The framework for financial supervision: offsite supervision and credit information

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Creating an effective framework of prudential regulation

Strengthening the regulatory framework

Recently much has been written about the broad attributes of sound financial regulation and supervision, particularly in light of the challenges presented by increasingly integrated global financial markets. For instance, a past chairman of the Basel Committee on Banking Supervision has identified the following prerequisites for effective banking supervision:[1]

- sound and sustainable macroeconomic policies;
- a well-developed public infrastructure;
- effective market discipline;
- procedures for efficient resolution of problems in the banking sector; and
- strong prudential mechanisms for promoting systemic risk management and protection.

The importance of stable macroeconomic conditions and effective supervisory structures for the well-being of the financial system is well documented. Spiralling inflation and recession wreak havoc with fundamental credit quality. Equally, an efficient financial infrastructure, e.g. a well-defined accountable legal system, and consistent, transparent accounting standards are in many ways a prerequisite to promoting effective supervisory structures.

Effective market discipline and improved practical measures provide both internal and external incentives to promote enhanced risk management and, thus, safeguard markets. For instance, with established and

[1] See de Swaan (1998). See also De Juan (1991), Goldstein and Turner (1996) and Polizatto (1990).

transparent procedures in place for resolving failing financial institutions, managers have adequate incentives to conduct prudent banking.

Finally, given that financial systems are characterised by systemic risk, removing or neutralising such risk will naturally introduce stability and balance into the financial system. For example, systemic risk protection in the form of safeguards of the payment system in the financial system can mitigate damaging behaviour in the marketplace. To briefly elaborate on some of the elements of effective market discipline:

Laws and prudential regulation

A broad, robust banking statute is essential to ensure that bank supervisors can fulfil and carry out their responsibilities. The legal framework applicable to banks must be both innovative and capable of being responsive to often rapidly evolving economic and business conditions. Banking law and associated statues should encompass prudential norms, disclosure, capital requirements, prudential standards, bankruptcy and foreclosure processes and taxation rules.

Banking supervision

An effective legal regulatory framework must be complemented by strong enforcement designed to prevent fraud, manipulation, and other market abuses. When laws and regulations are quite adequate, but effective enforcement is discouraged, supervisors lack adequate incentives to take required corrective actions to ensure regulatory compliance, such as implementing incremental improvements in operating procedures, seeking to raise new capital, providing costly but necessary disclosure, replacing inefficient or corrupt managers and forcing the exit or restructuring of failing banks.

First, of course, there has to be a political will to deal with such problems. Strong enforcement serves as a deterrent to future problems, often bigger problems. Thus, supervisory staff need to be presented with rational public policy goals which are an outgrowth of an effective statutory regulatory system. Furthermore, to promote such goals, supervisory organisations must have sufficiently trained personnel as well as be well staffed overall. Part and parcel of maintaining such a well-rounded organisation will be adequate compensation, strong, but

fair, leadership and a clear understanding of the role of supervision, both in the industry and society at large.

Accounting, disclosure and transparency

Transparency is another important component of the infrastructure that permits market mechanisms to function fairly and efficiently. Customers can make informed decisions, utilising publicly disseminated information. Improved transparency in market operations will, furthermore, help attract international investor interest. One element of transparency is good (internationally accepted) accounting standards and disclosure rules. Basic market integrity and efficiency depend on acceptable standards, as does promoting the best interests of both the bank's customers and investors. Promoting world-class accounting practices and business conduct rules will, at the same time, encourage the growth of an effective national accounting profession which is needed to ensure the establishment of uniform accounting standards that reflect the condition of financial institutions.

With that overview, in preparing this paper I will go further beyond these basic regulatory principles and this supervisory framework and explore in greater detail the nature of marketplace transparency. The financial sector is unique in that it takes "as many eyes as possible" to introduce transparency, and by inference resiliency, into the financial sector. However, in many developing economies, transparency is limited or hampered due to the lack of effective measures to ensure transparency.

The common themes of improving oversight and market transparency are extremely pertinent, but they are often overlooked and neglected in the supervisory practices adopted in developing countries. They are based on my experience in Asia – primarily in Indonesia, the Philippines, and briefly China – complemented by a survey of the Banking Regulatory Framework in Asia.[2] The suggested measures are relevant to China's effort to strengthen supervisory capacity, even taking into account differences in history, culture, customs and business practices. The recommendations that follow are based on the view that the experiences of other countries, both the good and the misdirected, can be

[2] See Pomerleano (1997).

used constructively by policymakers in China. Having said that, it would be naïve to characterise one country's regulatory system as better than another's; therefore, I am not suggesting the wholesale importation of regulatory practices, but rather taking a global perspective, hoping this experience is applicable to the effectiveness of China's regulatory and supervisory initiatives.

