deposits. The National Microfinance Bank was to provide basic depository services to the general population, and took the small deposits but no lending. The decision to set up a microfinance bank that would keep the rural branch network may have softened some of the political opposition to the privatization of the business bank. The separation provided difficult. Poor financial and operational controls led to the need for significant provisions on unreconciled balances, and there was a significant delay in producing financial statements after the split.

NBC-1997 was sold to the South African bank, Amalgamated Banks of South Africa Group (ABSA) in late 1999 with IFC participation. The microfinance bank remains unsold, but is now focusing on the provision of payments and savings services in its 95 branches.
Box 3.3 (continued)

Uganda
By the early 1990s, as Uganda was just starting to reemerge from the economic devastation of the turbulent 1980s, the government had stakes in all nine commercial banks, and owned the largest two: Uganda Commercial Bank (UCB), with about 50 percent of the market, and the Cooperative Bank. As of late 1991, about one-third of the loans of UCB were nonperforming, and the negative net worth of the bank was estimated at $24 million.

Timid restructuring efforts started. Loss-making branches were converted into agencies rather than being closed. The AMC that was to take bad loans was not created until 1996 and, even then, there was a significant lag in transferring bad loans. There was a performance agreement in 1994 between the Ministry of Finance and the bank’s board of directors, but the strategy pursued was to try to reduce the proportion of NPLs by growing the loan portfolio. Bank supervisors did not monitor compliance. Every improvement in profitability was temporary and losses continued to mount. By mid-1996 the financial position had deteriorated so that its negative net worth tripled from earlier estimates.

While the government’s intention was that the restructuring would culminate in privatization, management of the UCB was actively opposed to sale. Eventually, after three years of unsuccessful attempts to restructure the bank, it was agreed that a reputable merchant bank be selected to implement the sale, giving the buyer greater freedom to define which assets and branches were to be purchased. Again there was a lag, and the merchant bank was finally hired in February 1996 and, at its request, top management was finally changed in July 1996. Losses were mounting throughout the delay, and UCB was losing market share. Audited financial statements for 1997 showed another fall in interest income, wiping out the core profits advertised to investors six months earlier. With few expressions of interest, a sale agreement was signed in late 1997 with a Malaysian industrial and real estate company. By December 1998, however, the deal had unraveled amid allegations of corruption.


Argentina during the crisis and then more clearly after the banks were sold. Notwithstanding the political forces that may favor limited information, the current international attention to international standards might encourage greater transparency and thus this result. Also, mandatory publication of the audits of state banks, preferably by international firms, will allow the owners—the country’s citizens—to see what they own. Where privatization is limited by concerns about financing loan losses prior to sale, funding from multilateral development banks can help to stretch out the costs of privatization where longer-term markets are not sufficiently developed. As Clarke and Cull (1999) note, however, the fact that weaker banks are more likely to be sold suggests that preprivatization injection of funds should be avoided, as it may decrease the probability of sale and also can easily be squandered.
Since bank privatization can yield real benefits, and as there is considerable public ownership in many countries, moving to sell banks would appear to be an immediate imperative in many developing countries. When it occurs, though, privatization can also be badly designed and lead to crises. Stated differently, the above comparison on the gains from less state ownership were for “other things equal,” such as the quality of financial sector infrastructure and the regulatory environment, and provided no sense as to the speed and sequencing of bank privatization.

Experience is both limited and ambiguous. Chile (with bank privatization in 1975 and a crisis in 1982) and Mexico (1992 and 1994, respectively) both appear to have been cases with an underdeveloped regulatory and supervisory framework, and both have made remarkable strides since their crises. The emphasis was on speed of sale, which was accomplished, but the costs of the subsequent banking crises (about 42 percent and 20 percent of GDP, respectively) were high. Although both crises featured multiple causes, a weak regulatory environment appeared important and is widely acknowledged to lead to fraud, looting, and even crises. While it is entirely possible that these problems then produce a lobby for better financial infrastructure and regulation and ultimately faster growth, as arguably occurred in Mexico and Chile, privatization in a weak framework, followed by crises, is just as likely to provoke opposition to market-based reforms. Thus, in order to avert postprivatization crises, authorities as soon as possible should strengthen these elements and exercise some caution—while still moving forward—in the privatization of the banking system. A deliberate and credible phasing out of state ownership over some period while the environment is being improved accordingly is suggested.

The Argentine case noted above supports this sequencing argument. On the eve of privatization they had a reasonably developed regulatory and infrastructure environment for finance, and indeed by 1997 had one of the toughest bank regulatory environments among emerging market countries (World Bank 1998). Minimum capital ratios were 11.5 percent, with risk weights varying as a function of credit and market risk. In addition, banks faced stiff disclosure requirements and were compelled to issue subordinated debt, and liquidity requirements were high (20 percent, with an extra 10 percent in the form of a puttable swap for dollar assets), among other factors. Moreover, the system as a whole was anchored by the top ten banks, nine of which by 1997 were majority foreign-owned, and the mix of public and private oversight, recommended in chapter 2, largely was in place. The decision to embark on a

Privatization should be phased along with improvements to the infrastructure—

—and the regulatory environment.
program of bank privatization in such a strong regulatory environment can be made with greater confidence.

