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Banking Soundness and the Role of the Fund

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The interest in issues of banking sector soundness--in banking standards, bank supervision, the role of banks in the propagation of crises, and bank restructuring--now reaches well beyond its natural constituencies in the central banks, bank supervisory agencies, and among researchers, to the highest levels of government. These issues were discussed at the G-7 summit in Lyons in June 1996 and are reflected in the communique:

> The globalization of the financial markets has contributed to the creation of a more complex financial environment. Better prudential regulation and supervision in the financial markets are essential elements in preserving the stability of the international monetary and financial system. In this respect, we welcome the progress on the strengthening of capital standards, including the recent agreement on capital adequacy standards for banks' exposure to market risk, improved disclosure and enhanced surveillance.

This interest has been created by the startling frequency, scale and consequences of the banking crises of recent years. In the past ten years, well over half the IMF's membership has experienced significant banking problems in one form or another. These crises have afflicted every region of the globe, and countries at every level of economic development--among them the United States, most of the large Latin American countries, and countries in Africa, Asia, and Europe, including a number of the economies

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in transition. In some countries, the fiscal cost of resolving the direct banking sector crisis amounted to well over 10 percent of GDP.

But of course the costs extend beyond the banking sector. Banking sector crises have generally been associated with economic slowdown, higher fiscal burdens, higher inflation, and often exchange rate crises. Most economic crises do not originate in the banking sector, but the weaker the banking system, the more costly and lengthy the crisis will be, and the more difficult it will be to resolve.[2] And the weaker the banking system, the more likely it is that problems in individual banks will develop into a banking system crisis.

While no two banking crises are identical, a number of factors are typically present. These include problems of governance of the banks, an inadequate regulatory framework, poor supervisory capacity, the lack of a commercial credit culture,[3] as well as factors external to the banking sector, including macroeconomic imbalances, both domestic and external.

The costs, consequences and frequency of banking crises are reasons enough for the widespread interest in banking sector problems. More systematically, we can distinguish two aspects of the need for sound banks: macroeconomic stability, and growth. The macroeconomic interest results from the banks' role in the monetary transmission process. The impact of central bank operations in the money or the foreign exchange markets

[2]In this connection, it is remarkable that the resignation of the then Governor of the Chilean central bank in 1996 was a result of disagreements on how to handle one aspect of the aftermath of the Chilean banking crisis in 1982.

[3]The phrase is due to Jerry Corrigan.

depends on how the banking system transmits the interventions to borrowers and savers. If the banking system is weak, the transmission will be weak or perverse, with lower money market rates being used as an opportunity to rebuild the banks' capital base, rather than being transmitted to borrowing rates. Or, unsound banks may put pressure on the authorities for assistance whenever interest rates rise. The fiscal burden of dealing with weak banks also complicates the task of macroeconomic management.

On the international side, banking problems may both exacerbate and be exacerbated by exchange rate movements. With global capital mobility increasing, the role of banks in the international transmission mechanism takes on much greater importance. Banks that have taken open positions in foreign currencies are especially vulnerable to exchange rate movements.

The state of the banking system also has important effects on growth. The sounder the banks, the better they will perform the task of intermediating between saving and investment. The more efficiently the banking sector can collect savings from the economy and from the rest of the world, and onlend them to potentially productive borrowers, the more likely the economy is to grow. The stronger and the better managed the banks are, the lower their spreads are likely to be, and the better their ability to judge the quality of loans and borrowers. Conversely, where a banking sector is inefficient, and the banks weak, the saving-investment process will work badly, and growth will be inhibited.

In short, a sound banking system is critical both for economic growth as well as for domestic and international economic stability. While the primary responsiblity for dealing with the banking sector rests with the

national authorities, international organizations--among them the IMF, the Basle Committee, the BIS, the World Bank, and the regional development banks--all have a role to play in improving banking sector performance. Relying on comparative advantage, I will focus in this paper on the role the Fund can and should play in the international effort to improve the functioning of the world economy by strengthening banking systems.

I. The Role of the Fund: Surveillance

The Fund can help improve banking sector performance in member countries through its regular surveillance over their policies and prospects, through conditional lending, and through technical assistance.

IMF surveillance takes two forms: **multilateral surveillance**, in which the Fund provides its views on the world economy or global or regional issues, and countries draw conclusions about implications for their own policies; and **bilateral surveillance**, in which the Fund is involved directly in dialogue with an individual member over its economic policies.

