6 Foundations of financial systems

If financial systems are to be efficient and robust, they must be set within a suitable legal and regulatory framework. The difficulties of financial institutions in developing countries, discussed in Chapters 4 and 5, have much to do with weak legal systems, a lack of reliable financial information, and inadequate prudential regulation. A system of laws and regulations is needed to promote the use of contracts that are clear about the rights and obligations of contracting parties, to encourage discipline and the timely enforcement of contracts, and to foster responsible and prudent behavior on both sides of the financial transaction. Prudent and efficient financial intermediation calls for reliable information on borrowers, so adequate accounting standards and auditing arrangements are essential. Governments must also ensure that financial institutions (especially if they take deposits from the general public) are acting honestly. These are the objectives. This chapter examines the measures that can help to achieve them.

Financial contracts and debt recovery

Since ancient times, lenders have insisted upon appropriate assurances of repayment. Their difficulty has been that although they have considerable bargaining power before they enter into a loan agreement, the borrower is in the stronger position once the money is handed over. The borrower may waste or misuse the funds or simply refuse to repay.

Under early Roman law, if the debtor did not pay within a specified time after judgment had been passed, creditors were at liberty to dispose of the matter by selling him into slavery or executing him. Later Roman law viewed this as rather harsh and introduced a procedure whereby the whole of the debtor's property could be seized and sold, but the debtor was still not discharged from his liabilities. Eventually, voluntary bankruptcy proceedings with full discharge were introduced for the unfortunate borrower who could prove that his embarrassment was due to forces beyond his control.

By the fourteenth century, after the rediscovery of the Justinian codes of Roman law, debt recovery in Italy and Spain was based on Roman proceedings. These later influenced most of the countries of continental Europe. Under English common law, remedies were harsher. Defaulting debtors were usually imprisoned during the Middle Ages, and no distinction was made between honest but unfortunate debtors and dishonest ones. More lenient treatment of honest debtors was first introduced by statutory law in the sixteenth century. Debtor prisons remained common almost everywhere well into the nineteenth century, but have since been abolished (or at least used only in cases of fraud).

Industrial countries introduced far more complex bankruptcy statutes during the nineteenth century to deal with a larger number of different creditors. And in the twentieth century, with the emergence of large corporations, reorganization rather than liquidation became an important objective of bankruptcy statutes—first in the United States and more recently in other countries as well.

Apart from these ultimate remedies, creditors have traditionally made extensive use of collateral (mortgages, floating charges, liens, and so forth) and personal guarantees to reduce the probability and cost of default. Consequently, annual loan losses of commercial banks in industrial countries have typically been less than 1 percent of outstanding balances (which has helped to keep total intermediation costs at less than 4 percent). Nonperforming loans in many developing countries are now 20 percent of total loans and in some cases more. Profitable lending becomes almost impossible at these default rates, because few investments will yield returns high enough to cover the interest that must be charged (see Box 5.5 in Chapter 5). Only optimistic speculators or borrowers who intend to defraud the lender would be willing to borrow large sums at real rates of interest in excess of 10 or 15 percent.

The ultimate security of the lender is the commercial success of the borrower. This should be the primary basis for the decision to lend. But it is often difficult for lenders to assess the probability that a project will succeed. People who write eloquent loan and project proposals are not necessarily good managers or entrepreneurs, and vice versa. Bankers have thus traditionally been very conservative in their lending decisions and have relied largely on the track record of loan applicants. This inevitably meant that people with substantial wealth could borrow more than others. Since wealth can be acquired by inheritance as well as by entrepreneurial gifts, the governments of many developing countries viewed lending on the security of personal property as in conflict with their development objectives. For example, the Tandon study group appointed by the Reserve Bank of India pointed out in the early 1970s that "nationalization of the major commercial banks . . . called for a new policy with respect to deposit mobilization . . . and equitable disbursal of credit. The banking system was asked to adopt a new approach as a credit agency, based on development and potential rather than on security only, to assist the weaker sections of society . . . the security-oriented system tended to favor borrowers with strong financial resources, irrespective of their economic function" (Banking Laws Committee 1978, p. 77). This approach overlooks the fact that credit decisions are rarely the best way to deal with social inequities.

Developing the legal foundations

The development of clear legal rules concerning the economic rights and obligations of different agents should go hand in hand with economic and financial development. In rural societies local sanctions have played an important part in limiting dishonesty by contracting parties (see Chapter 8), but urbanization has made local sanctions less effective. More complex rules and regulations are required to govern the impersonal relations of modern commercial life. And the emergence of large corporations has called for a continuously evolving set of rules to resolve the shifting conflicts of interest among shareholders, managers, bondholders, employees, and consumers.

