Not since the 1930s have so many firms in developing countries been unable to service their debts. Their difficulties are rooted in the international shocks of the 1980s and their domestic aftermath and in the policies that governments have pursued over the past thirty years. The inability of firms to service debt has caused distress for many financial institutions. In some countries incipient financial crises forced the government to assist troubled banks. In others, although there has been no crisis, banks' losses are large enough to require government intervention. Failure to take action is costly. With delay, losses mount and so does the cost of restructuring. In all, more than twenty-five governments have helped distressed financial institutions during the past decade. Much has been learned from these measures.

In 1981 the Chilean government liquidated three commercial banks, four finance companies, and a development bank. Together these accounted for more than one-third of all loans made by the financial system. Fourteen months later the authorities intervened again. They placed eight institutions, which accounted for nearly half of all loans, under central bank management and extended financial support to all but one of the remaining commercial banks.

In the United States more than 1,000 savings and loan associations (S&Ls) were closed or merged with sounder institutions between 1980 and 1988. By early 1989, 600 S&Ls, or one-fifth of all S&Ls, were still thought to be insolvent, and the loss to the S&L deposit insurance fund was expected to total at least $120 billion. Among commercial banks the failure rate rose from ten a year during the 1970s to more than 150 a year in the late 1980s. In early 1989 about 10 percent of commercial banks were on the regulators' "watch list."

Cases like these are spectacular, but much financial distress remains hidden. Because intermediaries have rolled over unpaid loans and have capitalized unpaid interest, their insolvency is not apparent from their accounts. Accounting information may be kept confidential, and what is available is often unreliable. Where audits have been made using generally accepted accounting principles, nonperforming loans have proved to be substantial. In nearly all instances of government intervention, intermediaries' actual losses have proved to be far larger than reported. The number of bad and doubtful loans in the portfolios of many institutions is such that expected losses exceed the sum of capital, reserves, and loss provisions; these institutions are technically insolvent.

If reliable information were available, countries could be ranked according to the share of nonperforming loans in banks' total assets. At one end of the range would be countries in which nearly all intermediaries are profitable and solvent and nonperforming loans amount to only 1 or 2 percent of
assets. At the other would be countries in which 20 percent or more of all loans are nonperforming and many, if not most, banks are insolvent (some having losses equal to many times their capital). Although lack of data makes it impossible to measure financial distress precisely, it is clear that distress is widespread. Box 5.1 presents information for a select group of countries. This information may overstate the severity of distress in some countries and understate it for others.

In most cases banks are not illiquid (that is, they can still meet payment demands), but so many of their debtors are unable or unwilling to service their loans that the banks are making losses. The failure of some borrowers to service loans is common; even healthy banks expect to have some nonperforming loans. But losses large enough to impair the profitability and solvency of so many institutions in so many countries are unprecedented. Even during the depression of the 1930s, very few large banks in developing countries failed.

That banks remain open and continue to accept deposits and make loans does not mean that they

Box 5.1 Examples of financial distress

Argentina. The failure of a large private bank sparked the 1980-82 banking crisis. By 1983, 71 of 470 financial institutions had been liquidated. The restructuring process is not yet complete.

Bangladesh. Four banks that accounted for 70 percent of total credit had an estimated 20 percent of nonperforming assets in 1987. Loans to two loss-making public enterprises amounted to fourteen times the banks' total capital.

Bolivia. In late 1987 the central bank liquidated two of twelve private commercial banks; seven more reported large losses. In mid-1988 reported arrears stood at 92 percent of commercial banks' net worth.

Chile. In 1981 the government liquidated eight insolvent institutions that together held 35 percent of total financial system assets. In 1983 another eight institutions (45 percent of system assets) were taken over: three were liquidated, five restructured and recapitalized. In September 1988, central bank holdings of bad commercial bank loans amounted to nearly 19 percent of GNP.

Colombia. The 1985 losses of the banking system as a whole amounted to 140 percent of capital plus reserves. Between 1982 and 1987 the central bank intervened in six banks (24 percent of system assets), five of which in 1985 alone had losses equal to 202 percent of their capital plus reserves.

Costa Rica. Public banks, which do 90 percent of all lending, considered 32 percent of loans "uncollectible" in early 1987. This implied losses of at least twice capital plus reserves. Losses of private banks were an estimated 21 percent of capital plus reserves.

Egypt. In early 1980 the government felt compelled to close several large Islamic investment companies.

Ghana. By mid-1988 the net worth of the banking system was negative, having been completely eroded by large foreign exchange losses and a high proportion of nonperforming loans. The estimated cost of restructuring is $300 million, or nearly 6 percent of GNP.

Greece. Nonperforming loans to ailing industrial companies amount to several times the capital of the largest commercial banks, which hold more than 80 percent of total bank assets.

Guinea. The government that assumed power in 1984 inherited a virtually defunct banking system: 99 percent of loans proved irrecoverable. All six state-owned banks were liquidated, and three new commercial banks were established, each with foreign participation.

Kenya. Many of the nonbank financial institutions that have sprung up since 1978 are insolvent, and in 1986 several of the larger ones collapsed.

Korea. Seventy-eight insolvent firms, whose combined debts exceeded assets by $5.9 billion, were dissolved or merged during 1986 and 1987. In addition, the central bank lowered interest rates on its rediscounts to commercial banks on loans to troubled industries.