Multilateral surveillance

The Fund's World Economic Outlook (WEO) presents projections and analyses of global world economic developments every six months. In addition, the Fund prepares the International Capital Markets (ICM) report, which reviews global capital market developments as well as reporting on some individual countries. These publications are an excellent vehicle for bringing issues to attention of the official sector (in the first instance through discussion at the Executive Board of the IMF) and the international community more generally, through their subsequent broad distribution,

publication, and press coverage.

Banking sector developments have at different times figured prominently in both these exercises. The banking problems associated with the debt crises of the 1980s, for instance, impacted directly on prospects for the world economy as presented in the WEO during that period. In addition the reports contain special studies on aspects of banking sector developments. The ICM, for instance, studied the impact of the failure of Barings bank on international financial markets. It has also reported on banking issues in different countries, including Japan.

Recently the Fund has been considering how to play its part in improving banking sector safety and the dissemination of appropriate banking standards for the international community as a whole. This effort follows directly from the important work carried out by the Basle Committee on banking standards for the G-10 countries, and the desire to use the insights and conclusions of this work to extend it to other countries. In many countries outside the G-10 there have in recent years been attempts to develop banking standards based on interpretations of the Basle work. Some have been quite successful, but overall there remains a need for consistency and for full analysis of how those standards are to be applied under potentially very different conditions than those that obtain in G-10 countries.

Standards that were designed as minima for the G-10 countries may be insufficient to protect banking systems in more volatile environments. Other issues--such as accounting rules and asset valuation, loan classification, and provisioning rules--also need to be addressed to

develop an adequate overall framework.

The Basle Committee is doing further important work at present, seeking to establish prudential standards and guidelines that would apply to emerging market countries, and perhaps to a much broader group of countries, and we are happy to be able to co-operate in this effort. The additional dimension that the Fund brings in this context derives from its universal membership. It has detailed knowledge of the workings of countries across the world, and close relationships with the authorities in virtually all member countries. It has been intimately involved in work on the banking sectors in many countries. It is thus well-placed to work with the Basle Committee, to complement the expertise in that Committee, to conduct research on banking sector issues, and to help adapt banking guidelines for implementation in countries across our membership.

Bilateral surveillance

The Fund's principal means of bilateral surveillance is the regular Article IV consultations. Fund staff visit each country roughly once a year for detailed and in-depth dialogue and analysis of the country's economic policies with the authorities. On their return they prepare a report--the Article IV report--which is presented to and discussed by the Fund's Executive Board, and thus transmitted to the 181 member governments.

Article IV consultations always focus on macroeconomic issues, especially fiscal, monetary and exchange rate policies. Recently increasing attention has been devoted to the structural issues that underlie macroeconomic performance, including those concerning the banking sector. This reflects in large part the number and range of countries in

which banking sector problems have emerged in recent years. Experience has shown that the earlier emerging banking sector problems are diagnosed, and the more promptly effective remedial measures are implemented, the less costly they are likely to be.

For these reasons, Article IV consultations increasingly include surveillance of the state of the banking system and the financial infrastructure more generally. Indeed, staff from the Monetary and Exchange Affairs Department (MAE) of the Fund, co-host of this seminar, will participate in Article IV missions to some thirty countries this year--among them, some of the leading industrial countries. From the viewpoint of the member country, the Fund's increased attention to banking sector issues is an important route by which the weight of international experience can be brought to the assistance of domestic policymakers, particularly in an area such as banking where diagnosis of problems is often difficult.

To improve its diagnostic tools, the Fund is working on possible banking sector indicators to complement the macroeconomic indicators on which it already has substantial expertise. Early warning indicators developed and applied in recent years by supervisory agencies and by market participants will provide important input for our own work, but the purpose for the Fund is somewhat broader--to identify and assess developments that are most critical in affecting prospects for the banking sector, and for the economy as a whole.

Analysis of the banking sector has become important in the Fund's bilateral surveillance even where there is no risk of crisis. A banking

system may be sound, for instance by merely channeling the directed lending of the government, and yet not fulfilling its proper functions of providing efficient intermediation in directing resources to their most productive uses.

Bilateral surveillance serves not only the country whose economy is being appraised, but also the international community. Where a country is of major importance to the world or its regional economy, or where it has problems that are similar to those in other countries--for instance among the transition economies--this information may be of considerable use to domestic policy-makers in other countries. Executive Board discussion of the Article IV report makes this information available to other countries. It is the universality of the Fund's membership, and the central role of surveillance in its regular activities, together with the high professional standing of its staff, that makes it particularly well-placed to serve such a role.

II. The Role of the Fund: Conditionality

Countries turn to the Fund for financial assistance when they have macroeconomic crises or severe macroeconomic difficulties. Sometimes, though not always, the banking system in such an economy will also be in difficulties.

