Strengthening Banking Systems: Lessons From Around the World and Across the Ages

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I. Introduction

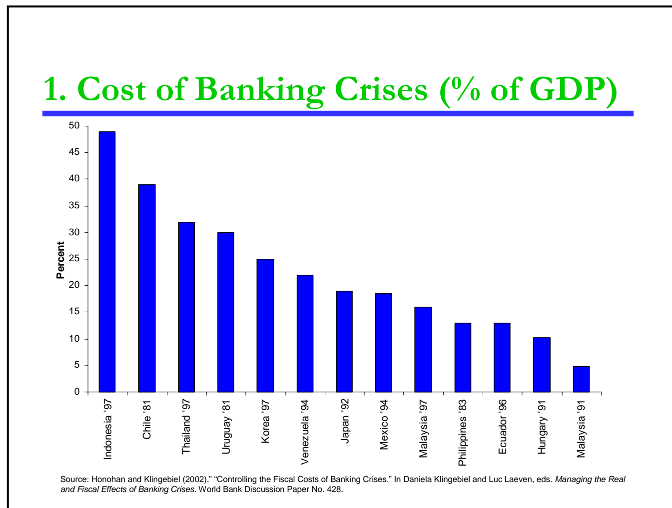
Banking-style institutions have existed for over two thousand years and are even documented in the earliest civilizations. For example, in ancient Egypt and Mesopotamia, barley and grain were forms of currency and the grain silos and state warehouses acted as banks.[1] An ancient Babylonian clay tablet explains that city workers received wages denominated in liters of barley that were "paid" by being placed in reserve at a local silo. When the worker wished to use his barley wages, such as to purchase a pair of shoes, the worker would give the shoemaker a receipt authorizing a withdrawal of barley from the local silo. These ancient banking operations became so widespread that laws governing them were included in the Code of Hammurabi.

Unfortunately, throughout time the existence of banking institutions has often tended to precipitate banking scandals and crises. For example, during the 12th century, the Knights of the Temple and Hospitallers provided banking services to finance expenses related to the Crusades (including the payment of ransoms). Kings and governments could not resist this source of funding and falsely accused the "bankers" of crimes largely to seize their assets and use the finances deposited in the banks for other purposes.[2] When Willie Sutton, the infamous U.S. bank robber, was asked why he robbed banks, he is alleged to have responded "because that's where the money is."

Over time governments have learned the importance of sustaining sound banking systems and developed regulations to improve their performance. Yet banking problems still persist. In fact, according to one count, there have been 113 systemic banking crises (defined as much or all of bank capital being exhausted) in 93 countries since the late 1970s, and an additional 50 smaller (non-systemic) banking crises in 44 countries.[3] Moreover, these banking crises are not limited to low-income countries. Since 1980, about three-quarters of IMF member countries have experienced significant banking sector problems and subsequent restructurings, often involving government financial assistance.[4]

Banking crises are a serious concern and can be extremely costly—not only in terms of the direct cost to governments and taxpayers, but also in terms of foregone growth. According to one study, governments spent an average of about 13% of GDP restoring financial systems after banking crises. In many cases, the costs were substantially greater. As shown in Figure 1, the government costs of banking crises reached about 50% of GDP

in Indonesia in 1997, about 40% in Chile in 1981, and just above 30% in Thailand in 1997 and Uruguay in 1981.[5] Another study estimates that between 1980 and 1998, banking problems cost developing and transition economies roughly $250 billion.[6] Moreover, these estimates only include the direct costs to the government of strengthening the financial system and do not include costs such as: the inefficient allocation of resources due to poor loan decisions, any contraction in economic activity during the banking crisis, or any related capital outflows, reserve losses, or currency depreciations.



Source: Honohan and Klingebiel (2002)." "Controlling the Fiscal Costs of Banking Crises." In Daniela Klingebiel and Luc Laeven, eds. *Managing the Real and Fiscal Effects of Banking Crises.* World Bank Discussion Paper No. 428.

Given these substantial costs of banking crises, it is critically important to strengthen banking systems in an effort to avoid—or at least reduce the likelihood of—banking crises. My comments will focus on seven key lessons on how to strengthen and reform banking systems, lessons learned from countries around the world and across the ages. Since this is in itself an ambitious topic, I will avoid discussing how to manage and resolve banking crises after they occur. I will also avoid discussing the important topic of how to deepen capital markets and develop other sources of financing outside the banking system—such as through the development of equity and bond markets.

More specifically, the seven key lessons for bank reform on which I will focus are:

- enact sound prudential regulations, independent supervision and strong corporate governance;
- provide partial, risk-adjusted deposit insurance;
- ensure banks operate on a commercial basis, free from political interference;
- encourage foreign investment in the banking system;
- combine bank reform with corporate restructuring;
- establish well-defined and speedy bankruptcy laws; and
- act promptly.

I will spend the most time discussing the first of these lessons—the importance of sound prudential regulations, independent supervision, and strong corporate governance—since this has not only been a key factor behind most banking crises, but is also an area where many countries have room for improvement. But all seven lessons are important, and countries that follow these recommendations should have stronger banking systems that are more solvent, profitable, and less vulnerable to costly crises. These recommendations should also ensure a more efficient intermediation and allocation of financial resources, thereby strengthening the overall economy and raising long-term growth rates.