The second section of this paper draws on the recent regulatory experience with offsite supervision in various countries. The third examines the role of private sector organisations in leveraging supervisory capacity. The fourth discusses the role of credit rating agencies. The fifth draws on the implications of the Asian crisis in outlining prospective challenges for supervisors in China.

Importance of offsite supervision

The advent of the "information age" has brought a new bank supervision technique: offsite bank surveillance systems[3] for the collection and interpretation of regular reporting returns and other statistical data. Several countries in Asia have implemented offsite systems, including Indonesia and Malaysia.

A critical component of this supervisory process is effective offsite supervisory capacity. Offsite monitoring systems have a number of advantages:

- they are less costly than onsite capacity;
- they can be updated frequently when new information is received through quarterly reports;
- they can provide the basis for a financial evaluation of the bank between examinations; and
- they are potentially able to isolate risk factors that may lead to future problems.

Therefore, offsite monitoring systems complement examinations' focus on the bank's current condition, e.g. credit, income, and capital, and are designed to accomplish a number of objectives. Foremost, they serve as an "early warning device" to detect emerging bank financial problems. In some cases, this early offsite detection of banking problems can mean

[3] For a discussion of offsite systems, see Baltrop and Sheng (1992).

the difference between taking timely action to save a bank from failure and inaction. At a more aggregate level, offsite surveillance systems employed by regulatory authorities can monitor the financial condition and performance of the entire banking system (or banks in a region or narrow geographic area). The aggregate data offer evidence on the condition of the banking system – and show changes or shifts that might require prompt adjustments in overall bank monetary or supervisory policy.

Offsite detection methods mandate periodic bank reports, in addition to the financial reports collected by the examiners. Examples of periodic reports that are useful to bank supervision are reports of condition and income; legal lending limit exposure reports; and reports of indebtedness of executive officers and principal shareholders and their related interests to banks.[4] The data are supplemented by generating critical ratios related to bank performance, and analysis of key bank financial ratios and other financial data.

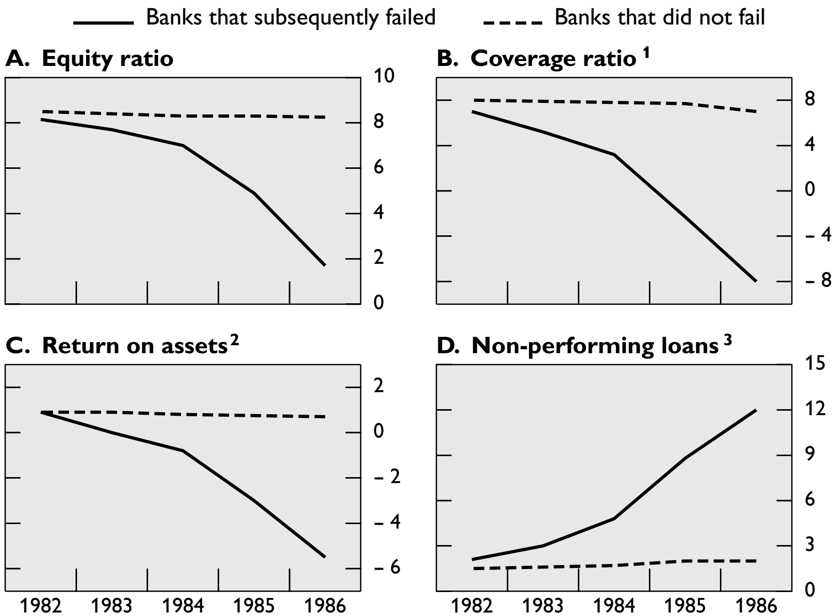
The offsite surveillance in the US and analysis can serve as illustration of the process. Offsite analysis precedes onsite examinations and inspections. This offsite system is used as well in evaluating applications filed for mergers and acquisitions. The regulatory agencies prepare a Uniform Bank Performance Report (UBPR), which is an analytical tool created for offsite surveillance and monitoring. UBPR data are presented in ratios, percentages and dollar amounts. The report is computed mainly from reports of condition and income submitted by banks. The database used to generate the reports contains several years' worth of trend-capturing data. In a concise format, the reports' data are used to evaluate earnings adequacy, liquidity, capital and asset and liability management. Examiners can use this report to further their understanding of a bank's financial condition and go on to identify risk areas. Each UBPR also contains corresponding average data for the bank's peer group and percentile rankings for most ratios. Therefore, the analysis permits evaluation of the firm's financial performance and facilitates comparisons with the performance of peers. The possibilities of isolating condition and risk factors by analysing banks' financial data are illustrated in Figure 1.