When the environment is weak, however, the need for care in the privatization process has been dramatized by the experience in transition countries, where there is the risk of capture of the legal, regulatory, and supervisory apparatus by insiders, or oligarchs (Hellman, Jones, and Kaufmann 2000). Those who capture control of this apparatus and banks will soon become oligarchs. Whereas bureaucrats have been shown to be bad bankers, oligarchs may be even worse. More generally, when there is “regulatory capture,” either through corruption or the control of banking and its regulation by the same interests, neither market nor official regulatory forces will work to support efficient and equitable development. The full story of the privatizations in Mexico in the early 1990s, with the purchase price sometimes allegedly paid from insider bank loans, and resulting in looting behavior that brought many banks down during the Tequila crisis, is only gradually coming to light (cf. the recent analysis by La Porta, López-de-Silanes, and Zamarripa (2000) mentioned in chapter 2 above). It too reinforces the need for an adequate regulatory environment for privatization.

Still, the conundrum is that although premature privatization in weaker environments can lead to significant problems, lagging bank privatization can undermine real sector reforms. The costs of delay are amply demonstrated by the Czech Republic, which tried to move fast in the privatization of nonfinancial firms, but slowly in selling banks. Chapter 1 already touched on aspects of the acute problems of governance associated with the Czech experience when the assets of many privatized firms were looted during the 1993–96 period. Another aspect of this story was the way in which some of it was facilitated by continued lending from public sector banks (box 3.4).

Tunneling—the appropriation of the firm’s assets by insiders—can occur even with private banks, but sustained looting—defined as borrowing with the expectation of not repaying—can only continue if the lending banks are not particularly concerned about their bottom line or can get compensated from government, both characteristics of public banks.

Thus maintaining the status quo with a significant share of state-run banks can be dangerous for the economy. Moving slowly but deliberately with bank privatization, while preparing state banks for sale and addressing weaknesses in the overall incentive environment, would appear to be a preferred strategy. Preparation, in addition to improvements
in infrastructure, could include some linkage of compensation for senior managers to the future postprivatization value of the bank, such as through stock options—an approach that appears to have helped in Poland. To be sure, this approach can only succeed if the process is credible, otherwise the deferred compensation will be too heavily discounted to have any value. Prolonged “contracting” of private managers likely will not work in banking, where it is too difficult to observe the outcomes of managers’ decisions.9 And, as mentioned, preprivatization recapitalization appears to be unwise, because it both risks dissuading officials of the need to sell the bank and can lead to a squandering of taxpayers’ resources. Publication of as much information as possible on the privatization process and vigorous oversight by the media will help limit the ability of insiders to dominate, but this itself requires that the media be active and independent.

Countries that can attract foreign entry from good foreign names—an ability that likely will increase as e-finance drives down the cost of entry
(chapter 4)—and from different countries are in a stronger position. Even though the regulatory environment may not be reliable, strong foreign banks both would bring good skills, products, and even a capacity to train local bankers, but would presumably be motivated to protect their reputations to behave in line with the highest fiduciary standards. Where powerful domestic interests or oligarchs are a barrier to sound banking, some reliance on foreign banking (see chapter 4 on its rise in some countries) may be the best alternative for development, even though it can be politically difficult to accept. Still, the possibility that foreign banks may be engaged in risky or criminal activities suggests that authorities cannot abdicate their own “due diligence.” Regulators in home countries may be legally constrained by the information that they can share, but they should be as proactive as possible to alert developing and transition country authorities to concerns about their own banks—even if it is merely helping to translate—in language and in meaning—information that is available in their own, deeper markets.

Political factors undoubtedly will determine the speed of privatization. The experience of several countries, including Argentina and Hungary, suggests that where state banks are smaller, fiscal pressures greater, and political patronage lower or more dispersed, it will be easier to privatize (Clarke and Cull 2000).

Precisely how much needs to be done until a country can privatize its banks and how much of its banking system it can privatize in a given regulatory environment are decisions that necessarily have to be made on a case-by-case basis and undoubtedly involve art as much as science. What has been shown at this point is the direction of change that will help increase living standards in low-income countries. To be sure, the process of bank privatization is difficult, but the gains seem to be substantial.

Governments as Caretakers

Governments are often forced to take ownership positions during a crisis—
resolved. This is the way to restore confidence, and to keep the financial system doing its job of channeling money from savers and investors on the one hand to businesses that need capital on the other.


EVEN GOVERNMENTS NOT DISPOSED TO TAKE A LARGE ownership position in the banking sector may find that bank owners have exercised the "put" option of handing over the bank's deposit liabilities with insufficient assets to repay them, especially in times of systemic crisis. Governments often then become involved in restructuring banks and even their assets—nonfinancial firms—in the process. In many cases, systemic crisis has led to significant increase in government ownership or "caretaking," even of some banks that have just recently been privatized (Mexico). This increase has tended to persist (figure 3.5). Yet the aforementioned evidence on governments' efficacy as "permanent" owners of banks implies that they will not excel at temporary ownership—restructuring failed or failing banks—either. In particular, if there is a tendency for political forces to dominate the economic judgments of bureaucrats in normal times, this tendency is even more marked during a systemic crisis, when the injection of substantial sums is in the offing, and the financial fate of powerful interests will be determined. This section

Figure 3.5  Government ownership of banks during the East Asia crisis

Assets in state banks, relative to total banking system assets

Note: Data is for year-end, except for the latest data, which is March 2000 for Thailand, and June 2000 for Indonesia and Republic of Korea. Source: World Bank.
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considers what research can tell us about general principles—strategy, not tactics—for how governments should behave when crises raise the issue of injecting funds into the banking system.

