RESOLUTIONS OF WEAK INSTITUTIONS: LESSONS LEARNED FROM PREVIOUS CRISES

Issues for Discussion

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ISSUES FOR DISCUSSION

1. Recent events serve as a stark reminder that concerns about safety and stability in the financial services industry are legitimate. Financial institutions and markets are susceptible to periodic problems of marked illiquidity and insolvency, as well as fraud, and other malpractices, which, if not addressed, can precipitate system-wide crises. This risk of instability exists both at the level of individual financial institutions and markets and in the aggregate, and when realised can result in large economic and social costs.

2. There have been numerous such episodes worldwide in which financial sector problems have reached crisis proportions. Caprio and Klingebiel (1996) report, for example, that between 1980 and 1995 three-quarters of IMF member countries experienced some form of financial crisis, many OECD countries among them. Analysis by the CMF has drawn similar conclusions, noting that severe banking sector problems were widespread among OECD countries during the 1980s and 1990s, sparked in many cases by apparent price ‘bubbles’ in real estate or equity markets (Box 1), which had been supported in some cases or encouraged by favourable tax incentives and accommodative macroeconomic policies. There is worrisome evidence that these episodes are increasing in frequency and severity.

3. The purpose of the background note is to examine the current turmoil in the context of past crisis episodes. It focuses on the locus of activities subsumed under the failure resolution component of the financial safety net. Numerous problems have occurred in previous crisis episodes, related in some cases to weaknesses in practices of institutions and markets, but sometimes in the resolution of these problems, in the form of unanticipated feedback effects on various market segments, improper sequencing of actions and other programme inconsistencies. Selected questions for discussion appear on page 7.

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2 Virtually all OECD countries experienced major increases in household and business debt-to-income ratios in the wake of financial liberalisation that in some cases resulted in severe adverse outcomes. The CMF’s review of the regulatory reform process suggested that numerous mistakes occurred in many countries that were related, at least in part, to deregulation and liberalisation. Problems included: inadequate institutional strength, as measured by the quality of human capital and the adherence to market-based principles; insufficient attention directed at imbalances in the economy (i.e. debt, balance of payments, about markets and the output gap more generally) and how liberalisation of institutions and markets would interact given these imbalances; and inappropriate sequencing of financial sector reforms.
4. Some crisis episodes have been characterised by widespread or large-scale failures of financial institutions or have involved a large share of financial system assets. Others have been limited to fewer, though still, systemically important institutions. The current crisis began with problems among a few institutions, but spread subsequently to many other institutions and markets and has given rise to considerable international contagion.

5. Episodes of widespread financial problems have had their origins in a number of areas, including deficient bank management and control; business factors; shortcomings in the regulatory and accounting framework; difficulties with state-owned banks or enterprises; excessive and distorted taxation, and exogenous (mainly macroeconomic) shocks. For purposes of simplification, these causes can generally be placed in one of three broad categories: (1) primarily microeconomic (e.g., bad banking), (2) primarily macroeconomic (e.g., recession or other macro shocks), or (3) primarily institutional (e.g. poor, or at least inadequate, regulation and supervision). In the vast majority of cases, multiple factors have been involved.

6. Given the importance of commercial banks in the intermediation process in most countries, they have often been at the forefront of financial instability, playing a supporting role in the build-up of imbalances and contributing to the bust by curtailing lending. But commercial banks have not been the only source of difficulties. Rather, mutuals and other savings institutions, merchant banks, insurance companies and, most recently, stand-alone investment banks have also suffered from severe liquidity and insolvency problems that have grown into more widespread problems. The problems themselves have often been internal to the institutions themselves, but not always. Some problems have stemmed from contagion.

7. Real estate markets have featured prominently in many crisis episodes in industrialised countries, but whereas previous crises have been prompted most often by problems in the commercial mortgage market and with corporate clients, the trigger for the current crisis was a sub-component of the residential

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**Box 1**

**Examples of severe stress in the financial system**

- 1982 LDC Debt Crisis
- 1987 Worldwide “equity market break”
- 1989 United States S&L Sector
- Early 1990s:
  - Systemic Bank Insolvency in Scandinavia
  - Banking problems in many countries (e.g. US, UK)
- Post-1990 banking crisis and insurance insolvency in Japan
- ERM crisis 1992-1993
- 1994-95 Mexico
- 1997 Asian Crisis
- 1998 Russia/Brazil
- Post 2000 “tech bubble” and “bear market” in equities
- 2007- Subprime mortgage crisis (origins in the US) and 2008 financial panic (international)
mortgage sector. The current episode is similar to others in that it was preceded by a significant accumulation of debt and assets in an environment characterised by very low risk premia and high concentrations of risk.