II. Enact Sound Prudential Regulations, Independent Supervision and Strong Corporate Governance

One of the most common causes of banking crises throughout time has been a lack of strong prudential regulations, or in cases where sound regulations exist, a lack of adequate supervision ensuring the regulations are enforced. It is critically important that banks have well-defined and comprehensive guidelines establishing the framework and principles under which they operate. There is an old saying among CEOs of commercial banks; "if you, as the head of a bank, have someone working for you, you should watch them. If they're making money for you, you should watch them closely. If they're making very good money, you should watch them closer still. And if they're making absolutely fantastic money, you should fire them, because they must be [taking] excessive risk."[7]

The Basel Committee on Banking Supervision has outlined a set of "Basel Core Principles for Effective Banking Supervision and its Methodology" with recommendations for the necessary foundations of a sound supervisory system.[8] These recommendations include:

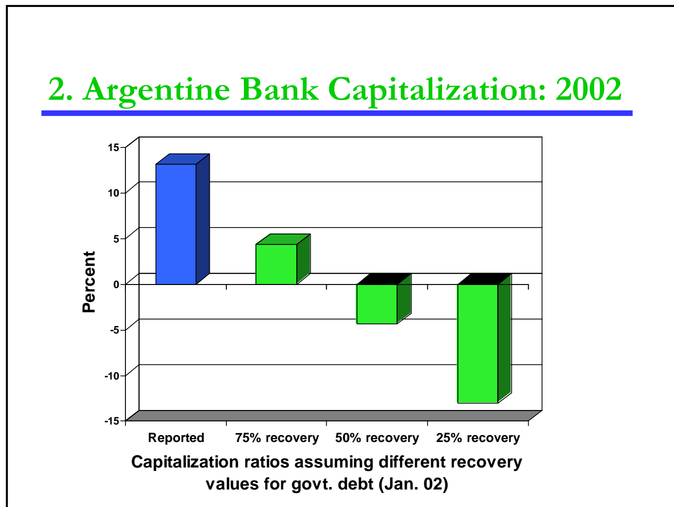
- prudential guidelines on issues such as capital, liquidity, lending concentrations, and asset valuation;
- comprehensive licensing rules, including guidelines for entry and exit;
- requirements for internal controls and risk management systems;
- requirements for effective corporate governance;
- requirements for periodic reporting and examinations, supervision, and public disclosure;
- corrective measures to overcome difficulties; and
- guidelines for accounting and auditing standards.

While all of these recommendations are important and should be adopted, I will discuss the first in more detail: prudential guidelines on capital adequacy, including asset valuations, lending concentrations, and liquidity. Countries should impose internationally-recognized capital requirements, at the very least requiring the 8% capital-adequacy ratio (the ratio between capital and risk-weighted assets) established by the Basel Committee on Banking Supervision. Most countries, and especially riskier countries, should seriously consider setting an even higher threshold to account for local conditions.

Just as important as establishing the minimum level of capital adequacy, however, is ensuring that the valuations used to calculate this ratio are accurate, especially in terms of capturing risk. In some countries banks often roll over or "evergreen" loans to companies that are insolvent and/or unable to repay existing loans, thereby enabling the banks to avoid reporting the loans as risky or non-performing. This practice of under-representing problem loans was a key factor underlying Japan's prolonged banking problems throughout the 1990s. For example, when Japan's Financial Supervisory Agency (FSA) inspected Ashikaga Bank in the fall of 2003, it uncovered ¥48 billion more of "doubtful" loans and ¥21 billion more of "uncollectible" loans than Ashikaga's own assessment.[9] The additional loan losses were enough to render Ashikaga insolvent.

Prudential regulations on capital adequacy should also include limits on exposure to certain sectors and individual borrowers, as well as on severe mismatches in maturity structure or currency denomination. Numerous historical examples suggest that concentrated lending exposure can lead to banking problems, from the exposure to developing-country debt behind the crises in the 1980s, to the exposure to Texas and New England real estate behind US bank failures in the1980s, to the exposure to excessive property lending behind the banking crises in Malaysia in the mid-1980s, in Japan in the early-1990s, and in Thailand in the mid-1990s.[10] Historical examples also suggest that severe mismatches in the maturity of banks assets and liabilities can increase banks' vulnerability. For example, short-term assets of Korean commercial banks covered only 55% of short-term liabilities at the time of Korea's 1997 crisis, and short-term assets of Mexican banks covered only 65% of short-term liabilities at the time of Mexico's1994 crisis.[11]

The recent crisis in Argentina provides a clear example of the importance of prudential regulations to ensure an accurate assessment of banks' capital adequacy. Most Argentine banks were generally viewed as sound and well-capitalized in the 1990s, with an average capital-adequacy ratio of nearly 15%, well above the 8% recommended by the Basel Committee. These strong ratios, however, hid a number of vulnerabilities. The banks held a large share of Argentine government bonds, which—per Argentine banking regulations—were assessed as risk-free when calculating capital-adequacy ratios. As a result, the banks capital-adequacy ratios would have been substantially lower if government debt was valued at the more accurate market price. For example, rough simulations shown in Figure 2 suggest that if the banks valued their holdings of government debt at about one-half of face value (which is still substantially more generous then the value at which Argentine government debt is currently trading), then at the start of 2002 the average capitalization ratio of Argentine banks would have been negative—and nowhere near the reported values.[12] In fact, at that time it would have taken an injection of roughly $10 billion dollars to restore capital-adequacy ratios to just the 8% Basel standard.