Systemic bank restructuring is a difficult and complex undertaking, and typically needs to be linked to wider corporate restructuring. The practitioners' literature calls for a comprehensive approach. Here we will not attempt to discuss the issues in any detail—not least because they have not yet been subject to systematic empirical investigation. Some points, however, will be made on bank restructuring, in particular to highlight a simple though important message. Because government is not effective as a bank owner, it must devise its approach to bank restructuring to ensure that it gets out of a temporary caretaker position as soon as possible. It must not use this position to pick the "winners and losers" itself, but rather should rely on the private sector for this key function. This message can be—and has been—carried over to the restructuring of corporates.

When a banking crisis occurs, authorities need to decide when and how to intervene. Much has been written on the former, starting with Bagehot (1873, to whom De Long refers above). When the problem is not systemic, bank creditors and supervisors should be left to proceed as usual. Indeed, well motivated subordinated debt holders and other creditors will have likely signaled the problem by not renewing credits and by pushing up the spreads at which problem banks borrow.

How should it be ascertained that a crisis is systemic, or when should the government intervene with other assistance? Although the application of mechanical trigger rules to this area is appealing—for example, all banks are on their own unless output has fallen by \( x \) percent or export or some other prices by \( y \) percent—most indicators either are available only with a lag (GDP), or are partial indicators of the severity of a problem (for example, the exchange rate). Moreover, the announcement of a rule based on specific commodity or stock prices or indices, interest rates, or exchange rates, can induce greater risk-taking once market participants are armed with the knowledge that some specific downside is covered. If a government states that it is willing to coinsure against a given decline in an economic indicator, it may well be expected to intervene before that point is reached. For example, if authorities commit to intervene in crises if GDP falls by 5 percent—aside from the problem of estimating output—markets may expect support well short of that decline, to the point that intervention even in mild recessions might become the norm.

Governments should only intervene when a crisis is systemic—

—but need to develop an exit strategy from the start

—but defining a systemic crisis is not easy
One possibility recently advocated (Mishkin 2000) is to announce a policy that, even in a systemic crisis, the first bank that fails will certainly not be bailed out, in the hope that each banker’s uncertainty as to whether they will be first will motivate them to guard against excessive risk-taking. In this context, however, failure is usually a regulatory decision. Perhaps because of the difficulty of defining when a bank has become insolvent, this option has not yet been chosen in any country. Instead, many central bankers have decided on constructive ambiguity as the main solution. Having chosen an approach based on discretion here, there are implications for the choice of how to intervene, noted below.

Given that the decision to intervene has been taken, that is, the problem is judged to have become “systemic,” the government has several goals. First is to maintain or restore a functioning financial system. This goal is difficult to debate, though the best means of doing so are not always clear. A second goal is to keep the lid on the budgetary cost of the crisis. Far from these costs being predetermined, research suggests that an easy or accommodating approach to intervention policy—before and after the crisis—can result in greatly magnified costs to the budget (and hence, as observed in chapter 2, in overall economic costs). The third goal, linked to the second, is for the government to ensure that their action helps decrease the likelihood of a subsequent crisis.

Fiscal Costs of Policy Choices

Does policy choice matter much in determining the fiscal cost of banking crises? Honohan and Klingebiel (2000) provide direct evidence as they examine the impact of different forms of intervention:

- Liquidity support of 12 months or longer in excess of total banking system capital.
- The issuance of a blanket guarantee for depositors.
- Two measures of forbearance: (a) permitting insolvent banks to remain open, or (b) suspending or easing prudential regulations to redefine solvency.
- Repeated recapitalizations of banks.
- The formation of centralized asset management companies (AMCs, more on which below).
- An across-the-board public debt relief program.
Using regression analysis, they examine how much of the variation in the fiscal cost of 38 crises in industrial and developing economies (1980–97) can be explained using these indicators plus macro variables (the real interest rate and stock prices). They find that open-ended liquidity support, regulatory forbearance, and blanket deposit guarantees are significant contributors to fiscal cost, and tellingly the signs of all these variables are positive. Strict policy—less of each of the above variables—results in lower fiscal costs. To check for reverse causality—did big crises cause the easy policies—the authors try an instrumental variables, two-stage least squares approach, and find their original results confirmed.¹⁴

This lesson seems well illustrated by the experience of several African countries (box 3.3 above), whose insolvent and illiquid state-owned banks were given a reprieve in the mid-1990s as donor resources were mobilized to restructure them. The results of bank restructuring efforts there, drawn out as they were over a number of years, were disappointing. In some cases, banks were stabilized by extremely high interest rates offered on their holdings of government bills—in effect, an ongoing recapitalization.

