Crisis in the Financial Sector

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Abstract
This paper examines the phenomenon of financial distress that has, in the late 1970s and in the 1980s, taken a worldwide dimension. It traces the causes back to external shocks that affected developing countries during that period and to overexpansionary domestic policies and their consequences. It concludes that financial distress has a severe impact on mobilization and allocation of financial resources and thereby on economic and financial development. The author is chief of the Financial Policy and Systems Division, Country Economics Department of the World Bank and is currently heading the 1989 World Development Report team.

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Introduction

Today, much of the world is experiencing a financial sector crisis of significant proportions. While unlike that in the 1930s this crisis does not involve uncontrollable runs on banks and bank failures, the number of banks and other financial institutions currently insolvent is without precedent in the last 50 years. The banks in almost all Latin American countries have been affected. The Chilean government was forced to help all but one bank. In Argentina the government has intervened in many banks, while Brazil, Colombia and Ecuador have encountered serious problems with bank capitalization. Asia, has also been affected. In the Philippines, the government has acquired six of the private banks and has had to restructure the two largest institutions, which were government owned; in Korea, the government has had to support the banks because of substantial bad loans; and in Thailand, several of the smaller financial institutions have recently been in trouble; in Bangladesh, banks' portfolios have a large percentage of nonperforming loans. In several EMENA countries, such as Algeria, Portugal, Turkey, and Yugoslavia, some financial institutions have had problems. Nor is the problem limited to the developing world. In the United States, the failures of Penn Square and Continental Illinois Bank and the crisis in the savings and loans subsector, in energy loans and agricultural finance, have been widely reported. In 1987, 150 U.S. banks had to be restructured; in Canada, 2 out of 14 banks failed. The Federal Republic of Germany has also had bank problems.

Actual bank failures are just the visible tip of a very large iceberg. I have talked to bank supervisors in many countries in recent years, and the story they tell is the same. The portfolios of financial institutions in many countries are in a sorry state. But failed banks, and even loans formally classified as bad and doubtful, represent only a fraction of the problem. Bankers often do not classify their larger nonperforming loans as such because that would impair their banks' stated capital. Only when the supervisors are forced to intervene do they learn the true state of the portfolio. A rule of thumb one supervisor suggested to me is that nonperforming accounts are eight times the amount shown on the balance sheet. That means that if financial institutions' assets were marked down to their true market values, many financial institutions' liabilities would be greater than their assets—in other words, they would be bankrupt.

Consider the following arbitrary definition: if in a country financial institutions holding more than 25 percent of the assets are bankrupt—that is, if adequate provisions for doubtful loans were made, the institutions would no longer
have any capital of their own—then that country's financial sector is undergoing a crisis. It is in that sense that I refer to widespread crisis in the financial systems of many developing countries. Of course, banks are in trouble because their borrowers cannot pay, thereby also implying deep problems in the underlying economic sectors. In addition to the domestic problems, one must add the difficulties many developing countries now have in meeting their external obligations. However, other papers already deal with that side of the financial crisis, and I shall not cover it here.

Causes

The causes of the crisis can be found at the macroeconomic level, the sectoral level, and the institutional level.

At the Macroeconomic Level. The most important causes of the crisis at the macroeconomic level are: (a) development strategies that put a premium on production for domestic markets at the expense of exports; and (b) the use of expansionary policies in the late 1970s and early 1980s to maintain growth in the face of large trade deficits caused by the development policies. Out of these policies came a set of relative prices that caused credit to flow toward consumption, toward production of nontradable goods, and toward real estate speculation.

Of course, these policies proved unsustainable. Starting in late 1982, countries found financing their current account deficits with foreign borrowing more difficult—the beginning of the so-called external debt crisis. This led to massive real devaluations and/or other changes in trade policies designed to discourage imports and encourage exports, and to stabilization programs of tight monetary and fiscal policies designed to reduce excess demand in both the foreign and domestic markets. The repercussions of these policies on individual firms and their ability to service their debts will be discussed later.

At the Sectoral Level. The macroeconomic problems were compounded by policies at the sectoral level. During the 1970s, central banks set the interest rates in most developing countries, and in many cases interest rates were not permitted to rise to keep pace with inflation. Depositors realized that the real value of their financial assets, including what they were being paid in interest, was being eroded. As a result many depositors shifted their assets either out of their countries or out of financial assets. Moreover, to a growing extent in the 1970s, governments directed banks to lend to the government itself, to public enterprises, and to so-called priority sectors in the private economy: agriculture, small business, housing, so on. These loans were not directed to projects with the highest returns, but to those that governments considered socially desirable. In many countries, many of today's nonperforming debts are found among these directed credits.