Moreover, although Argentine banks appeared to be well-hedged against currency risk before the 2001 crisis (with a similar share of assets and liabilities denominated in foreign currency), the banks did not account for the risk from a major currency movement reducing the ability of many companies to repay their loans. When the peso floated and then depreciated in 2002, many companies could no longer service their dollar-

denominated debt, putting additional pressure on the banks. This experience suggests that prudential banking regulations should include guidance on valuing government securities to incorporate risk and accounting for (or even limiting) currency mismatches.

Establishing the range of prudential regulations necessary to accurately calculate capital-adequacy ratios and account for risk is only part of the challenge. To ensure that the regulations are enforced, it also necessary to establish independent supervision and strong corporate governance. Countries should establish a strong supervisory agency for the banking system, one which is autonomous and independent in order to shelter it from government pressure. The agency should not be liable for any damages caused when supervisors legitimately perform their duties. The agency should also have the power to withdraw licenses, issue new prudential regulations and standards, conduct on-site inspections, and most important, to take corrective actions—including closing and initiating the liquidation of banks.

Even the most successful supervisory agencies must rely, to some degree, on the information provided by the individual banking institutions. Therefore, the supervisory agency should also establish requirements for reporting, transparency and all-around sound corporate governance. Banks should be required to regularly issue public financial statements based on internationally-accepted accounting standards. Banks should be required to use competent and independent external and internal auditors. The external auditors should be required to certify that the financial statements are accurate. Supervisors should also establish guidelines on ownership structure to ensure that banks are not subject to pressure to shirk these reporting requirements or engage in connected lending. There should be checks and balances in the governance structure, such as having non-executive directors, independent board members, and voting shareholders that can exercise oversight over management.

A key tenet of this supervision and sound corporate governance should be zero tolerance for corruption and blatant dishonesty. Officials, managers and owners that engage in fraudulent actions should be personally and severely penalized. Firing an individual is not sufficient to ensure that bank employees consider their own future livelihoods at stake, instead of just seeing “other people's money” at stake. Bank Mandiri (an Indonesian bank created from several state-owned banks after the 1997 crisis) has recently taken these concerns about corruption to a new level. This year the bank published newspaper adds requesting that corporate clients refrain from giving employees gifts, since gifts would be viewed as bribes and could cause employees to lose their jobs or be sued.[13]

New Zealand has recently issued a set of guidelines for supervision and corporate governance that are highly respected.[14] All banks are required to issue quarterly disclosure statements to the public, statements which are comprehensive and include disclosure along a number of risk dimensions. The statements must be approved by two annual external audits. Directors are required to sign the public disclosure statements each quarter and to attest to the adequacy of their banks internal control system. Directors face severe criminal and civil penalties when a disclosure statement is false or misleading.

III. Provide Partial, Risk-Adjusted Deposit Insurance

If a bank run started in the 19th century, the Bank of England told the tellers to use very small bills and count slowly.[15] More recently, when a bank run starts countries (such as Argentina in 2001 and the United States in 1933) often declare a bank "holiday" and simply close the banks. Bank runs which are not halted can be devastating. After the U.S. stock market crash in 1929, bank runs contributed to the failure of 744 U.S. banks within the first 10 months of 1930, and the failure of 9,000 U.S. banks by the end of the 1930s. Depositors are estimated to have lost $140 billion by 1933 due to these bank failures (equivalent to about $2 trillion today after adjusting for inflation).[16]

A second lesson learned after years of banking crises, and especially this experience of the United States during the 1930s, is that one way to improve confidence in the banking system and reduce the chance of bank runs is to provide deposit insurance—either through a publicly-mandated or private system. Deposit insurance is particularly important in countries with a history of bank failures. In these cases, deposit insurance may encourage people to use banks (instead of keeping money under their mattresses), thereby facilitating the development of the financial sector and increasing the resources available to fund investment. Deposit insurance can also be important in helping small banks compete with larger banks, since larger banks are often believed to implicitly have deposit insurance since they are "too big to fail".