Kuwait. Because of large losses sustained by speculators in stock and real estate markets, an estimated 40 percent of bank loans were nonperforming by 1986. The government has supported banks by providing highly concessional loans.

Madagascar. In early 1988, 25 percent of all loans were irrecoverable, and 21 percent more were deemed "difficult to collect." Given the low level of reserves (less than 5 percent of assets), the banking system as a whole was insolvent.

Malaysia. The 1986 failure of a deposit-taking cooperative (DTC) that held only 0.2 percent of the banking system's total deposits led to runs on other DTCs. Twenty-four DTCs (2.1 percent of total deposits) were judged insolvent, and all twenty-four were rescued. Three ailing commercial banks, with 5.2 percent of total deposits, were recapitalized during 1985–86.

Nepal. In early 1988 the reported arrears of three banks (95 percent of the financial system) averaged 29 percent of all assets.

Norway. Commercial and savings banks suffered heavy losses in 1987 and 1988 owing to the collapse of
Box 5.1 (continued)

the price of oil and to imprudent lending. The authorities replaced the management and board of a leading bank and forced banks to write off bad loans, restructure their operations, raise new capital, and merge with other institutions.

Pakistan. Under old regulations, which allowed indefinite accrual of income regardless of loan classification, the capital-to-assets ratios of five large banks (90 percent of the banking system) averaged 3 percent. Under new regulations the banks must make a major recapitalization effort to reach a similar ratio.

Philippines. Between 1981 and 1987, 161 smaller institutions holding 3.5 percent of total financial system assets were closed. In addition, the authorities intervened in two large public and five private banks. The public banks were liquidated in 1986, and their largest bad assets (equal to 30 percent of the banking system’s assets) were transferred to a separate agency. The five private banks are still under central bank supervision.

Spain. Between 1978 and 1983 fifty-one institutions holding nearly a fifth of all deposits were rescued; two were eventually liquidated, and the rest were sold to sound banks.

Sri Lanka. Two state-owned banks comprising 70 percent of the banking system have estimated nonperforming assets of at least 35 percent of their total portfolios.

Tanzania. In early 1987 the main financial institutions had long-standing arrears amounting to half their portfolio, and implied losses were nearly 10 percent of GNP.

Thailand. The resolution of a 1983 crisis involving forty-four finance companies that held 12 percent of financial system assets cost $190 million, or 0.5 percent of GNP. Between 1984 and 1987 the government intervened in five banks that held one-quarter of bank assets.

Turkey. A financial crisis erupted in 1982 with the collapse of several brokers, and five banks were rescued at a cost equal to 2.5 percent of GNP. Since 1985 two large banks have been restructured, but more may need to be done. Banks’ reported losses are 6 percent. According to some estimates, losses exceed 10 percent.

UMOA countries. More than 25 percent of bank credits in the UMOA countries are nonperforming. At least twenty primary banks are bankrupt; nonperforming credits are almost six times the sum of their capital, reserves, and provisions.

United States. Between 1980 and 1988 nearly 1,100 savings and loan associations (S&Ls) were closed or merged. In early 1989, more than 600 (one-fifth of all S&Ls) were insolvent, and the cost of restructuring was estimated to be roughly $80 billion in terms of present value. By 1989, 10 percent of commercial banks were on the regulators’ “watch list.”

Uruguay. After several banks failed in 1981–82, the central bank began to aid banks by purchasing their worst assets; by 1983 it had acquired $830 million in bad loans. The potential cost of recapitalizing the banks has been estimated at $350 million, or 7 percent of GNP.

1. The Union Monétaire Ouest Africaine (UMOA), or West African Monetary Union, comprises Benin, Burkina Faso, Côte d’Ivoire, Mali, Niger, Senegal, and Togo.

are solvent or that their insolvency has no economic cost—only that they remain liquid (see Box 5.2). It is possible for banks in one country to have larger losses than banks in another and still be more liquid. Thus waiting for banks to become illiquid before taking action can be costly. Indeed, in countries where government help has enabled insolvent banks to stay open, the cumulative costs of distress may well be higher than in countries where the authorities have closed or restructured insolvent banks.

Bank restructuring is not an end in itself. Banks’ losses reflect the difficulties of firms in other sectors, and these difficulties are a result not only of external shocks and subsequent policy changes but also of the development strategies pursued by many countries. Resolving firms’ problems and changing the policies that gave rise to them may prove more difficult than restructuring loss-

making banks, partly because of employment considerations. Although it is recognized that insolvency among financial institutions has deeper causes elsewhere, this chapter focuses mainly on banks’ portfolio problems—their consequences, causes, and cures.

Economic consequences of financial distress

Weakened by large losses, many financial institutions in developing countries have become less able to provide the services described in Chapter 2. Their diminished capacity to improve the allocation of resources has contributed to slow growth and has undermined some countries’ attempts at structural adjustment. Where governments have chosen to delay the restructuring of troubled firms and intermediaries, the high recurrent costs of assistance have compromised efforts to tighten mon-
etary and fiscal policy and in some cases have led to further macroeconomic instability.