Most developing countries have legal systems that were imposed during colonial rule. These were often at odds with local custom. Indonesia's sophisticated system of customary *adat* law uses legal concepts (for example, with respect to land tenure) that are quite different from those in the civil and commercial codes imported by the Dutch. Under the Dutch, adat law applied to Indonesians and Dutch law to Europeans and modern institutions such as companies and banks (since adat law does not cover loan contracts or similar transactions). These parallel systems are still in use today. Inevitably, they cause conflict and uncertainty, and weak judicial administration has compounded the problems. As a result the legal system has a diminished role in the settlement of disputes. Even in countries with only one legal system, the difficulties can be severe. A report of the Indian Banking Laws Committee (1978, p. 76) observed that "the present chaotic state of our credit-security law, particularly of our personal property security law, is primarily due to the application of archaic principles and concepts of Common Law developed a century ago."

In contrast to other developing countries, Korea and Thailand have imported and adapted foreign legal systems on their own initiative. Korea enacted new codes based on German law in 1958 and 1962 (see Box 6.1). Thailand adopted a civil and commercial code based on the French and German codes in 1923. Japan had done the same in 1898 and 1899. In all three cases local customs and polit-

Box 6.1 Civil and commercial law in Korea

Korea is one of the few countries that have introduced a comprehensive Western system of law on their own initiative. Like China, Korea was traditionally a Confucian society in which relations were structured not according to law but according to ideas of familial hierarchy, with the king or emperor at the top. After a period under Japanese domination (and Japanese civil law), the newly independent Republic of Korea set out to devise an entirely new legal framework. New civil and commercial codes were enacted in 1958 and 1962. Both were modeled largely on the German civil and commercial codes but contained significant changes to reflect local customs and traditions, particularly with regard to family law and succession. The Korean codes introduced some interesting innovations. For example, Korean law permits the use of mortgages on real property to secure future advances under a line of credit—a useful device that is not usually allowed by civil law.

Like most other civil codes, modern Korean law distinguishes between ordinary people and merchants; the commercial code applies only to the latter. Contractual obligations are more clearly defined than in most other developing countries, and enforcement is swift. Reorganization and bankruptcy are modeled on the U.S. bankruptcy code, which emphasizes the rehabilitation of a corporate debtor rather than the distribution of its assets to creditors.

ical conditions when the new codes were introduced were quite different from those prevailing in the countries whose legal systems were used as models. But the need to furnish their economies with a legal infrastructure that would facilitate exchange and financial intermediation was pressing. All three governments adapted the foreign codes to local customs (particularly with respect to family law) and to economic circumstances.

In some countries inherited legal systems have not been updated to meet the changing needs of the economy. In addition, commercial laws may be weakly enforced because of cumbersome procedures or because inadequate resources are devoted to the task. But just as too few rules can create uncertainty, so can too many—especially if they keep changing.

To make their legal systems more effective, governments need to provide for acceptable collateral (an issue closely related to the assignment and transferability of property rights), to rationalize company legislation (especially with regard to disclosure of information and bankruptcy and reorganization proceedings), and to strengthen law enforcement. Contract performance can be improved by making breach of contract more costly. Provision of security, such as pledged or mortgaged assets and third-party guarantees, is one approach. Lenders can ensure repayment in other ways too: by attaching covenants to the loan contract, by appointing a representative to the board of directors, through contingent ownership of assets (by means of convertible debt securities, for example), and by closely monitoring the borrower.

Property rights and collateral

The legal recognition of property rights—that is, rights of exclusive use and control over particular resources—gives owners incentives to use resources efficiently. Without the right to exclude others from their land, farmers do not have an incentive to plow, sow, weed, and harvest. Without land tenure, they have no incentive to invest in irrigation or other improvements that would repay the investment over time. Efficiency can be further served by making property rights transferable. A farmer might then sell his land to a more productive farmer and take up another occupation for which he is better suited. Together, these rights to use, benefit from, and freely dispose of an asset constitute ownership.

China's rural economic reforms consisted mainly of restoring land tenure to households. Farmers in China do not own their land, but tenure is now fairly long term; it amounts to the leasehold concept of common law. Farmers can use this leasehold as collateral. The success of the reforms dramatically illustrates the benefits that can spring from changes in an economy's legal infrastructure.

Property rights are not usually absolute. The state claims a share of the benefits from the use of resources in taxes—to pay for, among other things, the protection of property rights from external and internal threats. Societies recognize many other restrictions on property rights for the common good, including the right of eminent domain to build roads, harbors, power lines, and other infrastructure. Property rights may also be limited in time—for example, through leasehold of land rather than absolute ownership or (less directly) through inheritance taxes applied to a broad range of assets.

Changes in the value of resources as a result of economic development may require an expansion and redefinition of property rights from time to time, especially since conflicts between rights over different resources cannot be fully avoided. As resources become scarcer and more valuable, property rights become more important. Gradually, they have been extended to formerly "free" goods such as pastures, water, coastal fishing zones, broadcast frequencies, geostationary satellite orbits, technical inventions, and other intellectual property. Property rights are becoming universal.