Historical experience also shows, however, that unlimited deposit insurance can make banks less sound by encouraging them to take greater risks and reducing the incentives for depositors and regulators to monitor the banks. As a result, deposit insurance must be carefully designed and should incorporate several components:

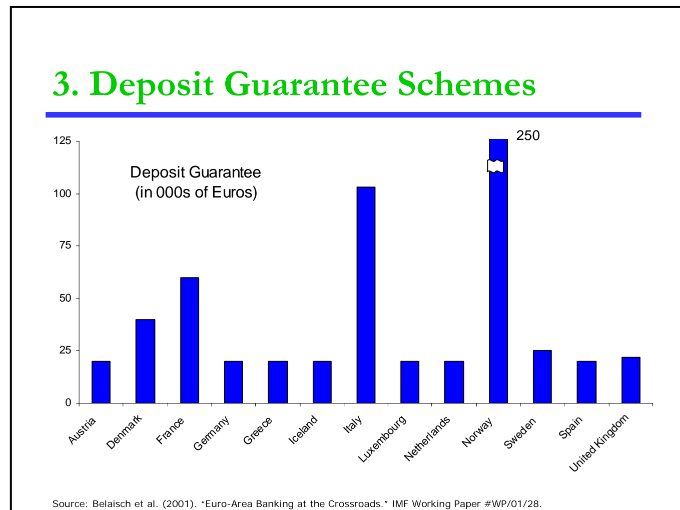
- include insurance premiums that are risk adjusted;
- be available only after banks meet certain regulatory requirements;
- provide limits or caps on the coverage; and
- include well-designed supervision and regulation.

Insurance premiums should be risk adjusted in order to reduce moral hazard and force banks to assume the increased cost of insurance if they engage in riskier lending. The Bush Administration has recently supported legislation to accomplish this goal in the Federal Deposit Insurance Reform Act. This Act, which is currently before Congress, would allow the Federal Deposit Insurance Corporation to adjust deposit insurance premiums based on factors such as a bank's loan growth.

Banks should only qualify for deposit insurance after they have met certain regulatory requirements, including a thorough audit. For example, last year Russia enacted a law that requires banks to meet strict prudential eligibility criteria in order to maintain their licenses and qualify for deposit insurance. Although this law has initially caused some instability in the banking system—such as identifying unexpected weaknesses in some banks and prompting withdrawals from banks that were believed to be unable to satisfy

the regulatory requirements—governments should avoid providing deposit insurance for banks that do not meet minimum standards.

Also, deposit insurance should only provide limited coverage in order to focus protection on small savers that would be devastated by a loss of their bank deposits. Large depositors, in contrast, tend to not only have additional financial resources, but also should be more able to monitor banks. As a result, capping the amount of insurance coverage for large depositors should help avoid complacency. Moreover, providing unlimited insurance coverage can substantially increase the fiscal cost to the government (or private insurance system) if there is problem in the banking system. As a result, most countries cap the amount of insurance they provide for bank deposits. For example, Figure 3 shows that Greece insures deposits up to €20,000, France to €60,000, Italy to €103,000, and Norway to €250,000.[17] The United States insures single deposits up to $100,000, and Japan plans to reduce its currently uncapped deposit insurance to a maximum of ¥10 million in April 2005.



The 2003 banking crisis in the Dominican Republic clearly illustrates the potential problems with unlimited deposit insurance. The Dominican Republic maintained a law providing deposit insurance coverage of approximately $24,000 per deposit. In the midst of the crisis, however, the government unexpectedly decided to reimburse depositors at one of the insolvent banks (Baninter) for the full value of their deposits. This decision was clearly a bailout for a small group of wealthy and politically-connected depositors. In fact, only 80 individuals held approximately 75% of Baninter's deposits; a much larger number of small-sized depositors held the remaining 25%. As a result, the cost to the Dominican government of bailing out the banks increased substantially and is currently estimated to be at least $3 billion (equivalent to 20% of GDP).[18] Moreover, the government resorted to a combination of new money creation and short-term bond issuance to help pay for this more expensive bailout. This contributed to a substantial increase in inflation (with CPI inflation rising from 5% in 2002 to over 27% in 2003) and raised the cost of debt issuance (with some debt carrying yields exceeding 60%).

In order to ensure that deposit insurance is effective and strengthens banks, it is critically important to combine deposit insurance with the first lesson of bank reform discussed earlier—enact sound prudential regulations, independent supervision and strong corporate governance. Strong regulations and oversight will help ensure that banks do not take advantage of the security provided by deposit insurance to engage in riskier activities. This argument is supported by several empirical studies. For example, one

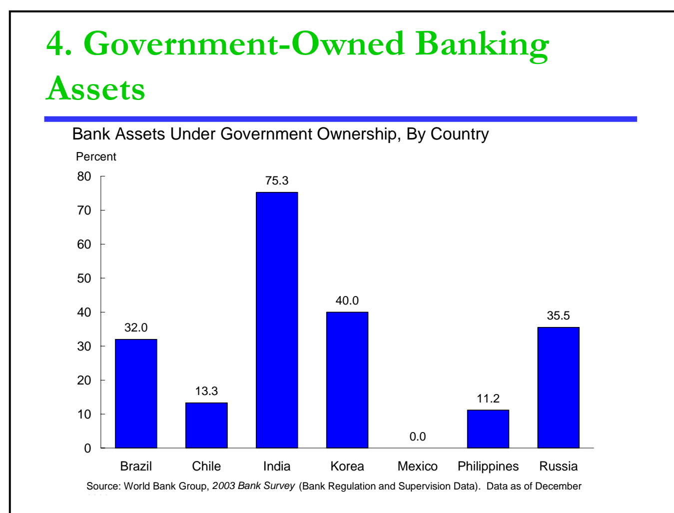
study concludes: "The weaker a country's informational, ethical, and corporate-governance environment, the more a wholly governmental system of explicit deposit insurance is apt to undermine bank stability".[19] Another study concludes: "where the rule of law is weak, regulation is lax and creditors' rights are poorly protected, explicit DI [deposit insurance] is likely to contribute to financial instability."[20] Therefore, countries wishing to strengthen their banking systems should seek to improve their regulation, supervision and corporate governance, not only for the reasons previously discussed, but also to improve the efficacy of any deposit insurance.

