

Centre for Central Banking Studies
Bank of England

Causes and Management of Banking Crises

Tony Latter

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**THE CAUSES AND MANAGEMENT
OF BANKING CRISES**

Tony Latter

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Foreword

This series of *Handbooks in Central Banking* has grown out of the activities of the Bank of England's Centre for Central Banking Studies in arranging and delivering training courses, seminars, workshops and technical assistance for central banks and central bankers of countries across the globe.

Drawing upon that experience, the *Handbooks* are therefore targeted primarily at central bankers, or people in related agencies or ministries. The aim is to present particular topics which concern them in a concise, balanced and accessible manner, and in a practical context. This should, we hope, enable someone taking up new responsibilities within a central bank, whether at senior or junior level, and whether transferring from other duties within the bank or arriving fresh from outside, quickly to assimilate the key aspects of a subject, although the depth of treatment may vary from one *Handbook* to another. While acknowledging that a sound analytical framework must be the basis for any thorough discussion of central banking policies or operations, we have generally tried to avoid too theoretical an approach. Moreover, the *Handbooks* are not intended as a channel for new research.

We have aimed to make each *Handbook* reasonably self-contained, but recommendations for further reading may be included, for the benefit of those with a particular specialist interest. The views expressed in the *Handbooks* are those of the authors and not necessarily those of the Bank of England.

We hope that our central banking colleagues around the world will find these *Handbooks* useful. If others with an interest in central banking enjoy them too, we shall be doubly pleased.

Needless to say, we would welcome any comments on this *Handbook* or on the series more generally.

Tony Latter
Series Editor

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ABSTRACT

Central banks are concerned for the stability of the banking sector, but the world seems to be continually beset by banking crises.

The structural evolution of the banking sector may have a significant bearing on questions of solvency and stability. Banking systems have developed in different ways among countries, for a variety of reasons, but the trend has been towards an increasingly liberal stance by the authorities as regards allowing banks to diversify their activities. This should be welcomed, but only on two conditions: first, that the management of individual banks is sufficiently capable; and secondly that every bank can be effectively supervised by the central bank (or other responsible regulatory body).

Access by foreign banks to a particular country is usually beneficial in terms of competition and efficiency.

The causes of banking crises can be categorised under several headings: macroeconomic instability; deficient supervision; poor strategies; weak management; inadequate control systems; operational failures; fraud. The experience of a number of countries is reviewed.

Whatever the causes, the authorities need a coherent strategy for addressing such crises. Various aspects of crisis management are discussed, and recommendations made.

THE CAUSES AND MANAGEMENT OF BANKING CRISES

1 Introduction

The world seems to be continually beset by banking crises of one sort or another. Indeed, the problems of the 1980s and 1990s have been described as more severe than at any time before. In 1996 the International Monetary Fund estimated that about 130 countries had experienced banking crises since 1980, and that 30-40 were perhaps still in crisis. The situation may now be improving, but only gradually.

The cost to government budgets of resolving these crises has been highly significant. Estimates vary, but examples from different sources - in particular a survey by World Bank researchers, published in 1996 [13]¹ - put the cumulative costs, expressed as a percentage of one year's gross domestic product for the country in question, at 2-3% in the case of the US crisis affecting savings and loans institutions and small banks during the 1980s and into the early 1990s; between 2% and 8% for the Nordic countries; 17% for the Spanish crisis (1977-85); 10% in Hungary; 4% in Bulgaria; 12-15% in Mexico (though official Mexican figures have been lower); 13-18% in Venezuela and well over 25% in several other cases, including Argentina and Chile. In many of these, as well as other transitional and developing economies and some industrial countries, such as France and Japan, difficulties remain to be sorted out and costs may still be accumulating.

Focusing for a moment specifically on transitional economies, the IMF estimated in 1996 that the bad debts of banks ranged from 14% to 65% of total assets. Given the suspected widespread inadequacy of provisioning and, despite that, published capitalisation which is often below the recommended 8% "Basle" minimum, there remain doubts as to the underlying solvency of the banking system in many of those countries.

Of course, the cost to the government's budget of resolving banking crises represents directly a mere transfer cost within the national economy and does not equate to the real net cost in terms of the welfare losses or gains to the economy as a whole. Any calculation of the real cost would

¹ Figures in square brackets relate to the list of references and further reading on page 44.

need to take account of administrative costs, the consequences of any diversion of macroeconomic policy enforced by the crisis, the possible benefits of averting a more serious crisis and the implications for the efficiency of financial intermediation of either supporting failed or failing institutions, or of allowing a shake-out in the banking sector to run its course. In theory, at least, it is conceivable that the benefits - for example from containing a crisis or from a shake-out which raised the efficiency of the sector - could, in terms of overall economic impact over the longer term, outweigh the costs of the crisis.

This *Handbook* begins by addressing the structural context - the definition of banking, the role of supervision, and some of the factors which have influenced the way in which the banking sector has evolved in different countries. Much of this is relevant to analysis of the causes of banking crises and of the reactions of the authorities in dealing with them. The *Handbook* then turns to examine more specifically the causes of banking crises and failures, and attempts to reach some conclusions as to the appropriate strategy for resolving them. In the Appendices the experience of a selection of countries is reviewed - the United Kingdom in particular. The country coverage of the Appendices is not intended to imply anything about relative severity of crises or relative success or failure in coping with them, but rather reflects the availability of information and the desire to encompass a reasonable cross-section.

2 The structural context

Banking has evolved in different ways in different countries, for a mixture of economic, political and other historical reasons. For example, the United States and Japan have possessed considerably fragmented banking systems, both geographically and functionally (though decreasingly so today). In many European countries operations have tended to be more consolidated, in terms of either geography or function, or both. In many developing and a few developed countries, as well as, of course, in all the former communist economies, state-owned banks were until recently the norm. And now many of the transition economies are characterised by a polarisation between large banks focused on broad economic sectors, emanating from the initial break-up of the

monobanking system, and a plethora of small banks, opportunistically established on the tide of liberalisation, but in many cases having ownership structures or concentrations of business which would flout the prudential standards of developed countries, and which in a significant number of cases have indeed led to early failure or closure.

This evolutionary process is bound to continue. For example, although the vast majority of the countries of the world are now more or less committed to the concept of the market economy and to the desirability of the state disengaging from ownership of banks² or interference in their business (other than as necessary for supervisory purposes), there is still a long way to go before these aims are fully achieved. Meanwhile, rapidly advancing technology will continue to transform or supplant some of the processes of banking in all countries. And banks as a group will probably continue to move into new areas of business.

What distinguishes a bank?

Specific legal definitions of what is a bank or what constitutes banking business vary from country to country. Many people might regard banks first and foremost as providers of credit, but that is not what makes banks unique, since credit is available from other sources, such as trade suppliers, retailers or - in securitised form - capital markets; nor would the granting of credit, on its own, necessarily make banks particular objects of attention from the regulatory authorities, since ill-judged decisions to grant credit might not be of concern unless the company granting the credit was itself also taking deposits.

It has become widely accepted that the activity which makes banks in some sense special is the taking of deposits, for the following reasons:

- a bank deposit is typically an unsecured, capital-certain claim;
- it therefore implies a strong element of trust;

² The one common exception is the central bank, which remains in public ownership in most, though not all, countries, irrespective of the degree of operational autonomy which it enjoys.

- borrowers, on average, require funds for longer periods of time than that for which depositors, on average, are willing to forego their funds; even overdrafts, which may technically have to be repaid on demand, have to be regarded, in total, as a fairly illiquid claim; thus, maturity transformation is central to the economic function of a bank, and is at the same time a key source of risk;
- deposits constitute money, notably in the transactions sense: funds on current account or at call, or term deposits at maturity, can generally be used, and are accepted, as a means of executing payments and settling debts with third parties;
- consequently, banks find themselves at the centre of the payments system, the efficiency of which is vital to the broader economy.

For the purposes of this *Handbook*, therefore, and notwithstanding differences which may exist from one country to another in legal definitions, a bank is regarded as any institution which accepts deposits from the non-bank private sector (ie from citizens, non-bank corporate entities etc; acceptance of funds *only* from other banks may not necessarily qualify), within the relevant definition of a banking deposit - which excludes, for example, down-payments to secure the supply of goods.