8. This phenomenon is recurrent and is suggestive of a tendency toward procyclicality in the financial system. Periodically, there tends to be erosion in market discipline as participants shun caution in pursuit of short-term profit opportunities. This lapse in discipline takes the form of declining underwriting standards in banking, with underwriting standards reaching their lowest point for credits that prove eventually to have been of the most dubious quality. In market-based finance, due-diligence wanes as the cycle progresses and margins and other collateral requirements are relaxed, supported by rising demands fuelled by limitations in risk perceptions and distortions in incentives. This build-up of credit and asset price bubbles feeds on itself until some shock triggers its collapse.

9. The shock itself by definition cannot be predicted and tends to vary from episode to episode. Partly for that reason, it is difficult to predict when or where the next crisis will erupt. That is one of the key lessons from previous experience. It is possible to identify the signs of fragility, but the system can remain fragile for a long time without breaking.

10. While a crisis is still unfolding, authorities may have little alternative to the use of safety net measures to restore calm and prevent problems from spreading. But these measures give rise to moral hazard. Market participants and the public at large can become addicted to government support. Thus, the measures should be given a finite life. That means that as soon as possible permit authorities should begin to resolve the actual problems in the system.

11. Previous resolution efforts suggest a number of general principles that should be observed. As one of the first steps in the process, authorities must obtain a complete and systematic evaluation of the size of the problem and its causes. All relevant parties must be involved and there must be sufficient political will to solve the problem. Once the causes and magnitude of the problem are identified, authorities must act promptly to resolve the difficulties. Cross-country experience suggests that it is prompt intervention that minimises the spread of concerns about the health of the system as a whole and reduces the costs of resolution activities in the longer run.

12. But authorities must balance the short-term exigencies to restore calm against the potential to foster increased moral hazard and unsustainable extensions of the financial safety net. Thus, in addition to promptness, efforts must be made to provide correct incentives and the measures used must be comprehensive and credible, capable of addressing the immediate financial problems of weak and insolvent financial institutions and corporations as well as any longer-term structural weaknesses.

13. Policymakers in many jurisdictions have faced these types of problems. Their responses to crisis episodes suggest a number of important principles for successfully resolving these types of situations. In most cases, authorities adopt an overriding objective to ensure that the underlying disturbance is contained and that public confidence in the system as a whole is preserved. But there is no optimal blueprint for how to achieve this goal. Procedures such as ‘prompt corrective action’ exist for individual institutions, but generally cannot be invoked for systemic problems, when the problems become too large and too deeply embedded in the system. Usually, the types of actions that have been tried have been introduced on an ad hoc basis, often depending on the perceived degree of urgency and according to how far the situation has progressed.

14. The factors underlying the crisis have a direct bearing on the choice of corrective measures. For example, where financial distress is linked to bad banking practises in a limited number of institutions, there is a strong case for measures that entail official intervention in the management of the troubled
institutions. However, when problems are more widespread or stem from other causal factors, different measures may be more appropriate. In short, the underlying causes and the choice of resolution technique are linked.

15. In this context, the scale of the problem is an important determinant. For non-systemic cases, principles of a good resolution process would suggest:

− that managers are punished,
− that shareholders are forced to bear their burden of loss as owners, and to the extent possible
− that the financial community as a whole is involved in the efforts to resolve the problem.

16. Even where problems have been significant but still systemically contained, resolution activity has tended to be directed at resolving troubled or failed institutions as expeditiously as possible. The point to note is not that when problems are not of a systemic nature, authorities have more freedom to focus on stopping the flow of funds to unsound credits and speeding up the disposal of bad assets, while authorities operating under crisis conditions must focus first on shoring up the system itself and maintaining public confidence.