IV. Ensure Banks Operate on a Commercial Basis, Free from Political Interference

A third lesson learned from centuries of banking crises is that it is critically important to allow banks to operate on a commercial basis without political interference. Banks should be able to freely set their prices for loans and deposits. They should develop a "credit culture" where prices are based purely on risk assessment – and not on whether a borrower has a personal connection to the bank or a political connection to a government official. Loans should not be priced based on an assumption that the company or the bank will be bailed out if the venture is unsuccessful.

One crucial practice to help enforce this market discipline is that insolvent banks must be allowed to fail. The costs of bank failures should be borne by the banks' owners and/or shareholders, and then by the banks' largest creditors. Mexico in the early 1990s provides an example of how difficult it can be to close insolvent banks in some countries.[21] Before 1994, exit mechanisms for insolvent banks did not even exist in Mexico. The authorities were required to obtain the prior consent of the courts before a bank went into bankruptcy, an approval process that could be lengthy. This inability of regulators to act rapidly and close insolvent banks undoubtedly contributed to the scale, duration, and cost of the Mexican banking crisis which began in the mid-1990s.

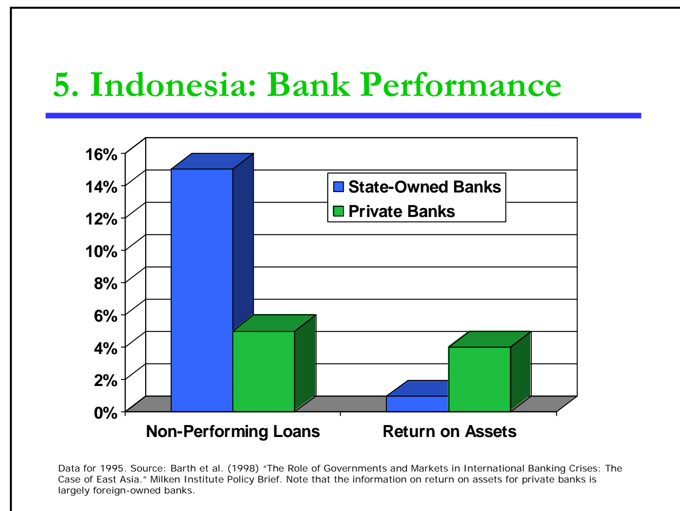
Effectively running banks on a commercial basis should also involve reducing government ownership of the banking system. In many countries the government still owns the largest banks in the country, or at least owns a large number of key banks. For example, Figure 4 shows that about 75% of banking assets are owned by the government in India, as are about 40% in Korea. Government ownership of banks tends to create the expectation that the banks will be bailed out if they are not profitable. This can reduce the incentives for banks to accurately



price loans, for depositors to assess the strength of banks they use, and even for supervisors to carefully monitor the banks. This combination of factors can not only lead to an inefficient allocation of resources (especially if government-owned banks are more likely to lend to companies preferred by the state), but also make banks more likely to experience costly crises.

Although privatization is no panacea, reducing the government ownership of banks can yield widespread benefits. Empirical studies show that greater government ownership of banks is associated with more poorly developed banks and financial systems, as well as with lower growth of income per capita and productivity.[22] A study of the Indian banking system from 1991/92 to 2000/01 finds that nationalized banks have lower profitability than private banks, largely due to higher operating costs.[23]

Another study of Indonesian banks shows that state-owned banks have higher shares of non-performing loans and are less profitable than other types of banks. More specifically, Figure 5 shows that in 1995, the reported non-performing loans at state-owned banks exceeded 15%, versus 5% for private banks. The return on assets for private (largely foreign) banks was over 400 basis points, versus less than 100 basis points for state-owned banks. This inferior performance of state-owned banks occurred despite the fact that state banks tended to be larger and receive special benefits.[24]