Role of the central bank and supervisors

Central banks may be interested in the structural development of the banking sector under four headings:

- the central bank is concerned with the overall stability of the financial sector and will wish to supervise banks to that end, or to be assured that they are being adequately supervised by another body;
- the central bank is usually concerned also for the efficiency of financial intermediation - of the banking sector in particular - and, although in a market economy it will not normally wish to intervene directly in the business of banks, it may nevertheless be involved in ensuring adequate infrastructure and competition and in nurturing collective initiatives for

the common good; in emerging market economies the banking sector usually plays an especially prominent role if other capital markets have not yet developed;

- the ability of banks to create money and credit in the normal course of their business gives the central bank an interest in banking developments from the macroeconomic monetary policy perspective.
- the regulatory authorities are normally concerned to protect individual depositors against loss; in this regard, the power to prevent unauthorised deposit-taking is also important; efforts to protect consumers are regarded as justified -
 - ◆ because of the relationship of trust between banker and depositor (money is deposited without any exchange of value or collateral); and
 - ◆ because of asymmetries in information (the average depositor cannot hope to be able to make an accurate assessment of the creditworthiness of a bank).

This *Handbook* mainly focuses on the first of the above reasons. Banking is regarded as more prone to contagion than are other commercial activities. If a manufacturing business fails, it is generally expected that other manufacturers of similar products will benefit. In banking, however, the opposite may be true, in that problems in one bank may spread to another, either because of actual financial linkages, for instance through the interbank market, or through confidence effects, whether rational or not. This is the justification for supervision of individual banks in the broader context of systemic stability.

Who supervises?

In some countries banking supervision is the responsibility of the central bank; in others it is entrusted to one or more separate agencies. Conflicts of interest may arise between the conduct of macro-monetary policy and supervision: the common example is of a situation where the fragility of banks delays necessary tightening or encourages undue relaxation of monetary policy. There is some record of such situations, in the United States and Japan, for example, as well as in a number of transition economies, but potential tensions cannot necessarily be avoided

just by distinguishing institutionally the two responsibilities.³ Indeed, it is noteworthy that in neither the United States nor Japan are banks supervised solely by the central bank.

It may also be argued that the close interaction between liquidity management of individual banks and the central bank's money-market operations, and particularly the fact that liquidity support for a troubled bank may have to come from the central bank, demands co-ordination and, optimally, co-location of the two responsibilities. In support of this view it is noted that in many countries where supervision is carried out by a separate agency, the central bank nevertheless retains some sort of supervision department to shadow the supervisory body and to take charge of problems involving liquidity support, if they arise. The central bank would anyway wish, as a minimum, to assess its own counterparties in the event of being called upon to provide liquidity. On the other hand, co-ordination ought to be achievable without, necessarily, co-location.

Given that the supervisory procedures for consumer protection may be distinct from those for ensuring overall systemic stability, the case could be made for entrusting these two aspects to separate agencies, but in practice this would also give rise to problems of co-ordination and overlap. In many countries, however, the specific function of operating a formal deposit insurance scheme is performed by a separate agency, usually in the public sector (private deposit insurance exists in a few countries, mainly in western Europe). In these cases, in order to avoid duplication of regulation, the agency may accept the authorisation of a bank by the central bank (or appropriate supervisory body) as a sufficient qualification for admission to the insurance scheme, although it is apparent that in some countries the insurance agency demands additional or duplicate information direct from the banks.⁴

Although there may, therefore, be understandable concerns as to who conducts banking supervision and the optimal permutation of regulatory activities, the discussion in the remainder of this *Handbook* is not significantly dependent upon whether supervision is carried out by the central bank or another body, or indeed split between agencies.⁵

³ Noted by the Governor of the Bank of England in [8], page 94.

⁴ See [7(b)] for a fuller discussion of deposit insurance.

⁵ Nor does this *Handbook* address the practical details of supervision. For an introduction to that subject see [7(a)], and for a detailed elaboration of core principles see [9].

The scope and structure of banking

It was noted above that deposit-taking is perhaps the point at which the definition of banking business begins; but where does it end? In addition to accepting capital-certain deposits, tailored to match customers' liquidity needs, the traditional activities of banks include services for payments and foreign exchange, the provision of credit for working capital and trade finance, personal loans and some longer-term investment finance - though this partly depends on the bank's ability to secure longer-term funding for itself. Banks may also undertake any of a wide range of other financial or related activities, such as securities trading, broking, underwriting and the associated functions of registration and custody services; fund management; corporate finance; equity participations; financial advice; and insurance. Moreover, some banks may even wish to diversify into activities well beyond the boundaries of finance. On the other hand, banks may, of their own choice or because of laws and regulations, specialise in particular activities or focus their business on particular sectors of the economy or in particular regions.

There are a number of factors which the authorities may need to consider when deciding what range of activities to allow banks to undertake or what sort of structure to steer the banking sector as a whole towards.

(1) Management of financial risk

Diversification may help to spread risk, but it may also add to risk if the new areas of business are clearly more risky, on average, than existing ones. It is for these opposing reasons that, for example, on the one hand, concerns have been expressed about the emergence of new, highly sector-specific or even firm-specific banks in Russia in recent years, while, on the other hand, laws were introduced in the United States in the 1930s, which are still formally in place today, despite some relaxations in interpretation and recurrent initiatives for more fundamental liberalisation, to prevent commercial banks from moving (or limit the extent of their

moves) into securities or so-called investment banking business.⁶ Another example is the general hesitance of most supervisory authorities to permit banks to own companies outside the financial sector or to invest depositors' funds in equity shares, despite the fact that the major German banks have held significant equity stakes in German industry for many years without evident problems.

However, what in the past were firmly ingrained rules have now given way to more flexible approaches, based nevertheless on firm supervisory principles. The risks of any strategy have to be properly assessed and provided for. A notable example of evolving attitudes is the securities business of banks, where there are now clear agreements among supervisors, enshrined in Directives so far as European Union countries are concerned, on the calculation of capital required to support securities trading activity, with an implied acknowledgement that a bank can be allowed to venture into securities business if it conforms to this regime (as well as to any other criteria laid down by its supervisory authority, such as regarding competence of staff or viability of business plan).

Another example is the not uncommon requirement that certain activities may be permitted only if conducted out of a separately capitalised subsidiary in a banking group, in order to limit the bank's formal liability in respect of that activity (but see below concerning contagion). Among financial activities, the writing of insurance may be taken as an example. Insurance involves the assumption of long-term liabilities, of uncertain scale, in contrast to the short-term fixed-capital liabilities that are typical of conventional banking. It may therefore be regarded as desirable to keep the activities separate.

If banks diversify into business beyond the financial sector (directly or via subsidiaries), or if non-banking groups are permitted to establish banks which would, in effect, be daughters or sisters of industrial or commercial companies, regulators may be concerned about possible contagion or reputational damage.⁷ However, in many transitional economies banks have been founded which are closely tied into non-financial corporate groups, and historical separations of business are also

⁶ See [12].

⁷ Occasionally a bank may find itself involuntarily owning or controlling an industrial company, as a result of bankruptcy proceedings for example. In such cases the supervisor may require divestment at the earliest reasonable opportunity.

being eroded in some other countries (in the United Kingdom a major supermarket chain has recently been allowed to establish a banking subsidiary). Key considerations for banks and supervisors in such cases are not only adherence to explicit supervisory rules concerning concentration of lending or credits to shareholders, but also insulation of the capital of the bank from any designs which other group companies may have on it, particularly in troubled times, absolute enforcement of that insulation and clear understanding of it by both the group companies and - just as importantly - by the bank's customers, who might otherwise panic unnecessarily at the news of difficulties elsewhere in the group.

In assessing a bank's strategy, the supervisor will take account not only of the relevant legal structures and the arithmetic of the potential risk, but also of the ability of the bank to manage its risks. The competence of management, set against the challenges inherent in any strategy, especially one involving expansion, are key ingredients in supervision (management failure in the context of banking crises is discussed later in this *Handbook*). In a wider context, the authorities will also wish to ensure that an adequate degree of competition exists within the financial sector; this may be grounds for not allowing certain institutions to expand in particular directions.

(2) *Reputational risk and contagion*

As noted above, there is a risk of confidence as a whole in a bank being undermined - and hence depositors' interests being put at risk, or a run on the bank being precipitated - as a result of financial losses or damaged reputation in any part of a banking group, even if formally insulated from the deposit-taking entity. Even if the problems arise in a separately capitalised subsidiary, the group may find itself obliged to commit additional funds in order to safeguard its reputation.