[4] A 1988 OCC study of 162 national bank failures between 1979 and 1987 concluded that insider abuse was a significant contributing factor in 35% of the failures, and fraud in 11%. See Office of the Comptroller of the Currency (1988).

Figure 1

Bank condition ratios for failed and non-failed banks

In percentages



[1] (Equity + reserves – non-performing loans)/assets. [2] Net income assets. [3] As a percentage of assets.

Source: FDIC Banking Review (1998), Vol. 11, No. 1, April.

Figure 1 demonstrates the predictive power of ratios measuring the current condition of banks – e.g. equity, non-performing loans – to detect vulnerable banks through offsite analysis. The US has even developed algorithms to assess fragility from the offsite reports: the FIMS[5] monitoring system developed in the Federal Reserve study predicts failure based on 11 key variables collected from the report of condition submitted to US bank regulators. Five of the 11 variables are related to the riskiness of commercial lending. Similarly, the FDIC has

[5] Cole, Cornyn and Gunther (1995).

developed the Growth Monitoring System (GMS). The system's premise is that rapid growth in total assets or loans represents a potentially risky activity. The system is based on the levels and quarterly trends of five summary measures: asset growth rate; growth rate of loans and leases; ratios to assets of equity capital; volatile liabilities; loans and leases plus securities with five-year maturities or more. Banks flagged by the GMS as rapid-growth institutions are identified for offsite review and may receive increased supervisory attention.

The success of an offsite system hinges on several elements. First, the accuracy and timeliness of the data submitted by banks. Second, the technology used to capture the data and compile the comparative ratios, trend analyses and percentile ranks relative to peers. Finally, the analyst makes a judgement based on a variety of financial ratios and trends, and combines the findings to offer compelling evidence of a specific bank's financial condition.

Therefore, a critical part of the offsite process is the analytical skills of the individual financial analysts requested to make judgements regarding the bank's financial condition. It follows that credible systems have to be complemented by skilled and trained financial analysts. In addition, it is important to note that every country has its own unique starting point for building up financial sector and supervisory standards, and China's unique economic and social factors will invariably help shape its offsite surveillance practices.

The first step

Development of an offsite system carries the promise that the periodical financial reports currently generated by the banks could be used even more efficiently to generate an early warning system, using, for example, peer group analysis to detect broad trends affecting the financial sector. Implementing an effective offsite system in China requires overcoming some obvious, though surmountable, impediments. Just the vastness of the nation presents a major obstacle. Also, in China, the headquarters of the state-owned banks have traditionally delegated control to the local branches. This strong tradition of local autonomy has impeded comprehensive consolidated risk management systems, preparing timely consolidated financial statements and generating comprehensive supervisory reports. I am also aware of the challenges posed by conversion to International Accounting Standards. Therefore, Chinese banks are hindered by the information collection and dissemination systems for timely internal risk control analysis.

Given these hurdles, it should be pointed out that Chinese banks are aware of the need to modernise their banking technology, including setting up a modern information system with real-time risk monitoring. Although the impetus for developing internal risk management can come from prescribed regulatory reporting requirements, the end result can be a banking system with more sophisticated risk management tools.

Role of industry associations and self-regulatory organisations (SROs) in an institutional supervisory capacity – appraisers, banking associations, auditors

Comprehensive laws, regulation, and supervisory standards need to be complemented by private sector support in the form of sound legal, banking, accounting and appraisal professions. This section explores the supporting "eyes" of accountants, lawyers and appraisers in strengthening the banking sector's professional capacity and integrity.

Effective industry organisations and quasi-governmental self-regulatory organisations (SROs) for bankers, accountants, lawyers and appraisers fulfil several vital second- or third-tier regulatory functions. First, these organisations have the potential to establish and help maintain high standards via uniform certification, registration, or licensing standards, including education, evaluation and compilation of disciplinary history databases. Industry associations (and SROs) have a vested interest in establishing professional standards and assisting members to improve their conduct, ethics, performance and overall expertise. The licensing process promotes these objectives, and protects the professional designation. For instance, SROs can implement a wide-ranging educational curriculum supporting the development and maintenance of professional skills. In addition, industry associations/SROs monitor performance and enforce – through sanctioning powers – current standards and requirements. Further, the SROs' membership can serve as a forum for articulating and communicating practitioners' views.

China would benefit substantially from nurturing the institutional capacity for independent industry associations (and eventual SROs) supportive of the regulatory and supervisory apparatus and climate in

such areas as appraisers, bankers, lawyers, accountants and securities and futures market participants.