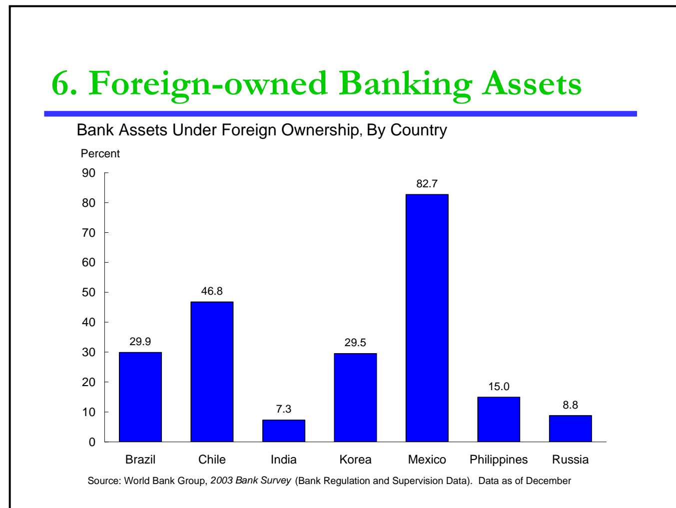
Data for 1995. Source: Barth et al. (1998) "The Role of Governments and Markets in International Banking Crises: The Case of East Asia." Milken Institute Policy Brief. Note that the information on return on assets for private banks is largely foreign-owned banks.

The experience of the transition economies in Eastern Europe showed that the process of privatizing banks is complex, and exactly how the process is implemented is critically important. This experience also suggested that encouraging mergers with or purchases by strong domestic or foreign banks can help ensure that privatization leads to a stronger and more efficient banking system.

V. Encourage Foreign Investment in the Banking System

A fourth key lesson for strengthening banks is that encouraging foreign investment in the banking system can have widespread benefits, in addition to facilitating privatization.[25] There are currently large differences across countries in the share of foreign ownership of the banking system. For example, Figure 6 shows that foreign ownership of the banking system is under 10% in India and Russia, as compared to about 45% in Chile and over 80% in Mexico.

Foreign banks can bring in additional financing and capital, thereby increasing the amount of funding available for domestic projects. In countries that have recently undergone a recession or currency crisis, foreign investment can even prevent potentially profitable assets and banks from being closed. Moreover, since foreign banks can draw on foreign, as well as domestic, sources of funds, they can increase the stability of available lending, making the entire banking system less vulnerable to business-cycle volatility. A study of bank lending in Argentina and Mexico shows that foreign banks generally had higher loan growth and lower volatility of lending than their domestic counterparts, so that foreign banks contributed to lower overall volatility of credit. The study concludes: "Diversity in ownership has contributed to greater stability of credit in recent times of crisis and financial system weakness."[26]



Another advantage of foreign investment in the banking system is that foreign banks and managers often provide more advanced technology and risk management. Not only are foreign banks generally subject to additional oversight by their foreign supervisors, but in developing countries foreign banks can bring in improved accounting standards, corporate governance, and transparency. The banking system is therefore strengthened not only from the presence of the stronger foreign banks, but also from the spillovers of improved regulation, expertise, and standards. Numerous studies provide empirical evidence of these beneficial effects of foreign investment in banking.[27] Studies also show that foreign banks tend to have more aggressive loan provisioning and higher loan recovery, further improving the overall soundness of the banking system by more aggressive screening and treatment of problem loans.[28]

The presence of foreign banks can also increase competition in the banking system, thereby encouraging domestic banks to find the most profitable use of their funds. This can help constrain any political efforts to use the banking system as an instrument of "connected lending" or "crony capitalism." These beneficial effects are also documented in a number of empirical studies. For example, one study shows that international openness tends to limit the rent-seeking activities of domestic banks.[29] Other studies show that foreign investment leads to greater efficiency in the domestic banking system, where efficiency is measured using statistics such as overhead costs and bank net interest margins.[30] Yet another study shows that operating costs are lower for foreign banks than domestic banks, and that domestic bank operating costs are pushed down by foreign entry.[31]

A detailed study of Hungary provides simultaneous evidence of many of these benefits of foreign investment in the banking system.[32] The study shows that the foreign investors demonstrated greater independence from domestic political influence than domestic banks. Foreign investors provided technical expertise and financial support. The foreign investment also increased competition in the retail market of the banking sector, promoting the development of innovative services and improving personnel training and marketing.

VI. Combine Bank Reform with Corporate Restructuring

A fifth lesson learned from centuries of banking crises is that if governments focus solely on the banking system and ignore related corporate problems, any attempts to strengthen the banking system will be futile over the longer term. Since other sessions in this conference focus on corporate restructuring and this is a complex topic, I will only touch on how corporate restructuring relates to bank reform.

If a bank is insufficiently capitalized, governments or investors can recapitalize the bank (such as through capital infusions or purchasing non-performing loans), leading to an immediate improvement in the "stock" measures of bank strength, such as capital-adequacy ratios. This may "fix" a bank in the short term, but if the bank continues to lend based on non-commercial evaluations, then the "flow" of bad loans can cause the bank to require additional recapitalization in the future to remain solvent. The historical experience shows that several countries have had recurring banking crises, even if they constantly recapitalize banks to fix the "stock", but ignore the more difficult issue of limiting the continued "flow" of unprofitable lending.