Another sector aspect of the crisis is the authorities' role in supervising and regulating financial institutions. In some countries, the banking laws have not kept up with changes in financial services and are outdated. In others, the bankruptcy laws make foreclosure on nonperforming loans difficult, if not impossible. In many of the countries with serious problems, loans were excessively
concentrated on relatively few borrowers or on a single industry or region. In some instances, these large loans were granted to public enterprises or to firms associated with a particular bank through common ownership. In countries with subsidized loans, one way for industrialists to be certain their firms had access to preferential credit was to purchase a bank. When problems developed, banks continued to lend to associated firms when a prudent banker acting at arms length would have stopped lending or even foreclosed on outstanding loans. In many countries weak bank supervision meant that the authorities were unable to keep on top of the situation as their portfolios deteriorated. Nor did supervisors force banks to make adequate provisions for bad loans or require owners to make infusions of new funds as capital eroded.

At the Institutional Level. Some of the problems—excessive loan concentration, lending to associated firms, continued lending as a client's position deteriorated—have already been mentioned above, but other problems also existed at the institutional level. Some banks had mismatched portfolios in terms of exchange rates, maturities, or interest rate systems; some had excessively high operating costs due to overbranching and overstaffing; some lacked proper internal controls, credit reviews, and planning procedures; and some followed go-go policies and grew too rapidly.

Once bankers found themselves in trouble for some reason many adopted management strategies that made matters worse. They rolled over doubtful loans without taking provisions or hid and paid dividends to conceal the absence of earnings. As things went from bad to desperate, some bankers engaged in speculative foreign exchange dealings or in buying land, real estate or stocks hoping for rising prices, and so on. Other banks paid above market interest rates to acquire funds and made very risky loans. Also, of course, outright fraud was involved in more than a few cases of bank failure.

Consequences

Those countries following the constellation of macropolicies outlined above are undergoing the most severe financial crisis. For the most part, these are also the countries with external debts they cannot service. Currency overvaluation and other trade policies shifted relative prices in favor of nontradables, and loans and resources flowed to these sectors. Furthermore, overly expansionary domestic policies created trade deficit and low foreign interest rates encouraged borrowing from abroad. When these policies proved unsustainable in the early 1980s, many countries had to make major adjustments in their currencies. Since 1978, Turkey has devalued 30-fold. That is the extreme case in the EMENA region, but many countries had to devalue. The exchange rate losses to firms, and by implication to financial institutions, were staggering. Moreover, during this period many developing countries in this period suffered adverse movements in their terms of trade plus slow export growth due to recession in their trading partners' countries, and inflation, throwing their own economies into recession and exacerbating the industrialists' problems. Finally, in the face of expected devaluations and distressed borrowing by firms facing bankruptcy, interest rates on domestic...
credits rose to unprecedented levels—rates of 20, 30, even 40 percent in real terms are found today in some of these countries. Such a constellation of forces—foreign exchange losses, decline in demand at home and abroad, drastic changes in relative prices and extraordinarily high real interest rates—have proved disastrous to many firms. And the firms' inability to service their debts has proved the undoing of many financial institutions.

As a result of the events described, some banks and other intermediaries have failed. However, failed banks that must be closed or merged with other institutions are the exception, and in most countries failed banks held only a fraction of financial assets. Far more numerous are banks that are alive but impaired, from mildly impaired, say potential losses from nonperforming loans less than capital, to highly impaired, with potential losses several times the value of capital. Even the highly impaired banks may not be illiquid and continue to operate. Checks written on them are honored, service provided, and employees paid. The concern arises because of the danger that impaired banks may fail, with the attendant nastiness of bank runs, uncontrolled changes in the monetary and credit aggregates, capital flight, disruptive bankruptcy proceedings, and so on. Short of that, problems still exist. For example, governments in many countries have been called upon to subsidize the banks in one way or another, thereby cutting their allocations to other programs. Also, governments have allowed banks to increase spreads between deposit and lending rates to help cover losses. This measure is usually coupled with other measures to limit competition from new banks and to prevent the development of commercial bills markets, which would develop in the face of large bank spreads. While possibly necessary, such measures are certainly not desirable and hamper the development and retard the liberalization of financial markets.

Possibly the worst consequence of a highly impaired financial system is its impact on resource allocation. By their very nature, nonperforming loans do not produce funds that banks can use for new loans. Secondly, new funds that come available through new deposits are disproportionately allocated to nonperforming debtors to prevent their bankruptcy, which would in turn lead to the failure of the financial institutions. Whatever the financial aggregates show about credit expansion, would-be borrowers perceive a scarcity of funds, which in turn has a depressing effect on investment and other economic activity.