The challenges of establishing credible industry associations and for self-regulation

I am aware that, in the short run, these organisations do not have the institutional capacity to achieve these objectives.[6] Considerable effort is needed in the institutional and human capital development of private sector organisations in China. With proper development over the long term, private sector organisations can bear the major responsibility for monitoring their members, ensuring compliance with rules and laws and training. Notwithstanding the challenges, nurturing the development of industry organisations alongside self-regulation is a worthwhile endeavour for the Chinese authorities.

Commercial real estate markets and the importance of real estate appraisers

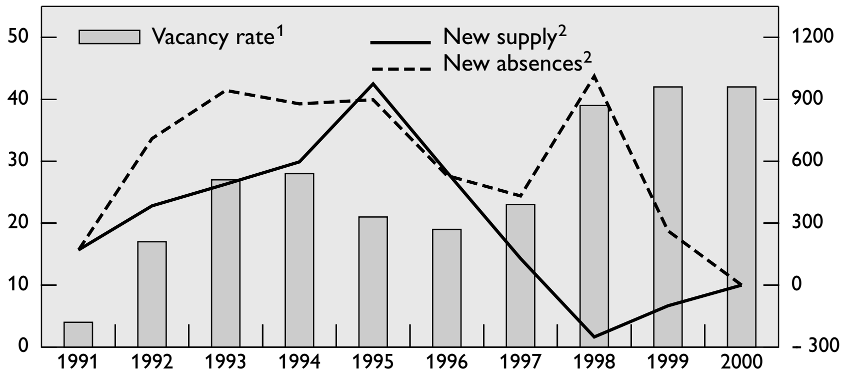
Commercial real estate development is inherently risky, in part because of the long gestation period of commercial construction projects. When completed projects finally come to market, absorption conditions may have changed considerably from what they were at the time of conception. For example, the gap between supply and demand in the Bangkok Metropolitan Region shown in Figure 2 illustrates the risks: vacancies reached 40% in Bangkok by the time the supply and absorption of new space stopped. Another risk element is the highly leveraged nature of real estate projects and risks of cost overruns. The Asian financial crisis has documented the heightened credit risks of real estate lending.[7] Loans to the real estate sector in Asia are estimated in the range of 15–20% of the total loan portfolio (see Figure 3). Regulators in Asia have come around to recognising that real estate is a sector prone to risks and dramatic price and supply/demand swings. In part, the solution is to contain real estate financing risks through more stringent supervision of real estate financing by banks and other regulated lenders. The following

[6] In the absence of strong professional associations, and as an interim measure ensure professional competence in China, the PBC licenses accounting professionals to work in the banking areas.

[7] World Bank (1998b).

Figure 2

Supply and demand in office space in the Bangkok Metropolitan Region



[1] In percentages (left-hand scale). [2] In thousands of square metres (right-hand scale).

Source: Jones Lang Wootton.

section examines the issues surrounding the real estate sector and recommends measures designed to establish a credible real estate appraisal profession.

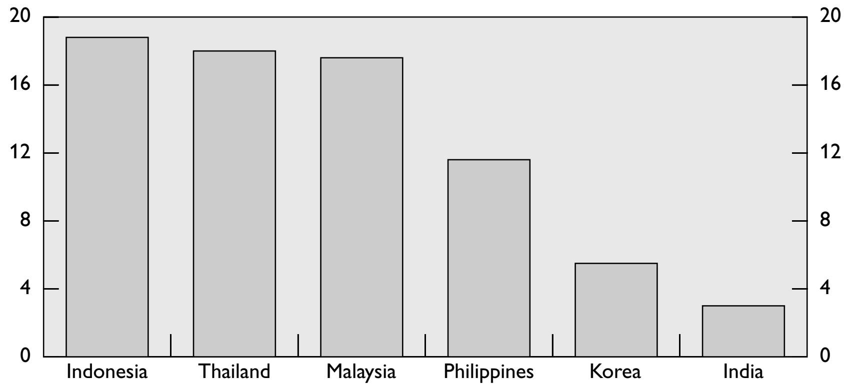
Similarly, after the S&L crisis, it became clear that irresponsible appraisals contributed, in part, to the real estate bubble of the late 1980s and the regulators and legislators explored for solutions. Figure 4 demonstrates that, in the US, banks with a high real estate exposure had a considerably higher likelihood of failing. The challenge from the Asian and US experiences is to improve the operation of real estate markets. The US upgraded the professionalism of the appraisal profession through legislation, licensing and supervision. In measures designed to instil enhanced discipline in the appraisal profession, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIREA") required all federally regulated financial institutions to use *state-licensed or certified real estate* appraisers to perform appraisals in federally related transactions. FIREA further authorised the States to certify, license and supervise real estate appraisers within their jurisdiction.