MORTGAGES. The assignment and transferability of property rights promote economic efficiency directly by creating new incentives, but also indirectly by making financial intermediation possible. They do this by allowing borrowers to offer security in the form of mortgages over real estate or other collateral. Some assets are better collateral than others. Immobile, general purpose assets, such as real estate, have very desirable properties: they cannot be easily misappropriated, and they can be quickly resold for an amount close to the purchase price. A copper smelter, in contrast, retains its value only if it can compete with other plants and the price of copper does not fall. Extensive debt financing of copper smelters is therefore risky.

When taking collateral, the lender is mainly interested in the efficient transfer of property rights, because the security is invoked only in the case of default and may deteriorate or disappear if too much time elapses before he can take possession. Mortgages over land and other real estate are therefore one of the best forms of collateral. In most countries real estate accounts for between half and three-quarters of national wealth. If ownership is widely dispersed, tenure is secure, and title transfer is easy, real estate can be good collateral for nearly any type of lending (see Box 6.2). Unfortunately, these conditions are not always met in developing countries. Land distribution is often skewed, tenure (if any) insecure, and title transfer cumbersome. One key to a smoothly functioning system of land tenure is land registers supported by cadastral surveys. In many developing countries these are still woefully inadequate or missing altogether.

Often, a loan secured with real estate will finance not the acquisition of real estate but something entirely different, perhaps a new entrepreneurial venture. The risk for the lender remains low because the borrower is bearing the entrepreneurial risk. But if the entrepreneur has no suitable collateral, the risks to the lender increase dramatically. The lender will then need far more information and perhaps a share in the proceeds if the venture proves a success. Venture capital, equity participation (with or without parallel loans), debt securities convertible into equity, and profit sharing ac-

Box 6.2 Financial and economic effects of land tenure in Thailand

Thailand has a relatively efficient system of land tenure, title transfer, and use of collateral. In 1901 the government introduced the Torrens system in which land titles are based on cadastral land surveys and registered with central land record offices. The use of land as collateral increased significantly, but land registration was concentrated in the more heavily populated areas. In the early 1960s half of the land area of Thailand was designated as national forest reserve, including land that was already being farmed. Most farmers in the forest reserve have no transferable title to their land, but the government has enforced the forest reserve policy flexibly and has not evicted farmers. About one-fifth of the farmed land does not have secure and transferable title.

Although uncertainty about continued possession does not seem to worry untitled farmers, lack of titled ownership affects their access to institutional credit. Untitled farmers cannot provide collateral and are limited to borrowing on the basis of personal or group guarantees or from moneylenders. (Moneylenders charge interest rates of 40–50 percent, compared with about 15 percent for loans from financial institutions.) In a sample study of matched groups of titled and untitled farmers, titled farmers were able to borrow on average three times more per acre of land. Secure land title not only affected the ability to obtain mortgage credit (which accounted for half of all credit among titled farmers) but also doubled access to unsecured credit.

Thanks to easier access to credit, titled farmers made significantly more land improvements and used significantly more machinery and other inputs. As a result they enjoyed 12–20 percent higher farm revenues and 12–27 percent higher productivity than untitled farmers in similar regions. The government has recently taken steps to improve land tenure for untitled farmers.

Box 6.3 Islamic banking

Several Islamic countries have recently introduced banking on Islamic principles. They include Iran, Malaysia, Pakistan, and Saudi Arabia. Islamic principles permit profit but do not allow fixed interest on deposits or loans. Nevertheless, Islamic banking can be made to work quite well and provides an interesting contrast to commercial banking practices elsewhere. In countries such as Pakistan the introduction of Islamic banking has improved the functioning of the financial system in some respects—for example, by making returns to financial instruments more market-driven.

Islamic banks offer savers risky open-ended mutual fund certificates instead of fixed-interest deposits. (This is not unlike cooperative banks and mutuals in the West, where deposits earn variable interest and double as equity.) Difficulties arise on the lending side. Arrangements to share profits and losses lead to considerable problems of monitoring and control, especially in lending to small businesses. In practice, profit sharing under *musharakah* agreements is often based on prior estimates of profit. Another way to avoid explicit interest charges is to combine commercial and financial contracts—for example, through hire-purchase arrangements or advance purchase by banks of inputs which are then resold at a markup.

Another difficulty has been to devise suitable government securities. A rather liberal interpretation of Islamic principles would permit discounted securities. Other possibilities include linking returns to nominal GDP growth or to the return on certain revenue-earning public projects.

cording to Islamic principles (see Box 6.3) are all examples of such arrangements.