**Resource misallocation**

The rising proportion of nonperforming loans has limited the volume of credit that banks can extend to new clients. Moreover, credit allocation has often become perverse, with banks extending more rather than fewer loans to their least solvent clients, especially to large borrowers. New loans to troubled firms might have been justified if the loans had been used to restructure the ailing enterprises or if the firms had not been insolvent but merely illiquid. But much new lending has simply financed the servicing of prior loans or prolonged the lives of nonviable firms. By channeling additional funds to borrowers unable to make profitable use of the resources already at their disposal, lenders have delayed the process of adjustment.

Credit misallocation caused by financial distress has been more pronounced in some countries than in others. In some countries losses built up gradually as banks, complying with government directives, continued to lend to unprofitable sectors. In other countries, however, loan portfolios deteriorated rapidly, especially in the highly indebted countries following the shocks of the early 1980s. With a large proportion of their clients suddenly in difficulty, bankers had to extend additional credit to their most troubled borrowers to stave off their own bankruptcy. Thus borrowers took on new debt to service old debt, domestic as well as foreign. In countries that experienced acute financial distress, a growing share of credit has gone toward the lives of nonviable firms. By channeling additional funds to borrowers unable to make profitable use of the resources already at their disposal, lenders have delayed the process of adjustment.

Widespread distress increases the demand for credit and therefore exerts upward pressure on real interest rates. During the 1980s real interest rates in several developing countries have often been extremely high, far exceeding the return on investment. Although various explanations for high real interest rates have been offered (including expected devaluation, unexpectedly low inflation, tight monetary policies, heavy public sector borrowing, and the reduced availability of foreign savings), the main reason firms were willing to borrow at real interest rates much higher than their return on capital was to avoid bankruptcy. The countries in which real lending rates have been highest (Argentina, Chile, Colombia, Costa Rica, Turkey, and Uruguay) are all countries in which firms and intermediaries have been under great financial stress.

**Box 5.2 Bank solvency and liquidity**

A bank is solvent if the value of its assets is greater than the value of its liabilities to depositors and other creditors; “net worth” is the amount by which assets exceed liabilities. The larger a bank’s net worth, the larger its cushion against insolvency—that is, the larger the fall in asset values that the bank can sustain and still be solvent. Bank supervisors try to ensure that banks have adequate capital, which is often defined as some minimum fraction of total or risk assets. If the required capital-to-assets ratio is 5 percent, for example, a bank with $100 million in assets and $98 million in liabilities (hence a net worth of $2 million) would be instructed to find $3 million of additional capital to bring net worth up to $5 million. Many banks in developing countries are insolvent and unable to earn the large sums needed to regain solvency; the negative net worth of some of these banks is many times their capital.

A bank is liquid as long as it can meet day-to-day operating expenses and withdrawals. Because it is highly leveraged, a bank can remain liquid long after becoming insolvent. That some countries have not experienced runs does not signify that their banks are sounder than banks in countries where runs did occur but merely that they are more liquid. Public ownership of banks, implicit or explicit deposit guarantees, periodic provision of liquidity to weak banks, and macroeconomic stability make depositors less likely to withdraw funds from insolvent banks and thereby help those banks to remain liquid.
mired some countries’ efforts at structural reform. Successful adjustment largely depends on the release of resources from less productive uses and their redeployment to more productive firms. Continued lending to unprofitable firms has impeded this flow. As a result the resources needed to finance investments made profitable by policy changes, such as devaluations and tariff reductions, have not been available. This has delayed recovery from recession in the short run and, by misdirecting resources that could be used for investment, has slowed future growth.

**Macroeconomic consequences of financial distress**

In the nineteenth century, before the advent of deposit insurance and official lenders of last resort, financial distress was usually deflationary. Rumors of bank insolvency precipitated bank runs, which forced even solvent banks to call in loans. This resulted in a contraction of the money supply and a corresponding fall in economic activity. Today central banks in developing countries are well versed in providing liquidity to the financial system. They have succeeded in stemming incipient runs on banks, as in Chile in 1983 and Malaysia in 1986. Occasionally deposits have shifted suddenly from one class of intermediary to another perceived as safer. In Argentina in 1980 depositors moved their holdings from domestic private banks, several of which had failed, to state- or foreign-owned banks. Such shifts created difficulties for the deposit-losing institutions, but the monetary authorities had the means to avoid sharp declines in total liquidity.

The existence of a lender of last resort has enabled countries to avert banking panics, but the financial distress of recent years has nevertheless contributed to macroeconomic instability, particularly in the highly indebted countries. Unlike in the nineteenth century, however, falls in output have typically been associated with expansions rather than contractions of the money supply. The weakness of firms and financial institutions has made it difficult for many governments to tighten monetary or fiscal policy without making matters worse for ailing banks. Thus, even as many countries were attempting to redress macroeconomic imbalances through fiscal and monetary restraint, the need to assist troubled banks and their borrowers compromised the governments’ efforts. Subsidies to state-owned financial institutions in the Philippines, for example, were equivalent to 3.4 percent of GNP in 1986, which made it difficult for the government to reduce its budget deficit.