Concomitantly, the Appraisal Subcommittee of the Federal Financial Institutions Examination Council ensures that real estate appraisers, who

Figure 3

Exposure of the banking sector in the property sector

Loans to the real estate sector as a percentage of total loans



Source: World Bank (1998), *East Asia: the Road to Recovery.*

perform appraisals in real estate transactions, are sufficiently trained to assure competency and independent judgement according to uniform high professional standards. An Appraisal Foundation is responsible for establishing and promoting minimum *uniform* appraisal standards and appraiser qualifications criteria. Two affiliated boards – the Appraisal Standards Board, which promulgates and maintains Uniform Standards of Professional Appraisal Practice ("USPAP"), and the Appraiser Qualifications Board, which establishes Appraiser Qualifications Criteria – carry these tasks.

Similarly, as China's commercial construction boom is fuelled in great part by increased bank lending, the regulatory authorities are well advised to develop more fully the nation's appraisal profession. China's real estate markets would benefit from the enhanced capacity of the appraisal profession.

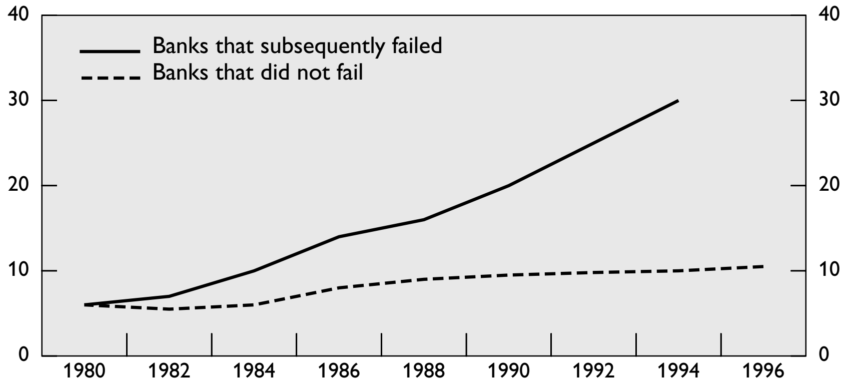
Banking Associations

A local Bankers' Association brings together the banking community with local industry leaders to promote economic development and direct investment. Banking groups provide professional continuing education

Figure 4

Ratio of commercial real estate loans to total assets in the US, failed and non-failed banks, 1980–94

In percentages



Source: FDIC Banking Review (1998), Vol. 11, No. 1, April.

and training for bankers, promote effective leadership in forging industry consensus and disseminate innovative practices, products and services. As an example of training, the American Institute of Banking (AIB), a national organisation dedicated to training, has an active curriculum offering over 50 banking programmes, ranging from compliance, corporate banking, management, marketing, sales and retail banking to core in-depth courses in accounting, communications and banking fundamentals. More than 150,000 participants enrol annually in AIB programmes. SROs established for the accounting and legal professions can reach similar training objectives. Therefore, initiatives designed to foster the capacity of the Bankers Association, accountants and lawyers in China are warranted.

Auditors

Another area worth exploring is fostering a greater role for and increased coordination between the work of external auditors, internal auditors and bank supervisors. A working relationship can leverage the use of the respective resources and expertise. The Basel Committee on

Banking Supervision in collaboration with the International Auditing Practices Committee of the International Federation of Accountants has provided guidance on the respective roles of bank supervisors and auditors and on how their mutual relationships can be strengthened.[8]

There are many areas where the work of supervisors and that of the auditors are complementary. For instance, management letters and reports submitted by external auditors can provide supervisors with insight into weak aspects of banks' operations. Many countries have adopted practices for such reports to be made available to the supervisors.[9] Similarly, the internal compliance and audit department can provide helpful, if not crucial, insights for supervisors. In this mutually beneficial relationship, the supervisory findings during an inspection, or before a management interview takes place, are customarily communicated to banks. These communications benefit the work of internal and external auditors and provide an independent assessment of risks and focus attention on specific areas of supervisory concern.

Credit information system

Regulation and supervision are one element of the institutional infrastructure for sound banking. Equally important elements are the professional organisations discussed in the previous section. In many developing countries, the capacity to evaluate credit risk is hampered by the absence of audited Financial Statements that meet International Accounting Standards. Further, credit markets in developing countries suffer from lack of credit discipline. Poor credit performance is attributable not only to adverse economic conditions, but also to the lack of credit discipline in the system. Ill-willed borrowers *do not have incentives* to perform on their credit obligations due to impediments in enforcing credit contracts and insufficient transparency regarding their creditworthiness. Loan workouts in the crisis countries in Asia have

[8] International Auditing Practices Committee of the International Federation of Accountants, *The relationship between bank supervisors and external auditors*, July 1989.