The likely extent of any reputational damage depends in part on whether the incident was, or is regarded by outsiders as having been, an isolated occurrence with readily identifiable causes which can be or have already been addressed, or was symptomatic of more deep-rooted weaknesses in the group. But there is also a risk simply from bad publicity, which may cause a loss of business, irrationally. It is for that

sort of reason that banks usually take immediate steps to repair or contain possible reputational damage: for example, Deutsche Bank was quick to make funds available to its United Kingdom subsidiary, Morgan Grenfell Asset Management, in order effectively to recapitalise three of its funds when its reputation was under threat (see page 35).

(3) *Competition in banking*

In some countries the desire to foster and preserve competition has been a significant influence over the authorities' strategy towards financial sector development. In other countries, efforts to limit competition have been more visible. History shows mixed results.

- In the United States the long-standing restrictions (only recently relaxed) on inter-state banking prevented larger banks with a potential for expansion from establishing country-wide networks. The policy was designed to protect smaller local banks and presumed that competition amongst them was sufficient. In the event, progress towards greater overall efficiency in banking was probably retarded, and the many small banks which proliferated were too small and dependent on too narrow a business base to prosper. Partly as a result of this, a large numbers of these banks, together with an even greater number of saving and loan institutions, failed during the 1980s (see page 37).
- In the United Kingdom much analysis has been focused during the past 30 years on the question whether consumer interests are best served by the domination of retail banking by a small number of large "high street" banks. For a while these worries were to some extent assuaged by the emergence of the building societies (best regarded, in the present context, as retail banks specialising in the provision of mortgage credit to house-buyers) as a strong competitive force. Successive investigations concluded, broadly speaking, that there were gains in efficiency from economies of scale; and in practice competition has been as intense as in other major countries.
- In some countries of continental Europe, regional or provincial banks, often owned or part owned by the state or regional authorities, enjoy significant market share of certain types of retail business. They may

enjoy implicit state guarantees and may also be to some extent protected from competition; it is evident that this situation may have slowed progress towards modernising banking services and widening the range of banking products to which the public has access.

- In many developing and transition economies, fear of too much competition (sometimes with vested interests pressing the infant-industry argument) has led to restrictions on the admission of foreign banks. The same could, until comparatively recently, have been said of a number of developed countries too, but the successful implementation of the European Union single market and the conclusion of the Uruguay Round have been instrumental in removing many of the remaining barriers.

Evidence suggests that banking is more efficient in countries which have been open to foreign participation, even though this may be at the expense of the development of a truly indigenous banking industry. Almost without exception, foreign competition and expertise bring benefits. The single most compelling example is perhaps the United Kingdom, where London's position as a leading financial centre owes much to the welcome extended to foreign firms over the years. As a result, wholesale and international business tends to be dominated by foreign-owned firms (penetration into retail banking has tended to be less marked), and it is acknowledged that they make a substantial contribution to UK national income.

Of course, not all countries can expect to develop such relatively large financial sectors of their economies as has the United Kingdom. What is more important is that financial intermediation should be carried out efficiently, for the benefit of the rest of the economy. If the country does not emerge as having a comparative advantage in the supply of financial services, it is generally better that this should be manifest in the ready availability of the best services, imported if necessary, with the local economy concentrating relatively more on other sectors, than in attempts to shore up local banking by anti-competitive restrictions.

(4) Social policy

It is by no means uncommon for governments to participate or intervene in the banking sector in the context of social policy, particularly to ensure adequate provision of dependable retail services to the whole community. Any such involvement should be transparent and constitutional, and unreasonable pressures should not be placed on banks to provide hidden subsidies to the budget or contort market forces at the behest of government.

In many instances it may not be economical for a commercial bank to provide basic banking services - deposit/saving and credit facilities and money transmission - to all citizens and all regions. If, as is normal, it is nevertheless regarded as desirable that these services be available, the government faces the option of providing them through public sector institutions, such as the postal system (if it is still in the state sector) or a government bank, such as, typically in most formerly planned economies, the Savings Bank, or subsidising private sector banks to provide the service - or even coercing them to do so. In some instances the government may go further than merely filling the gap which commercial banks will not fill, by competing with the commercial banks over a wider range of services. It may be hard to contest such a strategy if it is needed to fund the cross-subsidy to unprofitable activities, but any encroachment into services which the private sector can satisfactorily supply should be resisted as far as possible. These considerations are also relevant to the question of narrow banks - see below.

Technological advances and the advent of cash-dispensers, telephone banking and even mobile banks as witnessed in some countries, may render it progressively less expensive, rather than more so, to provide basic retail banking services, in which case many of the perceived problems of accessibility may in due course evaporate, although perhaps not for a considerable time in some places. Meanwhile, as the banking habit spreads, those who cannot or choose not to have a bank account may find themselves at an increasing disadvantage.

(5) *Industrial policy*

In many countries there is a perceived dearth of bank finance for the longer-term funding of particular sectors, in which case some official

intervention may seem justified. The shortage of finance may in part reflect the general problems which banks may face in undertaking sufficient maturity transformation to extend such credits on a prudent basis. In those circumstances the potential borrowers might seek funds through the capital markets or other channels. The important question is whether the shortage of funds reflects merely market failure - in which case some official intervention may be justified and may be economically viable - or genuinely poor credit risk, in which case no-one should lend for the project or it should be supported by explicit provisions from the government's budget.

Specialised banks

Partly in response to the sort of problems identified above in the areas of social or industrial policy, specialised banks may emerge or be created. These fall into two categories:

- banks which decide of their own volition to concentrate on a comparatively narrow range of activities;
- banks which are established by government or with government backing solely to undertake certain specified activities, or are formally directed to focus on a specific range of activities.

The first of these groups demands no special attention, save that the supervisory authorities must ensure that there is not too high a concentration of risk, which might jeopardise depositors' interests. Some so-called "niche" or "boutique" banks may be very profitable, but equally their performance may be volatile relative to that of more diversified banks.

Into the second category, typically, fall state-owned banks which serve specific purposes, and private sector banks which possess some sort of restricted authorisation. The existence and nature of such banks may differ much from country to country, but they often include banks for savings, industrial development, agricultural or foreign trade. For present purposes two examples only are discussed - *savings banks* and *industrial development banks*.

Savings banks

Savings banks specialise in providing a supposedly secure haven for household savings. They are commonly either banks owned by central or local governments, or private sector banks operating with some restriction on the deployment of their assets. Their origins lie in the desire both to provide country-wide access to basic banking services, for the social policy reasons mentioned above, and to provide security for savings, through government guarantee or cautious management of assets.

Events of recent years have refocused attention in a number of countries on the role, or possible role, of savings banks. Banking failures in several market economies have resulted either in losses to the small saver, or in large calls on public funds or deposit insurance funds. At the same time, the plight of the savings banks themselves in many of the former planned economies - hit first, at the macro level, by soaring inflation and then in a number of cases at the micro level by ill-judged diversification of assets - impoverished savers and posed serious questions for the authorities. Those responsible for regulating the banking sector may not be able to do anything to avert inflation, but they should be in a position to address deficiencies of bank strategy and management.

A proposal which has attracted some attention is to establish so-called “narrow banks”. These would provide savings and payment services for households and perhaps other small depositors, possibly with a limit on the size of any one person’s deposits, but would be constrained in the deployment of their assets - perhaps being allowed only to invest in government securities or to extend credits for particular purposes or backed by adequate security. Rates of interest on deposits would probably be lower than at other banks, but security would be stronger; deposits might even be explicitly guaranteed by government.

Such an arrangement has its attractions, particularly for countries where confidence in the banking system as a whole is lacking or conditions are not yet propitious to introduction of a deposit insurance scheme.⁸ However, it also has drawbacks. Deposits will tend to flow

⁸ It may be unwise to contemplate deposit insurance, other than on a limited basis, until a sound supervisory system is in place and the probability of calls on the scheme is sufficiently low to make it actuarially viable. See also [7(b)].

towards the narrow banks in unsettled times and away from them in more stable periods; this would have adverse implications for the rest of the banking system. Moreover, if there is any element of government subsidy (eg underwriting more generous deposit insurance than is available to other banks), there will be a competitive bias against other banks. And forced funding of the government is seldom consistent with the aim of an efficient allocation of finance across the economy. All of this suggests that governments should be cautious about taking any initiatives in this direction, although for social reasons or to compensate for market imperfections in banking such steps may sometimes properly be justified. Of course, any bank must be free to define its business along the lines of a narrow bank if it chooses, but the fact that few if any banks voluntarily follow that route suggests that such banks may not be commercially viable and would therefore, *prima facie*, require some sort of official support.