As seen in table 3.1, the impact of these policies is large. Even relaxing one policy variable while maintaining strict values for the others still results in a substantial increment in costs—a plausible result, as any channel for government funding to banks in trouble can result in similar opportunities for rent seeking. Indeed, the much larger impact of, say, liquidity support

<table>
<thead>
<tr>
<th>Type of accommodating measure</th>
<th>Cases where it was used (percent)</th>
<th>Cost of adopting each accommodating measure (percent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forbearance (a)</td>
<td>24</td>
<td>6.7</td>
</tr>
<tr>
<td>Multiple recapitalization</td>
<td>24</td>
<td>6.3</td>
</tr>
<tr>
<td>Liquidity support</td>
<td>58</td>
<td>6.3</td>
</tr>
<tr>
<td>Forbearance (b)</td>
<td>84</td>
<td>4.1</td>
</tr>
<tr>
<td>Debt relief</td>
<td>21</td>
<td>3.1</td>
</tr>
<tr>
<td>Blanket guarantee</td>
<td>55</td>
<td>2.9</td>
</tr>
</tbody>
</table>

Note: The table shows how much each accommodating measure can add to fiscal costs. For example, permitting insolvent banks to stay open (forbearance—a—see text) pushes up predicted fiscal costs by 6.7 percent of GDP, which is double the sample mean (each calculation uses the sample mean value of the other variables). Source: Honohan and Klingebiel (2000).
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compared with guarantees is likely a statistical artifact of the sample. Taken to extremes, as it often has been, open-ended liquidity support (through the lender-of-last-resort) is an alternative to announcing a blanket guarantee, and might only influence which government agency provides the funds. Many times the central bank ends up as the de facto owner of a bank to which it has provided what had been envisaged as merely temporary liquidity support. Also, it would be disingenuous to interpret these results to mean that governments can switch from a previous policy of ease prior to a crisis—such as the Chilean forbearance of 1977 (box 3.5)—to a strict policy in the midst of a crisis and enjoy such large gains.

Box 3.5  Intervening sets the stage for the next crisis

FOLLOWING DECADES OF NEGATIVE REAL INTEREST rates and state ownership, Chilean authorities privatized banks in 1975 and in 1976–77 essentially allowed free entry into banking and finance. By late 1976 ten finance companies became insolvent, and then Banco Osorno. Initially the government announced that the central bank would “back” the bank, and then created an explicit deposit guarantee for banks, finance companies, and savings and loan associations, up to about $3,000—a limit it then breached for Banco Osorno depositors. Prior to this failure, the banks seemed to have been acting as if they did not expect government support, and the bankers’ association even tried to organize a pool to cover failing banks, much like U.S. bank clearinghouses of the 19th century. Depositors also ran to the largest banks.

Banco Osorno clearly was gambling, but this does not presume that the owners thought that they would be able to put the losses to the government. Instead, they may well have been planning to pass the losses on to depositors, which is consistent with the prevalence of “self-lending,” in their portfolio. One factor in the government’s response was that the problems appear to have been a surprise, as they only had 10 bank inspectors for 14 banks and 26 finance companies, and these inspectors, because of the recent decontrol, could not have had significant experience with supervision.

Although the authorities allowed the finance companies to fail, and began to improve supervision, the failure of another bank (Banco Español) in early 1980, which was first sold to another business group (with no public or private capital injection) and then taken over by government in late 1981 with larger losses signaled that government support was available. Although macroeconomic factors undoubtedly played a major role in the 1982 crisis, lax incentives stemming from earlier interventions appears likely. For example, by the end of 1981, real loans were six times the level of 1976, or an annual average growth rate of 43 percent. Banks were doubling their real portfolio every 18 months, not the usual behavior for bankers that are concerned about their own capital. As de la Cuadra and Valdes suggest, this appears to have been Ponzi finance on a large scale, and early intervention, when the problem did not appear to be systemic, shares part of the blame for the ensuing collapse, whose ultimate fiscal cost was more than 40 percent of GDP.

Source: De la Cuadra and Valdes (1992).
Still, the lesson that the consequences of easier intervention policies are significant for the fiscal position is important. Some point to the fact that industrial countries have engaged in forbearance, leaving insolvent banks open, as a justification for developing countries to do the same. To be sure, authorities have a choice to make, but industrial countries both generally have stronger regulatory and supervisory capacity, meaning that they are more likely to be able to control risk-taking—the clear threat when insolvent institutions continue in operation. Moreover, rich countries, with higher incomes and better-developed tax regimes, can better afford what appears to be second-best (or worse) policy. Thus, some argue that the cost of the U.S. savings and loan crisis would have been about one-fifth its final cost had it not been for forbearance—but still the total bill was under 3 percent of GDP.

Last, fiscal costs and cash costs are not the same. One common trap is for those designing restructuring plans to become preoccupied with minimizing the up-front cash costs of recapitalization at the expense of higher longer-term fiscal costs and neglect of the incentives that are created for the restructured banks (Honohan 2001c). Yet the former are small relative to the latter.

Sending the Right Signals

The third goal noted above is the need to ensure that the manner in which authorities deal with the crisis provides signals and incentives that help decrease, rather than increase, the likelihood of a subsequent crisis. This may be the most difficult goal to weight appropriately in the midst of a crisis, but perhaps is the most important. While governments should be prepared to change their role in a systemic crisis, such as by becoming a caretaker for banks, their approach and the actions they take need to be designed in such a way as to convince participants that this is a “one-time” event. One way is by making sure that the consequences of excessive risk-taking are borne by those who undertook them. Such a focus on incentives will also help restrain fiscal costs. As noted in box 3.5, the consequences of giving short shrift to this goal can be dramatic.

To see the importance of attention to incentives, consider what happens to firms outside the financial sector operating close to or actually in a state of insolvency. Those in control of these firms get the message quickly that their poor performance is going to be costly to them. They
generally find it difficult or impossible to raise new funds in any form. This precludes acting on profitable investment opportunities and may force the firm to sell important assets. All their creditors recognize that insolvency may also distort the incentives of management, making them more susceptible to fraud and moral hazard, and at the least reduces the incentives of owner and managers to exert effort.