In some countries other assets can serve as collateral. Inventories and other movable goods are inherently poor collateral because they have comparatively little value, are destructible, and can be sold privately and informally. They are difficult to use as collateral when left in the possession of the borrower. A partial solution is to make some goods legally "immovable" by creating special title registers. This is feasible only for a few large and high-value movables, such as ships, aircraft, motor vehicles, or industrial machines. Another solution is to store commodities of a standardized quality in certified warehouses and issue warrants. Rice warehouse warrants have been used in Japan for several centuries. The spread of such facilities in various countries has increased the use of inventories as collateral.

For goods in transit, the bill of lading can serve as security. Documentary export-import credit is an important application of this sort of collateral. Korea and some other countries have further developed this idea by creating a domestic letter of credit based on an irrevocable export letter of credit. In this way the primary exporter can extend his creditworthiness to suppliers of intermediate inputs.

Debt recovery. Legal systems in developing countries often favor the borrower by making it hard for the lender to foreclose on collateral. Originally, such provisions were intended to protect small borrowers against unscrupulous moneylenders, but today they may adversely affect the ability of state-owned commercial banks to collect on loans. This raises the costs of intermediation and weakens banks' portfolios; as a result the ability of lenders to extend loans to new and creditworthy borrowers is undermined. Creditors often have to sue the defaulting debtor for payment, which in many countries in South Asia, for example, may take several years. Once a judgment has been obtained, the creditor may then have to sue for execution of his claim. Five to eight years may pass from the date of nonpayment to the final recovery of the collateral. Pakistan is among the countries that have recently taken legal and procedural steps to speed this process (see Box 6.4).

Cumbersome recovery procedures have led to new lending arrangements that redress the balance in favor of the creditor. Hire purchase and leasing may have become popular partly because the lender retains title to the asset being financed and can take possession without any legal formalities if the borrower is late in paying. Leasing also owes its popularity to its role in circumventing interest rate controls and taxes. It has often restored access to financing that excessive bank regulation and weak legal systems had blocked.

Company law

Large enterprises have become an important part of modern economic activity in most industrial and developing countries. Today, the largest 100 corporations typically account for between 30 and 50 percent of total manufacturing production in industrial countries. Industrial concentration is often even more pronounced in developing countries.

Box 6.4 Commercial law enforcement in Pakistan

Pakistan's financial institutions have suffered badly from excessive arrears. Matters did not improve when the major commercial banks were nationalized in the 1970s. Enforcement of loan contracts in default was too slow to have much disciplinary effect on borrowers. Often it took five years or longer before the bank could foreclose on mortgaged property.

Recognizing the problem, the government established a system of special banking courts in 1979. In 1984 a corresponding system was established to deal with loan recovery for the newly introduced Islamic financing instruments. Problems remain, however. Debtors can still challenge court rulings at every step, and five-year delays can still occur. More special courts are to be established over the next two years, and their jurisdiction will be narrowed to exclude very small claims. Once a bank has obtained judgment from a special court, it will no longer have to apply separately for execution of the decree.

An institutional innovation of the nineteenth century made this possible: the general incorporation of joint-stock companies with limited liability. Until the 1850s free incorporation and limited liability were viewed with considerable skepticism. General incorporation was prompted by the large capital requirements of railway construction, which could not be met by the small private banking houses.

The new companies called for rules and regulations to protect the interests of shareholders, creditors, and other interested parties, including employees. The resulting structure of control features agents (directors or independent auditors) who monitor management on behalf of the owners; elaborate accounting, information, and disclosure procedures; disciplinary systems that align the interests of managers and owners; and a clear assignment of responsibilities. With hundreds and sometimes millions of shareholders, limited liability became essential. Individual shareholders had little influence over the affairs of the company. They had become "investors," in some ways creditors more than owner-managers. Limited liability shifted more of the risk to other creditors. As a result better bankruptcy and reorganization rules were needed too, so that creditors could take control if the company ran into difficulty. And most countries have enacted labor laws to offer employees some protection against unscrupulous owners and managers.

State or private ownership—does it matter?

An alternative to the joint-stock structure for managing large enterprises is state ownership. Some of the first big industrial enterprises and financial institutions were publicly owned. State ownership is the predominant form of industrial organization in centrally planned economies, and state-owned enterprises account for a substantial part of the economy in many other countries. In a sample of nineteen developing countries in 1984 and 1985, state enterprises accounted for an average of 13 percent of GNP and 31 percent of domestic investment; they were concentrated in capital-intensive heavy industry and utilities such as steel, chemicals, electricity, oil, and gas. Intermediate forms of "ownership" such as cooperatives, mutuals, foundations, and franchises have also become common. State enterprises in some countries are legally constituted as joint-stock corporations; some of these (but not all) seem to operate like private enterprises.

