

# NAM BUSINESS FORUM ON SOUTH-SOUTH COOPERATION

## Workshop IV – Capital Markets & Finance

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### Introduction

In my contribution, I would first like to review the Asian experience in financial restructuring, and the lessons which we can draw from it. Based on these lessons, I will then indicate the possibilities of South-South cooperation in restoring and maintaining a viable financial sector and in developing well functioning local capital markets.

### The Asian Experience

By now, Asian countries have gained ample experience in financial reform and restructuring, which started in late 1997, after the outbreak of the Asian crisis, which, at the heart, was a banking crisis.

In all countries affected, the banking crisis had two root causes:

- (1) **Imprudent lending**, partly because of political interference and partly because of bad governance. This led to an accumulation of non-performing loans (NPLs) which undermined the capital base of the banks and eroded the confidence of depositors.

- (2) **Excessive foreign borrowing**, at short term, to finance the expansion of bank loans. This mismatch made banks vulnerable to a change in market sentiment and to a corresponding reversal of capital flows.

Three factors contributed to these developments:

- (1) lack of adequate banking supervision;
- (2) premature liberalization of the capital account; and
- (3) over-reliance of corporations on bank credit, because local capital markets were insufficiently developed.

The crisis broke out when the precarious position of banks became evident. Foreign lenders rapidly withdrew their funds and local depositors staged runs on banks. Governments had to take determined and radical action to prevent a full collapse of the banking system. These included the following:

- the large flow of central bank support funds to unviable banks was stopped and the banks were closed;
- the remaining banks were recapitalized through budgetary resources;
- some banks were temporarily taken over by the government;
- NPLs were moved from the banks to a government asset management corporation (AMC) to clean up the banks' balance sheets;
- the AMC restructured the NPLs and sold them in the market to recover part of the cost of bank restructuring;
- banks were mandated to proceed with internal reorganization, in particular to establish proper credit evaluation and risk management systems; and
- banks were urged to merge to increase their efficiency and capital strength;
- at the same time, temporarily nationalized banks were reprivatized;

- foreign capital was allowed to participate in the process of consolidation and privatization;
- to make the system more resilient against future crisis, **bank supervision** was strengthened through establishing an independent supervisory authority and introducing best international practices.

These measures prevented a collapse of the banking system and initiated a gradual rehabilitation of banks. By now, substantial progress has been made in all countries, although in differing degrees, but the process has nowhere been completed.

Parallel to the restructuring effort, the **local capital market** was developed to ease the concentration of corporate financing on bank credit. This required:

- the removal of legal and tax impediments to bond issues;
- government bond issues in local currency at different maturities, to establish a yield curve and benchmarks for corporate bond issues; and
- the establishment of rating agencies to give a credit rating to the issuing corporations.

### **Some Lessons**

The overwhelming lesson from this painful experience is that governments should not wait until the deterioration in the banking system threatens overall financial stability. At that stage, only drastic and costly action can avert disaster. Instead, government should at all times keep banks under close supervision, and take prompt action at the first signs of weakness in a particular institution.

In practical terms, ensuring the health of the banking system includes a number of actions by the government:

- prevent political influence on banking operations, in particular on credit decisions;
- bring banking regulations up-to-date;
- create a strong and independent bank supervisory authority, to enforce banking regulations and standards of governance, and to impose penalties in cases of non-compliance;
- ensure transparency of banking operations through reporting and disclosure requirements;
- phase in capital account liberalization in line with the strengthening of the domestic banks and the introduction of adequate prudential regulations;
- develop the domestic bond market to avoid excessive loan concentration by banks and provide corporations a more diversified source of funding.

### **Possibilities for Cooperation**

The efforts to safeguard the viability of the banking system can be significantly strengthened through international cooperation. While recurring banking problems are not a feature unique to developing countries, there are particularly strong possibilities in this area for South-South cooperation through a number of avenues:

- a regular **exchange of experience** between the agencies involved in bank restructuring – central banks, finance ministries, AMCs, and supervisory agencies;
- the **secondment of experienced experts** in these agencies to agencies in other countries;
- the **harmonization** of banking regulations between countries with a view to enhance the adoption of best practices by banks on a regional basis and to streamline cross-border operations;

- the joint introduction of **international best practices** in banking supervision;
- the **exchange of information by supervising agencies** on banks which operate across borders, in order to detect problems at an early stage;
- the **opening of bank ownership** to residents of other countries to advance the process of bank consolidation and to benefit from the transfer of managerial skills as well as from greater regional cooperation.

In addition to these areas of bilateral cooperation, I would also mention cooperation with **international commercial banks**. These banks can advance the restructuring effort by bringing in expertise in the disposal of NPLs (e.g. through international issuance of AB securities), and in internal bank reorganization. They can also mobilize capital and can provide assistance in developing the local capital market.

Furthermore, countries should also take advantage of the technical assistance of **multilateral financial institutions** (IMF, WB, regional development banks) in financial sector restructuring. These institutions can send in their own experts or mobilize independent experts, and they can also monitor international standards and codes.

## **Conclusion**

In sum, bank restructuring and the development of local capital markets provide large possibilities for cooperation, in particular South-South cooperation. Governments should fully use these opportunities which can greatly strengthen their efforts in this important area. After all, the restoration and maintenance of a healthy financial system is crucial for the overall stability and development of the economies of their countries.