Many governments have aided banks by transferring to the central bank the foreign exchange risk on banks’ foreign currency liabilities. The central bank exchanged liabilities denominated in domestic currency for liabilities denominated in foreign currency. Later, depreciations of the domestic currency resulted in valuation losses for the central bank. These losses had an indirect expansionary effect because banks were required to pay the central bank less than the amount needed to buy the foreign exchange to cover their obligations. To buy the necessary foreign exchange, the central bank then had to print money. In some countries the difference between what the central bank paid on foreign obligations and what it received from banks and governments has accounted for a large share of monetary expansion. The central banks of Costa Rica, Ecuador, and Yugoslavia had losses that sometimes exceeded the amount of new credit extended by the domestic banking system (see Figure 5.2).

A handful of countries (Argentina, Bolivia, and Yugoslavia among them) tried to alleviate financial
distress by lowering interest rates. Lower deposit rates, however, contributed to inflation and capital flight by encouraging holders of wealth to turn away from domestic financial assets toward goods or foreign financial assets. The process of disintermediation and the declining demand for domestic financial assets compounded banks’ difficulties, and the declining demand for money also amplified the inflationary effects of excessive money creation.

Financial distress may not be the principal cause of inflation, but the complex interaction between financial weakness and macroeconomic policy is certainly important. Distress and inflation are mutually reinforcing. Measures to assist banks have frequently added to inflation and thereby aggravated the distress they were meant to relieve. Resolving the banks’ portfolio problems and preventing their recurrence calls for a clearer understanding of why so many firms are unable or unwilling to service their loans.

Roots of financial distress

Explanations of firms’ financial difficulties can be grouped under three headings: macroeconomic conditions, industrial and financial policy, and debtor and creditor behavior. The importance of macroeconomic factors is clearest for the countries with large external debt burdens. The countries with the most acute domestic financial distress have generally been those with the most severe foreign debt difficulties. The external shocks that led to the international debt crisis and the policy adjustments that came after it left many domestic firms unprofitable and unable to service their debts, domestic or foreign.

The macroeconomic shocks of the early 1980s are only a proximate cause of financial distress, however. The financial and industrial policies pursued by many countries during the 1960s and 1970s left their financial systems weak and vulnerable to change. Banks were often directed to provide subsidized credit to firms in favored regions or sectors. In some countries firms in priority sectors have been consistently unprofitable. In others they were profitable only as long as they were protected; today such firms account for a large proportion of nonperforming loans.

In most cases macroeconomic conditions, directed credit programs, and interest rate controls are the principal factors underlying the current difficulties of firms and their creditors (as discussed in Chapter 4). But they are not the only factors. Many
governments gave too little thought to the ways in which concentration of risk, the quality of information flows, the adequacy of legal codes, and the nature of the regulatory environment can affect financial efficiency. Inattention to these issues has permitted borrowers and lenders to behave in ways that have contributed to banks' losses.

An important aspect of borrower behavior has been the tendency of certain groups of firms in developing countries to become highly leveraged. Chapter 4 concluded that the high leverage of these firms is partly a result of their governments' directed credit programs. The availability of credit at low or negative real interest rates discouraged the expansion of domestic deposits and gave borrowers a strong incentive to take on debt—an incentive reinforced in most countries by tax codes and by the lack of developed equity markets. Because credit was rationed, only firms with privileged access to lenders could become highly leveraged. One group of privileged borrowers consisted of firms in priority sectors, including public enterprises, another of firms belonging to industrial-financial conglomerates. Where banks were privately owned, the rationing of subsidized credit encouraged companies to buy their own banks in order to secure the advantages of cheap credit by lending generously to themselves.

A drawback to higher leverage was that firms became more vulnerable to a decline in earnings or a rise in interest rates. The firms most embarrassed by the decline in their profits and cash flows in the early 1980s were already highly leveraged at the beginning of the economic downturn. Many of these made matters worse when they reacted to declining sales and cash shortages by borrowing more rather than by cutting costs (laying off workers and closing plants, for example). Some expected the economic downturn to be short-lived and so considered borrowing to be their best strategy. Some on the brink of bankruptcy saw additional borrowing as their only course. Others, in countries with a history of government bailouts, gambled that the government would intervene to assist overindebted firms. This assumption often proved well founded. For example, the Korean monetary authorities, in 1972 and again in 1982, lowered lending rates because the prevailing rates were endangering too many borrowers. In Turkey public enterprises in financial straits have regularly received large budgetary transfers. In Chile the central bank granted generous terms to banks refinancing the debt of distressed but viable borrowers.

Firms could borrow more only if their bankers let them. Bankers often did cooperate when a financial institution belonged to the same conglomerate as its clients. In Chile, Colombia, Spain, and Thailand, for example, most bad loans were to related companies. Government-owned banks were often told to continue lending to public enterprises and priority sectors—another example of at-less-than-arm's-length credit negotiations. Other bankers continued to lend to unprofitable firms, particularly large ones, to prevent them from going bankrupt and in turn bankrupting the banks. Examination of failed and troubled banks has almost invariably revealed this type of mismanagement (see Box 5.3).

Bankers have been influenced by the authorities in other ways. Although only a few developing countries (Colombia, India, Kenya, the Philippines, Trinidad and Tobago, Turkey, and Venezuela) have explicit deposit insurance schemes, it became clear that governments would at least protect deposits in government-owned banks and the bigger private banks. Despite the difficulties of the 1980s, in only a handful of countries have depositors lost money. Implicit deposit insurance averted bank runs, but in doing so it removed the discipline associated with that threat. Depositors' lack of concern about the riskiness of bank portfolios has allowed undercapitalized banks to stay in business and encouraged bankers to take bigger risks. The smaller the amount of shareholder capital at stake, the more willing bankers will be to "bet the bank" by financing risky projects.