Industrial development banks

These banks are typically founded to promote longer-term capital formation. Participation by the state (or international agencies) is judged necessary because market forces and the usual parameters of prudent banking are not capable of providing the required funding. This approach can be justified if there is evidence of genuine market failure, or if there is a deliberate decision of government policy to assist the relevant sector(s) in this way.

The dangers inherent in this approach are that support goes beyond the boundaries of those criteria, with the result that the banks compete on unfairly advantageous terms for deposits, misdirect resources in the economy, or run up losses that eventually have to be borne by the community at large through the government budget.

As a point of principle, it is generally better to provide support to sectors or regions of the economy in as transparent a way as possible and with the minimum extraneous damage to the workings of market forces. This may mean that subsidies etc should be delivered directly from the fiscal budget, rather than less visibly through banks, or that, to the extent that, say, interest rate subsidies are to be provided, all banks should somehow be allowed to compete for the business of intermediating them.

The history of such banks or bank-type agencies is mixed. A notable success was the Japan Development Bank which was instrumental in financing Japan's economic transition particularly in the 1950s and 1960s. On the other hand there have been many instances of such institutions going bankrupt without having achieved a great deal, but it would be invidious to single out particular ones for mention.⁹

3 Causes of banking crises¹⁰

A variety of reasons may explain the onset of banking crises. Several of these may be related to the way in which the structure of the banking sector has evolved or been guided, as discussed above. Possible causes are classified here according to whether they arise from macroeconomic circumstances, from microeconomic or regulatory factors, from inappropriate strategies of individual banks, from operational failings in the banks, or from fraud.

(a) Macroeconomic circumstances

It is not uncommon for banking crises to be blamed on adverse macroeconomic developments. Indeed, macroeconomic instability is sometimes cited as the principal source of banking instability. The trigger may be some combination of a collapse of asset prices, especially in real estate (perhaps following an earlier unsustainable increase, which may in turn have been fuelled by inappropriate macro-policy or reckless banking decisions); a sharp increase in interest rates or fall in the exchange rate; an abrupt slowdown in the pace of general inflation (banks having generally prospered during high inflation, particularly from seignorage and money illusion, unless measures have been taken by the authorities to claw back such benefits); or the onset of recession. All of these factors are, of course, interrelated. Another source of difficulties, especially in transition economies, has been sharp shifts in relative prices or the removal of subsidies, creating pressure on particular businesses or sectors to which banks are exposed.

⁹ But see [17], especially chapter 15.6.

¹⁰ This and subsequent sections draw significantly on [22].

In principle, bank management and bank supervisors ought to ensure that banks are resilient to shocks such as these, within reasonable bounds of probability - although this itself begs the question as to what is considered “reasonable”. Therefore, unless the shock is way out of the range of probabilities for which anyone could reasonably be expected to allow for, macroeconomic conditions should not too readily be accepted as a scapegoat for banking failures. Regrettably, however, shocks have sometimes been outside that range, perhaps because of a very sharp monetary squeeze necessitated by a previous deterioration in the monetary or economic position, which may not have been fully visible (the Mexican crisis of late-1994 bore certain such characteristics), or because of political factors.

(b) Microeconomic policies

This heading covers all those structural and supervisory parameters which are under the government’s (or central bank’s) direct control or influence.

(i) Supervision

There is a common perception that every bank failure must represent a supervisory failure, but this is plainly misguided. Of course, in some cases a bank failure may fairly be ascribed to supervisory failure but, almost by definition, it can never be a sole cause because there must first be some shortcoming in the bank which escaped the proper supervisory attention. Moreover, if supervision were so tight as to eliminate all chances of bank failure, banking would in all likelihood be an extremely repressed and uncompetitive business, and therefore fail in its ultimate function of providing efficient financial intermediation to the rest of the economy. The authorities therefore have an element of choice as to how tight and intensive a system of supervision to operate, and it can readily be argued that the system should from time to time, for reasons of efficiency and in order to contain moral hazard, allow banks to fail.

(ii) Inadequate infrastructure in matters of accounting, law, etc

These may seldom be the immediate or sole cause of banking failure. However, shortcomings in accounting or auditing may disguise, or delay

realisation of, problems of illiquidity or insolvency. And inadequacies in accounting by bank customers may be as critical as such inadequacies in the banks themselves. Shortcomings in the legal infrastructure may, for example, inhibit the exercise of property rights or the pledging and realisation of collateral in support of bank loans.

(iii) *Liberalisation / deregulation*

Deregulation in the financial sector has occasionally encouraged rash behaviour, leading to subsequent problems. This is not an argument against deregulation but rather a reason for ensuring that bank managements - and regulators - understand the potential consequences and are particularly alert to possible adverse ones. Such considerations may be grounds for supporting a gradual rather than a big-bang approach to deregulation, although in cases such as the formerly centrally-planned economies the fundamental and widespread nature of the required structural changes has been such that gradualism may have been impracticable or may itself have created new problems. Deregulation - of activities - may require more attentive supervision in order to ensure that those activities are carried out and managed prudently. Some banking problems have arisen or been exacerbated because supervision has not kept pace.

(iv) *Government interference*

There have been instances where government interference in a bank's business - such as directives or pressure to lend to particular customers, possibly at preferential interest rates, or to maintain or extend uneconomic branch networks - has precipitated or hastened the onset of a liquidity or solvency crisis, or has bequeathed an unhelpful legacy in terms of assets or culture. Other potentially damaging official acts, which are still occasionally in evidence, include the imposition of pernicious reserve requirements, either unremunerated or bearing a sub-market rate of interest, and some form of obligation to fund the government's deficit, again on non-market terms.

(v) *Moral hazard*

If there is a general expectation that no bank will be allowed to fail, or if financial support in troubled times is too readily available to either banks or their depositors (the latter perhaps through too generous a formal system of deposit protection), moral hazard arises: banks may be tempted

into behaviour which exacerbates rather than ameliorates their position; and depositors may not bother to discriminate between “good” and “bad” banks, thereby possibly prolonging survival but magnifying a crisis when it eventually breaks.

(vi) *Lack of transparency*

If, as a result of an inadequate legal or regulatory framework, or perhaps simply as a matter of culture, the circumstances of a bank lack transparency to depositors and other counterparties, or even to shareholders, the role of market forces in determining the bank’s fate will be impeded and problems may be allowed to develop and multiply to an extent which might not otherwise have been possible.

(c) Banking strategies and operations

In many instances the problems of a bank have been brought about by the shortcomings of its own strategy or by operational failure. It is debatable to what degree supervisors should also be held responsible for having allowed poor strategies to be pursued; strategies are usually only known to be brilliant or disastrous after the event, and in a market economy it is questionable how far supervisors should interfere. Failures may arise -

- on the output side, as a result of, for example, mistaken or too rapid excursions into new geographic or product areas; from the episodes surveyed in the Appendices to this paper, the rush to expand has been perhaps one of the most common causes of failure;
- on the input side, as a result of failure to rationalise staff, to inculcate new management culture, to utilise information technology effectively, or otherwise to organise and operate effectively.

Some of the more common operational failures are as follows:

(i) *Poor credit assessment*

Despite the many and varied factors identified in this paper as contributing to banking crises, failure to make an accurate assessment of credit risk and to price accordingly is perhaps still the single most

common cause of banks' problems. Often this factor is particularly linked to the macroeconomic cycle. As recently noted by the Bank of England [6(a)]: "..... often ... in periods of economic growth, banks have concentrated on expansion of the balance sheet. With a combination of optimism about the economic future and competitive pressure to maintain market share, rigorous credit assessment takes second place so that subsequent problems are more severe than they need be. New business is worth booking only if it is good business".

An associated problem is that of so-called adverse credit selection. If banks pay insufficient heed to the pricing of risk, they may be tempted to deny credit to the more cautious customers, who perhaps set prudent upper limits on the interest rate which they feel able to pay, while granting credit to more speculative ventures which declare a readiness to meet higher interest charges, but where the risk of default is disproportionately greater.

(ii) *Interest rate or exchange rate exposures*

These exposures may result in losses, but ought to be limited by internal or supervisory controls. Sharp shifts in macroeconomic policies or circumstances (as mentioned above) may, however, provoke losses on this account beyond the usual tolerance of regulatory limits.

(iii) *Concentration of lending, and connected lending*

Again, as in (ii), controls should be in place, but in some countries individual banks either have long-standing links to particular customers or economic sectors, or have been established in the more recent past specifically with such close links in mind. Such concentrations have been shown historically to be a source of problems, and steps should be taken where possible to reduce any such dependence. In the developed countries ceilings on loan concentration are clearly specified and enforced.