Yet, in a private market economy, the economic functions of major nonfinancial firms need not cease when the firms themselves become insolvent. To the extent that they have a profitable core group of activities and new investment opportunities, the creditors’ interests may be best served by continuing their operations. In addition, most firms have made large investments in fixed capital goods that are often difficult to resell. As long as the net present value of the firm’s operating profits and tax losses carried forward exceeds its liquidation value, it makes sense to continue operations—albeit with minimal new investment, the divestiture of noncore activities, and the installation of new management. This is what a successful restructuring of a firm will achieve. What is relevant is that the imbalance between assets and liabilities is dealt with not by obtaining injections of new equity, but by marking down liabilities and equity to conform to the new, lower value of the assets and future cash flows. Equity holders generally see most of their claims wiped out while debt holders often have a portion of their claim converted to equity. New funding is provided only after this “marking to market” takes place. At the same time, old management is often replaced, a substantial portion of the firms’ assets are sold, and workers are laid off. In other words, this is not a mere reworking of the firm’s balance sheet, but rather very real changes are made in the way it does business, perhaps even in the business it does. For the economy, the happy result is that resources continue in their best use while all parties incur some costs for the firm’s poor performance.16

In large part the restructuring of banks should follow the same general principles. Admittedly, banks differ from other firms in two senses: first, as noted in chapter 2, their particular fragility, and the possibility of contagion; and second, their centrality in the payments and credit mechanism. Banking in many economies may only count for a few percentage points of value added in the GDP statistics, but unlike any other sector of similar size or greater, has major macro implications when it is in distress. Although these differences justify a different approach in banking compared with other financial and nonfinancial areas, they do not — by imposing real costs on all involved parties—

— and get resources back in productive use—
suggest that incentives matter any less. Indeed the evidence presented above on the links between bank ownership and financial sector development confirms that private incentives are every bit as important in this sector.

Unfortunately, as implemented in many countries, government-funded bank recapitalization programs—injecting capital usually in the form of bonds into banks—either mute or totally squelch the message that poor performance is costly, leaving out or minimizing the real restructuring. Recapitalization to support existing liabilities by itself leaves creditors completely protected, but forces no downsizing of the bank, no layoff of employees, no reallocation of peripheral assets to better uses; reduces the pressure to pursue delinquent borrowers; and even can reduce the accountability of regulators to the general public. Indeed, recapitalization without exacting some claim from the bank—and really exercising it—amounts to a transfer from taxpayers to shareholders, which is the group that keeps the residual value of the entity. Yet, even in crises that owe their origins mainly to macro events, some banks virtually always are discovered to have been taking on substantial risk, so it is important that this message be sent, adjustments made, and consequences felt.

Restructuring is when the message is sent that this is the opportunity for making changes to ensure that banks are (back) on the track to providing needed financial services and allocating credit to its best uses. Note that many of the above messages that need to be sent are harsh ones, such as laying off staff or informing previously and possibly well-heeled and well-connected shareholders and senior managers that they are, in effect, wiped out. Clearly the losers from this process are much more narrowly concentrated than the larger society, which will reap the gains of greater efficiency and faster growth. Governments and the political process are not well suited to this task. As seen above, the government has no comparative advantage in banking itself, and even the basis for determining which banks get funds is not simple and straightforward—if it were, that is, if it were easy to solve the information problem, it would have been easy to prevent the losses in the first place. For the harsh messages that are sent as part of restructuring, not only is this not a clear area in which the public sector excels, but also one that is ripe for abuse. The selection of individual winners and losers is what markets, not governments, do best.

Nevertheless, some government involvement is required if taxpayer funds will be injected. Again, the debate can be framed in terms of the rules vs. discretion approach, though here the outcome is somewhat different. It is
relatively easy to observe whether the government is providing support, and indeed most governments are eager to claim credit for such. Hence, leaving some discretion to officials as to when to intervene does not create significant opportunities for abuse. The size and targeting of support to individual banks, however, is more difficult to evaluate (does the choice make sense?) and monitor (is support being used well?), and creates a case for a greater reliance on a rule-based approach. Governments that inject equity will want to make sure that it is used wisely, that is to make sure that it goes to banks that are the least insolvent, regardless of the cause of the crisis, because there is a strong and necessary presumption that the most insolvent banks attained that status by dint of excessive risk-taking. If this presumption is not made, and the riskiest banks are not treated harshly, financial history teaches that banks will assuredly embark on an even riskier path. As agents of their country’s taxpayers, authorities will also want to ensure that their funds are not looted. Yet they must recognize that they do not function well as bank owners and therefore can only take temporary equity positions in banks. One way to achieve both goals is for authorities to make some amount of funding available for recapitalization of banks, but only to those who do the following:

- Secure matching of private sector funds in some ratio.\(^{18}\)
- Will restrict dividends that can be paid or withdrawals by private partners and individual borrowers, and even the amounts and structure of compensation contracts for senior managers, such as by granting them deferred compensation in the form of stock options tied to the bank’s equity value several years in the future.
- Adhere to stringent transparency requirements.

As long as the amount of funding is such that some banks fail, this approach removes government from decisions as to which banks survive. The availability of (truly) private sector funding serves to identify the candidates, and the restrictions on different ways to take these funds out of the bank, combined with greater transparency, makes it more likely that the banks will not be looted and facilitates prompt exit by the government.