Mismanagement and speculative behavior persist because prudential regulation and supervision are inadequate in many countries. Prudential regulation has two purposes: to prevent excessively risky behavior by lenders in the first instance and, should portfolio problems develop, to force lenders to address them promptly. In most countries, however, inadequate regulation has permitted risky lending, and ineffective supervision has permitted banks to ignore their losses. For want of timely and reliable accounting information, the authorities lack a clear picture of the health of the intermediaries under their supervision. Effective supervision is particularly important in financial liberalization because newly deregulated intermediaries are likely to engage in less familiar, and therefore more risky, types of lending. Box 5.4 argues that the combination of deregulation and inadequate supervision has proved costly in the case of the U.S. savings and loan industry. Chapter 9 contains further discussion of the experience of
Box 5.3 How good bankers become bad bankers

The quality of management is an important difference between sound and unsound banks, and in most countries the better-managed financial institutions have succeeded in remaining solvent. Four types of mismanagement commonly occur in the absence of effective regulation and supervision.

- **Technical mismanagement.** Poor lending policies are the most common form of technical mismanagement and are usually a consequence of deficient internal controls, inadequate credit analysis, or political pressures. Poor lending policies often lead to excessive risk concentration, the result of making a high proportion of loans to a single borrower or to a specific region or industry. Banks sometimes lend excessively to related companies or to their own managers. Mismatching assets and liabilities in terms of currencies, interest rates, or maturities is another common form of technical mismanagement.

- **Cosmetic mismanagement.** A crossroads for management is reached when a bank experiences losses. Strong supervision or a good board of directors would ensure that the losses are reported and corrective measures taken. Without these, bankers may engage in "cosmetic" mismanagement and try to hide past and current losses. There are many ways to do this. To avoid alerting shareholders to the difficulties, bankers often keep dividends constant despite poorer earnings. And to keep dividends up, bankers may retain a smaller share of income for provisions against loss, thereby sacrificing capital adequacy. If a dividend target exceeds profits, bankers may resort to accounting measures that increase net profits on paper, even if more taxes must be paid as a result. By rescheduling loans, a banker can classify bad loans as good and so avoid making provisions. The capitalization of unpaid interest raises profits by increasing apparent income. The reporting of income can be advanced and the recording of expenditure postponed.

- **Desperate management.** When losses are too large to be concealed by accounting gimmicks, bankers may adopt more desperate strategies. The most common of these include lending to risky projects at higher loan rates and speculating in stock and real estate markets. Such strategies, however, involve greater risk and may well lead to further losses. The problem then becomes one of cash flow: it gets harder to pay dividends, cover operating costs, and meet depositors' withdrawal demands with the income earned on the remaining good assets. To avoid a liquidity crisis a bank may offer high deposit rates to attract new deposits, but the higher cost of funds eventually compounds the problems.

- **Fraud.** Fraudulent behavior sometimes causes the initial losses, but once illiquidity appears inevitable, fraud becomes common. As the end approaches, bankers are tempted to grant themselves loans that they are unlikely to repay. Another common fraud is the "swinging ownership" of companies partly owned by the bank or banker: if a company is profitable, the banker will arrange to buy it from the bank at a low price, and if the company is unprofitable, the banker will sell it to the bank at a high price.

several developing countries that liberalized their financial sectors.

The lack of clear legal procedures for dealing with insolvent banks has been another obstacle to prompt action. In Argentina, for example, the Central Banking Act did not empower the central bank to take over banks, replace managers and directors, or order owners to provide new capital. As a result, intervention led to numerous lawsuits.

The difficulty of foreclosing on defaulting borrowers has caused losses for many banks. In some countries willful default is encouraged by the fact that bankruptcy and foreclosure procedures are slow and cumbersome. In Egypt, Pakistan, Portugal, and Turkey, for example, loan recovery proceedings frequently drag on for several years (see Box 6.4 in Chapter 6). In others, willful default has a more political cause: borrowers in priority sectors such as agriculture realize that governments are reluctant to let lenders foreclose. The default rate among small farmers in Ghana and India, for example, has been particularly high.

In sum, poor prudential regulation and supervision, together with inadequate legal systems, let lenders and borrowers in many countries behave in ways that have added to banks' losses.

**Lessons of financial restructuring**

As the 1980s proceeded, the distress of financial institutions in some countries precipitated crises and so forced the authorities to take action. As Box 5.1 indicates, intervention ranged from the closing of a few intermediaries with a small fraction of total assets, as in Malaysia, to the closing and replacement of nearly every bank, as in Guinea. During the next few years many more countries—especially those contemplating broader programs
of structural reform—will face difficult choices concerning the restructuring of their domestic financial institutions and the reshaping of their financial systems. Even some countries that have already taken steps may find further intervention necessary because many institutions still in operation are insolvent.

Restructuring a financial system is both a challenge and an opportunity. Not all institutions are worth recapitalizing; some need to be closed or merged with healthier ones. Restructuring gives countries a chance to build financial systems that can better provide the services their changing economies need.