(iv) *New areas of activity*

New activities, such as the trading of derivatives, may be imperfectly understood by senior management (and often by supervisors too), especially in countries where expertise is thinly spread. This indicates a need to proceed only step by step into new areas, but does not necessarily constitute a case for indefinite prohibitions.

(v) *Unauthorised trading or position-taking, associated with a failure of internal controls*

This appears to have become an increasingly worrying source of bank losses (either directly or in subsidiary companies) or ultimate failure. In each of the cases of Barings, Jardine Fleming, Morgan Grenfell and Daiwa - referred to in the Appendices - a single maverick individual seemed to be responsible for losses. The losses in the region of \$3 billion in the copper market, revealed in 1996 by the Sumitomo Corporation and apparently incurred by one trader, are another illustration of this danger; although Sumitomo Corporation is not a bank, there could have been knock-on effects to financial institutions.

(vi) *Other operational failures*

Problems may arise from a variety of other sources. The following are examples:

- poor quality of staff, or low experience, as a result of high staff turnover or too rapid expansion of business;
- deficient management structure with insufficiently clear lines of oversight and responsibility;
- inability or reluctance to control costs;
- reward structure for staff that encourages excessive risk-taking;¹¹
- inadequate documentation, recording and audit trails;
- over-reliance on IT systems, without adequate back-up, without sufficient trialling and verification, without proper audit arrangements, or without management understanding enough about the systems;
- absence of contingency plans to deal with either external or internal emergencies.

¹¹ See [15] for a discussion of issues relating, in particular, to the large bonus arrangements applying to some traders.

Although some of these may not be regarded as prime causes of crises, they may nevertheless exacerbate existing problems or serve as the “last straw” in precipitating a crisis.

(d) Fraud, corruption

Some of the cases cited in (v) above may amount to fraud by particular dealers or traders - depending on how legalistic a definition one adopts. There have also been instances of major frauds (such as BCCI) perpetrated by the management or pervading the whole structure, rather than being the work of just one or two errant employees. Employees, management or outsiders may all be susceptible to corruption or capable of fraud on a bank; and there are many possible channels for fraud - an obvious one in the present day is computer systems.

It is hard to draw any very specific conclusions as to the causes of banking crises. Episodes vary, and often there is more than one factor at work. Macroeconomic factors are perhaps too frequently assigned the blame when the real fault lies with banks’ own strategies or operations. There may sometimes be lapses in supervision, but it is not the purpose of supervision to ensure that banks never fail. Unhelpful or ambiguous involvement of government in the banking sector may precipitate or prolong a bank’s difficulties. Risk assessment may still be the Achilles heel of many banks. And the growing incidence of maverick unauthorised or fraudulent trading and the associated failures of internal control systems have perhaps been the distinctive factors to emerge in the current decade.

4 Actions to pre-empt or resolve banking crises

It is important for the authorities that their system for monitoring banks provides as prompt and accurate a warning as possible of any impending difficulties. Swift pre-emptive action can sometimes succeed in preventing a crisis or at least containing it.

In deciding what, if any, action to take when a bank or a group of banks does get into difficulties, the authorities may review some or all of the points in the following check-list:

(a) Solitary or systemic?

The chief concern of the central bank should be for the stability of the financial system, not the survival of any particular bank. It is of course a matter for judgement at the time, what the knock-on effects of a prospective bank failure might be. In some instances the threat of a credit crunch - an extreme reluctance to lend or borrow new money - and fear of its macroeconomic consequences may also be seen to justify intervention.

(b) Interest of depositors

Alongside concern for systemic stability, in most countries the authorities acknowledge a duty to depositors, particularly to retail depositors. To some extent this may be covered by deposit insurance, although it may be neither feasible nor advisable to attempt to provide deposit insurance for banks which do not meet basic prudential standards, or in countries where supervisory systems have not yet achieved a satisfactory level of reliability.

(c) Illiquidity or insolvency?

The central bank is usually content to provide some liquidity support if it can be satisfied that this is a temporary need and that in underlying terms the bank is solvent. In practice, however, illiquidity may merely be a signal of impending insolvency; indeed, insolvency may have preceded illiquidity, although it may be hard to assess the true position at the time assistance is first sought. On the other hand, a bank may be seriously illiquid today and hence unable to carry on unaided, while being prospectively solvent on a longer view - perhaps a longer view than customers and market counterparties are prepared to contemplate. The authorities may then feel justified in nursing the bank for an extended

period, albeit - realistically - more often to an orderly wind-down than to a resumption of active business. The central bank may be able to provide a certain amount of liquidity without incurring credit risk itself, through its money-market standing facilities or adaptation thereof - for example by purchasing securities, by collateralised lending or by releasing reserve requirements.

(d) Authority; speed

Speed is usually essential if a crisis is to be contained or averted. To this end it must be absolutely clear who is responsible for action (typically but not always the central bank); and that body must possess sufficient authority to take and implement decisions, or be able to conduct and conclude any necessary consultations (eg with the Ministry of Finance) in the shortest possible time-frame. It is also advisable that the public should already be aware of the principles and conditions which pertain to such intervention - so as to avoid false expectations and any subsequent accusations of policy having been enacted capriciously or without consistency.

(e) Confidentiality

Where appropriate it is vital that the central bank should be able to operate without any publicity - eg to prevent panic spreading. There may be a fine line between this necessity on the one hand and the rights of depositors or the public to information on the other. And the exercise of secrecy at the time should not exempt the authorities from being properly accountable for their actions in due course.

(f) Clear exit

If the central bank is to become involved in supporting a bank, it will need to have a clear idea of the eventual exit - be it through liquidation, takeover, rehabilitation, or whatever. A problem presents itself if a bank is deemed to be too big or important to be allowed ever to fail, since the authorities may then find themselves with a virtually limitless obligation to provide support.

(g) Limitation

Except in such extreme cases, the central bank will normally wish to limit its intervention in any banking crisis, both in terms of containing the

public cost and in order to avoid the presumption of open-ended support and the consequent moral hazard.

(h) Costs; recovery of expenditure

Support operations will have implications for the central bank's own profits and/or for the government budget (if support is provided directly from the budget or from the central bank's own resources but with an eventual reduction in net transfers of its profits to the budget). Ideally, a framework for such financial arrangements should be permanently in place, so that such questions do not delay a support operation when such becomes necessary. The central bank should so arrange that any outlays which it makes can be recovered, with appropriate seniority, if the circumstances eventually permit - see also (k) below. More especially, it will want to ensure that the shareholders of a failed or failing bank are not the beneficiaries of the expenditure of public funds in its rescue.

(i) Minimum interference with market forces

Plainly, any official rescue implies some interference with the natural play of market forces, as well as involving moral hazard. It is desirable that such distortions be kept to a minimum.

(j) Conditionality

The central bank may insist that its support is conditional on the bank in question taking various steps to improve its systems, alter its strategic direction, change its management, etc. To some extent this may be regarded as part of the banking supervision function. Such action may also be necessary in order to provide the central bank with a clear exit - see (f) above. Any set of conditions should as far as possible include incentives for the bank to rectify and improve its performance.

(k) Future of the bank

Whether or not it is addressed in the context of an exit strategy for the central bank or the conditions for official support, the future of any problem bank will need to be considered. Closure or liquidation may prove unavoidable. Alternatively, a survival strategy may involve a rescheduling of debts, a merger, a takeover (by another bank but, in the last resort, possibly by government), privatisation (if it is currently state-owned), or some other means of recapitalisation or restructuring. Two general areas for caution may be noted:

- if it is intended that the bank should continue in business, it will not be sufficient simply to deal with the *stock* problem - ie the existing non-performing debts; it is crucial that the *flow* of future business should be profitable and this may necessitate substantial changes in strategy, management and culture;
- any solution involving new ownership must take account of the quality of ownership, in respect of technical ability to oversee a bank, personal integrity, and financial resources; it is seldom appropriate for the authorities simply to hand control to the first bidder who appears with funds to cover the reserve price of acquisition; in the case of bank privatisation, particular care should be taken not to fall into the trap of presuming that private ownership necessarily equates to effective governance.