Consider the three banks shown in figure 3.6. All three are affected by a crisis, but Bank A’s capital ratio—with sound accounting practices—is not expected to fall below the minimum 8 percent ratio assumed to hold in regulatory guidelines. Bank C, on the other hand, is assumed to continue to worsen, and it is important that it be closed, downsized, or split up, with the good bank surviving alone or merged. Banks like bank B appear to be salvageable, and this decision should depend on the time

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Government involvement should aim to protect the interests of the taxpayers

— and to use the private sector to pick winners and losers
it would take for profits to be sufficient to rebuild capital and then earn returns for private owners. Private buyers are getting a claim on the franchise value of the bank—its future profits—and it is important that it be their expectations of profitability and their money that identifies the banks worth saving. Government officials will need to be alert to other attempts to loot the surviving banks, and the failure of the banks engaging in the most excessive risk-taking will help convince market participants that the program is credible.

These are tough criteria, and only desperate banks will agree to such terms. That is the point: government assistance should only be injected into banks in dire straits, yet simultaneously to those with a real chance of survival. By openly stating the terms on which it will assist banks and their (new) shareholders, and ensuring that those terms provide good incentives for the restructured bank going forward, the government is making the best use of market forces while minimizing its direct ownership involvement.

This strategy is fine on paper, but will it work in practice? By and large, it already did, as many of these features characterized the U.S. Reconstruction Finance Corporation’s (RFC’s) program of taking temporary preferred equity positions in banks (box 3.6). Bank failure was clearly still allowed: several thousand fewer banks opened their doors following the bank holiday of 1933, and failures continued for banks that did not meet the RFC’s criteria. Selling this program to the banks was difficult—in a crisis, bankers can get into a game of “chicken” with authorities, as the

Figure 3.6 Stylized evolution of three banks through a crisis: sound, salvageable, and doomed

Source: Adapted from Ingves and Lind (1996).
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Box 3.6 Lessons from the Reconstruction Finance Corporation

THE RECONSTRUCTION FINANCE CORPORATION (RFC), which lasted from 1932 to 1957, loaned or invested more than $40 billion, mostly with funds borrowed from the U.S. Treasury or the public. As in many crises, initially it was thought that the banks were merely illiquid, but by 1933 officials realized that many banks had solvency problems and needed to be closed or needed additional capital, so a preferred stock program was established. At its peak, the RFC had capital positions in 5,685 banks, representing 40 percent of all insured banks in the United States. Officials’ discretion was limited because “once the RFC received an application for assistance from a financial institution or commercial and industrial enterprise the agency only had the power to evaluate whether asset values were sufficient to secure assistance” (Mason 2000, p. 4). The combination of “sound asset values” with the restriction that the RFC could not hold more than a 49 percent stake in a bank (or firm) was intended to ensure that RFC funds did not go to deeply insolvent banks.

To be eligible for this program, however, banks had to agree to limit dividends and devote earnings to retiring the stock of the bank—essentially, buying out the government’s position. Also, by law the identity of all recipients of any RFC assistance was made public, reducing the chance of political favoritism. RFC staff had clear incentives. Hiring and promotions were outside the civil service framework, and much of the staff was located in decentralized field offices around the country that functioned relatively autonomously provided that they showed a profit. Intervention from Washington, including the possible replacement of field directors, occurred if the profitability guidelines were not met.

Individual deals had different features, not surprising in light of the RFC’s decentralized structure. Some were contingent upon raising funds from the public, others upon capital infusions from management, and some of both that also relied upon the replacement of key officers and directors with those approved by the RFC. The consistent attention to safeguarding taxpayers’ funds and the deliberate harnessing of the private sector stand out in this program.

It may be difficult to evaluate the success of efforts such as the RFC, but in this case, the intervention appears to have contributed to a recovery of confidence and output (until monetary tightening reversed both in 1937). The government recovered its initial capital and did not keep alive nonviable banks. In recent years, it is difficult to point to many similar records. Interestingly, the RFC took the same basic approach in its involvement with corporate restructuring, and saw similar success.

Source: Mason (2000 and correspondence with the author).

next program may be more generous than the current offer. However, the requirement that when the U.S. deposit insurance system opened in 1934, only healthy banks would be allowed in, finally helped persuade banks in trouble to issue preferred stock to the RFC. Governments already offering explicit depositor protection can encourage participation by dropping coverage for weak banks that do not opt in to the program.

With the increase in the sophistication of financial engineering since the 1930s, it is not surprising to find a huge variety of
innovative financial instruments being employed around the world in recent restructuring plans. They represent attempts—often ingenious, but not always successful—to tailor the government's commitments to the particular incentive issues involved. Careful, market-sensitive design of these instruments is essential if they are to be successful in achieving the desired effects at the least fiscal cost (cf. Honohan 2000). Sometimes the terms have been too tough to attract new private capital. Sometimes the financial engineering has brought liabilities into the bank's balance sheet whose eligibility as capital could be disputed.

Once in the program, the issue for government is how to extricate itself as quickly as possible, and how it performs while being a temporary owner of banks and even of enterprises. Each of the banks that is saved then becomes a key player in the restructuring process for individual firms. Like the RFC, which took temporary equity positions under the same stringent terms in nonfinancial firms, restructuring agencies may also become involved at the firm level. But the essence of the approach is that it is decentralized, with firms' creditors, among which banks usually are key, taking the lead.