This problem of a continued "flow" of unprofitable lending is evident in the evergreening of loans in Japan throughout much of the 1990s.[33] In order to avoid recognizing losses on non-performing loans, banks would basically roll over the loans and/or charge below-market interest rates to companies with poor repayment prospects. Several empirical studies document evidence of this practice. For example, loans from Japanese banks often increased to sectors after severe financial distress (such as in construction and real estate after the collapse in land prices). This type of behavior was more prevalent in weaker banks that would be less able to handle an increase in non-performing loans. These practices constituted a massive subsidy to inefficient companies. By supporting the "zombie" firms these practices distorted competition, reducing prices for the firms' products, and making it more difficult for new (and often more efficient) entrants.

Another example of the importance of regulating the "flow" of loans is the Polish experience in the early 1990s. Poland underwent a period of very high inflation in the late 1980s that basically wiped out all the banks' loans to the state-owned enterprises (loans which were unlikely to be repaid), leading to a rapid improvement in banks' balance sheets. There was no regulation, however, limiting banks from re-lending to the inefficient state-owned enterprises. As a result, 30% of the main banks' loan portfolios were again low grade by 1992.[34]

Moreover, accurately assessing whether loans will be repaid, which requires assessing corporate viability, is critical to evaluate the strength and viability of the banks. Ignoring this problem can lead to significant overestimates of capital adequacy and therefore hide bank weakness. Due to all of these concerns, any efforts to strengthen a banking system should be undertaken in conjunction with corporate reform. Regulators should force banks to workout bad loans, even if this requires foreclosures or asset sales. This will not only help banks recover some of the cost of any non-performing loans, but will also send a signal to insolvent borrowers that they will no longer be treated as leniently and will be subject to hard budget constraints in the future.

VII. Establish Well-defined and Speedy Bankruptcy Laws

A key instrument for facilitating the corporate restructuring necessary for a strong banking system is well-defined bankruptcy laws. The term bankruptcy comes from a medieval Italian custom "banca rupta" (meaning broken bench) and signified social opprobrium or punishment if the individual (or entity's) assets were less than their debts.[35] Bankruptcy laws today are not necessarily meant to cause "social opprobrium." Instead, they should provide a chance for an organization to reorganize and restructure, or, if the organization has no value as an ongoing concern, to conduct an orderly liquidation instead of being forced into a blanket seizure of assets. There is no single best practice for bankruptcy codes, and each country must tailor its code to balance the objectives of avoiding the premature liquidation of viable enterprises while protecting the rights of creditors. Any such bankruptcy law, however, should have well-defined rules and procedures and ensure that bankruptcy proceedings are completed in a timely fashion.

More specifically, some key components of a sound bankruptcy regime are that it:[36]

- establishes a court-supervised reorganization framework that protects debtors from asset seizures;
- gives priority for new lending;
- allows a debtor and its creditors an opportunity to work out a mutually-satisfactory restructuring plan;
- permits a majority of creditors to "cram down" a reorganization plan on a holdout minority of creditors;
- converts the case into a court-supervised liquidation if interim milestones and reasonable deadlines are not met;
- includes a legal presumption (which can be altered in negotiation) that the equity interests of all shareholders—including minority shareholders—are wiped out in the case of corporate insolvency; and
- involves substantial institutional capacity, such as experienced judges, receivers, and insolvency professionals.

The Japanese experience illustrates the problems that can occur if these basic tenets are not incorporated into a country's bankruptcy regime.[37] A number of gate keeping procedures and regulations engrained in Japanese law act as a barrier to court action, making it difficult for firms to start bankruptcy proceedings and for banks to collect

unpaid loans and force necessary corporate restructurings. More specifically, Japan requires corporations to make an advance payment of estimated court costs with a bankruptcy application. The size of the deposit varies with the size of the firm's liabilities and have typically ranged from ¥0.7 million to ¥4 million yen ($5,800 to $33,000), reaching more than ¥1 billion yen ($8.3 million) for the largest cases. If a firm is on the verge of insolvency, it may not be able to provide the cash required to file for bankruptcy. The length of time to complete a bankruptcy proceeding in Japan is also unusually long, partially because the government restricts the number of lawyers, judges and courts. In 1989, more than 75% of reorganization plans took more than five years from application to conclusion, and half of all liquidations required more than three years. This problem is aggravated in Japan because there is no automatic stay on the exercise of unsecured claims. As a result, creditors can seize assets while the court is deciding whether to accept the company's application for bankruptcy. In contrast, US bankruptcy law holds creditor claims in abeyance until they can be ruled on in the bankruptcy proceeding.