Rationale for intervention

During the 1980s more than twenty-five developing countries have undertaken extensive reorganizational of their financial institutions. In most cases financial crises had occurred or were imminent, and governments could not stand aside. Other countries, such as Pakistan and Sri Lanka, have not experienced crises but have nonetheless taken steps to strengthen their financial systems. Several of the centrally planned economies have decided to reorganize their financial systems to make them more efficient and competitive. Many governments, however, have been reluctant to take action, and their delay has led to continued losses at the institutional level and slower recovery at the macroeconomic level.

The authorities in some countries may be unaware of the seriousness of the situation, since a bank’s poor health is not always apparent from its audited financial statements. Even when governments understand the problem, they are often unwilling to act. Some may hope that intervention...
will not be necessary because defaulting borrowers will start to repay or because banks will make adequate provisions for their bad loans. But, as Box 5.5 argues, the likelihood of spontaneous recovery is low. Other considerations—the budgetary costs of restructuring, issues of fairness in allocating the losses, the embarrassment of bad loans made to public enterprises or political allies, or fear of bank runs—also lead governments to ignore the problem as long as they can.

If there is no crisis, should governments intervene merely to relieve financial distress? One reason most may have to is that earlier interventions have made a market solution unlikely. By providing implicit or explicit deposit guarantees and by regularly granting assistance to troubled banks and firms, governments have suppressed the market forces that otherwise would have eliminated or reorganized unprofitable firms and allocated the associated losses. Until governments take the further step of performing the market’s loss-allocating function, losses will continue. As losses mount, so do the costs of supporting the loss-making institutions. The continuing costs of periodic support will eventually outweigh the one-time cost of restructuring.

Governments can either take the next step, by performing the market’s loss-allocating function,
or take a step in the other direction, by withdrawing deposit guarantees and ending financial assistance to unprofitable intermediaries, so that the problems have to be resolved by the private sector. Once losses have become substantial, a market-imposed solution is likely to be costlier than government action because it could lead to bank runs and the loss of foreign credit lines. Events in Argentina, Chile, Colombia, Thailand, and Turkey illustrate the difficulty. After initially allowing creditors of failed institutions to lose money, the authorities in each country were forced to extend assistance to prevent widespread bank runs. Prompt government action is thus the less costly route, in terms of both the economic costs of continued resource misallocation and the accumulated financial losses that the government is likely to end up bearing.

Aspects of intervention

The central aim of intervention to relieve financial distress has not been to protect the interests of bank managers or bank owners or even to preserve particular banks as institutions but rather to keep the financial system as a whole in operation. Rehabilitating insolvent financial institutions has been the first step in that process. Most governments chose to close only small banks; larger ones, particularly those that were critical elements of the financial system, were merged or recapitalized.

Intervention has consisted of across-the-board relief, case-by-case restructuring, or a combination of the two. Case-by-case restructuring requires manpower, skill, and time, as the authorities must make management-level decisions concerning the fate of individual institutions. If, in addition, the costs of information and of bargaining with creditors are high, an across-the-board approach may look attractive. It seems faster, and it may be politically more palatable because it is less obvious who gains and who loses.

One across-the-board solution is to generate inflation deliberately to reduce real debt burdens. This happened in Argentina between 1981 and 1983. Another is for the authorities to absorb the banks' foreign exchange losses, as in Costa Rica, the Dominican Republic, Ecuador, and Yugoslavia. Across-the-board intervention, however, has usually proved wasteful. Since financial distress has seldom been evenly distributed among lenders or borrowers, much of the relief has gone to firms and intermediaries that did not need it. More important, troubled borrowers and banks usually need restructuring, not just financial assistance. Restructuring is feasible only as part of a case-by-case approach.

Information flows. Most countries have discovered that the information needed to judge the intermediaries' financial condition is either unavailable or unreliable. In only a few developing countries is bank supervision sophisticated enough to indicate the quality of an institution's earnings and portfolios. Even banks' audited statements are often misleading: interest is accrued whether it is received or not, nonperforming loans are rolled over, and new loans are provided to cover unpaid interest. Even banks with very few performing loans may report profits and pay taxes and dividends. One large state-owned bank in Latin America, for example, showed positive earnings for 1987, but three months after publishing its accounts its managers admitted that 60 percent of all loans were nonperforming. Insolvent, illiquid, and unprofitable, the bank lost approximately $100 million during 1987 alone.

Despite the poor quality of financial statements, in countries with serious financial distress there were usually warning signals. Some institutions offered deposit rates higher than those offered by other intermediaries, a sign that they were short of cash. At the macroeconomic level, real interest rates well above the average return on investment suggested that many firms were short of funds and were borrowing to remain in business. In some countries the failure of smaller institutions such as finance companies and new banks provided further evidence of widespread distress. Normally, governments tax banks through various mechanisms, including reserve requirements. Where loan portfolios deteriorated, however, the authorities were forced to cut the rate of taxation. As the amount of assistance to troubled banks increased, central bank profits declined, and some central banks even sustained large losses.

In short, acute distress has generated signals ranging from high real interest rates, widening interest rate spreads, a decline in the ability of banks to satisfy reserve requirements, and complaints from established borrowers about the scarcity of credit to the more obvious sign of failures among smaller intermediaries. Even if a central bank lacks the precise information that a good system of supervision would provide, it can hardly be unaware of widespread distress.