In such circumstances, both monetary and fiscal policy may be compromised. Monetary policy becomes more difficult because the tightening of policy when banks are insolvent increases their liquidity difficulties. Experience shows that in the early stages of banking crises, the central bank often provides large amounts of lending to banks in difficulty. Such lending is rarely offset by sterilizing the liquidity infusion, especially if banking sector problems are widespread.

On the fiscal side, any central bank losses from its actions to help the banks are transmitted to the budget, one way or another. Either the loss is explicitly recognized and compensated for by the government, implying a direct charge on the budget, or it is ignored, in which case the reduced profits of the central bank reduce transfers into the government budget in future years. Thus an initial monetary burden becomes a fiscal burden. Further charges on the budget will occur when the authorities restructure a banking system to restore it to soundness, for instance by recapitalizing the system and perhaps by compensating depositors. Although finance through bond issues means that these costs do not have to be incurred within a single year, even the interest rate burden on a bond issue is often substantial.

Targets in a Fund-supported program will need to make explicit

allowance for the implications of banking sector difficulties for the country's monetary and fiscal positions. Setting targets that will be consistent with desired growth and inflation paths will be difficult if significant monetary expansion or fiscal financing are envisaged to deal with banking sector problems. Additional adjustment measures will generally be needed to offset the monetary and fiscal effects of the banking sector problems.

Even worse from a program design point of view, it is hard to set any credible macroeconomic targets without having a full handle on the magnitude of banking sector problems, or without a quantified program to address them. In some cases, the magnitude of the monetary and fiscal costs may be such as to require major changes in the design of the program. Hence any possible banking system problems have to be fully investigated, and a plan to address them developed, before an overall macroeconomic program can credibly be put together. In a number of recent cases, Fund staff banking experts have participated with the macroeconomic teams in the design of a program to be supported with Fund resources. In several of these cases, the Fund and the World Bank have cooperated, both at the diagnostic stage, and later with the Fund taking the lead in the overall macroeconomic program and the Bank lending for the restructuring of the banking system.

What then should be done when a bank or group of banks is discovered to be unsound? The first step is to stop the bleeding: the authorities should act immediately to stop the continuing flow of losses from the banking system. The longer banking sector losses are allowed to continue,

the more costly the eventual restoration of banking sector soundness will be. Action may include the closure of banks that are insolvent, or the placing of constraints on the activities of particular banks. In many countries, the authorities set out memoranda of understanding with bank management, requiring for instance enhanced loan recovery efforts and lending limitations.

Second, the authorities should improve governance of the banking system, to staunch flow losses and prevent their recurrence. Banks should be subject to regular audit on internationally-accepted accounting principles, and should be required to disclose sufficient information that outsiders can have a true picture of their condition. Those responsible for bank unsoundness should pay a penalty for their behavior, in part to reduce the moral hazard of government intervention. Any provision of government money, or any write-down of liabilities to depositors or other creditors, should be accompanied by thoroughgoing changes in management and ownership. If former owners or management have acted illegally or in violation of prudential requirements, the authorities should forcefully press for the imposition of the available penalties. Such an approach needs to be applied both to the state and the private banks, although the disciplining of state banks by the state imposes special challenges.

Third, the authorities need to deal with ongoing banking sector losses. Having ensured that the owners of insolvent banks lose their rights to any assets of the banks, the authorities must determine how net losses will be shared among depositors, the remaining creditors, and the government. This will depend partly on fiscal considerations. A

government recapitalization of a bank, or of the banking sector, adds to the deficit, even if the budget includes only the repayment stream of the bond issue. Since most countries with banking sector problems have very little room to increase their fiscal deficits, expenditures on banking sector recapitalization will lead to difficult choices as to where there can be compensatory fiscal cuts. Nor is it any solution to provide financing through off-budget channels, for instance to use the central bank to lend to the banks or to effect the recapitalization. Not only will the ultimate cost have to be borne by the budget anyway, but such methods reduce the transparency of the process and tend to undermine the proper operations of the institution being used for this purpose.

If there is to be recapitalization by the public sector, the costs should be borne explicitly on the budget. If this forces the government to make difficult choices, it only reflects the reality of the situation--recapitalizing banks uses real resources. In general, the burden of resolving banking sector unsoundness should be shared. While the government may well have to take on its share, it should not take on the entire share, for here too moral hazard considerations weigh heavily. In some countries where the government bore the full cost of bank recapitalization, the solution was not regarded as once-for-all, and further recapitalization came to be needed. In some other countries, bank recapitalization schemes were arranged through deposit insurance funds financed partly or wholly by the banking community. This ensured that the banking sector had a strong interest in cost-effective bank restructuring.