Successful public enterprises such as British Steel, Renault (before its recent difficulties), and Brazil's Empresa Brasileira de Aeronáutica (EMBRAER) are often cited as proof that public enterprises can be as efficient and innovative as private enterprises. Indeed, it is often argued that ownership does not matter as much as the independence and accountability of management and the extent of competition.

In practice, however, the form of ownership goes a long way to determine the environment within which management operates. Lines of authority and responsibility are often blurred in state enterprises. Their chief executives usually take orders from various government agencies, their freedom to reward and discipline employees is circumscribed by rules of seniority and guaranteed employment, and their own compensation is rarely linked directly to profits. Understanding these drawbacks, some governments have tried to create a self-regulating regime for their state enterprises. But the boundary between the government's domain and the market's is ambiguous. Economies of scale, externalities, and scarcity of information cause complications that may prompt governments to intervene.

Bankruptcy and reorganization

For centuries bankruptcy procedures have enabled creditors to recover their resources from debtors who defaulted. The emergence of large corporations, however, called for a new approach. When a company is having difficulty in servicing its debt, reorganizing the enterprise might yield higher returns to its creditors than closing it down and selling its assets. Reorganization might mean rescheduling its interest and principal payments, reducing its interest charges, downgrading the quality of claims against it (for example, by releasing mortgage liens or by swapping debt for equity), or reducing or canceling its debts.

Such a far-reaching modification of the rights of creditors cannot be taken lightly and can be justified only if it is in their best interests—that is, if it will make them (or society) better off than debt recovery through liquidation. Reorganization may also weaken the incentives for good performance, particularly if the present management is left in place. Reorganization becomes more difficult as the number of creditors grows. Rules are needed, for example, to ensure that a few small creditors cannot jeopardize a reorganization plan that is in the interests of the majority.

Few developing countries have well-developed laws and procedures for reorganization. Often the task is delayed and takes place only through ad hoc government intervention. Indonesia's bankruptcy code, for instance, has rarely been used. China and Hungary have recently reintroduced bankruptcy regulations because state enterprises are becoming more independent and the private and cooperative sectors are expanding. Because many developing countries are now trying to rely more on decentralized decisionmaking, market forces, the private sector, and financial intermediation, they too will need to introduce procedures for corporate restructuring that go beyond liquidation and bankruptcy. To ensure that such procedures do not encourage managers to take excessive risks, governments could devise penalties for recklessness and fraud and for concealing the insolvency of a corporation.

Timely and accurate accounts

Because financial claims cannot be fully secured, monitoring and information are essential. In informal financial markets, information is usually obtained as a by-product of other activities of the lender—for example, through his trading with the borrower. For larger organizations, more formal monitoring techniques are necessary, both for internal use to monitor the performance of subunits and for use by outsiders with a legitimate interest in the performance of the corporation. These techniques are management accounting and financial accounting, respectively.

Standardized accounting concepts and principles were developed only after the financial crises of the 1920s and 1930s. Before then, there was no urgent need to standardize the conventions of management accounting: owners and managers set their own rules. But with the emergence of general incorporation and limited liability, standardized information became essential—a point brought home forcefully during the 1930s, when many small investors lost their savings because they trusted inaccurate financial statements.

Governments responded by tightening accounting and auditing requirements in a number of ways. In the United States, for example, the Securities and Exchange Commission (SEC) was created to regulate securities markets and to make the financial process more transparent. The SEC turned to the professional association of accountants to develop accounting concepts (such as fair market value, consistency, accrual, going concern) and detailed rules, or "generally accepted accounting principles," that became binding on the profession. A similar approach was adopted in the United Kingdom and in many Commonwealth countries.

Continental Europe and Japan and several other countries adopted a somewhat different approach. They placed greater emphasis on detailed rules laid down in company laws, usually with particular stress on prudence (historical cost accounting) as opposed to fair value, and on a larger role for the tax authorities in defining accounting rules. In many of these countries, tax accounts and financial accounts must be drawn up on a fully consistent basis.

Because of these and other differences in approach, company accounts cannot be easily compared across countries. For example, companies in Germany, Japan, Korea, and Thailand usually appear highly leveraged (that is, with high levels of debt relative to net worth) when compared with companies in Argentina, Brazil, Canada, or the United States. Most of the difference, however, is due to different accounting conventions. The first group relies more on historical cost accounting, with many assets (especially land) valued at less than their market value, whereas the second group regularly revalues some or all assets. In many countries with high inflation, full revaluation has become the rule because historical cost accounting becomes virtually meaningless under such conditions. Market valuation can be equally troublesome for assets with drastic, cyclical changes in value (for example, some types of securities, raw materials, and commercial real estate).

Efforts have recently been made to harmonize accounting and auditing practices internationally through the International Accounting Standards Committee and, in a more far-reaching way, within the European Community. The result is a convergence of the Anglo-Saxon and continental approaches, with greater standardization of financial statement formats on the one hand and a greater use of the concept of fair market value on the other.