In any such resolution, the treatment of non-performing assets may be particularly important. To leave them on the balance sheet may amount to a millstone round the neck of the bank: scarce management resources may have to be devoted to collecting these debts or playing some role in the management or liquidation of debtors, for which role bank management may not be well suited. And some of the bank's staff may bear responsibility for some part of the problem, or have personal connections with the debtor, in which cases they will not be the most suitable people to carry forward the resolution. In addition, the debtor may owe money to several banks, in which case a collective approach, through a resolution body, may help to maximise recoveries. Moreover, the uncertainties surrounding possible recoveries may present the bank with continuing problems in respect of, for example, valuation and provisioning, if the loans remain on its books.

It is for reasons such as these that resolution companies (variously referred to also as "bad banks" or "hospital banks") have been formed in a number of instances to take over the bad loans, but these inevitably have to be resourced from public funds. It may be possible to institute some arrangement whereby the authorities have a sort of equity stake in the problem bank, the profits from which - if the bank recovers - can eventually be used to defray the various expenses incurred in supporting it.

On the other hand, it can be argued that the bank itself has the closest knowledge of its clients and is therefore best placed to recover outstanding loans, in which case the poorly performing loans should be left on the balance sheet. A compromise approach could be to place the loans in a hospital bank but leave their recovery in the hands of the original bank as agent for the hospital bank.

The balance of argument regarding the treatment of bad debts may depend on the specific circumstances of a particular case, but in the majority of cases, notably where the problem is of a systemic dimension rather than an isolated incident, experience indicates that creation of a separate resolution body has been the preferred route.

5 Conclusions

As regards the structure of banking, it may be difficult - and even unwise - to attempt to define in law, or by precise regulation, the permitted scope or organisation of a bank's business. The most important considerations are:

- whether the bank's management and staff adequately understand each activity which the bank conducts (or wishes to conduct), have a proper appreciation of the associated risks and are competent at managing those risks;
- whether the supervisory authorities are confident that the structure of a bank, and the activities which it undertakes or proposes to undertake, can be supervised effectively (whether from the standpoint of systemic stability or consumer protection - which in some instances may involve different agencies); this applies as much to the potential difficulties of supervising a bank or banking group which may have a complex structure and be widely spread internationally, as it does to supervising particular activities or instruments.

These considerations point to the desirability of the supervisory authorities having a significant degree of discretion in the exercise of their duties, provided that there is a mechanism whereby a bank can ultimately appeal against a supervisor's ruling if the bank regards it as unfair or unreasonable.

Official intervention to manipulate the structure or composition of the banking sector should only follow from proper economic analysis (eg to demonstrate the existence of market failure) or conscious political decisions (eg to help a region or sector), and not from *ad hoc* decisions provoked, say, by political opportunism or by compassion. Even then one should examine mechanisms for distributing any subsidies or supplying any subsidised services in as market-oriented a way as possible.

As regards bank failures, they will never be entirely prevented. Indeed, they should not be, because in a competitive, market economy there must be room for the process of natural selection, although the authorities may wish to guide this process so that failure is associated with orderly closure or takeover, rather than crisis. The role of the authorities is to ensure as far as possible that banks are prudently run and that, consequently, the interests of depositors are protected and there is systemic stability within the financial sector.

Depositors can be protected to a degree by insurance arrangements. However, if these are too generous moral hazard is high. Moreover, insurance may only be feasible once the banking sector has achieved a reasonable degree of stability and is adequately supervised; this means that in many transitional economies it may yet be premature to consider introducing deposit insurance. Depositors' interests also require that the authorities are able to take prompt action should a bank experience serious problems.

Supervision provides some sort of safeguard both for the individual bank and the system. But supervision cannot and should not aim to eliminate all risk of failure, and the public should be made aware of the limitations of prudential supervision and so understand what responsibilities rest with them as customers. Banking is a business of risk-taking and would lose its *raison d'être* if all risks were eliminated or suppressed. It is a matter of judgement how tight or intrusive supervision

should be. There is a tendency for supervision to ratchet upwards: with every banking failure or crisis the political chemistry leads to calls for firmer supervision and more supervisors. New Zealand presents an interesting exception, with its move to reduce official supervision and rely more on transparency; some applaud, while others describe New Zealand as very much a special case because the major banks operating there are all incorporated in other countries.

What is clear is that a supervisory system in a market economy cannot be expected to police closely all aspects of a bank's operations. A more modest, reasonable and achievable aim of the supervisor (in addition to monitoring the basic statistics, ratios and limits pertaining to prudent banking) should be to ensure that the management of a bank is in competent and honest hands, and that the tools used for assessing and monitoring risks, whether grass-roots credit assessment or complex derivatives exposures, are sound and well understood. In addition, the supervisor should be satisfied that adequate systems of internal control are in place and functioning. As banking becomes more complex, supervisors are looking increasingly at the adequacy of banks' own systems for limiting risk (eg risk-evaluation models, systems and controls, internal audit) rather than merely imposing officially determined risk limitation ratios. The need for such a shift in emphasis has been highlighted by the fraudsters and rogue traders of recent history as much as by continuing tales of lamentable credit assessment. Banking supervision is as much about people and systems as it is about numbers.

Meanwhile, economies will no doubt continue, despite the best endeavours of policy-makers, to be subject to cycles and shocks. Risk management systems within banks should, as far as is reasonable, be designed to accommodate these, even when unexpected, so that neither are banks unduly vulnerable to macroeconomic fluctuations, nor does macroeconomic behaviour become a scapegoat for banking problems; and so that neither temptation nor pressure arises to subordinate macro policy to concerns about the health of banks.

Last but not least, the central bank - or other appropriate authorities - must have ready a coherent strategy for dealing with banking crises.

* * * *

United Kingdom

Contrary to the impression given by newspaper headlines, relating to two major failures in the 1990s - BCCI and Barings - the United Kingdom has been markedly more successful than many other countries in avoiding extensive crises or failures in core banks. Moreover, the costs to public funds and to the deposit insurance scheme in coping with banking problems have been extremely modest. Thus, the total cost to the Bank of England's own balance sheet of the various incidents in the 1990s (see below) has been provisions now standing at £95 million (less than 0.02% of one year's GDP - see page 3 for estimates of comparative figures for some other countries) and there has been no support at all from the government's budget. The Deposit Protection Fund has been drawn upon in a number of mainly small cases; this is funded from the banks and not the public purse. From its inception in 1982 up until 1997, net payments from the Fund (net of subsequent recoveries in liquidations etc) totalled £44 million (and there may still be some recoveries), whereas in the United States the Federal Deposit Insurance Corporation is estimated to have paid out the equivalent of some £20 billion over the past ten years or so and in Japan the Deposit Protection Fund, which had assets of some £5 billion equivalent in the early 1990s, has since been substantially depleted.

A basic principle followed by the Bank of England has been that support should only be given if there is a significant risk of contagion which could destabilise the financial system: it was in accordance with this principle that assistance was provided during the early 1990s for a clutch of small banks, but not for two larger banks in clear, isolated instances of malfeasance. Thus, a bank should in certain circumstances be allowed to fail. Another lesson has been that prompt and early action, most often behind the scenes, to nurture problem banks, whether towards closure or recovery, may help to prevent a wider or bigger crisis, and need not necessarily involve huge net outlays of public funds.

BCCI

The collapse of Bank of Credit and Commerce International (BCCI), which led to its liquidation and closure in 1991, was the result of a

massive fraud. It remains the largest bank failure ever experienced in the UK. BCCI had posed particular supervisory problems because the two companies through which it carried out its international banking business were registered in Luxembourg and the Cayman Islands (each audited by a different international firm of accountants), its principal shareholders were latterly based in Abu Dhabi and the group was largely managed from London. By 1988 it had branch or subsidiary presences in 73 countries.

The Bank of England had been aware of some of the problems facing BCCI, but had judged that, on the information then available to it and in the light of a commitment from its principal shareholders - essentially the government of Abu Dhabi - to recapitalise the bank and to oversee changes to its management, systems and group structure, the interests of depositors would best be served by dealing with the weaknesses within the on-going business. This approach was abandoned once the full scale of the problems was revealed by a special report commissioned by the Bank from accountants. Immediate action was then taken to close down BCCI. Eligible depositors were compensated from the Deposit Protection Fund - within the limits of the scheme - and liquidators have subsequently been able to distribute some dividends to creditors after complex realisation processes and much litigation.

The initial strategy of tackling BCCI's problems through remedial action reflected not only an assessment of what was likely to be in the interest of depositors at the time, but also successful experience with such an approach in other cases. This is not to suggest that the Bank of England would be in any sense hesitant to use its formal powers if it believed that the underlying problems could not be remedied - in the preceding five years 16 banking authorisations had been revoked and 25 subjected to temporary restrictions.