17. For instance, when problems of financial distress have been fairly widespread or have affected systemically important institutions, liquidations have been used infrequently. Closing institutions or allowing them to fail under these circumstances can precipitate runs or, in a worst-case scenario, a wholesale panic. The size of problem institutions also matters in this regard, with different measures adopted in the case of large institutions with perceived systemic importance than for smaller institutions. In particular, liquidation has seldom been used when large commercial banks have been in trouble. Instead, the focus is on restructuring viable institutions. This process has entailed several related steps:

• In the early stages, the measures introduced are generally designed to prevent runs and restore public confidence in the system as a whole (‘financial restructuring’).
• In the medium term, the focus shifts to re-capitalising institutions and addressing any associated nonperforming assets problem (‘operational restructuring’).
• Longer-term strategic measures seek to improve the accounting, legal and regulatory environment as required (‘institutional restructuring’).

18. The experiences with the crisis episodes in Box 1 and selected others that are identified in the background note suggest a number of important lessons. regarding common weaknesses in practices of financial institutions and markets and recommended policy approaches to address them. They include the following:

• A proper identification of the nature of a crisis is necessary if the correct prescriptions are to be applied. The use of safety net measures (e.g. lender-of-last-resort facilities) is appropriate in crisis situations to avoid negative externalities of financial instability. Financial system policy must be directed at redressing market failures, but needs to do so in a way that does not compromise incentives towards prudent behaviour.
• Among policy options for responding to crisis situations, liquidations tend to be costly and are perhaps best used as a last resort or only under certain circumstances, such as in non-systemic cases. Nonviable institutions should be closed. But liquidations must be used carefully, especially
where large institutions with numerous inter-connections throughout the system are involved. A widespread panic can ensue if such institutions are closed in the midst of a system-wide crisis. Successful liquidations depend on the existence of a credible system-wide policy on resolution that avoids spillover effects.

- Forbearance may be helpful in avoiding severe dislocations in the early stages of a crisis, but it is a risky proposition that can prove very costly if used improperly. Cases of successful forbearance have typically occurred when problems have arisen outside the banking sector and when the institutions in question have been temporarily impaired, but retained a positive franchise value in the sense of having the capacity to restore their capital over time by retaining profits. But the experience has not been all positive. Rather, turning a blind eye to problems has often permitted troubled institutions to remain open and to continue to accumulate losses. Thus, forbearance should be used sparingly and should ideally be accompanied by measures to ensure visible progress toward stronger prudential standards in the medium-term.

- Guarantees may be necessary in crisis situations, but they must be properly structured and be given a finite life to avoid high costs and moral hazard. It can be very difficult as a crisis unfolds to distinguish illiquidity from insolvency. As a consequence, open-ended liquidity support extended to all financial institutions will invariably include insolvent ones. Thus, liquidity support should be provided on an ongoing basis only where oversight is adequate. In the past, the extensive use of guarantees has in some cases resulted in governments ultimately bearing the costs on their budget. Therefore, these measures should be used carefully and perhaps not at all if funds are merely moving around within the system as opposed to fleeing it entirely.

- It is important to develop a thorough understanding of the various dimensions of the too-big-to-fail problem and its implications. Authorities must be wary of encouraging mergers and acquisitions to resolve troubled institutions when the transactions in question allow the newly merged entity to pass critical too-big-to-fail thresholds. In some cases, these types of combinations have become problems in subsequent distress episodes.

- There is a need to properly address interdependencies for institutions operating in or funding themselves across multiple jurisdictions. Various inter-dependencies among institutions and markets increase the potential for problems in one institution or market segment to spread.

- It is important that prudential requirements and other safety and soundness standards are incentive compatible and properly aligned with developments in risk management. In this context, the LTCM episode suggests a number of lessons, with implications for counterparty risk, liquidity risk, collateral requirements, and risk management more generally.

- Runs on market liquidity occur more often than runs on bank deposits. This importance of liquidity management is an undercurrent in many of the previous crisis episodes. In many cases, liquidity in trading and funding markets has suddenly evaporated, prompting failures of institutions that were not adequately protected and at times of entire market segments.

- An important step in crisis resolutions is the treatment of non-performing assets. Cross-country experience suggests that establishing asset disposition strategies that adapt to the changing circumstances of the banking system is an important requirement for successful resolutions. An important component of the framework for winding up financial institutions during times of crisis is the treatment of non-performing assets. A key issue in this context is whether institutions can be trusted to manage the assets on their own or whether the assets need to be separated and managed externally.
• Weaknesses associated with asymmetric, insufficient, or incorrect information are endemic in modern financial markets and have yet to be successfully addressed, despite numerous initiatives over the years to do so, including the rash of measures adopted after the corporate scandals of the late-1990s. Information problems can be managed and perhaps controlled to an extent, but they never completely disappear from the system. They simply manifest themselves in different ways over time. To wit, many of the problems that have featured prominently in the current crisis have also been present in previous episodes.