[9] The Group of Thirty has prepared "A Study Group Report Defining the Roles of Accountants, Bankers and Regulators in the United States" designed to achieve better financial reporting at US banks with less duplication and expense.

demonstrated that the number of lenders and amount of total debt involved were far more than expected. For instance, reports from Thailand indicate that moral hazard has been injected in the system during banking and corporate restructuring: borrowers with repayment capacity have stopped servicing debt in anticipation of moratoriums and massive "haircuts". Further, many banks, foreign and domestic, involved as creditors had limited knowledge of borrowers' total loans or total number of creditors. The benefits of transparency are evident and the role of Credit Information Systems essential.

What is a Credit Information Bureau?

A Credit Information Bureau (CIB) is an entity that collects loan and contingent liabilities profiles and payment performance. A credit report is a short report that helps evaluate new banking customers, pre-screen prospects, or perform a quick credit check.[10] The information is consolidated in a computerised database on a periodic basis, and a comprehensive profile of borrowers, including a performance record, is generated.

The Bureau distributes the information to interested parties on request: potential lenders or lessors obtain the credit history of someone to whom they were considering lending money or leasing equipment. Thus, any bank that is considering making a loan or lease or entering into a credit transaction with a commercial entity can buy information about the company's payment records. Argentina's central bank has established one of the most impressive credit information sharing schemes. It releases (on CD-ROM as well as on the Internet) on a regular basis detailed information on borrowers, including bank lines, credit rating by various lenders and status of repayments. Bureaus have been established in other developing countries, such as Malaysia, the Philippines and Indonesia, as well as developed countries, e.g. Denmark and France, for corporate borrowers.

[10] The typical credit check contains the following information: customer background (name, address, telephone number, parent company name and location, line of business, chief executive officer, year started, number of employees, sales and net worth); payment activity summary and payment history summary; and special events, such as updates on bankruptcy proceedings, changes in ownership, relocations, acquisitions or other newsworthy items.

What are the benefits of a Credit Information Bureau?

The benefits are threefold.

First, transparency about performance deters ill-willed borrowers: realisation on the part of the borrowers that their performance is monitored will eliminate moral hazard, and therefore lead to better performance on the part of existing borrowers to whom credit was extended; the knowledge that potential lenders know of the poor performance gives borrowers an automatic incentive to establish a good payment record.

Second, the CIB offers early detection of non-performing loans, and so prevents additional lending to poorly performing borrowers.[11] Therefore, macroeconomic benefits accrue to the economy by redirecting new credit from poorly performing credits to viable ones, thus promoting economic growth. Finally, the aggregate information from a Credit Information Bureau can be used for analysis, such as lending trends, and industrial allocation of credit.

In order to be successful, a Credit Information Bureau should adhere to several principles. First, clear and transparent rules governing the management of the Bureau, collection of information and the procedures for sharing it with the banking community. Second, the Bureau should cooperate with the banking industry and address explicitly up-front the banking industry's concerns. Enhancing the transparency of credit exposure (including contingent liabilities), collateral and delinquencies of borrowers through a Bureau is highly desirable in China.

Lessons from the Asian crisis … regulation as a "catch-up" game, and need for proactive regulation and supervision

The experience of other countries, mature and developing economies alike, suggests that the market is ahead of the regulators in terms of innovations, and many times regulation is a "catch-up" game. Regrettably,

[11] In this context, it is desirable to note that experience suggests total borrowings of defaulting borrowers in the system increase rapidly and disproportionately as their financial condition deteriorates.

in many instances, great financial distress acts as a catalyst to the regulatory and supervisory response. The financial crisis in Asia, the collapse of institutions such as Barings and Peregrine, and abuses such as the S&L crisis in the US underline the need for vigilance and proactive and anticipatory regulatory initiatives. In this context, what are the prospective challenges for regulation and supervision in China? I submit three topics for your consideration drawn from the Asian financial crisis.