Better information about banks' portfolios gives the authorities a clearer idea of the intervention
that may be necessary. The authorities in several countries, among them Bolivia and Ghana, commissioned external auditors to conduct independent audits of domestic banks. But lack of precise information is not a reason to refrain from taking action. The government of the Philippines relied upon the management of the two largest banks (the Development Bank of the Philippines and the Philippine National Bank, which are publicly owned and together hold about half of the banking system's assets) to identify nonperforming assets. It then assumed responsibility for all nonperforming loans above a certain value, along with a corresponding amount of liabilities.

At the heart of any review of a bank's financial condition is the issue of accrual of unpaid interest and the provisioning of loans. Because loan rollovers and interest capitalization have been common, the quality of loan portfolios can be judged only if loans are classified by the probability of their being serviced rather than simply by whether they are current or in arrears. In practice, adjusting for accrued but unpaid interest has been the single largest correction to banks' accounts following intervention. This underlines the importance of forcing banks to stop accruing interest and to make provisions for bad loans as soon as debt service is interrupted.

**Allocating losses.** Once governments intervened, they had to decide how to allocate losses in excess of capital and provisions. Regardless of formal obligation, most governments protected depositors against loss to avoid bank runs. Foreign creditors were also protected, even where they had lent to domestic banks without the benefit of government guarantees, as in Chile. Taxpayers had to absorb the losses instead.

Most governments have decided that management as well, in the hope that new managers, distanced from the mistakes of the past, will be able to make the changes necessary to restore the banks to profitability. In addition to loan foreclosure and recapitalization, measures to lower operating costs and improve profitability were needed—for example, closing branches and reducing staffing levels, establishing new interest rate structures, and eliminating loss-making activities. The Development Bank of the Philippines cut its staff by 50 percent, closed thirteen of its seventy branches, and plans to privatize all but thirteen of its remaining branches. In Guinea the number of people employed in the financial sector fell from 2,350 to 530, and lending to the public sector (including state-owned enterprises) has virtually ceased.

Failure to hold bank owners and managers responsible for past problems may encourage excessive risk taking in the future and thereby cause further financial instability. In large markets such as the United States, finding new owners and managers willing to take over weak institutions is usually straightforward, but in smaller markets there may be few potential buyers and few managers with the necessary expertise. Moreover, arranging the transfer to new management may take some time. So governments have sometimes found themselves responsible for the institutions in which they intervened. Both the Spanish and Chilean governments, for example, became the owners and operators of several restructured banks until suitable buyers were found.

**Cost considerations.** At the time of intervention the economic costs of financial distress have already been incurred in the form of poor past investments and slower growth in output. Restructuring has no economic cost. On the contrary, it brings an economic gain in that the economy may once again enjoy the benefits of a well-functioning financial system. The budgetary cost of restructuring consists of the government's cash outlays, which are a transfer from taxpayers to the creditors of insolvent banks.

This cost has depended on the extent to which the banks' losses exceeded their capital. In the United States, for example, the expected cost of dealing with the remaining insolvent S&Ls is equivalent to approximately 2 percent of GNP, and in Spain the estimated losses of banks were equivalent to 16.8 percent of GNP. In some developing countries banks' losses as a percentage of GNP
have been even larger. The cost of paying off depositors has been one reason most governments have chosen to close small banks and rehabilitate the bigger ones.

To make insolvent intermediaries solvent again, governments took over bad assets. In some cases they acquired bank liabilities at the same time; in others they replaced the bad assets with good ones. The authorities in the Philippines chose the first approach; they drastically shrank the balance sheets of the two largest banks by assuming 76 percent of their assets and a corresponding share of their liabilities. The second solution was more common, however; governments bought bad assets in exchange for long-term government securities, and the interest on the securities was then used by banks to pay interest on deposits. This method was used, for example, in Chile. Buying the bad assets for cash would have been too large a fiscal outlay and might have added to inflation by expanding the money supply.

Over time, restructuring costs are bearable, even for a country in which the bad assets acquired by the authorities amount to as much as 20 percent of GNP. In such a case, if the real interest rate paid on government bonds is 5 percent, the annual real cost to taxpayers will be 1 percent of GNP. And that figure may exaggerate the additional cost to the taxpayer. In most cases the government has already been paying some form of subsidy to help banks cover their losses. Furthermore, it may be able to realize something on the nonperforming assets.

Once the authorities have acquired the bad assets, they must decide what to do with them. A mechanism is needed to pursue bad debtors and dispose of physical assets taken over in foreclosure proceedings. Central banks have generally proved ineffective at recovery and liquidation. One possibility is to commission the banks that made the original loans to handle them on behalf of the central bank, but this has worked only when the banks were under new management and freed from the obligations of previous relationships. Another course, followed by the Philippines, is to establish an independent recovery agency with its own funding and staff.

Over the longer run, many countries have decided that their central banks should not be responsible for intervening in banks, ordering recapitalization, changing management and directors, or handling the disposition of nonperforming loans and the liquidation or merger of insolvent banks. Some countries have set up specialized institutions to handle these tasks. In the United States they are carried out by the deposit insurance agencies, which collect premiums to cover the losses of insolvent intermediaries. In keeping with their obligation to cover those losses, the insurance agencies have the power to inspect insured banks. The advantage of an insurance arrangement is that, in principle, it shifts the cost of monitoring intermediaries and covering their losses from the government to the financial system and codifies the procedure for dealing with troubled institutions. This is likely to produce quicker action than the ad hoc approach of most developing countries.