• The current crisis serves as yet another reminder that considerable work remains on the consumer awareness front. Retail consumers/investors remain a weak point. Among the problems they face are adverse selection, the possibility that they will choose an incompetent or dishonest firm for investment or agent for execution of a transaction, and conflicts of interest, the possibility that service providers or agents will put their own interests or those of an affiliate or another customer above those of the client or, worse, engage in fraud.

• And finally, as noted above, it doesn’t seem possible to predict the next crisis. Most of the major recommendations to address problems of instability, losses of confidence, and contagion have been by-products of past crises.

Questions for discussion:

• What are the comments from delegates regarding these lessons? Lessons seem to be drawn from crisis episodes, but are perhaps not really learned in the sense that the same patterns seem to reappear over time. Why? What could policymakers do to address this systematic oversight?

• Recent events raise additional questions about possible systemic weaknesses in the regulatory framework or, at least, in its enforcement. They include:
  – What should be the limits of financial innovation in general and securitisation in particular? How can the adverse consequences of any related changes in the incentive structure be prevented?
  – Should regulators intervene voluntarily in order to foster or impede financial innovations? What might be the ramifications of such intervention?
  – How can transparency and the valuation of complex innovative products be enhanced? What principles and practices should apply to the consolidation of related off-balance-sheet entities?
  – What level of conservatism should be built into future prudential regulations as pertains to capital and liquidity? Which types of institutions should be subject to these requirements?
  – Can direct regulation over a limited set of institutions effectively protect the system from distress among the unregulated?
  – How should responsibility for different dimensions of financial regulation be allocated, and how centralised or decentralised should it be?
  – What types of institutions should have access to central bank liquidity and under what conditions?
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<tr>
<th>Country</th>
<th>Period</th>
<th>Factors Causing Financial Distress</th>
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<tbody>
<tr>
<td>Australia</td>
<td>1989-1991</td>
<td>1989-1991 (poor lending practices and inadequate risk management controls resulted in a number of banks incurring substantial losses, in particular two state government-owned banks – the State Bank of Victoria and the State Bank of South Australia)</td>
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<td>Czech Republic</td>
<td>1990s 2nd half</td>
<td>chronic problems with the quality of loan portfolios of many banks, owing mainly to the heritage of the centrally planned economy, delayed restructuring of the corporate sector, poor lending practices of banks, abuses of legal loopholes, moral hazard and fraud</td>
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<tr>
<td>Finland</td>
<td>1991-1994</td>
<td>poor lending practices in the wake of financial sector deregulation, excessive risk taking at Skopbank and in the savings bank sector. Overheated real estate and asset prices. The private sector debt problems, combined with a strongly depreciating currency and the collapse of exports to the former Soviet Union, deepened the recession.</td>
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<td>France</td>
<td>1994-1995</td>
<td>poor lending practices at Crédit Lyonnais, then the largest bank, led to over-concentration in real estate loans and loans on speculative industrial and commercial projects</td>
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<tr>
<td>Hong Kong</td>
<td>1983-1986</td>
<td>over-exposure to the real estate sector with relatively loose institutional supervision, compounded by political uncertainties</td>
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<td>Hungary</td>
<td>1990s</td>
<td>combination of structural, institutional and macro-economic factors and weaknesses in asset classification and internal risk management of banks; solvency problems in the early to mid-1990s. Liquidity and solvency problems in 1997 with the second largest retail bank—Postabank. The problem was localised and no systemic crisis emerged.</td>
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<td>Italy</td>
<td>1970s-1980s</td>
<td>(problems in the special credit sector, owing mainly to an excessive sectoral and geographical concentration of lending; episodes of bankruptcy involving fraud); (crises of small and medium-sized savings banks and cooperative banks, attributable mainly to poor lending practices and mismanagement);</td>
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<td></td>
<td>1990s</td>
<td>(crises of publicly owned medium-sized and large southern banks, due to increased competition, adverse macroeconomic conditions and poor lending practices; crises of small and medium-sized banks, attributable to the same factors)</td>
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<tr>
<td>Japan</td>
<td>1990s</td>
<td>major financial disruption in 1997-98 caused in part by poor lending practices and overly close ties to industrial groups, which allowed for an over-exposure to real estate and equities and led to massive non-performing loan problems as asset prices plummeted with the collapse of the “bubble” economy</td>