Internationalisation of activities of Chinese banks, and the need for a global orientation of supervisors

Globalisation posed challenges for the capacity of the region's supervisory apparatus to oversee the international affiliates of domestic financial institutions. The Basel Committee made initial progress in the area of home/host reciprocal supervision of banking entities in several earlier documents, starting in 1975 and most recently in 1996. The gradual liberalisation of the financial system in China is leading banks to establish an international presence. Already, several Chinese banks have established international branches. In this context, it is important to note that the future happens sooner than we expect, and the regulatory authorities in China might be advised to consider the Basel Committee's approach and guidance on the subject, including harmonisation of capital standards and initiatives to improve cross-sector supervision. Similarly, China might benefit from international efforts to harmonise national rules that are under way, such as Core Principles developed under the auspices of the Basel Committee.[12]

Brave new world of financial services: implications for regulation and supervision of non-bank financial activities

Throughout Asia, there were non-bank financial institutions (NBFIs), such as the finance companies in Malaysia and Thailand, and merchant banks in Korea (see Table 1) in financial distress. In recent years, these NBFIs

[12] It should be noted, however, that while the Basel approach is accepted by banking supervisors, implementation of cross-border banking supervision is moving slowly: information-sharing arrangements, and examination of global risk taking are lagging. See International Monetary Fund (1998) and Basel Committee on Banking Supervision (1997).

Table 1

Structure of the banking system – number of financial institutions

	Private domestic commercial banks	State banks	Merchant banks	Financial institutions for the primary sector	Finance or security companies	Foreign financial institutions	Total
Malaysia	23	0	12	0	40	14	89
Indonesia	203	7	0	0	0	10	220
Korea	26	8	30	0	53	52	169
Thailand	15	2	0	0	104	11	132

Source: World Bank, *East Asia: the Road to Recovery*, 1998.

have become an important segment of the financial system in Asia. Part of the growth of the industry was attributable to efforts to circumvent prudential norms in the banking sector. However, the unregulated growth exacerbated the financial system's fragility. These developments were occurring within a legal framework that has not fully recognised the weaknesses in the regulatory framework and potential to exploit the loopholes.

NBFIs lacked adequate internal controls and credit discipline, and therefore their lending for real estate, margin loans for equity, consumer finance and car purchases were an important source of risk moving into the economies. Finance companies in Thailand and merchant banks in Korea were owned by banks, and therefore credit risks were directly transmitted to the parent banks. Furthermore, the erosion of the distinction between banks and NBFIs led to compromise in credit-underwriting criteria, with the finance company affiliates of banks extending credit that the banks were precluded from extending, due to prudential norms, such as legal lending limits.

As a result, the process created inequities, as well as unintended systemic risks. For instance, finance companies had different capital adequacy requirements. The challenge for regulation and supervision throughout Asia is to permit expansion of financial service activities in a framework that maintains the safety, soundness, and integrity of the overall financial system, and the banking system in particular, without imposing unnecessary regulatory burden or intrusion.

Also in mature markets, where the transformation in financial services is rapid and the distinction between financial products is blurring, brokerage houses are offering money market accounts, which in essence are checking accounts, and banking institutions have broadened their activities to marketing mutual funds and insurance products. The transformation poses challenges to regulatory authorities' efforts to regulate financial institutions. Regulatory responses around the world offer a range of potential solutions: Japan, Korea and the UK have adopted a model of an umbrella supervisor, while the US focuses on the holding company framework for permitting new banking organisation activities, while containing the risks to the system.

The US authorities have adopted the holding company framework[13] as a solution to NBFI activities. The governing principle is that non-bank activities and affiliations should not take place through subsidiaries of banks. The US regulatory framework requires that organisations that conduct financial businesses should organise in a holding company form where the bank and the other activities are subsidiaries of the holding company. The holding company is subject to capital adequacy and other prudential norms.[14] Profits and losses of the business lines accrue to the holding company and thus do not directly endanger the bank, nor the deposit insurance system. One major advantage is that any losses in an affiliate do not flow to the bank, as in the case of direct subsidiaries of banks, where the risk is not isolated and can be transmitted to the parent.

An economic argument supporting isolating non-bank activities outside the bank resides with offering a level playing field for competition. Banks, in the presence of explicit deposit insurance such as in the US, or implicit deposit insurance such as in China, have an economic advantage in the form of lower funding costs. This advantage is not directly available to the non-depository affiliates. Such a situation undermines the competitive playing field between bank subsidiaries and independent firms engaging in the same business, defying the purpose of competition in financial services. Therefore, a policy objective of creating a level

[13] Other countries subscribe to the universal bank approach.

[14] Provisions of Section 23A prevent the misuse of a member bank's resources through "non-arm's length" transactions with its affiliates. Section 23A places quantitative (i.e. percentage of capital) limits, and in some cases collateral requirements, on transactions between a member bank and an affiliate.

playing field, while at the same time preserving the integrity of the deposit insurance system, leads to segregation, regulation and supervision of non-bank activity. No matter what model China elects to isolate banks from non-bank activity risks, the challenge for China's policy-makers will be to anticipate the inevitable and fast-paced transformation now under way in financial services and to update the regulatory and supervisory framework to respond to innovative markets.