Instead, a centralized approach with banks' nonperforming loans being hived off into an AMC rapidly has become recommended practice in recent years, in part because of the apparent success of this approach in Spain in the early 1980s. Their success can be assessed in different dimensions. Klingebiel (2000) proposes the following:

- Did the AMC achieve their narrow objectives for which they were set up? (For those charged with rapid asset disposition, did they dispose of assets within a 5-year period? For restructuring agencies, did they sell off 50 percent or more of the assets under management within 5 years?)
- More broadly, did the banking system return to solvency, without problems reappearing, and was credit growth resumed? That is, did the banking system experience repeated financial distress, and did real credit to the private sector resume?

Unfortunately, it appears from Klingebiel's study that Spain was the sole clear case of success, in satisfying all these criteria, of seven countries that included Finland, Ghana, Mexico, and the Philippines. The remaining cases, Sweden (1992) and the United States (1989), met the narrow criteria, but not the broader ones within a two-year window, although they did so quite well subsequently with clear recoveries, and should be classified as relative successes. Only Sweden's agency was charged with

Shallow capital markets make restructuring harder in emerging markets
restructuring (box 3.7) and, like Spain and the United States, had the clear advantage that real estate and consumer loans dominated their portfolio, which can be bundled together and sold off in deep capital markets. In contrast, emerging markets have seen a greater prevalence of crises entailing significant effects on the corporate sector— with loans here being more difficult to restructure—and they lack the deep capital markets for asset sales.

Applying the same criteria to Korea, Indonesia, and Thailand does not add to the clear success list, because there has been a marked tendency for the AMCs to hold on to assets. Because it has not yet been five years since they were established, Klingebiel’s criteria could still be met. Still, the record with centralized AMCs in emerging markets is that they

**Box 3.7  The Swedish experience: a Saab in every garage?**

Sweden, which experienced a banking crisis in the early 1990s (and then a currency crisis with the realignment in Europe), often is held up as a model for developing countries to emulate in bank restructuring. With the onset of the crisis in late 1992—although problems were visible in the previous year—the government stepped in with a blanket guarantee covering all forms of bank debt. Securum, a “bad bank,” was established to take over nonperforming loans, and later a Bank Support Agency was created. It gave out at least one guarantee—a promise to inject equity should a bank’s net capital fall below 9 percent—which was not utilized. Securum moved quickly to dispose of assets, repackaging them and selling them relatively quickly—on the stock exchange and through other channels—and was completed by 1997. The net cost of the operation was estimated to be 2.1 percent of GDP, well below earlier fears.

Although these achievements were substantial relative to the potential size of the problem, Sweden enjoyed a number of advantages that many developing countries do not have. First, as noted in the text, many of the assets were real estate, which in contrast to corporations are not that demanding in reorganization skills. Moreover, when developing countries find that many of their large enterprises are in need of restructuring, the political difficulty rises significantly. Second, a relatively homogeneous population and well-developed democratic institutions were an incomparable advantage in dealing with the disposition of assets. Thus, for example, the political opposition was represented on the Bank Support Agency, and there was a high degree of transparency for both agencies. Third, the legal framework was highly favorable to enforcement of bankruptcy. As Klingebiel notes, they score higher than the United States in enforcing creditors’ rights, meaning that officials had a credible threat to speed up efforts. And funding and skills were not a constraint in the restructuring process.

Developing countries can aspire to these advantages, but they can also aspire to having a Saab in every garage. Without these advantages, it is not clear that the model as a whole is exportable. Some features, such as the lack of government interference with the private management of the banks, as in the RFC case (box 3.6) may be the most important parts of this lesson.

have a tendency to become long-term dumps, rather than active warehouses, for nonperforming loans. Although this result can be partly related to some characteristics of emerging markets—shallow capital markets and a dearth of restructuring skills—the record is also consistent with the failure to use the private sector in a transparent manner to identify those fit to survive. Interestingly, Mexico recently adopted a forced auctioning of assets if mediator-led reorganization efforts fail, which appears to be jump-starting a stalled process, and illustrates the promise of arm’s-length rules and quick exit as a cornerstone for government’s approach.

Greater concentration of firm ownership and wealth in recent crisis countries suggests a greater scope for abuses with the centralized AMC approach, and yet simultaneously greater difficulty in using the private sector. One remaining option is to use foreign entities, either to assist in managing the process or to buy and restructure problem assets, with the clear difficulty being that many societies are not prepared to have “national assets” pass from their hands. Otherwise, in line with the Becker-Stigler criteria, it will be important to ensure a great degree of transparency for the process, and high-efficiency wages to those involved in it (recalling the discussion of an appropriate balance of terror in chapter 2) can help reduce the likelihood of abuses. A serious threat that wrongdoing by public officials will result in their loss of a (sizable) pension may be the best tool to induce honest conduct. Successful resolution of banking crises will require a change of mindset and will win the confidence of domestic residents and foreigners alike. The outright failing of some banks at the start of the process, and convincing all that remaining banks are fit to survive, is the key to success, and using the private sector to identify the latter is the best practice available.

Conclusions

Increased politicization of banking decisions when the government is involved means that the incentives for efficient and sound intermediation are impaired with state ownership, whether it is longstanding or temporary. Governments that attempt to be both owner and regulator likely will achieve success at neither. Cross-country and limited case study evidence shows that state ownership of banking leads to less development, less access to credit outside the largest
firms, and a higher risk of crisis. Country authorities necessarily have to balance the hazards of privatization with the losses from state banking. A gradual program of credible privatization, preparing banks for sale and the regulatory infrastructure for participation by more private banks, appears to be a sensible path to navigate the dangers of action and inaction.