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<td>Korea</td>
<td>1997-2000</td>
<td>over-borrowing and over-investment by the corporate sector, imprudent lending by financial institutions funded by short-term borrowings in international markets, lack of transparency in accounting and risk management of corporations and financial institutions</td>
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<td>Country</td>
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<td>Mexico</td>
<td>1994-2000</td>
<td>poor lending practices and risk management practices at banks in the wake of rapid privatisation and financial liberalisation measures, with weak supervisory capacity, combined with a macroeconomic crisis</td>
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<td>New Zealand</td>
<td>1987-1990</td>
<td>combination of microeconomic and system related factors: rapid financial sector liberalisation changed risk dynamics in the economy, but banks had under-developed risk management practices and poor lending practices</td>
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<td>Norway</td>
<td>1987-1993</td>
<td>increase of debt and over-investment in the private sector during the years 1984-1986, combined with banks competing for market shares in the wake of financial deregulation, and negative real interest after tax are widely seen as the major explanation of the later downturn and the banking crisis</td>
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<td>Poland</td>
<td>early 1990s, mostly in 1993-1994</td>
<td>(financial distress took the form of a severe surge in classified loans. Reasons behind this problem were quite complex, combining macroeconomic, microeconomic and systemic elements. Basically, the problems originated in the transformation from the central planning to market economy. Among the most significant reasons can be found the following: 1) tight budgetary constraints of enterprises, 2) the government restraining from subsidising state-owned companies, 3) transformation recession and high inflation, “freed” interest rates (indebtedness pitfall), 4) poor lending practices, 5) lack of expertise and awareness of risk management role in banks, 6) lack of experience to operate in market economy by banks and their clients, as well as 7) weak regulatory framework and supervisory capacities</td>
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<td>Slovakia</td>
<td>1991-1993</td>
<td>poor lending practices, connected lending and other inadequacies dating back to the pre-transition era resulted in wide-spread solvency and liquidity problems</td>
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<td>Spain</td>
<td>1977-1985</td>
<td>Macro effect of oil price increases compounded by new entrants, poor lending practices, limited supervision enforcement capacity and resources, and inadequate legal framework</td>
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<td>Sweden</td>
<td>1991-1994</td>
<td>poor lending practices in the wake of liberalised domestic credit restrictions, high inflation and generous deductions on loan interest payments, combined with a deep recession and sharp fall in real estate prices, as well as inadequate supervision</td>
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<td>Country</td>
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| Turkey  | 2000-2001| A combination of various factors such as continued macroeconomic instability, severe external shocks and the unfavourable financial condition of a sizeable segment of the banking system; sharp increases in funding costs due to an increase in interest rates and maturity mismatch, capital losses due to a sharp mark-to-market decline in the value of government securities holdings, and due to a sharp change in foreign exchange rate and open foreign currency positions, as well as poor lending and risk management practices contributed to the start of two crises—the first in November 2000 and the second in February 2001.  
  - November 2000: liquidity crisis—overnight interest rates climbed above 2,000% p.a. caused by increased market scepticism about the ongoing fiscal and monetary program and were triggered by the need of a medium-sized private bank to refinance an excessive stock of government securities.  
  - February 2001: Against the background of increased political uncertainty and weakening of economic fundamentals, investors liquidated TL positions and fled to the US dollar. Interest rates spiked as high as 6,200% p.a., with a rapid depletion of the Central Bank of the Republic of Turkey’s foreign exchange reserves. The crawling-peg exchange rate regime was abandoned and the Turkish government floated the Lira. Since February 2001 crisis, 8 banks were intervened by the Banking Regulation and Supervision Agency (BRSA), bringing to 19 the total number of banks that have been transferred to the Savings Deposit Insurance Fund (SDIF) during the past 5 years. |
| United States | 1984-1991 | Economic, legislative and regulatory factors on a national level; regional and sectoral recessions, and excessive risk taking by financial institutions. |
|         | 2007-    | Defaults on subprime residential mortgage loans triggered a collapse in ratings on related structured products, heightening uncertainties about the valuation and location of risks in the financial system, leading to a drying up of liquidity in numerous market segments and a crisis of confidence, eventually precipitating the failures of a number of large intermediaries and a worldwide financial panic. |

Sources: Central Banks, Finance Ministries, and/or Bank Supervisory agencies, Secretariat