In developing countries accounting and auditing practices are sometimes weak, and financial laws and regulations do not demand accurate and timely financial reports. Developing an effective accounting and auditing profession is essential for building efficient financial markets, and projects to do this have recently been introduced in Indonesia and Madagascar, for example. Training and education are the main requirements, but appropriate regulation and regulatory bodies are also needed.

Timely accounts are very important for financial institutions. Annual or quarterly accounting might be sufficient for most nonfinancial firms, but financial institutions can lose their risk capital virtually overnight if, say, they hold large open positions in foreign exchange or futures and options contracts. Internal and external financial reporting therefore needs to be much more frequent, with certain kinds of information available to management daily.

Prudential regulation of financial institutions and markets

Procedures for settling private disputes are set forth in most company laws, commercial codes, and special banking acts, but the development of a sound financial system requires additional measures. Prudential supervision by government authorities is warranted for banks and some other financial institutions and markets. Banks hold an important part of the money supply, create money, are the main means of implementing monetary policy, administer the payments system, and intermediate between savings and investments. Problems in one bank can quickly spread through the entire financial system. Bank failures have monetary and macroeconomic consequences, disrupt the payments system, and lead to disintermediation (which decreases the mobilization of resources and the availability of finance for investment).

As financial systems develop, different institutions evolve to take over some activities formerly performed by banks and to provide new services. All these institutions, old and new, are integrated in an increasingly complex financial system. This complexity limits the ability of creditors to exercise effective control and calls for prudential regulation and supervision.

Regulation of banks

Bank supervisors in many developing countries focus on compliance with monetary policy regulations, foreign exchange controls, and economic policy regulations such as those for allocating credit. They pay relatively little attention to the prudential aspects of financial monitoring. For example, in many countries supervisors make no independent assessment of the quality of assets and give scant regard to accounting procedures and management controls. Together with macroeconomic instability and the lack of adequate legislation, this is one of the main causes of bank insolvency.

Governments in developing countries are preoccupied with faster economic growth; they see banks as an instrument for promoting the desired investments. Often, however, these investments are the most risky from a bank's point of view, so the volume of credit extended to them remains less than the governments would like. The government reaction is often to force the banks to extend credit to priority sectors. This policy has been pursued without adequate attention to the risks involved. With the benefit of prudential regulation and supervision, however, governments can obtain information about the consequences of their policies while there is still time to modify them.

The goal of bank supervision, then, is to promote a safe, stable, and efficient financial system. The main task is to prevent bank failures, but this does not mean that financial institutions should not be allowed to fail. Bank supervisors must try to identify problems at an early stage and intervene before the situation gets out of hand. For this reason they have to be organized in such a way that they are constantly aware of developments.

ORGANIZATION. In many developing countries supervision tends to rely predominantly on analysis of bank reports or on bank inspections. Off-site supervision cannot assess risk adequately, and inspections tend to be too infrequent. Effective su-

Box 6.5 Elements of a bank supervision system

An adequate system of bank supervision should allow for both off-site supervision and on-site inspection. The task of the off-site supervisors is to analyze reports of the banks, identify possible problems, and propose remedies. Banks in most countries have to submit monthly balance sheet information for purposes of monetary control. It would make sense to combine the two reporting requirements.

After receiving the reports, the *off-site* supervisors should:

- Check their completeness, accuracy, and consistency
- Check their compliance with prudential ratios and regulations
- Analyze the financial situation of the bank and identify the main changes in financial ratios
- Identify other risks such as foreign exchange risks, interest rate risks, and concentration risks
- Prepare a summary for the management of the supervisory agency and recommend action.

The *on-site* inspectors should check the accuracy of the periodic reports to the supervisor and analyze those aspects of a bank that cannot be adequately monitored by off-site supervision. Inspections, however, should not become audits. They should focus on the bank's main activities and on the potential problems that were identified by off-site supervision. Inspections should assess the quality of assets, management and control procedures, and accounting systems. The inspectors should:

- Study the main credit files (and a sample of smaller files) to assess the lending procedures and the quality of the loans
- Evaluate lending procedures and review minutes of meetings of the credit committee and the board of directors
- Check management information systems and internal controls, especially with regard to the activities of branches and subsidiaries
- Evaluate accounting procedures, especially those for provisioning and interest accrual.

pervision calls for both. Off-site supervisors should analyze reports periodically submitted by the banks, and on-site inspectors should verify their accuracy, obtain detailed information about potential problem areas, and review the elements that off-site supervisors cannot properly assess. Box 6.5 goes into this in more detail.

LICENSING. The purpose of licensing should be to ensure adequate capitalization and sound management, not to limit entry or restrict competition. Bank supervisors should have the authority to screen potential owners and managers to prevent those lacking adequate professional qualifications, financial backing, and moral standing from obtaining a banking license. In many countries restrictions on entry into banking are so severe that they cause oligopolistic practices and suppress competition.