Banking resolutions

A visible limitation of the regulatory framework in Asia was the lack of an explicit exit policy for failing financial institutions. Bankers in many cases resisted timely exit or recapitalisation of failing institutions, with a resulting increase in the ultimate costs to the financial and economic system.[15] Further, the lack of expertise with financial restructuring techniques led to gridlock and delays in resolving, or working out, failing financial institutions. Banking resolutions will be addressed in a separate session; however, briefly, I would like to share some pertinent observations on the resolution process.

First, the restructuring should focus on the objective of the exercise: fundamentally changing banking practices in order to prevent a recurrence. Recapitalisation must be accompanied by thorough financial, operational and managerial restructuring and transparency. Authorities granting regulatory forbearance and accounting relief to banks only help banks avoid the actual recognition of realised losses. In reality, forbearance does not change the underlying economic losses in banks, and ends up costing more later on. Therefore, the key to the effectiveness of the restructuring programme is not whether the recapitalisation achieves an improvement in capital ratios. Rather, the ultimate success resides with the programme's effort to address the underlying weaknesses of the system.

Second, banking resolutions are challenging, and the resolution process poses a set of complex choices to the authorities. What resolution technique is needed to adopt whole bank purchase and assumption transactions, deposit transfer, payoff and liquidation, or conservatorship? In most instances, the preferred course of action is the

[15] See Pomerleano (1997).

privatisation of selected items in the balance sheet of the intervened bank, so that the original institution preserves the franchise value, and continues to operate in private hands with a cleaner set of financial assets.

Third, the experience from banking crises has been that failing banks' losses are substantial and their capital base is insufficient to cover them. Most of the time a loss for the government is unavoidable, and in a large number of cases the transactions require financial assistance from regulators, i.e. the taxpayers. Thirdly, in all cases, worldwide experience shows that designated government agencies end up with a portfolio of bank assets of substandard quality. This is because the assets that cannot be included in the privatisation deals stay behind in the hands of the regulator or a state agency created *ad hoc* to deal with these problem assets and associated liabilities, such as emergency funding provided at the onset of the crisis. It is worth noting that the treatment of depositors and creditors in failing institutions indicates that there are compelling arguments to provide *de facto* deposit insurance, even in the absence of formal deposit insurance. In numerous resolution cases in Asia during the crisis, uninsured depositors were protected due to fear of serious repercussions and loss of national confidence in the banking system. On the other hand, the innate moral hazard in such an approach is evident. This discussion illustrates the complex choices facing supervisors and leads to the following recommendations.

Fourth, resolution strategies can benefit from *financial engineering*. Experience has shown that it is desirable to make the private sector investment banks and accounting firms a partner in *asset dispositions*. The private sector has the specialised skills – such as securitisation and flexibility – to solve problems and preserve value. Otherwise, the danger is that poorly managed residual assets (managed by the government) will end up costing the state – and, again, ultimately the taxpayer – much more than anticipated. Provided that the right incentives are introduced in resolutions, and structure and contract provisions are clearly spelled out, the private sector can dispose of troubled assets in a more cost-efficient manner than the government.

Finally, *incentives should be a paramount consideration in designing market-based resolutions* by introducing appropriate incentives for acquirers of assets, while preserving risk. For instance, incentive structures are evident in the recapitalisation process in Thailand. Drawing again on

the US experience, "asset pool" arrangements illustrate the need for adequate incentives in resolutions. In "asset pool" arrangements the regulator pays someone to work out assets, in addition to a flat fee. The easiest compensation formula is to agree to reimbursement of *all* the costs connected with managing assets. Unfortunately, such open-ended arrangements discourage prompt disposition of assets and give rise to disputes about proper allocation of costs. Acquirers will expend resources up to the point where their own profit, not the government's, is maximised. For instance, they will dispose of the "easy assets" and neglect the tough ones, knowing that the government bears the economic risk of loss. The United States, over time, learned to avoid open-ended cost reimbursement provisions in assistance agreements, and told potential acquirers to build the cost into their bid. Compensation schemes with the right incentives will pay increasing percentages of successive "tranches" of collections, e.g. 3% of the first 40% of book value collected, 6% of the next 10% collected, 9% of the next 10%, etc.

The previous discussion highlights the complexity of banking sector restructuring and reinforces the need for a *systematic approach* by regulators to the resolution of bank failures. Adoption of the systematic approach in China to resolutions is desirable. Such an approach consists of legislation enabling the regulatory authorities to address promptly failing banks, subject to bankruptcy and foreclosure law. This approach also requires establishing a skilled, experienced and *dedicated* unit to focus on troubled banks, with the power to intervene with a coherent rehabilitation programme and alternative resolution game plan.

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