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What have we learned from the international experience of bank restructuring?

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Introduction

It is a pleasure to comment on these two extremely interesting bank restructuring cases from Hungary and Chile. I believe that the experiences of these two countries are of particular relevance today for at least two reasons. The first is that they provide a useful insight into bank restructuring from two apparently very different cases: a former Transition Economy in Central and Eastern Europe, and an Emerging Market economy in Latin America. And the second is that it is possible, drawing on these two cases, to identify some conclusions that might be of interest in the context of the situation of the banking sector in China today.

At first sight, it would seem that the experience of Hungary might be of more direct relevance to China, given its background as a former planned economy. The roots of its banking crises, associated with a large build-up of bad debts due to soft-budget constraints from State ownership would seem to be quite close to the experience of China today.

In contrast, as we have learned this afternoon, the banking crisis in Chile stands out as a case of "twin crises", in which the collapse of the exchange rate resulted in widespread bank and corporate insolvency, due to heavy overborrowing in foreign currency. Such developments prompted a different kind of banking crisis, characterised by high macroeconomic volatility, and also a bank run. While one might think that the collapse of the exchange rate is totally implausible in China today, it is also true that Chile underwent a fast process of financial liberalisation without adequate bank regulation and supervision. This particular dimension of the crisis may be potentially useful to China, given the steady but firm process of financial liberalisation currently under way.

In my presentation I will try to organise my comments around four main topics. I will first talk about differences and similarities between Chile and Hungary at the time of bank restructuring. From this comparison, I will attempt to highlight some of the key strengths in China, but also some major challenges. Then I will say something about those aspects of the bank restructuring experiences of Chile and Hungary which may be potentially more relevant for China. After that I would like to add a few remarks on a slightly different matter, but a very relevant one in the context of bank restructuring: the role of the central bank and the importance of coordination between policies. In this regard, I will try to make the case that the coordination of different economic policies is key to successful bank restructuring and also for the sustained development of the financial system thereafter. Finally, I will conclude my presentation with a few more general thoughts.

Common factors and key differences between the Chilean and Hungarian experiences

Each crisis is unquestionably unique. Its sources as well as the combination of events that led to the problem are probably impossible to repeat in any approximate way, so any generalisation runs the risk of being too simplistic. But bearing in mind these caveats, let me share with you at least three issues in the experiences of Chile and Hungary which to me seem to have much in common. Obviously, there are also several important differences that should be taken into account.

The common factors in the two cases include most notably the **macroeconomic conditions**. Both Chile and Hungary faced huge economic shocks in the run-up to their crises, with a devastating effect on the corporate and banking sectors. In spite of latent vulnerabilities in both financial systems, had it not been for the strong terms-of-trade shock in Chile or for the collapse of large export markets in Hungary, their financial systems might arguably have continued to run for years.

The second common factor is the presence of **shortcomings in the regulatory and supervisory frameworks**. With the benefit of hindsight, it has been acknowledged that regulation and supervision were outdated both in Chile and in Hungary. Risks such as overborrowing, related-party lending or concentration were tackled late, and key prudential regulations such as provisioning or financial disclosure were poor or simply not there. All these faults probably compounded the problem, increasing the costs of the banking crises.

Finally, the third common factor is the lack of adequate **corporate governance and risk management** at the bank level, which have also been acknowledged as key weaknesses that led at least to bad lending decisions, and in some cases even to outright fraud.

Let me now turn to those factors which I believe are quite different. In addition to the already mentioned different sources of banking problems in the two countries, the approach to bank restructuring was also different. In the case of Chile, bank restructuring was based on corporate and household debt restructuring and on the recapitalisation of banks, followed by a major revamp of the regulatory and supervisory frameworks. In Hungary, however, key features were the portfolio clean-up, recapitalisation and finally privatisation, which was primarily aimed at reinforcing corporate governance and risk management and which resulted in the very significant presence of foreign banks.

How does China compare?

I would like now to move on to those experiences of Chile and Hungary in bank restructuring which may be more useful to the specific case of China. But let me first briefly review how I think that the general situation in China today compares to that of Chile and Hungary at the time of bank restructuring.