This evidence also suggests that authorities need to be planning for their own exit whenever they take a temporary stake in banking as part of systemic restructuring. As in earlier chapters, working with the market has been argued to be the preferred course for government, especially in letting market forces pick winners and losers. Foreign banks can play an important role in taking over from the state, all the more so if there is genuine concern about a few insiders dominating both banks and the bank regulatory apparatus.

Notes

1. The La Porta, López-de-Silanes, and Shleifer (2000) data could be limited by the focus on the top 10 banks, but as they note in virtually all countries this captures a large percentage of the banking system, which they have defined to include development banks. However, the Barth, Caprio, and Levine (2001b) data, which are based on a survey of regulators, provides estimates of the percentage of assets in majority-owned state banks, and their data are highly correlated with that of La Porta, López-de-Silanes, and Shleifer for the 1990s.

2. In their growth regressions, these variables include years of schooling, initial level of financial and economic development, inflation, the black market premium, an index of government intervention, tax and subsidy rates, and latitude.

3. Specifically, real GDP per capita, corruption, expropriation risk, bureaucratic efficiency, and the law and order tradition of the country. This study, as with most of the data underlying figure 3.1, is based on the World Bank Survey of Prudential Regulation and Supervision, and refers to the percent of the entire commercial banking sector assets in majority-owned state banks, as of 1997–98.

4. Additionally, Cetorelli and Gambera (2001), who find some positive effects of greater bank concentration in promoting the growth of industrial sectors in need of external finance, report that this gain is negated by greater state ownership.

5. Although the original Barth, Caprio, and Levine (2001a) paper with about 60 countries found only an insignificant link between state ownership and crises, their forthcoming study, based on 105 countries, finds a significant link.

6. State bank lending to SOEs reportedly declined again in the late 1990s.

7. For countries with deep financial systems, the conclusion is reversed, which may also be rationalized by a political-economy argument, though less crisply. Proximity to the next election also appears to deter socially costly policy reactions to crisis, reinforcing the message that political constraints are important. The variables employed by Keefer to indicate the level of public information available do not perform as strongly in the regressions, but are not inconsistent with the theory.

8. Postprivatization losses also can rightly be blaming, at least in part, on preexisting losses and weak initial conditions. Although many transitional economies experienced bank failures in the immediate years after
transition started, often these problems occurred in state banks, represented the manifestation of losses in the prereform era, or were inevitable given the real sector turbulence, and virtually always were associated with a weak regulatory framework.

9. Governments could even consider retaining ownership and contracting out the management of banks to private parties, but perhaps fortunately have not done so, as management contracts have been found to work only in industries in which quality is easily verified and reputation is paramount (World Bank 1995). Thus hotels are an example satisfying both criteria for management contracts: output quality can be monitored by anyone (it is easy to see if the towels are clean) and quality matters (hotels with dirty towels lose business). However, it is difficult for depositors, creditors, supervisors, and even management to evaluate the health of bank portfolios, that is to tell if their portfolio is clean. And since the importance of reputation—once paramount in banking—in most countries is diminished by the presence of implicit or explicit deposit insurance, banking is not well suited to management contracts. Perhaps in recognition of this fact, there has been little experimentation with contracting out in banking.

10. A partial list would include Claessens, Djankov, and Klingebiel (1999), Dziobek (1998), Garcia (1999), and Lindgren and others (2000), and sources cited therein.

11. It may appear to be inconsistent for the authorities to maintain a constructive ambiguity about their policy stance, while insisting on transparency from others. There is clearly a tension between policy certainty and the strategic advantage to be gained from discretion. But, provided the government is seeking the common good, there seems no reason to refrain from using strategic tools denied to private agents.

12. The common view, one that authorities have difficulty resisting, is that they must be proactive in a crisis, yet Baer and Klingebiel (1995) showed that in 5 crises in which depositors were allowed to take losses, there was a prompt recovery of output.

13. Many central banks limit liquidity support from the discount window to a short period, from 7 days to several months. Normally banks coming in for repeated liquidity support are subject to increased supervisory attention and indeed forced to seek other sources of funds, including where it exists the deposit insurance facility.

14. The instruments they employ—a measure of government corruption and the law and order tradition—rank high in terms of exogeneity. Also, they check a regression of the residuals on these instruments, and find no significance.

15. Even when excessive risk-taking occurred in the U.S. Savings and Loans, the losses were still under 3 percent of GDP.

16. Actually, the same is true for banks. Bartholomew and Gup (1999) show that in non-U.S. G-10 countries, banks in most cases are rarely closed, and usually any liquidation involves a transfer of part of the bank’s operations to other, presumably viable, banks.

17. State banks often are recapitalized—even though it is not clear how capital on their balance sheet differs from the contingent claims they hold on their governments—without sacking managers or otherwise other consequences.

18. When banks are sold, the identity of the buyer matters—both Uganda and Ghana (box 3.1) had costly ‘failed’ privatizations to foreign manufacturing companies, which demonstrates the importance of finding ‘fit and proper’ buyers. Consistent with the message of this section, relatively clear definitions should be set out elaborating these criteria.

19. Since profits will depend on entry into the banking sector, authorities likely will have to agree to some limits on bank entry, otherwise prospective returns will be insufficient to attract responsible investors.