Sometimes entry restrictions are defended by citing the poor quality of the existing banks' portfolios. The supervisors fear that these banks could not withstand competition from new institutions with "clean" portfolios. If portfolios are weak because of government lending directives or drastic adjustment programs, a good case can be made for cleaning up the balance sheets of the existing banks before liberalizing entry. More generally, however, managers and shareholders should be held responsible for past mistakes. If that means losing market share to leaner and more efficient competitors and, in extreme cases, bankruptcy or reorganization, so be it. But liberal entry into financial services should not mean unqualified entry. Several countries with easy entry (Egypt, Thailand, and Turkey, for instance) have experienced problems with unregulated, undercapitalized, and poorly managed banks and other financial institutions.

CAPITAL ADEQUACY. Banks need capital to absorb unusual losses. The need to maintain an adequate capital-to-assets ratio exerts discipline on lending. Regulations should set minimum guidelines for capital adequacy that cover both assets and items not listed on the balance sheet (such as guarantees and lines of credit). Standards of capital adequacy can take account of different degrees of risk by requiring, for example, 100 percent capital for high-risk items such as industrial shares, 10 percent for unsecured loans, 5 percent for secured loans, and so on. The recent agreement among major industrial countries on standards of capital adequacy uses risk weights and might serve as a starting point for others. In many countries financial institutions were significantly undercapitalized even before portfolio and other losses were recognized. Government-owned banks, in particular, often operate with little capital. When government officials and the public at large believe that state ownership is a guarantee against failure, the management is not subject to the discipline that capital adequacy requirements would provide for a private institution.

ASSET CLASSIFICATION AND PROVISIONING. Banks in developing countries rarely make realistic provisions for potential losses or problem assets. Often they fail to write off or provide for actual losses or to suspend interest on nonperforming loans. As a result their balance sheets and income statements are misleading. Bank supervisors should be able to require banks to make appropriate provisions for loan losses, to write off uncollectible assets, and to suspend interest on nonperforming loans.

LIQUIDITY. In many developing countries banks have to comply with a short-term liquidity ratio. This ratio is often used more as a reserve requirement for purposes of monetary policy than as a prudential measure to guard against lack of liquidity. Liquidity risk arises because banks borrow money at short maturities and lend it at long. The risk is not just that a bank will not be able to repay depositors' money when called, but also that interest rates on short-term liabilities will rise faster than those on longer-term assets. Ratios therefore need to be set and monitored for long-term as well as short-term liquidity.

PORTFOLIO CONCENTRATION. Limits on lending as a percentage of a bank's capital are necessary to prevent the concentration of risk in a single borrower, a group of related borrowers, or a particular industry. Some developing countries set no lending limits at all. In others the limits are set at imprudent levels, in some cases exceeding 100 percent of bank capital. Ghana's central bank had legal authority to set lending limits but until recently did not do so. The resulting concentration of risk eventually led to the technical insolvency of several major banks.

ENFORCEMENT POWERS. In many countries supervisors can impose fines and penalties for criminal acts and violations of specific banking statutes. There may, however, be little they can do to address unsafe and unsound banking practices. Their options are either to cancel the banking license or to do nothing—neither of which is acceptable. Supervisors could be empowered to take certain intermediate steps: impose fines for unsound practices, suspend dividends, deny requests to expand the number of branches or undertake new corporate activities, issue cease and desist orders, remove managers or directors, and hold directors legally accountable for losses incurred through illegal actions and willful contraventions of prudential regulations. The lack of such powers often causes inaction.

RESTRUCTURING. Bank supervisors try to minimize losses by intervening at or near the point of a bank's technical insolvency. Poor information, an inadequate legal framework, and lack of political will often permit banks to stay open, multiplying their losses, even after they have lost their book capital many times over. In many developing countries banks are subject to the same bankruptcy and restructuring procedures as nonfinancial corporations. While bank restructuring is under way, depositors may not have access to their funds. In addition, shareholders may retain an equity interest which they use to obstruct plans to recapitalize and transfer ownership. If supervisors are to dispose of insolvent banks quickly, they must be granted authority to close a bank; to replace its management and directors; to dissolve existing shareholder interests; to purchase, sell, or transfer bad assets; and to merge, restructure, or liquidate as necessary.

AUDITS. In some developing countries the authorities require no external audits of banks. In others audits are performed, but there are no clear guidelines on the standards to be used or on the scope, content, and frequency of the audit program. As a result audits are often inadequate and misleading. Indeed, it is not uncommon for banks that are known to be insolvent to be given clean audit reports. The prudential framework therefore needs to set minimum audit standards and to prescribe the form and content of the related financial disclosures.

