

CHAPTER 5: SOME CONCLUDING OBSERVATIONS

The experience with resolving NPLs in bank restructuring has already produced valuable lessons, many of which will evolve as the process continues. In particular, many “conclusions” at this time are actually interim assessments, as it will take several years before the resolution of NPLs will be completed.

The NPL problem has multiple causes. The bad news is that there is no single solution. Part of the problem is the endogenous factors contributing it: bad management or poor lending policies, and skimping on the resources which contributed to higher NPLs rate; fraud and embezzlement; high credit and country risk; growth of lending activity; moral hazard incentives where banks with low capital respond to moral hazard incentives by increasing the riskiness of their loan portfolio; lack of diversification on loan portfolio, and “evergreening” loans. Another part of the problem is the exogenous factor, namely, the heavy government intervention and tight government control of banking sector besides the bursting of speculative bubbles and economic downturn; adverse consequences of financial liberalization and the weaknesses in prudential regulation and supervision.

The good news is that there are several possible policy measures that can significantly reduced the severity of NPL problem. Prudential credit risk and country risk management, limiting loan guarantee and credit rationing are some of the measures identified. Careful screening and monitoring of borrowers can reduce the risk of bad lending decisions. Factors to consider for lending during hard times are

also equally important. Prudential regulation and supervision, which includes adequate bankruptcy law and public disclosure, are essential for resolving the problem.

Management of NPLs and other value-impaired bank assets is one of the most critical and complex aspects of bank restructuring. There is no single optimal strategy for all circumstances but rather a combination of options that may vary over time for each bank, depending on factors such as the nature of the problem assets, their overall size and distribution, and legal and governance constraints. The strategy will need to consider whether or not use a centralized process, which also involves ownership choices. Countries have taken different views on the role of asset management companies. Indonesia, South Korea and Malaysia have opted for centralized public asset management companies that buy assets from private banks to help banks clean up their balance sheets. The key issue in asset purchases by an asset management company is realistic valuation, so as to ensure that it does not become a tool for the indirect bailout of existing shareholders, thus undermining the incentives for private sector recapitalization and proper governance of asset management companies and banks.

One cause of lack of progress in resolving the NPL problem is that the linkages between financial sector issues were poorly understood. Today, there is a growing focus on the linkages between Governments actions and market confidence; between creditors and debtors; between banks and trade finance; between bank restructuring

and the necessary legal tools required to collect debts; between banks supervisory agencies and enforcement capabilities and so on. Steps are now taken to assure better coordination between different parties and greater consistency in program design.

The challenge is to create safe and sound institutions which are able to identify and support efficient borrowers with good prospects for loan repayment. These institutions must be well-regulated and supervised, subject to appropriate and timely enforcement actions, and sufficiently capitalized to absorb a rate of credit losses inherent in the banking business world.

Several countries are going through a difficult period of resolving the NPLs and banking sector restructuring, and are attempting to address the consequences of, inter alia, earlier failures of prudential oversight. These failures, and the lessons learnt from banking difficulties worldwide, have naturally prompted national authorities almost everywhere to take a good look at their safeguards against NPLs and other systemic financial problems. In some emerging economies, policy measures have been taken to improve the quality of banking supervision. In many others, these questions are under active consideration. The severity of NPL problem in developing countries over the past decade and a half argue against complacency. Banking restructuring need to be more widely shared and deeply rooted than was the sustained commitment. The ways that international co-operation, in several guises, can encourage or sustain this commitment is clearly an issue that requires urgent consideration.