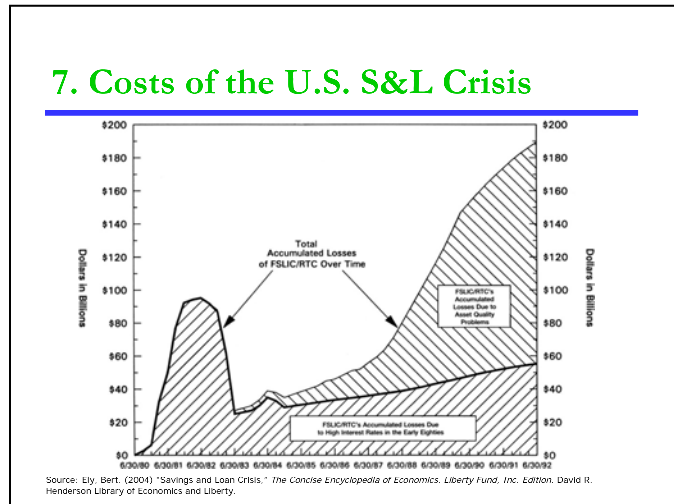
In sharp contrast, Hungary enacted a strong bankruptcy law at the end of 1991 in what has been called a period of "legislative shock therapy." This bankruptcy law requires that firms initiate self-bankruptcy procedures if they are in default on their debt for more than 90 days. This is quite stringent—even when compared to bankruptcy laws in many developed countries. The law was strictly enforced and soon helped deflate an existing inter-company credit balloon and also triggered a wave of bankruptcies. The adjustment process was painful, but it helped weed out unviable companies early in the transition process instead of prolonging the necessary adjustment. Equally important, this stringent bankruptcy law helped banks to realize losses all at once, limiting the opportunity for banks to continue lending to insolvent companies and accumulate further losses. All of these factors significantly reduced the cost of bank consolidation later in the transition process and helped create a stronger banking system in Hungary.[38]

VIII. Act Promptly

A final lesson for strengthening banks is that banking problems tend to get worse, instead of better, over time. Putting off or prolonging any reform tends to raise, instead of lower, the cost. Moreover, it is often easier to gain political support for bank reform early on, and more difficult to maintain this support over time, especially if the banking system appears to be recovering.

A report by the Bank for International Settlements on how to deal with weak banks writes: "Supervisors should act promptly. Experience from many countries shows that regulatory and supervisory forbearance has exacerbated the problems of a weak bank. By not dealing with the problems promptly, they have grown rapidly making the eventual resolution efforts more difficult and more expensive, with the possibility of becoming more widespread and systemic."[39]

The cost of delaying bank reform is clearly exhibited in the U.S. experience during its Savings and Loan crisis. In the early 1980s there were signs that a number of U.S. savings and loan banks (S&Ls) had financial problems and that the agency responsible for insuring them might not be able to afford the costs. If supervisors had acted quickly and responded to these concerns, the costs would have been manageable. The banks financial difficulties grew rapidly over the 1980s, however, and by the time the Resolution Trust Corporation (RTC) bailed out the system, the cost to U.S. taxpayers had increased dramatically. As shown in Figure 8, this cost would have been substantially lower if fast, decisive action was taken earlier in the decade when the problems first arose.



Source: Ely, Bert. (2004) "Savings and Loan Crisis," *The Concise Encyclopedia of Economics, Liberty Fund, Inc. Edition.* David R. Henderson Library of Economics and Liberty.

IX. Summary and Conclusions

This discussion has focused on seven lessons learned from around the world and across the ages for strengthening banking systems: enact sound prudential regulations, independent supervision and strong corporate governance; provide partial, risk-adjusted deposit insurance; ensure banks operate on a commercial basis, free from political interference; encourage foreign investment in the banking system; combine bank reform with corporate restructuring; establish well-defined and speedy bankruptcy laws; and act promptly. Although this list may seem extensive and daunting to a government wishing to strengthen its country's banking system, it is still far from exhaustive. There are many additional lessons that have been learned from centuries of banking crises—such as how to recapitalize weak banks and how to dispose of non-performing loans—many lessons which will hopefully be covered by other speakers.

Moreover, although these lessons are far from exhaustive, even this limited discussion suggests that designing and implementing the rules, regulations, and reforms to accomplish these seven goals can be challenging. It is not surprising that even though banking institutions have existed for thousands of years, we are constantly learning new lessons and improving regulatory and supervisory practices. Therefore, countries wishing to strengthen their banking systems should not hesitate to draw on outside expertise. The World Bank and IMF have built extensive knowledge on this subject and can provide technical expertise and advice. Countries should consider a Financial Sector Assessment Program (FSAP) through these institutions. The FSAP is a comprehensive analysis of a country's financial sector. It assesses the country's observance of internationally-accepted standards and codes and performs "stress tests" to evaluate how well the country's financial institutions can handle adverse situations. This assessment can help

countries identify vulnerabilities and prioritize what gaps should be addressed. It can also provide concrete suggestions and technical assistance on exactly how to improve their prudential regulations and supervision.

Finally, strengthening banking systems to account for many of these lessons is unlikely to occur overnight. Reforming weak banking systems may take years to successfully complete. This is not, however, an excuse to delay starting to strengthen your banking system today. Instead, the story of the French Marshal Lyautey and his gardener provides a useful lesson. The gardener was planting a tree and the marshal asked how long it would be until the tree was fully grown. The gardener said it would take about 100 years for the tree to reach its full height. The marshal's response was: "In that case, there is no time to lose, plant it this afternoon."[40] Similarly, any country wishing to strengthen its banking system and avoid costly banking crises should learn from these seven lessons from around the world and across the ages and start implementing reforms today.

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