Inevitably, after the collapse of BCCI there followed a formal enquiry - conducted by Lord Justice Bingham. His report [10] made some criticisms of the detail of the Bank of England's supervisory approach, though did not call for any radical changes to the basic system. The Bank accepted Bingham's recommendations, which led to the establishment within the Bank of a new legal unit and special investigations unit; a review of arrangements for involving the Board of Banking Supervision (a statutory body established under the Banking Act to advise the Bank in

the exercise of its supervisory role); improved communications within the Bank and between the Bank and relevant government departments; and better training of supervisors to enhance their alertness to fraud or malpractice.

But from an international standpoint the more important legacy of the Bingham Report was the attention which it drew to the prevailing shortcomings in the supervision of internationally-spread banking groups. This has led to a tightening of international standards, as established by the Basle Committee of Supervisors, which have since been given legislative backing in the European Union and elsewhere. Changes include the power to refuse or revoke a banking authorisation if a bank cannot, on account of its group structure, be effectively supervised; a requirement that the head office of a bank must be located in the same state as its registered office; improved “gateways” for sharing information among supervisors, accountants and anti-fraud bodies; and a duty on auditors and other professional experts to report suspicions to supervisors.

Barings

The collapse of Barings in 1995 also exposed problems in a group with business spread internationally, but in this case there was a massive fraud perpetrated by a single “rogue trader” in a non-bank subsidiary rather than, as with BCCI, a fraud in which top management was complicit.

The fraud occurred in a Singapore subsidiary. The holding company in London did not engage in hands-on management of the subsidiary and began to worry only when massive losses became apparent. A matrix management structure left different strands of management each believing that others were in charge of the situation. The trader claimed to be arbitraging in a risk-free manner between derivatives markets in Singapore and Osaka. He disguised the position by having arranged that an all-important “error” account should be excluded from daily management reports, and by fixing, through fraudulent entries, the balance on this account to be zero at month-ends. He reported falsely to the Singapore Exchange so as to reduce required margin payments. The final loss, once all positions had been closed out, amounted to some £900 million. There had been an absolute failure of internal controls to detect these activities.

Subsequently ING Bank acquired Barings for a nominal sum, thus ensuring that all depositors and trade creditors were fully protected.

The Board of Banking Supervision was asked to conduct an investigation into the Barings affair [11]. They produced seventeen recommendations for improvements in supervisory procedures, all of which were accepted and have been acted upon by the Bank of England. These included more rigorous procedures for consolidated supervision; steps to ensure that senior management of banks sign off the statistical returns submitted to the Bank of England; more rigorous policing of large exposures; stronger relations with internal auditors and audit committees; improved co-operation with other regulators, both within the UK and overseas; and the establishment within the Bank of England of a “quality assurance” function for supervision.

Other problems

There have been a number of other incidents which, despite lesser appeal in terms of scale and notoriety, may be at least as instructive in terms of any analysis of strategic approaches to banking problems. The collapse of Barings, and the apparent ease with which a single malefactor could wreck a banking group, was an alarming example of failure of internal controls. During 1996 a further two incidents involving rogue individuals in British financial institutions attracted publicity, although in neither case did the immediate problem arise in a bank subject to UK banking supervision. In Hong Kong a fund manager in Jardine Fleming Investment Management was found to be trading for his own benefit: put simply, he allocated shares which he bought to a fund in which he had an interest if their price rose in the immediate period after dealing, but to clients’ accounts if their price fell. In Morgan Grenfell Asset Management in London (MGAM - a subsidiary of Deutsche Bank), a trader acquired unlisted securities well in excess of limits set for the funds which he was managing.

In both cases the incident occurred in a securities firm rather than a bank, and the regulator immediately responsible was the relevant securities regulator. But in each case there was a parent bank whose reputation was at stake (and, in the case of MGAM, Deutsche Bank agreed to make good any losses which investors may have suffered). In

both cases actions have been taken by management or regulators to discipline those involved and to guard against any possible repetitions.

In contrast to these well publicised episodes - BCCI, Barings, Jardine Fleming, MGAM - there is an altogether different tale to tell. Early in the 1990s a number of small banks in London were experiencing increasing liquidity difficulties as a result of steep falls in asset prices - especially real estate - brought on by general economic recession. These banks were typically reliant on the interbank market for funding, and this source dried up as concerns arose as to the health of their assets and as the interbank market itself was rocked first by the placing of British and Commonwealth Merchant Bank in administration in June 1990 (as a consequence of problems in the wider British and Commonwealth Group), then by withdrawals of funds by some foreign banks (eg US and Japanese banks) which were themselves encountering problems at home, and finally by the BCCI scandal. From mid-1991 the Bank of England discreetly organised liquidity support for some of these small banks - action which was judged necessary to avert a more serious systemic crisis. Details were revealed only a couple of years later, after the pressure had passed.

During this period a number of banking authorisations were surrendered, in part because of the direct fall-out from that liquidity crisis but also because the crisis prompted these institutions to review their fundamental strategies. Some then concluded that the overall costs of compliance with supervisory requirements outweighed the benefits from continuing authorisation. In some cases it appeared feasible to finance activities in future from sources other than deposits. Arising from this episode one bank, National Mortgage Bank, which had received liquidity support, was acquired, in 1994, by the Bank of England for a nominal sum in order to facilitate control over asset realisation.

Summary of causes

As regards the causes of banking problems, a Bank of England study in 1996 [21] identified 22 cases of banks which failed or encountered severe difficulties since 1984, and the following reasons:-

Number of banks judged to have encountered each problem

Poor asset quality		16
<i>over-concentration of lending (and failure of one or small number of such loans)</i>	5	
<i>over-specialisation (eg by sector or region)</i>	10	
<i>incorrect pricing of risk</i>	13	
Mismanagement		18
<i>poor strategy</i>	11	
<i>poor systems & controls</i>	17	
Dealing losses		2
Group structure or contagion		4
Illiquidity		9
Fraud / concealment		7

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Appendix 2

Other countries

Episodes of banking problems in some other countries are briefly examined here, mainly in order to identify causes and eventual solutions. Given the huge number of countries where difficulties have been experienced, it is not possible to be comprehensive, and the selection of countries, and of episodes within countries, may not necessarily provide a globally balanced view.

United States

The savings and loan crisis in the United States peaked in 1987/88 and by the turn of the decade it was substantially resolved. More than 1000 savings and loan institutions (known as “thrifts”) or small banks required intervention of some sort - in many instances resulting in closure. The roots of the thrifts crisis lay in their simple role of providing residential mortgage loans at fixed rates of interest, which had to be funded from deposits taken in what was, following deregulation, an increasingly competitive variable-rate market. It is perhaps remarkable that such a plainly imprudent strategy survived, or was permitted to survive, for as long as it did. Through periods of relatively stable interest

rates serious problems might not have been encountered, but the sharp upward movement in US interest rates in the early 1980s delivered a major shock. Other factors which may have contributed to the demise of the thrifts and small banks were their small size and the concentration of their lending in particular regions (a restriction often imposed by law) or sectors (real estate), and perhaps also the moral hazard implicit in very generous deposit insurance arrangements.

Japan

The problems which have been encountered by the Japanese banking sector in the 1990s arose for a different, and varied, set of reasons. Perhaps the most important factor was the over-extension of lending, supported by rising land and share prices, evident for most of the 1980s until a sharp tightening of monetary policy in 1989 precipitated a collapse in asset prices and hence of collateral. Frailty has since perhaps been most visible in the Jusen sector; the Jusens are essentially non-bank affiliates of banks, originally established to provide housing finance but later drawn into lending for commercial property development; the Jusens became largely insolvent and their losses rebounded onto the banks. The banks have suffered from their own direct exposure to real estate as well as via the Jusens.

But this was not the only cause of the problems. Japanese banks had been expanding rapidly during the 1980s, with greater attention to asset growth than to rate of return; and, although many of them struggled to reach minimum international capital ratios, this seldom constituted more than a temporary brake on expansion, which proceeded apace both abroad and at home, where deregulation in the late 1980s (such as the lifting of restrictions on deposit interest rates) propelled them into a more competitive environment for which management may not have been adequately prepared.