Restructuring borrowers. The portfolio problems of financial institutions reflect the difficulties of their clients. If loss-making firms are not restructured, the newly recapitalized banks that lend to them will eventually become insolvent again. Restructuring indebted borrowers is harder than restructuring financial institutions. Bank restructuring may involve closing branches and laying off personnel, but it mostly entails rewriting paper claims. Restructuring companies raises the same difficult issues of management, ownership, and fairness that have to be addressed in the case of banks, but it also calls for decisions about the viability of firms, the restructuring of physical assets, and the disposition of large numbers of employees.

Because recapitalized banks are in a new position of strength with regard to their former clients, they can refuse to lend money to those they think nonviable. Thus, in principle, restructured financial institutions have an important role to play in the restructuring of loss-making firms. But if the private sector's restructuring skills are undeveloped, if the borrowers in need of restructuring are large, or if the legal system is weak, governments may have to play a more active role, perhaps with the help of outside experts. Box 5.6 provides an example of the complexities that can be involved in restructuring a large, overindebted firm.

Reforming the financial system

The present frailty of financial institutions in many developing countries is the visible expression of a complex set of problems. Financial distress in many cases was precipitated by the macroeconomic shocks of the 1980s, but its roots lie in the development strategies followed since the 1960s. Banks in many countries were directed to provide subsidized credit to priority sectors and public en-
Box 5.6 Restructuring a large corporation: a Mexican example

The Valores Industriales S.A. (VISA) group, an integrated beverage and consumer goods conglomerate with more than 40,000 employees, is one of Mexico's largest industrial concerns. During the late 1970s VISA borrowed heavily to finance ambitious expansion and diversification plans, but by 1987 it could no longer service its debt. Like other Mexican companies that had borrowed abroad, VISA was hurt by devaluation, high interest rates, and the recession that began in 1982. As debt service began to consume most of its severely depressed cash flow, investment plans had to be postponed and basic maintenance expenditure reduced to a minimum. The consequent decline in efficiency and productivity made matters worse, and in early 1987 VISA engaged the International Finance Corporation (IFC) to help it formulate a restructuring proposal that would restore the conglomerate's viability and reduce its $1.7 billion debt to a sustainable level.

Eighteen months of negotiations among the existing shareholders and creditors, Mexican government agencies, and new investors and creditors produced a complex restructuring agreement. VISA was to merge two large companies—fully integrating their manufacturing facilities—redeploy some of its other installations, and reorganize its administration. In addition, several non-core businesses would be sold.

VISA offered its creditors a variety of options, including debt buybacks at a discount, debt-for-debt swaps (including exchange of VISA debt for sovereign debt), and debt-to-equity conversions. The array of options made it easier for VISA to meet the needs of its sixty-seven creditors, who held varying views of VISA's future profitability, had different liquidity preferences, and faced different accounting and loss provision regimes. Creditors were also permitted to trade claims among themselves. Some creditors chose to receive cash for their claims, at a substantial discount from face value. Others rescheduled $153 million at floating market rates and $75 million at lower fixed rates and also received an equity stake in the restructured company.

To finance its restructuring and debt reduction program, VISA raised $334 million in cash from new and existing shareholders and investors. Of this, $135 million came from new long-term loans, $36 million from bond sales to the Mexican public, and $5 million from public share offerings in the Mexico City Stock Exchange; the sale of assets (including automotive parts firms and hotels) brought $108 million, and a foreign institutional investor bought a $50 million equity stake.

The restructuring restored VISA's competitiveness and reduced its debt from $1.7 billion to $0.4 billion, leaving it a viable concern. The success of its negotiated debt reduction program was based on the sharing of losses between lenders and shareholders. Many more firms in developing countries will have to go through similar reorganizations to become viable.

Enterprises and often were not permitted to foreclose on defaulting borrowers; occasionally the process was more political than developmental, with loans being made to friends of the government. Many loans went to industries in which countries had no comparative advantage and which were profitable only as long as they were protected. By the 1980s many firms became unable to service their debts. This is not to suggest that all directed loans were mistakes; many were successful. Financial institutions are highly leveraged, however, and so can be bankrupted if even a small fraction of their loans go bad. The inadequacy of prudential regulation and supervision meant that most institutions were not made to take adequate provisions or write off bad loans, and their books gradually became a catalogue of past mistakes.

Problems at the microeconomic level were exacerbated by macroeconomic policy in many countries. Interest rate ceilings hindered the growth of financial systems and encouraged capital flight. Overly expansionary fiscal policies led governments to borrow heavily at home and abroad. Financial distress has been most serious in countries with large external debts. Domestic borrowing in those same countries crowded out private sector borrowing and produced inflation. In countries with greater macroeconomic stability, financial distress tends to be chronic rather than acute.

Economic recovery requires the restructuring of financial intermediaries and insolvent firms. It also requires a policy environment in which finance can become less a tool for implementing interventionist development strategies and more a voluntary market process for mobilizing and allocating resources. The success of that transition depends partly on increasing lenders' confidence that future financial contracts will be honored, which in turn calls for an improvement in the ability of lenders to assess risk and to enforce contracts. This is the subject of the next chapter.