Fourthly, the authorities need to establish the credibility of the

restructuring plan. They need to formulate a plan, announce it, and stick to its general principles. Banking sector unsoundness may well not be the only major problem facing the authorities, and its resolution may even add to other problems--for instance, bank recapitalization may increase fiscal imbalances, and increasing loan recoveries may worsen the problems of the enterprise sector. A policy that does not take account of these feedbacks may be incoherent and unsustainable.

The feedback effects between macroeconomic policy and the health of the banking sector operate in both directions. Where banking sector problems are the result of poor economic policies, any restructuring plan must be accompanied by improved economic management: macroeconomic stabilization improves conditions for the banking sector, as it does almost every sector of the economy. This reinforces the case for addressing banking sector problems in the context of an overall stabilization program.

In the reverse direction, banking sector problems impact on the design of a stabilization program. For instance, on the monetary side the size of the money multiplier is a key relationship for determining the amount of credit expansion that would be consistent with a given inflation target. Loss of public confidence in the banks causes this relationship to be unstable and unpredictable. Broad money may decline while holdings of currency and foreign currency in the economy increase. A program based on broad monetary variables would have to make some provision for the uncertainty about monetary relationships, including by paying more attention to the behavior of interest rates, inflation, changes in asset prices, and to the extent possible, indicators of real activity.

In addition, the authorities may lose many of the instruments of monetary policy in a banking crisis. For instance, the market for government securities may have collapsed, ruling out the sale of securities as a means for managing domestic liquidity. Fund program targets have to be adjusted accordingly.

In sum, these linkages between the health of the banking system and macroeconomic policy mean that any program of macroeconomic stabilization must take explicit account of the state of the banking sector and the measures that might be needed to improve it. This is what the Fund tries to do in its macroeconomic conditionality.

In many Fund programs, work on the banking system is coordinated with the World Bank, which has particular expertize in the restructuring of banking systems. Depending on the Bank's previous involvement with a country, it might be in a position to offer an early diagnosis of the state of the banking system, and in any case both the Fund and the Bank are likely to be involved. In many cases the Fund will take responsibility for the overall macroeconomic program, with the Bank taking the lead in and providing financing for bank restructuring. The relevant regional development bank may also contribute to or take the lead in providing financing for bank restructuring in some countries. Sometimes, when speedy action is needed, the Fund might have to include banking sector reforms as part of its conditionality even before a Bank program can be in place.

III. The Role of the Fund: Technical Assistance

Fund technical assistance can play a role at each stage of the process of addressing banking system problems: diagnosis; the planning of remedial measures; and their implementation, both in the initial restructuring stage and over the longer term. In some cases this assistance is part of an ongoing program of institution building that the Fund has been providing to many of its member countries, particularly among the transition economies. In other cases the Fund might not have had such an intense involvement, but the authorities may request assistance when banking sector problems emerge.

Often the Fund will work by putting together teams comprising Fund staff plus outside experts, generally from cooperating central banks. Indeed, the arrangements that the Fund has in place with over twenty central banks for their specialist staff to participate in technical assistance teams to transition economies are an important element in the international community's ability to provide a timely and effective response to requests for assistance, including on issues concerning the banking sector.

Similarly, Fund technical assistance will often be combined with technical assistance from the World Bank and also in some cases from the regional development bank.

IV. Principles of Fund Involvement

While the details of the Fund's involvement will vary depending on the characteristics of the country's economy, it tends to follow certain principles.

Fund advice and assistance is bound to reflect the Fund's overall perspective and objectives: they will therefore be supportive of increasing openness in the world economy, greater economic liberalization, and greater market responsiveness. Hence a Fund-supported bank restructuring plan is unlikely to involve the imposition of extensive controls, for instance on withdrawals of deposits or the exchange of currency. This follows from our experience that such controls are at best ineffective and at worst induce distortions on the economy that will vitiate the achievement of the objectives at which they are directed. They have a negative impact on investor and public confidence, and hence may well undermine the restructuring program, even if they appear superficially attractive.

Second, it is also important that ownership of any banking sector program stays with the country itself. The Fund may provide advice, and set conditions under which it is prepared to give financial support, but experience shows that programs are more likely to succeed the more the government owns--that is, accepts and takes responsibility for--the program. Why? Because it is the government that has to implement the program, explain it to its people and the international community, and find appropriate responses if problems develop. Unless they are committed to sustaining the program, they are unlikely to stay with it if conditions become difficult--and most programs are tested at some point.