Faced with failure, both debtors and their bankers stress survival rather than longer-term objectives, including profitability. Debtors borrow at interest rates above the rate of return on assets—distress borrowing—which is one of the reasons for the very high real interest rates in a number of countries. In this way, markets become perverse. Higher interest rates lead to increased not decreased demand for credit as debtors must borrow to pay interest, and bankers make loans to impaired borrowers to stave off their own failure. The situation is made worse and continues longer, if those involved have expectations that the government will eventually be forced to intervene to bail out troubled debtors and their bankers. Even viable firms suffer—they cannot borrow to expand their activities, and furthermore, interest rates are so high that these firms use funds generated by profits and depreciation not to expand, but to repay outstanding loans. Transfer of resources to loss making activities has an adverse impact on resource allocation and seriously impedes recovery and growth.
Cures

In those cases where macroeconomic instability has been a major factor in generating crisis, it can only be resolved in parallel with the implementation of other stabilization and structural adjustment measures. But where the financial system has been seriously decapitalized, however, stabilization of the economy will not be sufficient to end the banking crisis. The stabilization measures—devaluation, tight credit, higher interest rates, depressed domestic demand—are actually likely to deepen the crisis, particularly if combined with liberalization of both the real and financial sectors. For example, liberalization of the trading regime has caused changes in relative prices, making yet more domestic firms uncompetitive and unable to service their loans. Similarly, removal of interest rate controls has led to very high real interest rates in inflationary countries, exacerbating the problems of illiquidity at the firm level. Countries cannot avoid the pains of stabilization and/or liberalization of financial sector policies because of their adverse impact on the financial system, as that would simply perpetuate the problems indefinitely. However, authorities should understand the likely consequences of these measures on the financial system, and look for and be prepared to deal with financial distress in firms and financial institutions should it develop. While stabilization and/or liberalization may trigger financial distress, they are not the cause the crisis. The cause lies in the policies that produced the problem in the first place.

First, on the institutional level, the first step in designing a cure is to persuade the authorities to address the problem. Unless the situation is dire—as it was in Chile—that may be the most difficult step, for as I have noted, financial institutions can go on operating long after their losses are equal to or greater than their capital. Bank supervisors tell me that in nine out of ten cases in which they delayed action, the situation at the institutional level deteriorated. Yet in many countries where the authorities know there are problems, they are delaying action. The reason is that restructuring banks when the problem is widespread is costly, difficult, likely to prove politically embarrassing, and, if done correctly, likely to force the authorities and the bankers to make very difficult decisions about the future of firms that have been unable to service their debts, many of which may be state enterprises. Furthermore, explicit recognition of the problem, if not handled correctly, can affect the public's confidence in the banks, accelerate capital flight, and so on. As a result, many governments appear to think the costs of addressing the problem exceed the gains. Yet I believe that the underlying policies and practices that caused the financial crisis in all its manifestations at the level of the firms, the institutions, the banking systems, and the countries are the single most important cause of slow economic growth in the 1980s. I fear that until we resolve this situation, slow growth will continue. Unfortunately, many countries will not act until faced by a crisis of such proportions that further delay is impossible.

Four problems that must be addressed to resolve the crisis: (a) allocating the burden of past losses; (b) determining which firms and financial institutions are viable and will be restructured and which closed; (c) undertaking the actual restructuring and recapitalization; and (d) resolving the issues responsible for the problems in the first place.
With regard to allocation of losses, to the extent feasible, shareholders of the firms that cannot pay their debts and of the banks should bear the losses. However, there is no crisis unless the market value of banks' liabilities is greater than that of their assets, that is the losses exceed the value of the equity. In some countries, banks can draw on deposit insurance funds, but these are relatively rare in developing countries, and where they do exist, they have limited assets. If the losses exceed available deposit insurance, either taxpayers or depositors must bear the costs. In the 19th century and before, depositors bore the loss, but more recently, governments have consistently intervened to protect depositors. The justification is that this protects the financial system from loss of confidence runs, and so on.

However justified, government intervention to protect depositors prevents the functioning of the mechanisms through which markets would allocate losses. Therefore, further government intervention is needed to distribute losses. The following mechanisms carry out this distribution: (a) inflation combined with ceilings on interest rates; (b) subsidized refinancing and other across-the-board measures; and (c) case-by-case restructuring. Of these, a case-by-case approach is probably best because of the shortcomings, inefficiencies, and inequities of the other two approaches.