POLICY PRIORITIES AND POLITICAL WILL. To be effective, prudential regulation must be backed by a political commitment to supervision and enforcement. The supervisory body must be given clear policy goals, and it must be independent. Too often in developing countries, supervisors are undercut by political interference. Such interference was blatant in the Philippines in the 1970s and early 1980s, when supervisors feared reprisals if they attempted to discipline bank managers; it happens in a subtler form in many countries. Once aware of the scale of a banking problem, governments often postpone the day of reckoning. When they finally act, the cost of putting matters straight may be far greater.

One sign of political commitment is the amount of resources given to the supervisory agency. If the government means business, it must give the supervisory agency clearly defined responsibilities and then support that mandate with adequate funds for staffing and training. Bank supervisors must be offered good compensation and career prospects if they are to resist corruption and command the respect of the institutions they supervise. If the civil service cannot attract personnel of the required quality, it might be sensible to have banks examined by private auditing firms and to recover the costs through a general levy on banks (with due care to avoid conflicts of interest).

Regulation of other financial institutions

Many of the principles of bank supervision and regulation also apply to other financial institutions, such as finance companies, insurance companies, pension funds, and mutual funds. A vital test in deciding on the extent of regulation is the number and type of creditors. Financial institutions that do not have deposit-like liabilities to the general public need not be regulated as closely as those that do, because their deposits are not part of the payments mechanism and their insolvency is not as costly to the economy. The general provisions of commercial and company laws may therefore be adequate. Conversely, those financial institutions that are like banks in all but name (for example, some investment funds) should be just as closely regulated and supervised (see Box 6.6).

INSURANCE. Insurance companies are usually heavily regulated in both industrial and developing countries. These regulations have often been introduced in response to failures or fraud. Regulations typically provide for compulsory disclosure of information, government supervision with implicit or explicit guarantees of solvency, oversight of contract terms and conditions, controls on entry, restrictions on investment portfolios, and rules concerning prices or profits. Regulation to promote transparency is desirable, but many of these measures limit competition and efficiency. For example, instead of insisting that a large share of insurance assets be placed in low-interest government bonds, portfolio restrictions should require that risks be adequately diversified. Life insurance and other contractual savings schemes would then be more attractive to savers. Investments in shares and corporate bonds have often been severely restricted, eliminating a potentially important source of long-term capital.

Box 6.6 Investment funds in Egypt

The recent experience of Egypt illustrates the need for adequate regulation and supervision of nonbank financial intermediaries that take deposits from the general public. Investment funds were organized in the mid-1970s to handle remittances from Egyptian workers abroad and the savings of small investors. These Islamic investment companies paid profit-related returns, sometimes as high as 30 percent a year. They were not required to conform to banking regulations and did not come under the supervision of the central bank.

Some of these institutions have faced increasing difficulties in the past two years, and their financial condition has deteriorated. Many had made large initial profits through trade finance not otherwise available to importers or through foreign exchange transactions in the parallel market. Some paid high dividends to earlier depositors out of funds paid in by new depositors. When deposit growth slowed, some could no longer pay the promised high returns. To prevent further deterioration, the government had to step in.

A law regulating the investment funds was passed in 1988. It restricts deposit taking to joint-stock companies, imposes minimum capital standards, and vests regulatory oversight with the Capital Markets Authority.

SECURITIES MARKETS. An appropriate regulatory framework for securities is needed to increase investor confidence. Regulation is unlikely to be satisfactory if left entirely to the market. The experience of many countries shows that some government guidance is desirable. In Hong Kong, for example, the stock market collapsed in 1973 partly because of insider abuses. A new securities commission helped to restore confidence. It was able to persuade brokers and underwriters that an orderly market which protected investors was in their own long-term interests.

The regulations need to provide for adequate disclosure of information about companies so that investors can make informed decisions; they need to license securities intermediaries and to curtail improper activities in the market, especially the use of privileged information by corporate officers and directors for their personal gain (insider trading). These regulations are usually embodied in the company laws that form the legal framework for joint-stock companies.

If securities firms and the securities market as a whole are to perform efficiently, the firms must be profitable and well capitalized and have professionally trained staff. This does not happen automatically in an emerging securities market. The government has a crucial role. If minimum capital requirements are set too high in relation to the size of the market, new securities firms will not appear. But if firms have insufficient capital, they will not be able to take on the risks of underwriting new issues; nor will they be able to work as market makers (that is, to buy and sell shares for their own account) and thus provide liquidity for the secondary market. Brokerage rates, underwriting fees, and so on must be high enough for firms to attract and train staff and still leave their shareholders with an adequate return on capital.

The regulation of companies and securities markets is linked to important social issues. Promoting widespread ownership of productive assets may be one way to forestall greater concentration of wealth and economic power. At the same time, it can provide an income for the elderly at a time when industrialization and urbanization are breaking down the extended family and the traditional transfer of income between generations.