Third, the Fund seeks to help establish help establish principles of appropriate commercial bank behavior among bankers and their authorities. In many transition countries (and indeed in other countries too) the emergence of a banking sector over the past decade was not fully matched by an understanding of the role of banks in a market economy. In a number of countries the authorities still saw the banks, especially the state-owned banks, as a conduit to funnel credits to favored sectors of the economy, especially as they came under increasing pressure to cut their fiscal deficits. Such credits have generally not been subject to serious credit risk analysis, and indeed may not have been intended to be repaid. A similar situation has often prevailed in the private sector, with a perception that ownership of a private bank was essentially a means to extend credit to a favored circle. As the consequences of such attitudes manifest themselves in insolvency and bank closing or restructuring, successor owners and managers need to understand the causes of their predecessors' failures, and should themselves act in accordance with sound commercial banking principles. In large part this should be achieved by comprehensive and effective supervision, a topic which the Fund always stresses. In addition, the Fund encourages the authorities to foster a culture of sound commercial banking practice.

Fourth, as already noted, the Fund operates in coordination with other international organizations, particularly the World Bank. The Bank has been involved in banking and financial sector issues for many years, and will be increasing its involvement. Indeed, the World Bank can bring greater levels of staff resources to banking sector issues than can the

Fund. The Fund will tend to be involved when the banking problems are systemic, and when they have spillover effects to the rest of the economy. The Bank will generally be involved together with the Fund, helping to design the strategy, and providing assistance to particular banks or other special institutions involved in handling the banking sector problems (for instance an asset realization agency), as well as potentially providing financing for banking sector restructuring.

There is close cooperation between the Bank and the Fund whenever both are working with the same country. Often World Bank staff participate in Fund missions, and vice versa. At headquarters, staff from each institution will participate in meetings at the other. Management and senior staff of the two institutions meet regularly, to discuss and reach a common view on the involvement of their respective institutions, from the broadest strategic aspects to the detailed handling of particular country cases.

Sometimes the Fund may be involved when the World Bank is not. This relates to the fact that the Fund, through its surveillance activities, will often have an intensive ongoing relationship with its members even when they are not borrowing. For instance, the Fund has undertaken surveillance of banking difficulties in some industrialized countries where the Bank was not involved. Further, sometimes the Fund's technical assistance can be more de-linked from financial support than is the case for the World Bank. Thus in countries where there is no World Bank lending in the financial sector, the World Bank may not be actively working on banking issues. The Fund would welcome arrangements that would enable the

Bank to increase its involvement in such cases.

While there is much that needs to be done, and much that the international institutions can contribute, we have to be realistic about the Fund's resource constraints. The staff is already fully committed to its existing tasks and any expansion of involvement in banking sector work is likely to be at the expense of some other activity. The Fund needs to be sure that it does not generate expectations among member country authorities that it cannot fulfill, and will have to decide how best to deploy its resources.

V. Final Observations

The handling of banking sector problems is likely to be very different now than in earlier periods, because of the greater openness of the world economy in general and the banking sector in particular, and because there are now far fewer domestic and external financial controls. We are experiencing the benefits and challenges of operating in an environment where the authorities have fewer direct instruments, and are more subject to the constraints of markets, international as well as domestic. This affects the management of the banking sector as well as of the economy more generally. Any resolution of banking sector problems is therefore likely to depend heavily on market reactions, and hence on the restoration of confidence. For this reason, not only macroeconomic stabilization, but also the establishment of guidelines and incentives for sound banking practices, including incentives for increasing efficiency in the banking system through competition, are likely to be important

concomitant elements of any bank restructuring strategy.

Banks are now frequently very diverse and complex institutions. Some undertake the marketing of highly refined products for a sophisticated market; others may be quasi-fiscal credit intermediaries or financing vehicles for non-bank activities. The Fund seeks to tailor its recommendations to the particular situation at hand.

Banking sector problems have implications for the design of Fund programs. Instability in the demand for money during banking sector restructuring, for instance, may lead to the Fund needing to find alternative anchors and indicators for the programs it supports. More broadly, the need for and the costs of bank restructuring and the limits banking sector weaknesses place on the transmission of monetary policy need to be reflected in program design.

The international community is now involved in a major effort to improve the quality of banking systems around the globe. Through our surveillance, multilateral and bilateral, through conditionality in Fund-supported programs, and through technical assistance, the Fund in cooperation with other institutions, will play its full role in that effort.