While governments can reduce excessive indebtedness by lowering the real value of debt through inflation while controlling interest rates, this destabilizes the economy and in the end usually leads to costly contractionary policies that lead to further financial crises. Argentina's experience is a good example. A number of countries have tried some form of across-the-board transfer to either the borrowers or the bankers. This solution is costly because it wastes resources by helping debtors and financial institutions that do not need assistance. Worse, it does not force the institutions and authorities to take the hard decisions to close firms that are no longer viable.

A case-by-case restructuring program should involve (a) closing nonviable firms; (b) restructuring viable nonfinancial firms; and (c) recapitalizing viable financial intermediaries. However, debtor firms and their bankers will not agree to absorb losses unless they are convinced that the government will not bail them out and that it is in their best interest to stop refinancing nonperforming loans. Unfortunately, in many countries the expectation of government bailouts is valid and is slowing adjustment.

As regards the restructuring of financial institutions, the orthodox approach in developed countries is for governments to intervene in the recapitalization of the banks, but to leave the restructuring of the debtor firms to market processes. Banks are forced to collect as much of their debt as possible through foreclosure proceedings, sale of collateral, and similar procedures. If the banks fail in the process, they are merged, closed, or recapitalized. In the end, the banking sectors health is restored and the good assets of bad debtors have been sold to other firms and their bad assets written off. This was the approach to the Spanish banking crisis in the late 1970s and early 1980s. It has not been used in developing countries with widespread problems, however, because the private sector's ability to absorb the good assets of bad debtors is limited, entrepreneurial talent is scarce, and during a crisis, even the number of potential buyers for assets is limited. Furthermore, a widespread transfer of assets at low prices would lead to excessive wealth concentration if bought locally or to loss of control if sold to foreigners. While
governments are reluctant to allow the demise of a substantial portion of industrial entrepreneurs and managers, the latter should not be spared from losses. The owners should be requested to either inject more capital themselves or to see their ownership position diluted.

The issue of the management of banks is different from that of firms, both because the reasons for their replacement are stronger and because their substitution is easier. The case of replacement is based on one pragmatic reason: when a financial institution gets into serious trouble, top executives develop a style of management (like concealing losses, disregarding prudent financial practices,) that is impossible to eliminate from the institution if the managers are not removed. The problems posed by the substitution of shareholders and managers in the financial sector are alleviated by two factors: (a) typically, the number of failed banks is much smaller than the number of failed firms; and (b) managing one bank is quite the same as managing another.

Normally in the case of crisis, banks in distress are taken over by some authority (a deposit insurance corporation, a superintendent of banks, or a similar institution); the bad loans are written off against the bank's equity capital, and what is left is either sold to a stronger bank or is liquidated. In cases of major financial crises, however, there are not enough strong banks. In such circumstances, the government must intervene more directly to recapitalize and restructure the banking system. This involves not only a transfer of resources, but temporary government management of the most seriously distressed banks aimed at restructuring them before selling them back to the private sector. Cases of government intervention in the management of seriously distressed banks include the Continental Illinois Bank in the United States (which is still under the control of the Federal Deposit Insurance Corporation), many Spanish banks that were taken over by the Deposit Guarantee Fund in the last decade and sold back to the private sector after restructuring, and five Chilean banks that are being sold to private entrepreneurs after the superintendent of banks managed them for almost five years.

In conclusion, I want to stress that the crisis cannot be resolved solely by recapitalizing banks. It is necessary to force the restructuring of the financial institutions themselves including reducing costs, disposing of unnecessary assets, streamlining the administration, and increasing operational efficiency in general. In most cases, the crisis in the financial system only reflects the problems of the borrowers. To resolve this problem, governments must also address the problems in the productive sectors.
Questions for discussion

1. Are there financial institutions in your countries that have serious solvency, liquidity, and income problems?

2. Is the problem sufficiently serious that it has consequences for the way credit is being allocated? Is there a danger of institutions getting into liquidity problems and forcing the central bank to take action?

3. If a portfolio review was done of your financial institutions, are there particular classes of borrowers whose debts could be delinquent? What should be done to deal with the problems of the delinquent borrowers?

4. What can be done about the troubled intermediaries in terms of portfolio restructuring, reduction in costs, improvement in operating systems, change in management, recapitalization, etc? Who will bear the cost?

5. Over the longer run, do you understand the source of the financial problems in your country in the first place: macro policy, financial sector policy, government intervention in credit decisions, bad management at the level of the intermediary and uncontrollable events? What changes do you contemplate to see that these problems are not repeated?