When problems did emerge, a tradition of the strong supporting the weak, coupled to the existence of only a rather modest deposit insurance fund, led the authorities to work behind the scenes to shore up weaker institutions - initially by persuading the stronger to provide support, but increasingly with public funds. This culture of not permitting outright failures created moral hazard and probably impeded the development of

adequate risk-consciousness in banking. There had also been, historically, a lack of transparency in banking, with, arguably, insufficient internal and external accountability and no very strong tradition of internal audit. As a result Japanese institutions suffered their share of scandals relating to unauthorised or unsupervised trading, such as in the case of Daiwa in New York.

Public sympathy in Japan for the operations in support of the banking sector has been tested by the authorities' tendency to underestimate the scale of the problem, by revelations of fraud and by perceptions that both depositors who took evident risks in seeking particularly high interest rates, and the management and shareholders of the banks, were benefiting disproportionately from support operations. It may still be too soon to guess at the eventual cost of the exercise, but the worst may be over: while 17 out of the 20 largest Japanese banks reported pre-tax losses for 1995, only three did so in 1996. As a result of their problems, Japanese banks have had to face a premium in the markets; retrenchment has been forced upon them; and the image of the Japanese banking sector has been damaged, at least temporarily. In November 1996 the Japanese authorities for the first time forced a bank - Hanwa Bank, which was discovered to have huge bad debts - to close. However, the authorities took steps to ensure that all deposits would be honoured, if necessary from official support to the deposit insurance fund. In April 1997 two banks from among the top twenty announced their withdrawal from international business; one consequence is that they will only have to satisfy the domestic capital adequacy ratio of 4% rather than the international one of 8%.

Nordic countries

In Europe, banking problems in the 1990s have perhaps been the most severe in the Nordic countries, where the crisis reached its peak in 1992. BIS estimates [2] suggested that support was then being given to banks accounting for 70% of the sector in Norway, 92% in Finland and 27% in Sweden. In each case government committed itself, explicitly or implicitly, to supporting the sector financially; in addition governments were instrumental in assisting with mergers and restructuring. The proximate cause of the crisis was again the collapse of asset values, but

the crisis also revealed more fundamental weaknesses in banks' credit assessment procedures and in banking supervision.

It is of interest to note that in Sweden a "bad bank", Securum, set up in 1992 to take over the bad debts of a number of commercial banks, is likely to be wound up during 1997 and to pay back a significant part of the equity originally subscribed by the state, as a result of partial recoveries of bad debts on a larger scale and more speedily than envisaged. This illustrates the point which has also been evident in the United Kingdom, that a patient realisation strategy over a number of years may produce a notably better outcome than expected at the time of crisis. In Sweden the crisis itself was probably also contained by the prompt action of the authorities in pledging support to troubled banks.

France

A headline case in Europe in recent years has been that of Credit Lyonnais in France. This state-owned bank recorded large losses for 1993, partly as a result of falling property values, and these losses persisted subsequently. In March 1994 it received a sizeable injection of state aid (Fr 4.9 billion in capital, plus Fr 40 billion of guarantees), but it rapidly became clear that this was insufficient to deal with the problems. In 1995 a further complex package was devised, which involved the transfer of some Fr 125 billion of problem assets to a special-purpose state-owned company, funded in turn by a government-guaranteed loan from Credit Lyonnais itself. Even this proved inadequate and in September 1996 a third package, including a government injection of a further Fr 3.9 billion of capital, was announced. Early in 1997 it was proposed that yet another capital injection, of up to Fr 30 billion, would be required prior to possible privatisation. This would bring the total of government financial support to this one bank to about 1% of annual GDP.

Although a deterioration of credit quality was one immediate cause of the crisis, the problems of Credit Lyonnais ran deeper. It had earlier embarked on a major expansion, as part of a government-backed drive to become a global force. This strategy involved several prestigious foreign acquisitions, and appeared successful for a while. But the bank at the

same time remained saddled with too close and ambiguous a relationship with government, which resulted in continued large exposures to public sector industries or projects which may not have been fully justified in commercial terms. Critics have also pointed to awkwardnesses in management culture, inadequate control systems, and the difficulty of rationalising the staffing structure in view of the attitude to, and of, state sector employees. Nor have the supervisors escaped adverse comment.

A notable feature of this story has been the lack of finality in actions. The initial injection of support was felt not to have been accompanied by an adequate commitment to address the root problems. There was a widespread presumption - justified in the event and probably true for any country if one of the very largest banks faced such troubles - that Credit Lyonnais was “too big to fail” and could therefore count on limitless support. Under European Union rules, however, continuing state subsidies are not permitted, so pressure from that quarter, at least, has been focusing minds on finding a lasting solution.

Mexico

The Deputy Governor of the Bank of Mexico attributed (reported in [19]) the banking crisis of December 1994 to the sudden and drastic reduction in net foreign credits to Mexico. This raises the interesting question of the interrelation between the macroeconomic situation and the health of banks. Plainly, the reduction in net inflows, the associated depreciation of the peso and the inevitable hike in interest rates put pressure on the banks. More precisely, it put pressure on borrowing customers, who faced higher interest charges and, for those who had borrowed in foreign currency without being certain of a corresponding foreign currency cash flow, potential losses on foreign exchange mismatches; and these pressures fed back to the banks. It does not escape notice, however, that an earlier surge in bank lending was one of the factors to blame for the upswing in the macroeconomic cycle, which had now turned down.

Tracing a bit further back in time, the reprivatisation of the banking sector in the early 1990s, after a decade in public ownership, placed the banks under considerable pressure to increase profits - in part to reward their new owners for the not inconsiderable sums expended in acquiring

ownership. This pressure led in turn to ambitious lending decisions, by banks which may have lacked adequate numbers of staff suitably skilled in credit appraisal, and which may have, for similar resource reasons, been inadequately supervised. As a result of the rapid and, to a degree, ill-controlled growth of credit in the period 1991-93, non-performing loans were already becoming significant before the full crisis broke at the end of 1994. And, generally speaking, the groups which had acquired the banks through privatisation lacked the financial strength to provide much shareholder support when difficulties emerged.

A run on the banks in December 1994 was averted by an explicit commitment of the government to guarantee deposits. A programme of financial support, restructuring and tougher supervision was then introduced. The costs to the government were substantial, but the measures appear to have been largely successful in their objective of stabilising the banking sector and placing it on a surer long-term footing.

Transition economies

Finally, a word about the economies in transition in central and eastern Europe and the former Soviet Union. Without exception they have all experienced severe banking problems. The reasons are mostly common to all: on the macroeconomics side, the lurch to hyper-inflation and (in most cases by now) back; severe recession for a few years; bankruptcy of traditional customers; and so on; on the microeconomics side, lax licensing; lax supervision; too close an involvement with particular industries; loans to major shareholders; government interference; and so on.

If the reasons are quite uniform, the resolution of these crises has displayed greater diversity of approach. Apart from a general move towards tightening up of licensing and supervision, choices have varied as between different combinations of rationalisation, mergers, foreign participation, “hospital” banks, government recapitalisation, privatisation and so on.

There is insufficient space to address the experience of individual transition economies, but a number of lessons have emerged:

- In some countries it has proved hard to break the culture whereby large single exposures and cosy lending relationships with shareholders are regarded as the norm. In the case of some of the large sector-focused banks, this was an inheritance from the initial carve-up of the monobank system in the early stages of perestroika, but many new, small banks have also been established as so-called “pocket” banks, and in Russia the initiative to create financial industrial groups (FIGs) seems to be based on the same philosophy, at least to some extent. Already, however, the problems of such ties have been becoming apparent: many pocket banks have had to be closed down, and the large banks which have retained highly concentrated loan portfolios have in some instances been visibly vulnerable (particularly those oriented to agriculture). However, in circumstances where information about potential customers is either unreliable or unavailable, and where the identification and enforcement of property rights or of bankruptcy range from difficult to impossible, it is understandable that banks should want to deal only with a close, known group of customers. If it proves impossible to break from these traditions, then perhaps westerners will be forced to adjust their expectations and adapt their attitudes in respect of these countries; transparency of such relationships may come to be regarded as a substitute (albeit second-best) to their elimination.
- Supervisory resources have needed strengthening, but, as in all countries, this has of course been easier said than done.
- Massive moral hazard has arisen from the authorities standing ready to support banks; however, in the absence of deposit insurance, or in the face of systemic collapse, the authorities have had little choice. The key objective must be to ensure that action to improve management or restructure the bank is an obligatory element in any package to rescue a bank; and the limits of official support should be specified up front and not be breached.
- There appears to have been some correlation between progress towards a sound and efficient banking sector, and the extent of foreign participation. This issue was discussed on page 13 above.

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