One of the first apparent differences between the cases of Chile and Hungary, on one hand, and that of China, on the other, is the **nature of their banking crises.** Both in Chile and Hungary, the banking crises were "full-blown", in that these were periods of pervasive bank unsoundness coupled with significant bank runs or other substantial portfolio shifts, collapses of financial firms, or massive government interventions. With a varying degree of timeliness, resolution strategies were put in place only after the crisis had severely hit those financial systems. In China, however, we cannot speak of a banking crisis although there are indications of potential bank unsoundness when looking at the volume of NPLs. Therefore, recent bank restructuring initiatives taken by the Chinese authorities since 1998 are, for the most part, in anticipation of what could come later, and this foresight may be taken as one of its principal strengths.

A second key difference is **economic growth**, which continues to be robust in China after years of expansion, and which remains underpinned by the strength of domestic demand, as compared to Chile and Hungary. Sustained high economic growth in China is unquestionably a "plus" when it comes to the timing of bank restructuring.

A third important strength of the Chinese economy is the large stock of in**ternational foreign reserves**, together with a sound **fiscal position** and relatively low government debt ratios. Even if the fiscal positions in Hungary or Chile at the time of bank restructuring were considered as relatively healthy, and instrumental in limiting the fiscal costs of restructuring especially compared to many other countries, it should be recalled that the strength of public sector finances has been acknowledged as one of the key lessons from recent financial crises around the world. Weak public sector finances together with high levels of public debt and fiscal deficits have, in too many of the most salient banking crises of late, intensified the magnitude of the crisis by limiting the choices available to manage it, and also jeopardised the conduct of monetary policy.

Finally, two interrelated additional sources of strength for China at the present time are the **low levels of foreign currency borrowing**, which in the particular case of Chile were a significant (and costly) vulnerability when the crisis broke, and the prevalence of **capital controls**, which for the time being heavily restrain the possibility of capital flight from China. In Chile, most of those controls had already been lifted when the crisis hit the country, and needed to be reintroduced afterwards, while in Hungary financial liberalisation had started much later.

All in all, then, it would appear that the Chinese economy has been in recent years and also is at present in a very good position to address bank restructuring and recapitalisation. This, coupled with the fact that challenges are increasing (financial liberalisation and the restructuring of State-owned enterprises), would seem to call for resolute steps forward with the reform process.

But within this very positive context, there are also a few issues pending which will need to be faced. The first is the bulk of **NPLs in the financial system**, which remain high even following substantial recapitalisation in the last few years. Hungary probably faced a similar situation in the run-up to its banking crisis, while in Chile the build-up of NPLs had a different origin.

Another key potential weakness is the challenge posed by the ongoing **financial liberalisation** process, which has moved a long way on the domestic side, but less so externally. In the particular case of China, the liberalisation of the capital account and the heightened competition it would entail could pose a challenge for the banking system, primarily due to the high volume of NPLs, low profitability and limited knowledge of risk management. These challenges also had to be tackled by Chile and Hungary at the time, each one in its own specific way.

Aspects of the bank restructuring experiences of Chile and Hungary of most relevance for China

There are at least three findings from the experiences of Hungary and Chile that could be relevant for China at this point. One is, obviously, that there are major challenges in the **transition from a State-owned banking system to a market-based system**. Such challenges encompass issues as important and diverse as radically changing the way in which banking business is conducted, encouraging competition, and learning to manage risk and be profitable in a context of market-determined interest and exchange rates. And last but certainly not least, adapting banking regulation and supervision accordingly.

A second finding concerns **policy choices in bank restructuring, including privatisation and the entry of foreign banks.** In Hungary, recapitalisation was followed by privatisation. Following the positive experience of Hungary but also the negative ones of other transition countries, it became clear that the key aspect of privatisation was to obtain an ownership structure that ensured effective corporate governance. In Hungary this was attained largely by selling banks to strategic investors. In practice, this meant that Hungarian banks were sold mostly to foreign banks, which provided capital, corporate governance, risk management and technology, even if in some cases the privatisation through the local stock exchange to domestic investors also worked well. This obviously meant a major change from the previous ownership structure to one in which competition and the availability of financial products and services has increased as a result of foreign bank participation, even if there is still room for improvement. Today, the Hungarian banking system is widely viewed as one of the strongest in the region.

Thirdly, I would also like to highlight some relevant findings from the experience of Chile, which stem from the **risks of financial liberalisation with insufficient "checks and balances"**. The first is the importance of anticipating, and of preventing, through a prudent economic policy mix, the problems caused by excessive risk-taking and the accumulation of large financial imbalances. The second is that a sound institutional framework must be in place when a country decides to liberalise, and that the proper timing of financial liberalisation is key to its success.

Bank restructuring and the role of the central bank

Let me now add a few comments, as mentioned before, on the interaction between bank restructuring and monetary policy. With these comments I want to convey to you the importance of coordinating different policies in pursuing a successful bank restructuring process.

Past experience in bank restructuring shows that the role of the central bank has been crucial in all phases of a banking crisis resolution. During the initial "containment" phase, the central bank is typically in charge of providing sufficient liquidity. At the same time, it will have to manage a potential short-term conflict between its responsibility in safeguarding financial stability and that of preserving monetary stability. If the central bank is credible, and sufficiently flexible monetary policy instruments are available, it will be able to safeguard the smooth functioning of the payments system in order to prevent a further deterioration of economic conditions while at the same time ensuring that inflation expectations remain in check. Later, during the bank restructuring and reintermediation phases, the central bank will also play an important role by adapting monetary conditions to the new environment, with a view to ensuring that the financial system is back on a sound footing and that it can resume its natural role as a provider of credit to the economy. This will facilitate enormously the conduct of bank restructuring, containing some of its costs.

General conclusions arising from the international experience of bank restructuring

Finally, let me end my presentation by discussing some of the most important general conclusions that can be derived from the very rich international experience of bank restructuring.

First, each bank restructuring experience **is unique** in many ways. Different country-specific circumstances, initial conditions, sources of banking problems, institutional frameworks or even the degree of financial development are bound to determine different approaches to bank restructuring. But it is also important to note that, as we have learnt today, there are also a few common factors in past restructuring experiences which may be of great use to policymakers when they need to address a new process.

A second conclusion is that most banking problems can be structured **in three phases**: one of containment, a second of bank restructuring and a third of financial reintermediation. Since the focus of this conference today is on the latter two, I would like to emphasise that the choice of bank restructuring strategy should be aimed at minimising the net present value of the costs of the crisis. But similarly important is the fact that the financial reintermediation strategy be designed in such a way as to lay the foundations for a financial system which is viable, efficient, sound and resilient.

In this regard, it is also appropriate to recall that early detection of problems and firm political resolve to address them are instrumental in reducing the magnitude of the crisis. Delays in tackling banking problems are only likely to end up increasing the costs. Likewise, having in place a clear and consistent restructuring strategy that is transparent and well-communicated to the public so as to make it credible is fundamental to success.

Thirdly, restoring and maintaining **macroeconomic stability** is also a major determinant of the final success of bank restructuring processes. Similarly, it is difficult to make progress in bank restructuring without dealing with **corporate restructuring** too.

A fourth conclusion that can be drawn is the importance of **good risk management both at the macro-prudential and individual bank level**. From past experience, the coordination of different economic policies is clearly crucial for avoiding some of the key risks related to financial liberalisation and for ensuring successful bank restructuring. Capital-account liberalisation should be sequenced appropriately, i.e. paying particular attention to lifting short-term capital inflow restrictions, and especially those on capital outflows, only after the domestic financial system has built in sufficient buffers and is perceived as sufficiently robust. Incidentally, this is to a large extent the approach that China has rightly been following. Likewise, financial regulation, supervision and enforcement need to be upgraded as liberalisation proceeds, in accordance with the basic principles of risk assessment and risk management. Finally, it is also essential that a strong credit culture and improved corporate governance should be well-established within banks, so that lending decisions are taken on the grounds of risk management to avoid the fresh build-up of NPLs.

And finally, I would like to stress the importance of having an **adequate institutional framework** for a successful bank restructuring process. In this regard, a credible central bank, high-quality financial regulation and supervision, and sound fiscal policies are among the cornerstones of a good policy framework for bank restructuring. But equally important in the process are appropriate disclosure and accounting standards, the respect for property rights, well-designed bankruptcy laws and the effective functioning of the judiciary.

To conclude, bank restructuring is certainly a complex process, involving a number of public and private economic agents, that must be designed with care and carried out effectively in order to be successful. I hope that some of the ideas put forward in this discussion can help us better design and pursue such processes in the future.